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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.

Supervision of Subsidiaries (Funding Policies) Section 2010.1

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.

2010.2.1 UNIFORM REAL ESTATE LENDING STANDARDS

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

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.

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(s) 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 and/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, 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 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 and/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 provide clear guidance on its appetite for credit risk and that will 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 these sound practices into the overall assessment of credit-risk management.
8. To be alert to indications of insufficiently rigorous risk assessment at BOs, in particular, inadequate stress testing and excessive reliance on strong economic conditions and robust financial markets to support a borrower's capacity to service its debts.
9. To be attentive in reviewing a BO'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 there has been significant and undue reliance on favorable assumptions by the banking organization about borrowers or the economy and financial markets. If so, to carefully consider downgrading, under the applicable supervisory rating framework, a BO's risk-management, management, and/or asset-quality ratings and, if deemed sufficiently significant to the BO, its capital adequacy rating.
11. To determine if the BO'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 less thorough internal loan reviews. To incorporate such findings into the determination of supervisory ratings.

2010.2.4 INSPECTION PROCEDURES

Loan Administration

1. Obtain an organization chart and determine various levels of responsibility and job functions of individuals involved with the lending function.
2. Obtain and review BHC loan policy; determine if it 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 further 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 significant 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 the timeframes involved; seek rationale if no action was taken or if the action taken was halfhearted.
6. Review the organization's financial statements, the bank call reports, and the BHC FR Y-series reports submitted to the Federal Reserve and 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 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, and/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, on a random basis coordinate the selection of loans subject to classification, and 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 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 type(s) of covenants to be imposed for specific loan types, and
   c. the treatment and reporting of policy exceptions, both for individual loans and for 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 understandably.
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 and/or exposure, to allow for consideration of whether proposed loans might affect this composition suffi-

ciently 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 determine accurately 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 for excessive reliance on strong economic conditions and robust financial markets to support the capacity of borrowers to service their debts, as well as 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;[8] 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."

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

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.

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

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-

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.

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).

2010.6.1.3.1.4 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.

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.

The Federal Reserve Board and the other federal regulators of banks and savings associations issued a joint policy statement that provides comprehensive guidance on the maintenance of an adequate allowance for loan and lease losses (ALLL) and an effective loan-review system. The statement, effective December 23, 1993, is designed to further promote consistency in supervisory policies among banks and thrifts.

This policy statement applies to all depository institutions insured by the Federal Deposit Insurance Corporation (FDIC) except for FDIC-insured branches and agencies of foreign banks. The statement also does not apply to nonfederally insured branches and agencies of foreign banks. FDIC-insured and nonfederally insured branches and agencies of foreign banks continue to be subject to separate guidance issued by their primary supervisory agency. *The policy statement does not apply directly to bank holding companies. However, the board of directors and management of bank holding companies should consider the statement as they supervise and administer policies and procedures pertaining to the financial institution subsidiaries of the bank holding company. Bank holding company examiners should consider the guidance of the policy statement when evaluating a bank holding company's supervisory policies as they pertain to its financial institution subsidiaries.*

The policy statement discusses the nature and purpose of the ALLL; defines an adequate ALLL; and covers the responsibilities of the board of directors, the institution's management, and the examiner. The policy statement emphasizes that it is the responsibility of the board of directors and management of each institution to maintain the ALLL at an adequate level. The policy statement also discusses the analysis of the loan and lease portfolio, factors to consider in estimating credit losses, and the characteristics of an effective loan-review system.

In addition, the statement includes a section on examiner responsibilities consisting of quantitative guidance the examiner should use to identify those institutions whose ALLL levels and related ALLL evaluation processes should be subject to closer review by examiners. Although this examination guidance does not pertain directly to the inspection of bank holding companies, it keeps the holding company management and Federal Reserve System bank holding company examiners apprised of the methods used by federal financial institution examiners to assess and evaluate the adequacy of the ALLL for bank holding company bank and thrift subsidiaries. See SR-93-70 (December 22, 1993).

The policy statement reiterates existing policy that Federal Reserve state member bank examiners will generally accept bank management's estimates in their assessment of the adequacy of the ALLL when management has (1) maintained effective systems and controls for identifying, monitoring, and addressing asset-quality problems in a timely manner; (2) analyzed all significant factors that affect the collectibility of the portfolio in a reasonable manner; and (3) established an acceptable ALLL evaluation process that meets the objectives for an adequate ALLL.[1]

The Financial Accounting Standards Board (FASB) Statement No. 114, "Accounting by Creditors for Impairment of a Loan" (FAS 114), as amended by FASB Statement No. 118, "Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures" (FAS 118), sets forth standards for estimating the impairment of a loan for general financial-reporting purposes. According to FAS 114, a loan is *impaired* when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement. FAS 118 eliminated the former income-recognition provisions of FAS 114.

FAS 114 and FAS 118 became effective for fiscal years beginning after December 15, 1994, with earlier application permitted. FAS 114 requires that an allowance be established based on the present value of expected future cash flows of the loan discounted at the loan's effective interest rate (that is, the contract rate, as adjusted for any net deferred loan fees or costs, premiums, or discounts) or, as a practical expedient, at the loan's observable market price or at the fair value of the collateral if the loan is collateral dependent. Since allowances under FAS 114 apply only to a subset of loans (those

1. SR-99-13 reemphasizes the need for balanced, yet conservative, reserving practices. Banking organizations may reserve conservatively at the higher end of the range of estimated losses when those levels are management's best estimate. They may also reflect a margin for imprecision. Unallocated reserves are acceptable when they are determined in accordance with GAAP.

that are subject to the standard and that are deemed to be impaired), FAS 114 does not address the adequacy of a creditor's overall ALLL or how the creditor should assess the adequacy of its ALLL. In addition to the allowance for credit losses calculated under FAS 114, a creditor should continue to recognize an ALLL necessary to comply with FASB Statement No. 5, "Accounting for Contingencies" (FAS 5). Furthermore, the guidance in FAS 114 applies only to a subset of the loan and lease portfolio as the term is used in this policy statement.[2]

FAS 114, as amended by FAS 118, has been adopted by the Federal Financial Institutions Examination Council (FFIEC) for purposes of reporting by banks in call reports, subject to the additional regulatory reporting guidelines discussed below. Furthermore, the FFIEC concluded that FAS 114 sets forth methods for establishing only a portion of an institution's ALLL. Accordingly, while banks must use the methods set forth in FAS 114 to determine the portion of the ALLL attributable to impaired loans as defined by the statement for purposes of reporting in call reports, no separate reporting of the portion established under FAS 114 has been required in these reports. The overall ALLL should continue to be reported on existing call report line items. The text of the interagency policy statement follows.[3] See also sections 2065.1 and 2065.2.

2. In 1999, the FASB considered the interaction between the two primary accounting standards on the ALLL, FASB Statements No. 5 and 114. An allowance calculated under FAS 5 may be required for loans that are not individually identified as being impaired under FAS 114. Reserve calculations for specific impaired loans under FAS 114 should incorporate an evaluation of environmental factors (such as industry, geographic, economic, and political factors). Reserves calculated under FAS 5 should not be required for loans that are determined to be impaired under FAS 114. See SR-99-13.

SR-99-22 reaffirms the principles in SR-99-13. It indicates that the SEC does not have a policy of seeking reductions in financial institutions' loan-loss allowance levels and that it will consult with the banking agencies as it considers whether to take a significant action regarding an institution's ALLL accounting practices.

3. This policy statement applies to all depository institutions insured by the Federal Deposit Insurance Corporation (FDIC) except for FDIC-insured branches and agencies of foreign banks. The statement also does not apply to nonfederally insured branches and agencies of foreign banks. FDIC-insured and nonfederally insured branches and agencies of foreign banks continue to be subject to any separate guidance that has been issued by their primary supervisory agency.

For savings associations, the ALLL is included in "general valuation allowances" (GVAs). GVAs may also be required on assets other than loans and leases.

2010.7.1 INTERAGENCY POLICY STATEMENT ON THE ALLOWANCE FOR LOAN AND LEASE LOSSES (ALLL)

Nature and Purpose of the ALLL

Federally insured depository institutions ("institutions") must maintain an ALLL at a level that is adequate to absorb estimated credit losses associated with the loan and lease portfolio, including all binding commitments to lend.[4] To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated credit losses associated with off-balance-sheet credit instruments such as standby letters of credit.[5]

For purposes of this policy statement, the term "estimated credit losses" means an estimate of the current amount of the loan and lease portfolio (net of unearned income) that is not likely to be collected; that is, net charge-offs that are likely to be realized for a loan or pool of loans given facts and circumstances as of the evaluation date. These estimated credit losses should meet the criteria for accrual of a loss contingency (i.e., a provision to the ALLL) set forth in generally accepted accounting principles (GAAP). When available information confirms specific loans and leases, or portions thereof, to be uncollectible, these amounts should be promptly charged off against the ALLL.

Estimates of credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. For individually analyzed loans, these estimates should reflect consideration of the facts and circumstances that affect the repayment of such loans as of the evaluation date. For pools of loans, estimated credit losses should reflect consideration of the institution's historical net charge-off rate on pools of similar loans, *adjusted for changes in trends, conditions, and other relevant factors* that affect repayment of the loans in these pools as of the evaluation

4. In the case of binding commitments to lend and off-balance-sheet credit instruments, such losses represent the amount of loans and leases that will likely not be collected (given facts and circumstances as of the evaluation date) and, thus, will be charged off. For purposes of this policy statement, the loan and lease portfolio, binding commitments to lend, and off-balance-sheet credit commitments are referred to as "loans," "loans and leases," the "loan and lease portfolio," or the "portfolio."

5. Recourse liability accounts (that arise from recourse obligations for any transfers of loans that are reported as sales for regulatory reporting purposes) should be reported as liabilities that are separate and distinct from the ALLL.

date. Methodologies for the determination of the historical net charge-off rate on a pool of loans can range from a simple average of an institution's net charge-off experience over a relevant period of years—coupled with appropriate adjustments as noted above for factors that affect repayment—to more complex techniques, such as migration analysis.

As discussed more fully below, for analytical purposes, an institution may attribute portions of the ALLL to individual loans or groups of loans. However, the ALLL is available to absorb all credit losses that arise from the loan and lease portfolio and is not segregated for, or allocated to, any particular loan or group of loans.

Responsibility of the Board of Directors and Management

Adequate ALLL level. It is the responsibility of the board of directors and management of each institution to maintain the ALLL at an adequate level.[6] For purposes of the Reports of Condition and Income (call report) and the Thrift Financial Report (TFR), an adequate ALLL should be no less than the sum of the following items *given facts and circumstances as of the evaluation date* (after deduction of all portions of the portfolio classified loss):

1. for loans and leases *classified substandard or doubtful*, whether analyzed and provided for individually or as part of pools, all estimated credit losses over the remaining effective lives of these loans;
2. for components of the loan and lease portfolio that are *not classified*, all estimated credit losses over the upcoming 12 months;[7] and
3. amounts for estimated losses from transfer risk on international loans.

Furthermore, when determining the appropriate level for the ALLL, management's analysis should be conservative so that the overall ALLL appropriately reflects a margin for the imprecision inherent in most estimates of expected credit losses. This additional margin for imprecision might be incorporated into the ALLL through the amounts attributed for analytical purposes to individual loans or groups of loans or in a portion of the ALLL that is not attributed to specific components of the loan portfolio.[8]

The adequacy of the ALLL should be evaluated as of the end of each quarter, or more frequently if warranted, and appropriate provisions made to maintain the ALLL at an adequate level as of each call report or Thrift Financial Report date. This evaluation will be subject to review by examiners.

Related responsibilities. In carrying out their responsibility for maintaining an adequate ALLL, the board of directors and management are expected to—

1. ensure that the institution has an effective loan-review system and controls (which include an effective credit-grading system) that identify, monitor, and address asset-quality problems in an accurate and timely manner (to be effective, the institution's

6. Financial Accounting Standards Board (FASB) Statement No. 114, "Accounting by Creditors for Impairment of a Loan," provides that an "allowance for credit losses" must be calculated on a present-value basis when a loan is impaired. FASB Statement No. 114 states that it "does *not* address how a creditor should assess the *overall adequacy* of the allowance for credit losses" (emphasis added), and that, in addition to the allowance for credit losses calculated under FASB Statement No. 114, a creditor should continue to recognize an ALLL necessary to comply with FASB Statement No. 5, "Accounting for Contingencies." Furthermore, the guidance in FASB Statement No. 114 only applies to a subset of the loan and lease portfolio as the term is used in this policy statement (e.g., the FASB standard does *not* apply to leases, binding commitments to lend, and large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment). In contrast, this policy statement provides guidance on assessing the *overall adequacy* of the ALLL.

7. In certain circumstances, subject to examiner review, a net charge-off horizon of less than one year from the balance-sheet date may be employed for components of the portfolio that have not been classified. For institutions with conservative charge-off policies, a charge-off horizon of less than one year might be appropriate for pools of loans that are neither classified nor subject to greater-than-normal credit risk and that have well-documented and highly predictable cash flows and loss rates, such as pools of certain smaller consumer installment or credit card loans. On the other hand, a net charge-off horizon of more than one year for loans that have not been classified might be appropriate until an institution's loan-review function and credit-grading system results in accurate and timely assessments of the portfolio. In such situations, an institution should expeditiously correct deficiencies in its loan-review function and credit-grading system.

8. As discussed later in this policy statement, institutions are encouraged to segment their loan and lease portfolios into as many components as practical when analyzing the adequacy of the ALLL. Therefore, institutions are encouraged to reflect the margin for imprecision in amounts attributable for analytical purposes to these components of the portfolio, to the extent possible.

loan-review system and controls must be responsive to changes in internal and external factors affecting the level of credit risk in the portfolio);
2. ensure the prompt charge-off of loans, or portions of loans, that available information confirms to be uncollectible; and
3. ensure that the institution's process for determining an adequate level for the ALLL is based on a comprehensive, adequately documented, and consistently applied analysis of the institution's loan and lease portfolio that considers all significant factors that affect the collectibility of the portfolio and supports the range of credit losses estimated by this process.

As discussed more fully in appendix 1, it is essential that institutions maintain effective loan-review systems, although smaller institutions would not be expected to maintain separate loan-review departments. An effective loan-review system should work to ensure the accuracy of internal credit-grading systems and, thus, the quality of the information used to assess the adequacy of the ALLL. The complexity and scope of the institution's ALLL evaluation process, loan-review system, and other relevant controls should be appropriate in view of the size of the institution and the nature of its lending activities, and provide for sufficient flexibility to accommodate changes in the factors that affect the collectibility of the portfolio.

Analysis of the Loan and Lease Portfolio

In determining the appropriate level of the ALLL, the institution should rely primarily on an analysis of the various components of its portfolio, including all significant credits on an individual basis. When analyzing the adequacy of the ALLL, institutions should segment their loan and lease portfolios into as many components as practical. Each component would normally have similar characteristics, such as risk classification, past-due status, type of loan, industry, or collateral. A depository institution may, for example, analyze the following components of its portfolio and provide for them in the ALLL:

1. all significant credits on an individual basis that are classified doubtful (or the institution's equivalent)
2. all other significant credits reviewed individually (If no allocation can be determined for such credits on an individual basis, they should be provided for as part of an appropriate pool below.)
3. all other loans and leases that are not included by examiners or by the institution's credit-grading system in the population of loans reviewed individually, but are delinquent or are classified or designated special mention (e.g., pools of smaller delinquent, special-mention, and classified commercial and industrial loans; real estate loans; consumer loans; and lease-financing receivables)
4. homogeneous loans that have not been reviewed individually or are not delinquent, classified, or designated as special mention (e.g., pools of direct consumer loans, indirect consumer loans, credit card loans, home equity lines of credit, and residential real estate mortgages)
5. all other loans that have not been considered or provided for elsewhere (e.g., pools of commercial and industrial loans that have not been reviewed, classified, or designated special mention; standby letters of credit; and other off-balance-sheet commitments to lend)

In addition to estimated credit losses, the losses that arise from the transfer risk associated with an institution's cross-border lending activities require special consideration. Over and above any minimum amount that is required by the Interagency Country Exposure Review Committee to be provided in the Allocated Transfer Risk Reserve (or charged against the ALLL), the institution must determine that the ALLL is adequate to absorb all estimated losses from transfer risk associated with its cross-border lending exposure. (See appendix 2 for factors to consider.)

Factors to Consider in the Estimation of Credit Losses

As previously mentioned, estimates of credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. While historical loss experience provides a reasonable starting point for the institution's analysis, historical losses, or even recent trends in losses are not, by themselves, a sufficient basis to determine the appropriate level for the ALLL. Management should also consider any factors that are likely

to cause estimated credit losses associated with the institution's current portfolio to differ from historical loss experience, including but not limited to—

1. changes in lending policies and procedures, including underwriting standards and collection, charge-off, and recovery practices;
2. changes in national and local economic and business conditions and developments, including the condition of various market segments;[9]
3. changes in the nature and volume of the portfolio;
4. changes in the experience, ability, and depth of lending management and staff;
5. changes in the trend of the volume and severity of past-due and classified loans, and trends in the volume of nonaccrual loans, troubled-debt restructurings, and other loan modifications;
6. changes in the quality of the institution's loan-review system and the degree of oversight by the institution's board of directors;
7. the existence and effect of any concentrations of credit and changes in the level of such concentrations; and
8. the effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution's current portfolio.

Institutions are also encouraged to use ratio analysis as a supplemental check or tool for evaluating the overall reasonableness of the ALLL. Ratio analysis can be useful in identifying divergent trends (compared with the institution's peer group and its own historical practices) in the relationship of the ALLL to classified and nonclassified loans and leases, to past-due and nonaccrual loans and leases, to total loans and binding commitments, and to historical gross and net charge-offs. However, while such comparisons can be helpful as a supplemental check of the reasonableness of management's assumptions and analyses, they are not, by themselves, a sufficient basis for determining the adequacy of the ALLL. In particular, such comparisons do not obviate the need for a comprehensive analysis of the loan and lease portfolio and the factors affecting its collectibility.

9. Credit-loss and -recovery experience may vary significantly depending upon the business cycle. For example, an overreliance on recent credit-loss experience during a period of economic growth will not result in realistic estimates of credit losses during a period of economic downturn.

Examiner Responsibilities

Examiners will assess the asset quality of an institution's loan and lease portfolio and the adequacy of the ALLL. In the review and classification of the loan and lease portfolio, examiners should consider all significant factors that affect the collectibility of the portfolio, including the value of any collateral. In reviewing the adequacy of the ALLL, examiners will—

1. consider the quality of the institution's loan-review system and management in identifying, monitoring, and addressing asset-quality problems (this will include a review of the institution's credit-grading system and loan-review function);[10]
2. evaluate the ALLL evaluation process that management has followed to arrive at an overall estimate of the ALLL and the related assumptions made by management in order to ensure that the institution's historical loss experience and all significant factors that affect the collectibility of the portfolio (including changes in the quality of the institution's loan-review function and other factors previously discussed) have been appropriately considered;
3. review the overall level of the ALLL and the range of credit losses estimated by management for reasonableness in view of the factors discussed in the prior sections of this policy statement;
4. perform a quantitative analysis (e.g., using the types of ratio analysis previously discussed) as a check of the reasonableness of the ALLL; and
5. review the adequacy of the documentation that has been maintained by management to support the adequacy of the ALLL.

After analyzing an institution's policies, practices, and historical credit-loss experience, the

10. The review of an institution's loan-review system (including credit grading) by an examiner will usually include tests involving a sample of the institution's loans. If differences noted between examiner credit grades and those of the institution's loan-review system indicate problems with the loan-review system, especially where the credit grades assigned by the institution are more liberal than those assigned by the examiner, the institution would be expected to make appropriate adjustments to the assignment of its credit grades to the loan and lease portfolio and to its estimate of the ALLL. Furthermore, the institution would be expected to improve its loan-review system. (Appendix 1 discusses effective loan-review systems.)

examiner should further check the reasonableness of management's ALLL methodology by comparing the reported ALLL (after the deduction of all loans, or portions thereof, classified as loss) against the sum of the following amounts:

1. 50 percent of the portfolio that is classified doubtful
2. 15 percent of the portfolio that is classified substandard
3. for the portions of the portfolio that have not been classified (including those loans designated special mention), estimated credit losses over the upcoming 12 months *given facts and circumstances as of the evaluation date* (based on the institution's average annual rate of net charge-offs experienced over the previous two or three years on similar loans, adjusted for current conditions and trends)[11]

This amount is neither a ''floor'' nor a ''safe-harbor'' level for an institution's ALLL. However, examiners will view a shortfall relative to this amount as indicating a need to more closely review management's analysis to determine whether it is reasonable and supported by the weight of reliable evidence and that all relevant factors have been appropriately considered.[12]

In assessing the adequacy of the ALLL, it is important to recognize that the related process, methodology, and underlying assumptions require a substantial degree of judgment. Even when an institution maintains sound loan-administration and -collection procedures and effective internal systems and controls, the estimation of credit losses will not be precise due to the wide range of factors that must be considered. Further, the ability to estimate credit losses on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. Therefore, examiners will generally accept management's estimates in their assessment of the adequacy of the ALLL when management has (1) maintained effective systems and controls for identifying, monitoring, and addressing asset-quality problems in a timely manner, (2) analyzed all significant factors that affect the collectibility of the portfolio in a reasonable manner, and (3) established an acceptable ALLL evaluation process that meets the objectives for an adequate ALLL.

After the completion of all aspects of the ALLL review described in this section, if the examiner does not concur that the reported ALLL level is adequate or if the ALLL evaluation process is deficient or based on the results of an unreliable loan-review system, recommendations for correcting these problems, including any examiner concerns regarding an appropriate level for the ALLL, should be noted in the report of examination.

ALLL Level Reflected in Regulatory Reports

The agencies believe that an ALLL established in accordance with this policy statement will fall within the range of acceptable estimates developed in accordance with GAAP. When an institution's reported ALLL does not meet the objectives for an adequate ALLL, the institution will be required to increase its provision for loan and lease losses expense sufficiently to restore the level of the ALLL reported on its call report or TFR to an adequate level as of the evaluation date.

2010.7.1.1 Appendix 1—Loan-Review Systems

The nature of loan-review systems may vary based on an institution's size, complexity, and management practices. For example, a loan-review system may include components of a traditional loan-review function that is independent of the lending function, or it may place

11. In cases where the institution has an insufficient basis for determining this amount, the examiner may use the industry-average net charge-off rate for nonclassified loans and leases.

12. The weights of 50 percent and 15 percent for doubtful and substandard loans, respectively, are estimates of the industry's average loss experience over time on similarly classified credits. Because they represent the average industry experience, these weights do not take into account idiosyncratic factors that may be important for estimating expected credit losses for a particular institution, such as the composition of its portfolio; the quality of underwriting, collection, and loan-review systems; and current economic conditions and trends. *Nor do these weights incorporate any additional margin to reflect the imprecision inherent in estimates of expected credit losses.* Due to such institution-specific factors, including an institution's historical loss experience adjusted for current conditions and trends, in many cases an ALLL exceeding the sum of 1, 2, and 3 above might still be inadequate, while in other cases, the weight of evidence might indicate that an ALLL less than this amount is adequate. In all circumstances, for purposes of the call report or Thrift Financial Report, the reported ALLL should meet the standard for an adequate ALLL set forth in the section entitled ''Responsibility of the Board of Directors and Management.''

some reliance on loan officers. In addition, the use of the term "loan-review system" can refer to various responsibilities assigned to credit administration, loan administration, problem-loan workout, or other areas of an institution. These responsibilities may range from administering the internal problem-loan reporting process to maintaining the integrity of the credit-grading process (e.g., ensuring that changes are made in credit grades as needed) and coordinating the information necessary to assess the adequacy of the allowance for loan and lease losses (ALLL). Regardless of the structure of the loan-review system in an institution, at a minimum, an effective loan-review system should have the following objectives:

1. To promptly identify loans having potential credit weaknesses and appropriately classify loans with well-defined credit weaknesses that jeopardize repayment so that timely action can be taken and credit losses can be minimized.
2. To project relevant trends that affect the collectibility of the portfolio and isolate potential problem areas.
3. To provide essential information to determine the adequacy of the ALLL.
4. To assess the adequacy of and adherence to internal credit policies and loan-administration procedures and to monitor compliance with relevant laws and regulations.
5. To evaluate the activities of lending personnel
6. To provide senior management and the board of directors with an objective and timely assessment of the overall quality of the loan portfolio.
7. To provide management with accurate and timely information related to credit quality that can be used for financial and regulatory reporting purposes.

Credit-Grading Systems

The foundation for any loan-review system is accurate and timely credit grading, which involves an assessment of credit quality and leads to the identification of problem loans. An effective credit-grading system provides important information on the collectibility of the portfolio for use in the determination of an adequate level for the ALLL.

Regardless of the particular type of loan-review system employed, an effective credit-grading framework generally places primary reliance on loan officers to identify emerging loan problems. However, given the importance and subjective nature of credit grading, a loan officer's judgment regarding the assignment of a particular credit grade to a loan may be subject to review by (1) peers, superiors, or loan committee(s); (2) an independent, qualified part-time or full-time person(s); (3) an internal department staffed with credit-review specialists; or (4) outside credit-review consultants. A credit-grading review that is independent of the lending function is the preferred approach because it typically provides a more conservative and realistic assessment of credit quality. Because accurate and timely credit grading is a critical component of an effective loan-review system, each institution should ensure that its loan-review system includes the following attributes:

1. a formal credit-grading system that can be reconciled with the framework used by the federal regulatory agencies[13]
2. an identification or grouping of loans that warrant the special attention of management
3. documentation supporting the reason(s) why a particular loan merits special attention
4. a mechanism for direct, periodic, and timely reporting to senior management and the board of directors on the status of loans identified as meriting special attention and the action(s) taken by management
5. appropriate documentation of the institution's credit-loss experience for various components of its loan and lease portfolio[14]

An institution should maintain a written description of its credit-grading system, including a discussion of the factors used to assign appropriate credit grades to loans. Loan credit grades should reflect the risk of credit losses.

13. An institution may have a credit-grading system that differs from the credit-grading framework used by the federal banking agencies. However, each institution that maintains a credit-grading system that differs from the agencies' framework should maintain documentation that translates its credit-grading system into the pass—special mention—substandard —doubtful—loss credit-grading framework used by the federal regulatory agencies. This documentation should be sufficient to enable examiners to reconcile the totals for the various credit grades under the institution's system to the agencies' categories listed above.

14. Institutions are encouraged to maintain records of net credit-loss experience for credits in each of the following categories: items not classified or designated as special mention, special mention, substandard, doubtful, and loss.

In addition, the loan-review program should be in writing and reviewed and approved at least annually by the board of directors to evidence their support of and commitment to the system.

Loan-Review System Elements

The following discussion refers to the primary activities comprising a loan-review system that were previously addressed, ranging from the credit-administration function to the independent internal loan-review function. An institution's written policy and documentation for its loan-review system should address the following elements:

1. qualifications of loan-review personnel
2. independence of loan-review personnel
3. frequency of reviews
4. scope of reviews
5. depth of reviews
6. review of findings and follow-up
7. workpaper and report distribution, including distribution of reports to senior management and the board of directors

Qualifications of Loan-Review Personnel

Persons involved in the loan-review function should be qualified based on level of education, experience, and extent of formal credit training, and should be knowledgeable in both sound lending practices and the institution's lending guidelines for the types of loans offered by the institution. In addition, these persons should be knowledgeable of relevant laws and regulations affecting lending activities.

Independence of Loan-Review Personnel

An effective loan-review system utilizes both the initial identification of emerging problem loans by loan officers and the credit review of loans by individuals independent of the credit-approval decisions. An important element of an effective system is to place responsibility on loan officers for continuous portfolio analysis and prompt identification and reporting of problem loans. Because of their frequent contact with borrowers, loan officers can usually identify potential problems before they become apparent to others. However, institutions should be careful to avoid overreliance upon loan officers for identification of problem loans. Institutions should ensure that loans are also reviewed by individuals that do not have control over the loans they review and are not part of, or influenced by anyone associated with, the loan-approval process.

While larger institutions typically establish a separate department staffed with credit-review specialists, cost and volume considerations may not justify such a system in smaller institutions. In many smaller institutions, an independent committee of outside directors may fill this role. Whether or not the institution has an independent loan-review department, the loan review function should report *directly* to the board of directors or a committee thereof (though senior management may be responsible for appropriate administrative functions so long as they do not compromise the independence of the loan-review function).

Frequency of Reviews

Optimally, the loan-review function can be used to provide useful continual feedback on the effectiveness of the lending process in order to identify any emerging problems. For example, the frequency of review of significant credits could be at least annually, upon renewal, or more frequently when internal or external factors indicate a potential for deteriorating credit quality in a particular type of loan or pool of loans. A system of ongoing or periodic portfolio reviews is particularly important to the ALLL determination process, which is dependent on the accurate and timely identification of problem loans.

Scope of Reviews

The review should cover all loans that are significant. Also, the review typically includes, in addition to all loans over a predetermined size, a sample of smaller loans; past-due, nonaccrual, renewed, and restructured loans; loans previously classified or designated as special mention by the institution or by its examiners; insider loans; and concentrations and other loans affected by common repayment factors. The percentage of the portfolio selected for review should provide reasonable assurance that the results of the review have identified the major problems in the portfolio and reflect its quality as a whole. Management should document that

the scope of its reviews continues to identify major problems in the portfolio and reflects the portfolio's quality as a whole. The scope of loan reviews should be approved by the institution's board of directors on an annual basis or when any significant changes to the scope of reviews are made.

Depth of Reviews

These reviews should analyze a number of important aspects of selected loans, including—

1. credit quality,
2. sufficiency of credit and collateral documentation,
3. proper lien perfection,
4. proper approval by the loan officer and loan committee(s),
5. adherence to any loan-agreement covenants, and
6. compliance with internal policies and procedures and laws and regulations.

Furthermore, these reviews should consider the appropriateness and timeliness of the identification of problem loans by loan officers.

Review of Findings and Follow-Up

Findings should be reviewed with appropriate loan officers, department managers, and members of senior management, and any existing or planned corrective action should be elicited for all noted deficiencies and identified weaknesses, including the timeframes for correction. All noted deficiencies and identified weaknesses that remain unresolved beyond the assigned timeframes for correction should be promptly reported to senior management and the board of directors.

Workpaper and Report Distribution

A list of loans reviewed, the date of the review, and documentation (including summary analyses) to substantiate assigned classifications or designations of loans as special mention should be prepared on all loans reviewed. A report that summarizes the results of the loan review should be submitted to the board of directors on at least a quarterly basis.[15] In addition to reporting current credit-quality findings, comparative trends can be presented to the board of directors that identify significant changes in the overall quality of the portfolio. Findings should also address the adequacy of and adherence to internal policies, practices, and procedures, and compliance with laws and regulations so that any noted deficiencies can be remedied in a timely manner.

2010.7.1.2 Appendix 2—International Transfer Risk Considerations

With respect to international transfer risk, an institution should support its determination of the adequacy of its allowance for loan and lease losses by performing an analysis of the transfer risk, commensurate with the size and composition of the institution's exposure to each country. Such analyses should take into consideration the following factors, as appropriate:

1. the institution's loan portfolio mix for each country (e.g., types of borrowers, loan maturities, collateral, guarantees, special credit facilities, and other distinguishing factors)
2. the institution's business strategy and its debt-management plans for each country
3. each country's balance-of-payments position
4. each country's level of international reserves
5. each country's established payment performance record and its future debt-servicing prospects
6. each country's sociopolitical situation and its effect on the adoption or implementation of economic reforms, in particular those affecting debt-servicing capacity
7. each country's current standing with multilateral and official creditors
8. the status of each country's relationships with bank creditors
9. the most recent evaluations distributed by the Interagency Country Exposure Review Committee (ICERC) of the federal banking agencies

15. The board of directors should be informed more frequently than quarterly when material adverse trends are noted.

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.

Supervision of Subsidiaries (Private-Banking Functions and Activities) Section 2010.11

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

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

This section provides examiners with guidance for reviewing private-banking activities at all types and sizes of institutions. It is intended to supplement, not replace, existing guidance on the inspection of any activities associated with private-banking activities and to broaden the examiner's review of general risk-management policies and practices governing private-banking activities. The overview of private banking includes a discussion of the general types of customers and the various products and services typically provided. The Functional Review subsection describes the critical functions that can constitute a private-banking operation and identifies certain safe and sound banking practices. These critical functions are Supervision and Organization, Risk Management, Fiduciary Standards, Operational Controls, Management Information Systems, Audit, and Compliance. Included in the risk-management portion is a description of the basic know-your-customer (KYC) principle that is the foundation for the safe and sound operation of a private-banking business. A self-explanatory Preparation for Inspection subsection assists in defining the scope of the inspection and provides a list of core requests to be made in the first-day letter.

1. Throughout this section, the word "institution" will be used to include bank holding companies and their bank and nonbank subsidiaries as well as other types of financial institutions and other entities that are supervised by the Federal Reserve System. The term "board of directors" will be interchangeable with "senior management" of all these entities, including branches and agencies of foreign banks.

In reviewing specific functional and product-inspection procedures, 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 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. See SR-97-19.

2010.11.1 OVERVIEW OF PRIVATE BANKING AND ASSOCIATED ACTIVITIES

Private banking offers the personal and discrete delivery of a wide variety of financial services and products to the 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, competition to serve it, both in the United States and globally, is becoming more intense. Consequently, new entrants in the private-banking marketplace include banks and nonbank 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 (for example, institutional investors). Institutions often differentiate domestic from international private banking,

and they may further segregate the international function based on 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 advisor, a trust, a personal investment company (PIC), or an offshore mutual fund.

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 can vary, 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 for 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 client-account activity to detect, and 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 sizeable 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 regarding client-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 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.

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. Each bank holding company should initiate and maintain supervisory controls and procedures that require each subsidiary private-banking function or institution to have account-opening procedures and documentation requirements that must be fulfilled before a depository 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). Each bank holding company should provide adequate supervision of deposit-taking subsidiary activities to ensure that the transaction activity into and out of these private-banking deposit accounts is closely monitored for suspicious transactions. Transactions that are inconsistent with the client's profile of usual transactions may represent suspicious transactions that could warrant the filing of a suspicious-activity report.

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 based on recommendations from the institution'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 institutions 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 by 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. With respect to bank holding companies, information on trust assets is not collected. However, the income from fiduciary activities is reported, on a consolidated income basis, on Schedule HC-I of the FR Y-9C report. Consultations should be made with Federal Reserve trust examiners and specialists with regard to uncertainties about procedures, transactions, and/or trust activities.

2010.11.1.1.4 *Credit*

Private-banking clients may request extensions of credit either on a secured or 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, and loan tenor as well as the collateral used in the financing. When lending to individuals with high net worths, whether on a secured or unsecured basis, the creditworthiness determination is bolstered by a thorough and well-structured KYC process. If that process is not thorough,

collateral derived from illicit activities may be subject to government forfeiture.

2010.11.1.1.5 Payable-Through Accounts

Another product that may be seen 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 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 out 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.

2010.11.1.1.6 Personal Trust and Estates

Trust and estate accounts offer management services for 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 who 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 institution. For these accounts, the institution 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. A bank holding company's supervision of its subsidiaries must include the application of proper controls and procedures to ensure each institution's proper administration of trusts and estates, including strict controls over assets, prudent investment and management of assets, and meticulous recordkeeping.

2010.11.1.1.7 Custody Services

Custodial services offered to private-banking customers include securities safekeeping, receipts and disbursements of dividends and interest, recordkeeping, and accounting. Custody relationships can be established in many ways, including by referrals from other departments in the institution or from outside investment advisors. The customer, or a designated financial advisor, 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, bank holding company supervision of its subsidiaries must ensure that the procedures for proper administration of custody services have been initated, maintained, and regularly reviewed on a preset schedule.

An escrow account is a form of custody account in which the institution agrees to hold cash or securities as a middleman, or third party. The customer 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, are 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, bank holding companies must ensure that their subsidiary institutions maintain strong controls and adequate supervision over funds transfers.

2010.11.1.1.9 Hold Mail

Hold-mail, or no-mail, accounts are often provided to private-banking customers who elect to have bank statements and other documents maintained at the institution rather than mailed to their residence. Agreements for all hold-mail accounts should be in place, and they should indicate that it was the customer's choice to have the statements retained at the institution 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 institution) by special courier or the institution'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 institution and the customer should exist. Typically, a customer might request that the institution debit a deposit account for credit card bills, utilities, rent, mortgage payments, or other monthly consumer charges.

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, 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 adequate supervision of a bank holding company's subsidiaries should include assurances that each subsidiary institution's risk-identification process and risk appetite are 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 institution. The discharge of responsibilities by institution directors should be effected through an 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. Organizational planning is the joint responsibility of senior institution and private-bank management and should be integrated with the long-range plan for the institution.

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. An institution'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 accept and 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; to 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 KYC 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 Know-Your-Customer Policy and Procedures

A bank holding company's adequate supervision of subsidiaries should mandate that each institution develop and maintain sound KYC policies and procedures. Sound KYC policies and procedures are essential to minimizing the risks inherent in private banking. They 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. They should be designed to ensure that effective due diligence is performed on all potential clients, that client files are bolstered with additional KYC information on an ongoing basis, and that client-account activity 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, an institution's 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 KYC policy is a comprehensive knowledge of the client, the institution's policies and procedures should clearly reflect the controls needed to ensure the policy is fully implemented. KYC policies should clearly delineate the accountability and authority for opening accounts and for determining if effective KYC practices and due diligence have been performed on each client. In addition, policies should delineate due diligence, 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 relationship managers (RMs).

In carrying out prudent KYC practices and due-diligence efforts 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 institution;
   d. checking with a credit bureau or professional corroboration organization; or
   e. using 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 KYC process, the RM should document in "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 institution, and updates and strengthens the KYC profile.

As a rule, most private institutions make it a policy not to accept "walk-ins." 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 to override existing procedures.

In most instances, all KYC information and documentation should be maintained and avail-

able for inspection at the location where the account is located or where the financial services are rendered. If the institution 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 KYC information will be allowed only if the institution has adopted, as part of its know-your-customer 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 institution demonstrates that the appropriate review of the information and documentation is being performed by personnel at the offshore location.

KYC procedures should be no different when the institution deals with a financial advisor or other type of intermediary acting on behalf of a client. To perform its KYC responsibilities when dealing with a financial advisor, 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 KYC analysis with respect to that beneficial owner. The imposition of an intermediary between the institution and counterparty should not lessen the institution's KYC 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 institution's KYC procedures should allow for the collection of sufficient information to develop a "transaction/client profile" for each customer to be used in analyzing client transactions. Internal systems should be developed for monitoring and identifying transactions that may be inconsistent with the customer's transaction/client profile and 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 component of the institution's KYC program. Under the SAR regulations, institutions must report any suspicious transaction relevant to a possible violation of law or regulation if the transaction is conducted or attempted by, at, or through an institution; involves $5,000 or more; and if the institution's management or staff knows, suspects, or has reason to suspect the transaction involves funds from illegal activities or is conducted in order to hide or disguise assets; is designed to evade the Bank Secrecy Act recordkeeping or reporting requirements; or the transaction has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the institution's management and/or staff knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction.

The concept of "reason to suspect" implies that the institution incurs liability for failing to file an SAR if it did not exercise due diligence in monitoring the account or in determining the true identity of the customer. The institution's internal systems for capturing suspicious activities should provide essential information about the nature and volume of activities passing through customer accounts. It is important that any information suggesting that suspicious activity has occurred be pursued, and, if an explanation is not forthcoming, the matter should be reported to the institution'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, which concludes with a decision on the appropriateness of filing an SAR. Examiners should see sections 902 and 1002 of the *Bank Secrecy Act Manual* for specific procedures on identifying suspicious activities related to teller and wire-transfer functions.

2010.11.2.2.2 Credit

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 apply to these loans. This includes *all* subsidiaries (institutions) of the bank holding company. 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 an institution'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. A bank holding company's supervision of its subsidiaries should include procedures and controls that ensure that the institution's managment and staff perform due diligence and that institution management and staff adequately and reasonably ascertain and document that the funds of its private-banking customers were derived from legitimate means. Institutions should also verify that the use of the loan's proceeds is for legitimate purposes.

In addition, institution 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 the development of effective policies, procedures, and controls. In managing its fiduciary risk, the institution 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 interests. All potential conflicts identified should be brought to the attention of management and the trust committee, with appropriate action taken. Conflicts of interest may exist in any part of the institution but are most prevalent in trust or investment management departments. Consequently, management throughout the institution should receive training in these matters.
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, this 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. Listed below are some of those guidelines which cover specific private-banking services.

2010.11.2.4.1 Segregation of Duties

A bank holding company's supervision of its subsidiaries should include procedures and controls that require subsidiary institutions to have procedures and controls that ensure the segregation of the duties of employees. Institutions should have guidelines on the segregation of employees' duties 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 KYC 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 institution should be similarly independent so that they can operate autonomously from line management.

2010.11.2.4.2 Inactive and Dormant Accounts

The management of a bank holding company's subsidiary depository institutions should know that institution laws in most states prohibit institutions from offering services that allow deposit accounts to be inactive for prolonged periods of time (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, segregation of signature cards for dormant accounts, dual controls of records, and 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 institution; several risks are involved in providing these accounts. In particular, if the U.S 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. institutions are used for illegal purposes, the entities could be exposed to reputational risk and risk of financial loss due to asset seizures and forfeitures brought by law enforcement authorities. As stated in SR-95-10, it is recommended that U.S. institutions 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. insitution 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 an institution's use of such accounts and the adequacy of its controls surrounding 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

Controls over hold mail 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 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 provide guidance on the appropriate action required for suspicious activity. The following is a checklist to guide institution 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 institution, 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 institution'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 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 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 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 on-line information services. Such on-line 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 institution'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 within all levels of the organization (the bank holding company and all subsidiary institutions). 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 KYC procedures. Compliance with KYC policies and procedures and the detailed testing of files for KYC 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 institution 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 staff to review and authorize account-opening documentation and KYC 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 function of the Office of Foreign Assets Control (OFAC) in the U.S. Department of the Treasury is to promulgate and administer regulations dealing with the economic sanctions that the U.S. government imposes against certain foreign countries and the "specially designated nationals" of those countries. Under the International Emergency Economic Powers Act, the president can impose sanctions such as trade embargoes, freezing of assets, and import surcharges on these entities.

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 Federal Reserve System's *Bank Secrecy Act Examination Manual.* In addition, the procedures for conducting BSA examinations of foreign offices of U.S. institutions are detailed in SR-96-5.

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 timeframe 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 management at the institution to ascertain what changes have occurred since the last inspection or are planned in the near future. For example, have there 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.

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 institution's business lines and services overlap, and 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 institution's organizational structure. These structures may vary considerably depending on the size and sophistication of the institution, its country of origin and the other geographic markets in which it competes, and the objectives and strategies of its management and board of directors. To the extent possible, examiners should understand the level of consolidated private-banking activities an institution conducts in the United States and abroad. This broad view is needed to maintain the "big picture" impact of private banking for a particular institution.

2010.11.3.4 Risk-Focused Approach

Examiners reviewing the private-banking operations should implement the "risk-focused" inspection approach. The inspection scope and degree of testing of private-banking practices

should reflect the degree of risk assumed, prior inspection 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.

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 inspection. The following is a list of requests regarding private banking that examiners should consider including in the FDL:

1. organizational chart for the private institution on both a functional and legal-entity basis
2. business and/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 KYC 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 and/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 advisors 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. copies of any SARs filed since the last inspection

Responses to the above items should be reviewed in conjunction with responses to the BSA, fiduciary, audit, and internal control inquiries.

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 from 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

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; *Comment: The inspection may need to extend beyond a rudimentary review of private-banking operations if the institution's business lines and services overlap, and 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 as to key contacts at the institution and to the timeframe 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-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/examination report(s) make no mention of private banking; 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.

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. Make an assessment of the private-banking organization 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 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 KYC 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 provides adequate supervision of its subsidiaries with respect to custody services, making certain that each institution has established and currently maintains procedures for the proper administration of custody services, including their regular review 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, verifying and documenting that the funds of its private-banking customers were derived through legitimate means, and, when extending credit, that the use of loan proceeds was also 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, which includes a sound decision on the need or applicable regulatory requirements to file an 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."

The analysis of intercompany transactions between a parent company, its nonbank subsidiaries, and its bank subsidiaries is primarily intended to assess the nature of the relationships between these entities and the effect of the relationships upon the subsidiary banks. Both legal and financial ramifications of such transactions are areas of concern. Certain intercompany transactions are subject to the provisions of Section 23A and/or 23B of the Federal Reserve Act. Several types of intercompany transactions and their relevance to regulatory concern are presented below:

1. Dividends Paid by Subsidiaries to the Parent:

Dividends represent a highly visible cash outflow by subsidiaries. Should the dividend payout ratio exceed the level at which the growth of retained earnings can keep pace with the growth of assets, the subsidiary's capital ratios will deteriorate. Such dividends may also have a negative effect on the subsidiary's liquidity position.

2. Transactions with Affiliates:

Transactions with affiliates is another area of potential abuse of subsidiary banks. Regulatory concern centers on the quantitative limits and collateral restrictions on certain transactions by subsidiary banks with affiliates. Such restrictions are designed to protect subsidiary banks from the potential jeopardy involved in being used as a source of financing by affiliates, and to ensure the collectibility of extensions of credit.

Checking accounts of the parent or nonbank subsidiaries at subsidiary banks present the potential for overdrafts, which are regarded as extensions of credit to an affiliate by the subsidiary bank. Overdrafts can potentially have an adverse effect on the bank's financial condition. Interest paid and the timing of payments on savings accounts and certificates of deposit are of concern, also.

3. Fees Paid by Subsidiaries:

Management or service fees also represent cash outflows by bank subsidiaries. Such fees may be paid to the parent, the nonbank subsidiaries, or in some cases to the other bank subsidiaries. Regulatory concern focuses on whether such fees are reasonable in relation to the services rendered and on the financial impact on the bank subsidiaries.

4. Tax Allocation:

A bank holding company organization's determination of the allocation of taxes among its component companies involves questions of both the magnitude and timing of the cash flow effects. Unreasonable or untimely tax payments or refunds to the bank can have an adverse effect on the financial condition of the banking subsidiaries.

5. Purchases or Swaps of Assets:

Asset purchases or swaps between affiliates create the potential for abuse of subsidiary banks. Regulatory concern focuses on the fairness of such asset transactions, their financial impact and timing. Fairness and financial considerations include the quality and collectibility of such assets and liquidity effects. Asset exchanges may represent a mechanism to avoid regulations designed to protect subsidiary banks from becoming overburdened with nonearning assets. Improper timing or certain structurings of asset transactions can also cause them to be regarded as extensions of credit to affiliates with the potential for violations of applicable regulations and statutes.

6. Compensating Balances:

A subsidiary bank may be required to maintain excess balances at a correspondent bank which lends to other parts of the holding company organization possibly to the detriment of the bank. The subsidiary bank may be foregoing earnings on such excess funds which may adversely affect its financial condition.

7. Other Expense Allocations:

In general, a subsidiary bank should be adequately compensated for its services or for the use of its facilities and personnel by other parts

of the holding company organization. Furthermore, a subsidiary bank should not pay for expenses for which it does not receive benefit.

2020.0.1 ROLE OF THE EXAMINER

In order to assess properly intercompany transactions and relationships between affiliates, the examiner must make a thorough analysis of most intercompany transactions and must have a knowledge of applicable laws, regulations, and rulings. In particular, the examiner should be familiar with sections 23A and 23B of the Federal Reserve Act.

If a subsidiary bank of a holding company is not a State member bank, the bank's primary regulator should determine the bank's compliance with pertinent banking laws. In reviewing the subsidiary bank's examination report, any violations of laws and regulations applicable to intercompany transactions should be noted. If the violation resulted from the actions of an affiliate, the affiliate's role should be identified and be subject to criticism in the inspection report.

Violations of banking laws discovered during the inspection should be brought to management's attention; however, any action or criticism levied directly on the bank should come from the bank's primary supervisor. In the inspection report, violation of banking laws should be discussed only in cases where the holding company was the cause of or a party to the violation.

2020.1.1 SECTION 23A OF THE FEDERAL RESERVE ACT

Section 23A of the Federal Reserve Act (FRA) (12 U.S.C. 371c) applies to all state member banks and FDIC-insured banks (including non-member banks). In addition, section 301 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) made the provisions of the Federal Reserve Act applicable to savings associations as if they were member banks.

Section 23A of the FRA is designed to prevent the misuse of a bank's resources stemming from non-arm's-length transactions with its affiliates. Banks are prohibited, in accordance with section 23A, from engaging in "covered transactions" with an affiliate. The statute defines covered transactions to include extensions of credit.

Section 23A prohibits a bank from engaging in covered transactions with an affiliate unless—

1. the bank limits the aggregate amount of covered transactions to that particular affiliate to not more than 10 percent of the bank's capital stock and surplus or
2. a bank limits the aggregate amount of all covered transactions with all of its affiliates to 20 percent of the bank's capital stock and surplus.

In addition to these quantitative limitations, there are specific prohibitions on the substance of the transaction:

1. A bank must conduct its transaction with its affiliate on terms and conditions that are consistent with safe and sound banking practices.[1]
2. A bank and its subsidiaries cannot purchase or accept as collateral a low-quality asset from an affiliate. A low-quality asset is a classified or past-due asset. A low-quality asset is (1) classified "substandard," "doubtful," or "loss," or treated as "other loans especially mentioned" in the most recent report of examination prepared by either a federal or state regulatory agency; (2) carried in a nonaccrual status; (3) more than 30 days past due in the payment of principal or interest; or (4) renegotiated or compromised because of the deteriorating financial condition of the obligor.
3. A bank cannot accept securities issued by an affiliate as collateral for a loan to *any* affiliate.

Any transaction by a bank with any person is deemed to be a transaction with an affiliate to the extent that the proceeds of the transaction are transferred to, or used for the benefit of, the affiliate. With respect to any bank within a holding company, its affiliates include, among others, its parent, the parent's subsidiaries, and other companies directly or indirectly controlled by the bank's shareholders.

An insured depository institution's capital stock and surplus for purposes of section 23A of the FRA is—

1. tier 1 and tier 2 capital included in an institution's risk-based capital under the capital guidelines of the appropriate federal banking agency, based on the institution's most recent consolidated FFIEC Report of Condition and Income filed under 12 U.S.C. 1817(a)(3); and
2. the balance of an institution's allowance for loan and lease losses not included in its tier 2 capital for purposes of the calculation of risk-based capital by the appropriate federal banking agency, based on the institution's most recent consolidated FFIEC Report of Condition and Income filed under 12 U.S.C. 1817(a)(3).

Section 23A covered transactions also are subject to the provisions of section 23B of the FRA. However, transactions between chain banks or "sister" banks are not subject to section 23B.

During the examination of a bank, transactions between a subsidiary bank and an affiliate are reviewed for compliance with sections 23A and 23B of the FRA and other banking regulations and statutes. Any violations of either section 23A or section 23B of the FRA involving a transaction with a bank affiliate that is disclosed or found during the examination should be reported on the Violations report page of the inspection report.

1. Board staff has taken the position that safety and soundness requires that the transaction be conducted on market terms.

2020.1.1.1 Definition of an Affiliate

In general, companies that control or are under common control with a bank are defined by section 23A as "affiliates" of the bank.[2] The definition includes a bank subsidiary of a bank and any company that a bank, or its subsidiaries or affiliates, sponsors and advises.[3]

The Gramm-Leach-Bliley Act (GLB Act) expanded the definition of affiliate to include financial subsidiaries of banks. A financial subsidiary is defined in the GLB Act as a subsidiary of a bank (1) that engages in activities that national banks are not permitted to engage in directly or that are conducted under terms and conditions that differ from those that govern the conduct of such activities by national banks, and (2) that a national bank is not specifically authorized to control by the express terms of a federal statute (other than section 24A of the FRA). (See 12 U.S.C. 371c(e)(2).)

The GLB Act also created a rebuttable presumption that a company or shareholder controls any other company if the company or shareholder directly or indirectly owns or controls 15 percent or more of the equity capital of the other company, pursuant to the merchant banking provisions of section 4(k)(4)(H) or (I) of the Bank Holding Company Act. (See 12 U.S.C. 371c(b)(11).) Under section 371(b)(1) of the FRA, these companies ("portfolio companies") are affiliates under the statute.

With respect to a bank, an affiliate means—

1. any company that controls[4] the bank and any other company that is controlled by the company that controls the bank;
2. any bank subsidiary of the bank;
3. any company—
   a. that is controlled directly or indirectly, by a trust or otherwise, by or for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, by trust or otherwise, the bank or any company that controls the bank; or
   b. in which a majority of its directors or trustees constitute a majority of the persons holding any such office with the bank or any company that controls the bank;
4. any company (including a real estate investment trust)—
   a. that is sponsored and advised on a contractual basis by the bank or any subsidiary or affiliate of the bank; or
   b. any investment company, with respect to which a bank or any affiliate thereof is an investment adviser as defined in section 2(a)(20) of the Investment Company Act of 1940; and
5. any company that the Board determines by regulation or order to have a relationship with a bank or any subsidiary or affiliate of the bank, such that covered transactions by the bank or its subsidiary with that company may be affected by the relationship to the detriment of the bank or its subsidiary.

The definition of affiliate does not include—

1. nonbank subsidiaries of a bank, unless the Board determines not to exclude such subsidiary company from the definition of affiliate under item 5 above;
2. any company engaged solely in holding the premises of the bank;
3. any company engaged solely in conducting a safe-deposit business;
4. any company engaged solely in holding obligations of the United States or its agencies or obligations fully guaranteed by the United States or its agencies as to principal and interest; and
5. any company where control results from the exercise of rights arising out of a bona fide debt previously contracted, but only for the period of time specifically authorized under applicable state or federal law or regulation or, in the absence of such law or regulation, for a period of two years from the date of the exercise of such rights, whichever date is later, subject, upon application, to authorization by the Board for good cause shown of extensions of time for not more than one year at a time, but such extensions in the aggregate shall not exceed three years.

2020.1.1.2 Covered Transactions

A covered transaction under section 23A of the FRA means—

2. It is not necessary for banks and nonbanking companies to be under common corporate ownership to be affiliates. For example, banks and nonbanking companies that are part of a chain banking organization are "affiliates" under section 23A.

3. The Board has the authority to expand the definition of affiliate to include a company that has a relationship with the bank so that covered transactions between the company and the bank may be affected by the relationship to the detriment of the bank.

4. "Control" is defined as the power to (1) vote 25 percent or more of the voting shares of a company, excluding situations in which the stock is controlled in a fiduciary capacity; (2) elect a majority of the directors of a company; or (3) exercise a controlling influence over a company.

1. a loan or extension of credit by a bank to an affiliate;
2. a purchase of, or an investment in, the securities of an affiliate by a bank or an affiliate of a bank;[5]
3. a purchase by a bank of assets from an affiliate, including assets subject to an agreement to repurchase;
4. the acceptance by a bank of securities issued by an affiliate as collateral security for a loan or extension of credit by the bank to any person or company; or
5. the issuance by a bank of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate.

If a transaction between a bank and an affiliate cannot be determined to be within one of the above categories, it is not a covered transaction for the purposes of section 23A and is not subject to its limitations. For example, dividends or fees paid by a bank to its parent holding company are not covered transactions under section 23A.

2020.1.1.3 Collateral for Certain Transactions with Affiliates

Section 23A also restricts a bank's use of collateral for transactions with affiliates.[6] Each loan or extension of credit to, or each guarantee, acceptance, or letter of credit issued on behalf of, an affiliate by a bank or its subsidiary must be secured at the time of the transaction by collateral having a market value equal to—

1. 100 percent of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit, if the collateral is composed of—
   a. obligations of the United States or its agencies;
   b. obligations fully guaranteed by the United States or its agencies as to principal and interest;
   c. notes, drafts, bills of exchange, or banker's acceptances that are eligible for rediscount or purchase by a Federal Reserve Bank;[7] or
   d. a segregated, earmarked deposit account with the bank;
2. 110 percent of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit if the collateral is composed of obligations of any state or political subdivision of any state;
3. 120 percent of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit if the collateral is composed of other debt instruments, including receivables; or
4. 130 percent of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit if the collateral is composed of stock, leases, or other real or personal property.

2020.1.1.4 Limitations with Respect to Collateral

For covered transactions, banks may accept as collateral for covered transactions receivables, leases, or other real or personal property.[8] The following are limitations and collateral restrictions:

1. Any collateral that is subsequently retired or amortized shall be replaced by additional eligible collateral. This is done, when needed, to keep the percentage of the collateral value relative to the amount of the outstanding loan or extension of credit, guarantee, acceptance, or letter of credit equal to the minimum percentage that was required at the inception of the transaction.
2. A low-quality asset is not acceptable as collateral for a loan or extension of credit to, or a guarantee, acceptance, or letter of credit issued on behalf of, an affiliate.
3. Securities issued by an affiliate of a bank shall not be acceptable as collateral for a loan or extension of credit to, or a guarantee, acceptance, or letter of credit issued on behalf of, that affiliate or any other affiliate of the bank.

5. The investment by a bank or its affiliate in a financial subsidiary of the bank excludes the retained earnings of the financial subsidiary.

6. The bank must perfect the security interest in the collateral. *Fitzpatrick v. FDIC,* 765 F.2d 569 (6th Cir. 1985). A bank, however, is not required by section 23A to secure a purchase of assets from an affiliate.

7. Regulation A includes a representative list of acceptable government obligations (12 C.F.R. 201.108).

8. Letters of credit and mortgage-servicing rights may not be accepted as collateral for purposes of section 23A. See FRRS 3-1164.3.

4. The above collateral requirements are not applicable to an acceptance that is already fully secured either by attached documents or by other property having an ascertainable market value that is involved in the transaction.

2020.1.1.5 Exceptions

There are several exceptions to section 23A for transactions between banks and their affiliates. Except for the requirement that all transactions be on terms and conditions that are consistent with safe and sound banking practices, the provisions of section 23A are not applicable to the following:

1. Any transaction between banks, except for the purchase of a low-quality asset, when 80 percent or more of each bank's voting shares are controlled by the same company or one bank controls 80 percent or more of the voting shares of the other bank.[9]

   Credit card banks insured by the Bank Insurance Fund (BIF) and savings banks are banks for purposes of section 23A. Foreign banks are not banks for purposes of section 23A, and thus transactions between domestic banks and foreign banks are not eligible for this exemption. Savings associations are not banks for purposes of section 23A and therefore are not eligible for the exemption. FIRREA provides for a limited exemption for transactions between banks and thrifts if (1) the bank holding company owns 80 percent of the voting stock of the thrift, and (2) every thrift and bank controlled by the bank holding company complies with all applicable capital requirements on a fully phased-in basis and without reliance on goodwill.
2. Making deposits in an affiliated bank or affiliated foreign bank in the ordinary course of correspondent business, subject to any restrictions that the Board may prescribe by regulation or order.
3. Giving immediate credit to an affiliate for uncollected items received in the ordinary course of business.
4. Making a loan or extension of credit to, or issuing a guarantee, acceptance, or letter of credit on behalf of, an affiliate that is fully secured by—
   a. obligations of the United States or its agencies,
   b. obligations fully guaranteed by the United States or its agencies as to principal and interest; or
   c. a segregated, earmarked deposit account with the bank.
5. Purchasing securities that are issued by any of the kinds of investments in entities described in section 4(c)(1) of the Bank Holding Company Act of 1956.[10]
6. Purchasing assets that have a readily identifiable and publicly available market quotation, and that are purchased at that market quotation or, subject to the prohibition in of section 23A(a)(3), purchasing loans on a nonrecourse basis from affiliated banks.
7. Purchasing from an affiliate a loan or extension of credit that was originated by the bank and sold to the affiliate subject to a repurchase agreement or with recourse.[11]
8. A transaction between affiliated insured depository institutions if the transaction has been approved by the appropriate federal bank agency pursuant to the Bank Merger Act. (See 12 C.F.R. 250.241 (at FRRS 3-1128).)

2020.1.1.6 Leases

Lease transactions which constitute the functional equivalent of a loan or an extension of credit may be subject to section 23A. Such lease

9. Banks that are affiliated in this manner are referred to as "sister" banks. Sister banks can thus improve their efficiency via intercorporate transfers under this exception. Also, "company" in this context is not limited to a bank holding company. For example, if a retail bank owns two credit card banks, the two credit card banks would be "sister banks," although owned by a bank, and the sister-bank exception could be used for transactions between two credit card banks.

10. This refers to the purchase of shares of a company that—
- holds or operates properties used substantially or entirely by any banking subsidiary in its operations or property acquired for such future use;
- conducts a safe-deposit business;
- furnishes services to, or performs services for, the bank holding company or its banking subsidiaries; or
- liquidates assets acquired from the bank holding company or its banking subsidiaries or those that were acquired from any other source before May 9, 1956, or the date upon which the company became a bank holding company, whichever is later.

11. A sale of federal funds by a bank to an affiliate of the bank, unless the affiliate is a sister bank, is subject to the quantitative and collateral limitations of section 23A. (See 12 C.F.R. 250.160.) A transaction in federal funds involves a loan on the part of the "selling" bank and a borrowing on the part of the "purchasing" bank.

arrangements, in effect, are equivalent to a loan by the bank and are essentially financing arrangements. Some of the characteristics that would normally cause a lease to be construed as a loan equivalent include the lessee's having responsibility for the servicing, maintenance, insurance, licensing, or risk of loss or damage, and the lessee's having the option to purchase the equipment.

2020.1.1.7 De Facto Extensions of Credit

Other transactions may constitute de facto extensions of credit by a subsidiary bank to other members of the holding company family. For example, rent subsidies or use of a bank's personnel, funds, or equipment without adequate compensation may be de facto extensions of credit.

2020.1.1.8 Limitations of Amount—Valuations of Transactions

Section 23A(b)(7)(D) of the FRA defines as a covered transaction a bank's acceptance of securities issued by an affiliate as collateral security for a loan or extension of credit to any person or company. In a 1984 opinion, the Board's staff said that, for purposes of the quantitative limit in section 23A, the value of an extension of credit that is secured in any part by securities of an affiliate is the amount of the entire loan rather than the value of securities pledged as collateral.

The 1984 staff opinion has been revised. In situations in which a loan is secured by affiliate shares and other collateral, it is reasonable to reflect the fair market value of the nonaffiliate collateral in determining the applicability of the quantitative limits in section 23A to loans by a bank to an unaffiliated third party. For purposes of applying these quantitative limits, such mixed-collateral loans should be valued at the lesser of (1) the total value of the loan less the amount of nonaffiliate collateral (if any) marked to fair market value, or (2) the fair market value of the affiliate's shares that are used as collateral. Under this calculation method, if the loan is fully secured by collateral with a fair market value that equals or exceeds the loan amount (excluding the affiliate's shares), the loan would not be included in the bank's quantitative limits. If the loan is not fully secured by collateral excluding the affiliate's shares, the amount that the bank must count against its quantitative limits is the difference between the full amount of the loan and the fair market value of the nonaffiliate collateral, up to a maximum of the value of the affiliate's shares. This methodology takes account of the bank's reliance on the fair market value of nonaffiliate collateral in a loan transaction, while also recognizing that a portion of the loan may be supported by shares issued by an affiliate. If a portion of a loan is secured with nonaffiliate collateral that was marked to its fair market value, that part of the loan should not be subject to the quantitative limits of section 23A. (See FRRS 3-1199.)

Under section 23A(c)(4), the securities issued by an affiliate are not acceptable collateral for a loan or extension of credit to any affiliate. Moreover, if the proceeds of the loan that are secured by the affiliate's shares are transferred to an affiliate by the third-party borrower to purchase assets or securities from the affiliate, the loan is treated as a loan to the affiliate. The loan must then be secured with collateral in an amount and of a type that meets the requirements of section 23A for loans by a bank to an affiliate. (See FRRS 3-1167.3.) Moreover, a loan that is secured with any amount of an affiliate's shares must be consistent with safe and sound banking practices.[12]

2020.1.1.9 Contributing Shares or Assets of a BHC Affiliate to a Bank

The holding company's contribution to a bank of the shares or assets of an affiliate may result in a "purchase of assets" under section 23A to the extent that consideration is given by the bank for the shares or assets it receives. The consideration may be given in the form of cash, a note booked by the bank as a receivable, or the assumption by the bank of the nonbank's liabilities owed to another affiliate. In addition, a bank's assumption of a liability to an unaffiliated party may also raise supervisory concerns. These transactions warrant particular scrutiny to ensure compliance with section 23A and to ensure that the transfer is not indicative of a broader liquidity problem of the holding company.

2020.1.2 SECTION 23B OF THE FEDERAL RESERVE ACT

Section 23B of the FRA became law on August

12. Staff opinion of January 21, 1999 (FRRS at 3-1199).

10, 1987, as part of the Competitive Equality Banking Act of 1987. This section also regulates transactions with affiliates. Section 23B applies to any covered transaction with an affiliate, as that term is defined in section 23A, but excludes banks from the term "affiliate." Thus, transactions between sister banks and banks that are part of a chain banking organization are exempt from section 23B. FIRREA made section 23B of the Federal Reserve Act, as well as section 23A, applicable to savings associations. The transactions covered by section 23B consist of the following:

1. Any covered transaction with an affiliate. Any transaction by a bank or its subsidiary with any person is deemed to be a transaction with an affiliate of the bank if any of the proceeds of the transaction are used for the benefit of, or transferred to, the affiliate.
2. The sale of securities or other assets to an affiliate, including assets subject to an agreement to repurchase.
3. The payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise.
4. Any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person.
5. Any transaction or series of transactions with a third party if—
   a. an affiliate has a financial interest in the third party, or
   b. an affiliate is a participant in such transaction or series of transactions.

Any transaction by a bank or its subsidiary with any person is deemed to be a transaction with an affiliate of the bank if the proceeds of the transaction are used for the benefit of, or transferred to, the affiliate. A bank and its subsidiaries may engage in transactions covered by section 23B of the FRA, but only on terms and under certain circumstances, including credit standards, that are substantially the same or at least as favorable to the bank as those prevailing at the time for comparable transactions with or involving nonaffiliated companies. If comparable transactions do not exist, the transaction must be on terms and under circumstances, including credit standards, that in good faith would be offered to or applied to nonfinancial companies.

Section 23B restricts transactions with affiliates in the following situations:

1. A bank or its subsidiary cannot purchase as fiduciary any securities or other assets from any affiliate unless the purchase is permitted (1) under the instrument creating the fiduciary relationship, (2) by court order, or (3) by law of the jurisdiction creating the fiduciary relationship.
2. A bank or its subsidiary cannot knowingly purchase or acquire any security during the existence of an underwriting or selling syndicate for that security, if an affiliate of the bank is a principal underwriter in the syndicate, unless the purchase was approved by a majority of the bank's outside directors before the security was offered initially for sale to the public.

A bank or its affiliate cannot advertise or enter into any agreement stating or suggesting that it is in any way responsible for the obligations of its affiliates.

2020.1.3 INSPECTION OBJECTIVES

1. To analyze and assess the financial impact of transactions (including loans and purchases of assets) between the subsidiary banks and their subsidiaries and all affiliates.
2. To determine whether transactions between a subsidiary bank (and its subsidiaries) and its affiliates in the holding company are restricted to the range of covered and permissible transactions cited within sections 23A and 23B of the FRA.
3. To determine if transactions between a subsidiary bank and its affiliates in the holding company are on terms and conditions and under circumstances, including credit standards, that are consistent with safe and sound banking practices and whether the terms and conditions of the transactions are the same as those that would be offered or applied to nonaffiliated companies.
4. To determine whether a subsidiary bank or its subsidiary has purchased low-quality assets or has purchased, as fiduciary, any securities or other assets from an affiliate in the holding company.
5. To determine whether a subsidiary bank, or any subsidiary or affiliate of the bank, has published any advertisement or has entered into any agreement that states or suggests that it will, in any way, be responsible for the obligations of affiliates.
6. To determine if securities were purchased or acquired by the subsidiary bank or its subsid-

iaries from an underwriting or selling syndicate affiliated with the bank and, if so, if the majority of outside directors of the bank approved the purchase or acquisition of securities before they were offered for sale to the public.
7. To confirm that the subsidiary bank or its subsidiary has not purchased as fiduciary any securities or other assets from a nonbank affiliate in the holding company unless the purchase was permitted in accordance with the instrument creating the fiduciary relationship, by court order, or by the law governing the fiduciary relationship.
8. To ascertain if any subsidiary bank (or its subsidiary) had knowingly purchased or acquired any security from an affiliate in which the principal underwriter of that security was a nonbank affiliate within the holding company organization.
9. To determine if the subsidiary bank and its subsidiaries have conducted transactions with their parent holding company or any other company affiliated in the holding company organization that are not in compliance with the restrictions found in sections 23A and 23B of the FRA (for FDIC-insured nonmember banks, section 18(j) of the Federal Deposit Insurance Act (FDIA)).

2020.1.4 INSPECTION PROCEDURES

1. During the pre-inspection, perform the following activities:
   a. Review examination reports of subsidiary banks for comments on loans to affiliates, intercompany transactions, other transactions with affiliates, and violations of the restrictions of sections 23A or 23B of the Federal Reserve Act or, for FDIC-insured nonmember banks, section 18(j) of the FDIA.
   b. Review the most current FR Y-8 (Report of Intercompany Transactions) and interim reports for information on transactions with affiliates.
2. In the officer's questionnaire, request a list of subsidiary bank (and the subsidiaries of the bank) transactions with affiliates since the previous inspection, including the terms and any collateral, consisting of—
   a. a loan or extension of credit to the affiliate;
   b. a purchase or sale of an investment in securities issued by or sold to the affiliate, or a purchase or sale of other assets, including assets subject to an agreement to repurchase;
   c. the acceptance of securities issued by the affiliate as collateral security for a loan or extension of credit;
   d. the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit on behalf of an affiliate;
   e. the payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise;
   f. transactions in which an affiliate acts as agent or broker or receives a fee for its services to the bank or to any other person;
   g. any transaction or series of transactions with a third party if—
      - the affiliate has a financial interest in the third party, or
      - the affiliate is a participant in such transactions; and
   h. any transaction by a subsidiary bank or its subsidiary with any person, if the proceeds of that transaction are used for the benefit of, or transferred to, the affiliate.
3. During the inspection, perform the following activities:
   a. Review the listed transactions with affiliates provided in response to the officer's questionnaire.
   b. Review and determine that all transactions within the holding company organization comply with the restrictions on transactions with affiliates found in sections 23A and 23B of the FRA (section 18(j) of the FDIA for FDIC-insured nonmember banks).
   c. Review all related documentation, terms, conditions, and circumstances for each transaction, including any resolutions for securities purchased (or established standards for securities purchased from affiliates).
   d. Determine the purpose and use of the proceeds.
   e. Review all outstanding guarantees, endorsements, or pledge agreements by the bank to support the affiliates' borrowings.
   f. Review, on a test-sample basis, advertisements and written agreements to ascertain whether the bank or any subsidiary or affiliate of the bank has stated or suggested that it shall be responsible

for the obligations of any affiliates in the holding company organization.

g. Review the holding company's policies and procedures regarding intercompany transactions of subsidiary banks.

4. Give additional attention to the following problems involving the BHC and its subsidiaries:
   a. The subsidiary bank would not have made the loan or would not have made the loan with such favorable terms and conditions, or engaged in any other covered transaction, except for the parent holding company's insistence due to the affiliate relationship.
   b. The bank's condition is weakened due to the extension of credit or the nature of the transaction with the affiliate.
   c. The affiliate has not provided adequate qualifying collateral to support the loan or extension of credit provided by the subsidiary bank.
   d. The loan, extension of credit, or transaction with an affiliate is not in compliance with the limits and restrictions found in sections 23A or 23B of the FRA.
   e. Purchases of low-quality assets by a subsidiary bank or its subsidiaries from an affiliate, unless previously exempted by Board regulation or order, or unless the bank subsidiary or subsidiary affiliate, pursuant to an independent credit evaluation, had not committed itself to purchase the low-quality assets before the time such asset was acquired by the affiliate.
   f. During the existence of any underwriting or selling syndicate, a subsidiary bank or its subsidiary has purchased or acquired a security from a bank affiliate or bank holding company affiliate, including an affiliated broker-dealer, when the principal underwriter of that security is an affiliate of the bank.
   g. The purchase or acquisition of securities was not approved by the majority of the outside board of directors before the securities were offered for sale to the public and were not, in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would have been offered to, or would have applied to, nonaffiliated companies.
   h. The existence of advertisements or agreements that state or suggest that the bank, its subsidiaries, or affiliate will be responsible for the obligations of its affiliates.
5. Review any checking accounts and bank statements for overdrafts the parent company or any of its nonbank subsidiaries may have with a subsidiary bank.
6. Review the accounts payable to the subsidiary bank(s) and other accounts payable accounts for servicers, contractors, lessors, and other affiliates to determine if they arose as the equivalent of an extension of credit, purchase of securities or other assets, or as a liability to third parties. Ascertain whether those transactions were listed in response to the officer's questionnaire, and whether the transactions were in accordance with the restrictions found in sections 23A and 23B of the Federal Reserve Act.
7. Review the accounts receivable from the subsidiary bank(s) and other accounts receivable of other affiliates for sales of securities or other assets, and the payment of money or the furnishing of services. Ascertain whether those transactions were reported in response to the officer's questionnaire and whether they are in accordance with the section 23A and 23B restrictions placed on transactions with affiliates.
8. Review all other transactions that the holding company organization has engaged in with its affiliated bank(s) and their subsidiaries, including lease arrangements, to determine whether they are subject to the restrictions found in sections 23A and 23B, and, if so, whether they are in compliance therewith.
9. Discuss the findings with appropriate management personnel.
10. a. Determine management's actions regarding any comments raised by the bank's primary regulator in an examination report. If violations are disclosed in a subsidiary bank's examination report or during an inspection of the holding company, the examiner may criticize management on the Examiner's Comments and Matters Requiring Special Board Attention page of the inspection report for causing the bank to be in violation or for engaging in unsafe and unsound practices.
    b. If loans to or transactions with affiliates within the holding company organization appear to adversely affect a subsidiary bank, request management's assessment of such effects and its rationale

for the transactions. Use of the Examiner's Comments and Matters Requiring Special Board Attention report page may be appropriate.

2020.1.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*FRRS*[3]	*Orders*
Definition of affiliate, subsidiary, bank, company, and "covered transaction"	371c, FRA section 23A(b)		3–1111	
Treatment of transactions with financial subsidiaries of banks	371c(e), FRA section 23A		3–1114.1	
Limitations and collateral requirements	371c, FRA section 23A(c)		3–1112 3–1199	
Applicability to FDIC-insured banks	1828(j), FDI Act section 18(j)		1–398	
Restrictions on transactions with affiliates	371c-1, FRA section 23B		3–1116	
Undivided profits as part of "capital and surplus"		250.162	3–1505.1	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

It is common practice for a bank to sell to or place with other banks loans that the bank itself has made to its customers. A loan participation is a share or part of a loan which entitles the holder to a pro rata share of the income determined by the extent of the holder's contribution to the original loan and a preference ordering for repayment. Such loans may be sold outright without liability to the selling bank in case of default by the borrower, or they may be sold with terms granting the purchasing bank recourse to the selling bank should the loans become uncollectible. Sales to or placement of loans with other banks are for the accommodation of either the selling or purchasing bank and are arranged for purposes of increasing the rate of return when loan rates differ between banks, achieving diversification of loans by type, and altering liquidity positions. It is also common practice for banks to sell or place with other banks those portions of individual loans that would be in excess of the bank's legal lending limit (overlines) if the total loan were retained. Participations of this type should be placed without recourse as a matter of prudent banking practice; otherwise, the purpose of compliance with the legal lending limitations would be defeated in the event of default.

Banks also sell or place loans or participations with their parent holding companies or nonbank affiliates. A BHC's purchase of loan participations from its subsidiary bank(s) generally constitutes the making of a loan or extension of credit within the meaning of section 225.28(b)(1) of Regulation Y, and as such, a bank holding company needs prior approval to purchase loan participations from its subsidiary bank(s).

A bank may participate in or purchase a loan originated by its parent holding company or one of its nonbank subsidiaries. A subsidiary bank's purchase, or participation of a loan, note, or other asset from an affiliate is considered a purchase of an asset from an affiliate within the meaning of section 23A of the Federal Reserve Act and thus is a "covered transaction" that is subject to the quantitative limitations and the prohibition against purchasing of low-quality assets. Subsidiary banks must make independent judgments as to the quality of such participations before their purchase to avoid compromising the asset quality of such banks for the benefit of other holding company entities. All loans and participations must be purchased on market terms.

A bank's purchase of a loan or loan participation from a bank holding company or its subsidiary may not be a covered transaction under section 23A if (1) the bank makes an independent credit evaluation on each loan prior to the affiliate making the loan, (2) the bank agrees to purchase the loan prior to the affiliate making the loan, and (3) the bank's purchase of the affiliate's loans is not the primary source of funding for the affiliate.

In some cases, a bank may renew a loan or a participation that it purchased from another affiliated bank even when the original participation has become a low-quality asset. In some instances, a bank's renewal of a low-quality asset, such as a troubled agricultural loan, or an extension of limited amounts of additional credit to such a borrower may enable both the originating and participating banks to avoid or minimize potential losses. It would be inconsistent with the purposes of section 23A to bar a participating bank from using sound banking judgment to take the steps that it may deem necessary to protect itself from harm in such a situation, so long as the loan was not a low-quality asset at the time of the original participation and the participating bank does not assume more than its original proportionate share of the credit.

The following factors thus characterize the situation where it would be reasonable to interpret section 23A as not applying to the renewal of an otherwise low-quality asset:

1. the original extension of credit was not a low-quality asset at the time the affiliated bank purchased its participation,
2. the renewal and/or the extension of additional credit has been approved by the board of directors of the participating bank as necessary to protect the bank's investment by enhancing the ultimate collection of the original indebtedness, and
3. the participating bank's share of the renewal and/or additional loan will not exceed its proportionate share of the original investment. In addition, it is expected that, consistent with safe and sound banking practices, the originating bank would make its best efforts to obtain adequate collateral for the loan(s) to further protect the banks from loss.

Loans and loan participations by the various members of the holding company family to indi-

vidual borrowers or to the same or related interests may represent concentrations of credit which are large in relation to the holding company's consolidated capital position. These concentrations of credit should be assessed for potentially harmful exposure to the holding company's financial condition.

2020.2.1 INSPECTION OBJECTIVES

1. To determine the bank holding company's loan participation policy.
2. To assess the impact of a subsidiary bank's participation in loans with affiliates and to ensure that the bank's financial condition is not compromised and that the bank is not providing the funding needs of the affiliates, except within the parameters of sections 23A and 23B of the Federal Reserve Act.
3. To assess the impact of any concentrations of credit on the holding company's overall financial position.

2020.2.2 INSPECTION PROCEDURES

1. During the preinspection process, review each subsidiary bank's examination report for comments on participations with affiliates.
2. In the officer's questionnaire to the holding company, request the BHC's policy on loan participation. Request a list of any loan participations the holding company or the nonbank subsidiaries have with the subsidiary bank(s).
3. During the inspection, review the policy statements and each participation the holding company or the nonbank subsidiaries have with the subsidiary bank(s). The following characteristics should be analyzed:
   a. any repetitive transaction patterns which may indicate policy;
   b. the adequacy of credit information on file;
   c. the extent to which the terms of the participation including interest rates are handled in an arm's-length manner;
   d. the degree that the bank is accommodating the funding needs of the nonbank subsidiaries or its parent;
   e. the impact of these transactions on the subsidiary bank;
   f. eligibility for exclusion from section 23A restrictions and, if applicable, compliance with such restrictions.
4. Review participations among the bank holding company, nonbank subsidiaries, and the subsidiary banks to determine potentially adverse concentrations of credit.
5. Discuss with management—
   a. written and verbal policies regarding participations both within the holding company and with nonaffiliated third parties and
   b. any adverse findings on intercompany participations.
6. Comment on policy on the appropriate page of the inspection report (see section 5010.6). If any adverse comments on participations with affiliates are contained in a bank subsidiary's examination report, comment on their current status and the bank holding company's efforts to remedy the problem.

2020.2.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Limitations and restrictions	Section 23A(c), FRA 371c			
Purchase of loans from mortgage banking affiliates		250.250	3–1133	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Sales and transfers of assets between subsidiary banks and other entities in a bank holding company organization pose the potential of risk to the subsidiary banks. Asset purchases are covered by Section 23A and Section 23B of the Federal Reserve Act. The limitations state that all covered transactions, including asset purchases, by a bank with a single affiliate, may not exceed 10 percent of a bank's capital and surplus, and transactions with all affiliates may not exceed 20 percent of the bank's capital and surplus. In addition, all transactions must be conducted on market terms.

A bank's purchase of a loan or loan participation from a bank holding company or its subsidiary may not be a covered transaction under Section 23A if:

1. the bank makes an independent credit evaluation on each loan prior to the affiliate making the loan;
2. the bank agrees to purchase the loan prior to the affiliate making the loan; and
3. the bank's purchase of the affiliate's loans is not the primary source of funding for the affiliate.

Sale and transfer of assets can also occur through swaps and spinoffs. Examples of such transactions which may have an adverse effect on a bank include the transfer of a profitable activity or subsidiary from the bank to the holding company, or the transfer of an unprofitable activity or subsidiary from the holding company to the bank. In addition, the transfer of a bank holding company subsidiary to a bank, whereby the bank assumes the liabilities of the affiliate raises supervisory concerns and may violate Sections 23A and 23B of the Federal Reserve Act.

Another example is the transfer of a subsidiary bank's deferred taxes, together with an equivalent amount of cash or earning assets, to the parent. In such a transaction, a subsidiary bank's liquidity position is weakened. All such transfers of deferred taxes must be reversed and the bank's asset and liability accounts restored to their level prior to the transfer. For a detailed discussion on transfers of a bank's deferred tax liability, see Manual section 2070.0.

A bank holding company may transfer a liquidating asset from a subsidiary bank to a section 4(c)(1)(D) liquidating subsidiary of the holding company. Also, pursuant to section 4(c)(3) of the Act, a BHC may transfer from a subsidiary bank an asset to be disposed of pursuant to the request of the bank's primary regulator. For more information on the transfer of such assets and the time parameters involved, refer to Manual section 3030.0.

The purchase of low-quality assets is prohibited by Section 23A of the Federal Reserve Act. Refer to section 2020.1.1.5 for a listing of transactions that are exempt from the limitations of Section 23A of the Federal Reserve Act.

2020.3.1 INSPECTION OBJECTIVES

1. To review intercompany sale and transfer of assets to assess the impact on the subsidiary bank.
2. To initiate corrective action to reverse the transaction, if necessary.

2020.3.2 INSPECTION PROCEDURES

1. During the preinspection process, review all notes to financial statements, the FR Y-8 report, and the examination reports of subsidiary banks to ascertain whether any purchase or transfer of assets has occurred between the subsidiary banks and the parent holding company or nonbank subsidiaries.
2. In the officer's questionnaire, request information on any transfer or sale of assets between the subsidiary bank and the parent holding company or the nonbank subsidiaries.
3. During the inspection, review all facts regarding any sale or transfer of assets transactions and assess their impact on the subsidiary bank. Examiners should determine:
    a. Whether the transaction required and received the approval of the bank's primary regulator; and
    b. The quality of the assets transferred or sold, and whether the sale of the assets was at a price significantly higher than would have been realized in an arm's-length transaction.
4. Discuss findings with management including:
    a. Apparent prejudicial transactions and violations of regulations; and
    b. Any unsound practices.

A compensating balance is a deposit maintained by a firm at a bank to compensate the bank for loans and lines of credit granted to the firm. Often, a commercial bank, when extending credit, requires an average deposit balance equal to a fixed percentage of the outstanding loan balance. Compensating balance requirements vary from informal understandings to formal contracts. Deposits maintained as compensating balances may be demand or time, active or dormant. Frequently, a lending bank will allow compensating balances to be supplied by a depositor other than the borrower itself. If compensating balances are maintained by a BHC's subsidiary bank on behalf of its parent, the practice is considered a diversion of bank income (i.e., the bank loses the opportunity to earn income on the balances that could be invested elsewhere). In general, this practice is inappropriate unless the bank is being compensated at an appropriate rate of interest. If the bank is not being appropriately reimbursed, the practice should be criticized and action taken to insure that the bank is compensated for the use of its funds.

BHCs borrow directly from nonaffiliated banks, using the proceeds for both bank and nonbank operations and investments. Also, bank holding companies seek credit lines from banks to back their borrowings in commercial paper markets and for other liquidity purposes. Nonbank subsidiaries of bank holding companies borrow from banks to fund activities such as mortgage banking, leasing and sales finance. In some cases, when a bank holding company or its nonbank subsidiaries borrow, the subsidiary bank's deposit at the lending institution may be accepted as a compensating balance for the borrowings of other members of the bank holding company organization. Such transactions raise questions under Section 23B of the Federal Reserve Act regarding the bank's compensation for such services.

Often the distinction between correspondent balances and compensating balances is not clear. Occasionally, the rate of the required compensating balance is written into the loan agreement; however, informal understandings usually appear to determine the amount of compensating balance maintained. At times, a balance may be identified in the bank's books as a compensating balance. A compensating balance may also be identified as an amount above a correspondent balance historically maintained by the bank. Compensating balances may also appear as a dormant account or may be the aggregate amount of a number of deposits of various subsidiary banks.

The interest rate on the loan to the holding company organization may also be helpful in determining the existence of compensating balances. Loans below the lending bank's normal rate may indicate that the lending bank is receiving compensation in another form.

At times, excess correspondent balances are maintained to encourage participation relationships and for other goodwill reasons. Therefore, the existence of excess balances may not always indicate that there is a compensating balance agreement.

Although a bank holding company may compensate its subsidiary banks for the use of the funds, the compensation may not equal the opportunity cost associated with providing the compensating balance. As a result, subsidiary banks which maintain compensating balances for holding company members may forego profit opportunities, and this practice may have a negative impact on the bank's earnings and capital adequacy. The amount of such compensation should be equal to a fair market rate.

If the lending bank has the right of offset to compensating balances maintained by the subsidiary bank in case of default by parent or nonbank subsidiaries, the subsidiary bank's funds are jeopardized. Such potential loss of funds should be commented on by the examiner.

2020.4.1 INSPECTION OBJECTIVES

1. To identify compensating balances maintained by a subsidiary bank for the parent holding company or any nonbank affiliate.
2. To determine whether the subsidiary bank is adequately reimbursed for the maintenance of any compensating balances.

2020.4.2 INSPECTION PROCEDURES

1. During the preinspection process:
    a. Review the subsidiary bank examination reports or contact management to determine whether the non-affiliated banks, lending to the holding company organization, are correspondents of the subsidiary banks. Where applicable, request detailed loan information which could

provide information on the compensating balances' terms required by the lending bank.

b. Review the notes to the financial statements and other available material, such as 10–K reports filed with the SEC, which may describe compensating balance agreements. FR Y–8 reports should be reviewed for questions applicable to compensating balances.

2. Review interbank loan agreements to determine whether compensating balances are formally required. Assess the terms of the loan to determine whether the loan appears to be at fair market rates for this type of credit request.

3. Request and review the account balance and monthly account statement provided by the lending bank to identify the amount of compensating balances. The statement should be available within the holding company or bank.

4. Request from management information regarding compensating balances maintained by subsidiary banks for the benefit of other affiliates.

5. Review the subsidiary bank's historical level of correspondent balances to assess trends. Compare levels of balances prior to any loan origination or interest rate changes.

6. Review intercompany accounts to determine the amount of compensation paid to the subsidiary bank for maintaining compensating balances. Assess adequacy of compensation. Assess impact of practice on the bank's financial condition.

7. Discuss with management the reasons for any apparent excess balances, and whether compensating balances are formally or informally required.

Dividends are a means by which a corporation distributes earnings or assets to its shareholders. Although the word "dividends" usually applies to funds paid out of net profits or surplus and is usually thought of in such a context, dividends can also be made "in kind," which means in property or commodities. This section does not discuss "stock dividends" which represent transfers from retained earnings to paid-in capital rather than distributions of earnings. Dividends from the subsidiaries, both bank and nonbank, to the parent company are the means by which a cash return is realized on the investment in subsidiaries, thus enabling the parent to pay dividends to its shareholders and to meet its debt service requirements and other obligations.

Dividends paid by any corporation are generally limited by certain State laws. Banks, however, are subject to further legal restrictions on dividends by their chartering authority and other regulators. Aside from the statutory limitations, the primary consideration in this area is the subsidiary's level of capital and its ability to meet future capital needs through earnings retention.

Although there are no specific regulations restricting dividend payments by bank holding companies other than State corporate laws, supervisory concern focuses on the holding company's capital position, its ability to meet its financial obligations as they come due, and its capacity to act as a source of financial strength to its subsidiaries. Some one-bank holding companies may be restricted in the amount of dividends they may pay as a result of certain limitations placed on future dividend distributions at the time of the holding company's formation. (see Manual section 2090.2)

When analyzing the dividend practices of the subsidiaries and the parent company the following must be considered: the present level of capital in relation to total assets, risk assets, and classified assets; growth rates and additional plans for expansion; past earnings performance and projections; and the ability to service debt.

Aside from reasonable and timely fees for services rendered, the most appropriate way for funds to be paid by the bank to the parent is through dividends. This principle applies, in general, to bank payments of funds to service holding company debt, even when the debt was initially incurred to raise equity capital for the subsidiary bank. It is not considered an appropriate banking practice for the subsidiary bank to pay management fees for the purpose of servicing holding company debt. Funds for servicing holding company debt should, as a general rule, be upstreamed in the form of dividends.

2020.5.1 POLICY STATEMENT ON CASH DIVIDEND PAYMENTS

On November 14, 1985 the Board approved a policy statement on the payment of cash dividends by state member banks and *bank holding companies that are experiencing financial difficulties.* The policy statement addresses the following practices of supervisory concern by institutions that are experiencing earnings weaknesses, other serious problems, or that have inadequate capital:

- The payment of dividends not covered by earnings,
- The payment of dividends from borrowed funds,
- The payment of dividends from unusual or nonrecurring gains, such as the sale of property or other assets.

It is the Federal Reserve's view that an organization experiencing earnings weaknesses or other financial pressures should not maintain a level of cash dividends that exceeds its net income, that is inconsistent with the organization's capital position, or that can only be funded in ways that may weaken the organization's financial health. In some instances, it may be appropriate to eliminate cash dividends altogether. The policy statement is as follows:

2020.5.1.1 Policy Statement on the Payment of Cash Dividends by State Member Banks and Bank Holding Companies

The Board of Governors of the Federal Reserve System considers adequate capital to be critical to the health of individual banking organizations and to the safety and stability of the banking system. A major determinant of a bank's or bank holding company's capital adequacy is the strength of its earnings and the extent to which its earnings are retained and added to capital or paid out to shareholders in the form of cash dividends.

Normally, during profitable periods, dividends represent an appropriate return of a portion of a banking organization's net earnings to its shareholders. However, the payment of cash dividends that are not fully covered by earnings, in effect, represents the return of a portion of an organization's capital at a time when circumstances may indicate instead the need to strengthen capital and concentrate financial resources on resolving the organization's problems.

As a matter of prudent banking, therefore, the Board believes that a bank or bank holding company generally should not maintain its existing rate of cash dividends on common stock unless 1) the organization's net income available to common shareholders over the past year has been sufficient to fully fund the dividends *and* 2) the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality, and overall financial condition. Any banking organization whose cash dividends are inconsistent with either of these criteria should give serious consideration to cutting or eliminating its dividends. Such an action will help to conserve the organization's capital base and assist it in weathering a period of adversity. Once earnings have begun to improve, capital can be strengthened by keeping dividends at a level that allows for an increase in the rate of earnings retention until an adequate capital position has been restored.

The Board also believes it is inappropriate for a banking organization that is experiencing serious financial problems or that has inadequate capital to borrow in order to pay dividends since this can result in increased leverage at the very time the organization needs to reduce its debt or increase its capital. Similarly, the payment of dividends based solely or largely upon gains resulting from unusual or nonrecurring events, such as the sale of the organization's building or the disposition of other assets, may not be prudent or warranted, especially if the funds derived from such transactions could be better employed to strengthen the organization's financial resources.

A fundamental principle underlying the Federal Reserve's supervision and regulation of bank holding companies is that bank holding companies should serve as a source of managerial and financial strength to their subsidiary banks. The Board believes, therefore, that a bank holding company should not maintain a level of cash dividends to its shareholders that places undue pressure on the capital of bank subsidiaries, or that can be funded only through additional borrowings or other arrangements that may undermine the bank holding company's ability to serve as a source of strength. Thus, for example, if a major subsidiary bank is unable to pay dividends to its parent company—as a consequence of statutory limitations, intervention by the primary supervisor, or noncompliance with regulatory capital requirements—the bank holding company should give serious consideration to reducing or eliminating its dividends in order to conserve its capital base and provide capital assistance to the subsidiary bank. . . .

This statement of principles is not meant to establish new or rigid regulatory standards; rather, it reiterates what for most banks, and businesses in general, constitutes prudent financial practice. Boards of directors should continually review dividend policies in light of their organizations' financial condition and compliance with regulatory capital requirements, and should ensure that such policies are consistent with the principles outlined above. Federal Reserve examiners will be guided by these principles in evaluating dividend policies and in formulating corrective action programs for banking organizations that are experiencing earnings weaknesses, asset quality problems, or that are otherwise subject to unusual financial pressures.

2020.5.2 INSPECTION OBJECTIVES

1. To assure compliance with statutes and the Board's November 1985, Policy Statement.
2. To determine reasonableness of dividend payout at both the subsidiary and holding company levels.

Depending on the type of charter and membership in the Federal Reserve, all insured commercial banks are subject to certain legal restrictions on dividends. In the case of nonbank subsidiaries and holding companies, there are no specific federal statutes, other than the policy statements discussed, which apply to dividend payments. State corporate laws would apply. One objective of the inspection process is to check for compliance with these laws and to follow-up on any violations.

In some cases dividends which comply with the regulations still may not be in the best interest of the bank. It is the examiner's responsibility to assess the reasonableness of dividend payments in relation to each subsidiary's capital

needs. Evaluation of the holding company's dividend policy and payment requires a review at both the parent company and the consolidated levels. On a consolidated basis the holding company's capital level in relation to the quantity and quality of total assets, earnings history and potential, and growth rates are important in the assessment of a reasonable dividend payout. At the parent level, the method of funding dividends should be reviewed. For example, a well capitalized corporation with strong earnings might pay dividends which could be considered unreasonable if the organization were in a strained liquidity position.

2020.5.3 INSPECTION PROCEDURES

1. Review dividend payments by subsidiaries and the parent company. Check for compliance with appropriate statutes and the Board's November 14, 1985 policy statement on the Payment of Cash Dividends. Discuss violations with management and comment on the "Examiner's Comments" page.

This step will often require a review of net earnings and changes in the capital accounts in the past years, as legal restrictions on dividends often apply to cumulative income for several years rather than just the year the dividend is actually paid. For this reason detailed working papers are important, as these can help to avoid duplications of effort at future inspections. In some situations the regulations provide that dividends may be paid in excess of current year's earnings. If prior approval from the bank's primary regulator is necessary, verify that it has been obtained. Any violations of dividend statutes should be discussed with management and cited in the "Examiner's Comments" page of the inspection report.

2. Analyze dividend payouts of subsidiaries and the parent in terms of capital adequacy, earnings and earnings potential.

Discuss excessive dividend payouts at any level with management and comment on the "Examiner's Comments" page of the inspection report. In assessing the reasonableness of dividend payments by subsidiaries and the holding company, the organization's capital adequacy and future capital needs must be judged with the following in mind: the volume of total assets; asset quality (the percentage of weighted classified assets to gross capital could be used as an indicator of quality); asset mix and liquidity; asset growth rates and projections; and plans for expansion and development of new areas. The subsidiary's or the holding company's ability to augment capital through earnings is also important. If a bank, nonbank or holding company has a consistently strong earnings record and its capital position is healthy, a higher dividend payout may be acceptable than would be otherwise. In analyzing the strength of earnings both quantity and quality must be considered. The actual quality of earnings and earnings potential are related to operating income rather than extraordinary items, significant capital or securities gains, or substantial increases resulting from tax considerations.

3. Review the funding of dividends paid by the holding company. Analyze the parent's cash flow and income statements in accordance with section 4010.0 of this manual. Discuss any inappropriate funding with management and comment on, based on their severity, either on the "Cash Flow Statement (Parent)," or the "Analysis of Financial Factors" and the "Examiner's Comments" pages.

An analysis of the parent company's cash flow statement supplemented by the income statement will identify the source of cash for dividend payments. The parent company has cash inflow from various sources including: dividends from subsidiaries, income from activities conducted for its own account, interest income on advances to subsidiaries, management and service fees, borrowings, and tax savings resulting from filing a consolidated tax return. Dividends should be internally funded from dividends paid by the subsidiaries, the parent company's earnings from activities for its own account or from interest income on advances to subsidiaries. Should the analysis of the cash flow statement indicate that dividends paid by the parent exceed cash inflow from these sources, further attention to the area is required to determine the actual underlying source of dividend funding. As discussed in the section on management and service fees, these are properly assessed at market value or cost of services rendered. They are not to be charged simply to divert income from subsidiaries in order to pay dividends. Borrowing to fund dividends is fundamentally an unsound practice.

When dividends paid by the holding company are funded by the bank subsidiary, it is possible to control indirectly the holding company's dividend payout level when it is determined to be detrimental to the bank subsidiary. It is important to remember that the primary responsibility of bank regulators is the promotion of safe and sound banking operations. Other

than the mentioned policy statement there are no specific federal laws restricting dividends paid by bank holding companies; however, the System's cease and desist authority over bank holding companies does afford the ability to curb excessive dividend payouts.

Whenever the examiner determines that dividend payments at the subsidiary level or parent level are not reasonable, are not in the best interest of the organization, or are not funded in a proper manner, discussion with management and a close look at its philosophy are essential. Remarks on the matter should appear on the "Examiner's Comments" page of the report.

2020.5.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Dividend limits for national banks	5199(b) R.S.A.			
Dividend limits	5204 R.S.A.			
Dividend limits for State member banks	Section 9, F.R. Act			
Capital limitations and earnings limitations on the payment of dividends by state member banks		208.19	3–400.81	
Board policy statement on assessment of financial factors, one bank holding companies (para. 4 dividend restrictions)			4–855	1980 FRB 320
Board policy statement on dividends for banking organizations having financial difficulties			4–877	1986 FRB 26

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

A bank holding company is permitted to own nonbank subsidiaries that furnish services to or perform services for its other subsidiaries pursuant to section 4(a)(2)(A), 4(c)(1)(C), or 4(c)(8) of the BHC Act. Many bank holding companies charge fees for providing to their subsidiaries services such as management advice, personnel services, data processing, marketing, supply administration, investment advice, bookkeeping, and trust services. The fees for these services that are assessed against subsidiary banks take many forms and are an area of potential abuse. In addition to direct fees paid to an affiliate, the compensation for providing these services might take the form of salaries or directors' fees paid to the bank holding company's management. A holding company should not, directly or indirectly through other subsidiaries, burden its bank subsidiaries with excessive fees or charge for services unrelated to value received in order to fund its debt service, dividend payments, or support of other subsidiaries.

Examiners should review the fees charged by a holding company's bank and nonbank subsidiaries to any banking subsidiary and judge the reasonableness of those fees by examining the reasonableness of the services provided and the basis for allocating fees. Fees charged nonbank subsidiaries and independent third parties should not be more favorable than fees charged banking subsidiaries. They should be reasonable and justifiable and be based on the fair market value of services provided or, when there is no market established for a particular service, on actual cost plus a reasonable profit. *The market value of similar services is the preferred basis of fee assessment.* When fees are based on cost plus a reasonable profit, there is less incentive for the efficient and effective use of resources, because a profit margin is built in regardless of the costs involved. In many situations, however, the cost method is the only method possible.

Any method of pricing services provided to bank subsidiaries that is based on anything other than value received is inappropriate. The fee mechanism should not be used to divert income from any bank subsidiary to meet the parent's financial needs if those needs are unrelated to the provision of services to that subsidiary. In addition, banks are prohibited from paying management fees* if it would cause the institution to become undercapitalized (see title I, section 131 of the FDIC Improvement Act of 1991 or section 38 of the FDIC Act).

Any fee for services to a banking subsidiary should be supported by evidence that the parent or other affiliate provided the service. Services provided by bank holding companies should serve the needs of the subsidiary bank; charges for services that appear to duplicate existing subsidiary-bank functions should be supported by a detailed explanation of the net benefit derived by the subsidiary bank and by an analysis of the reasonableness of the fee.

When it is impractical to allocate expenses on a direct-charge basis, bank holding companies frequently allocate overhead expenses to subsidiaries. Although this practice can be considered acceptable with regard to nonbanking subsidiaries, allocating all bank holding company expenses to bank subsidiaries is not permitted. The parent company should bear a portion of the costs connected with, for example, the holding company's investor/shareholder relations, regulatory reporting requirements, acquisitions, formations, applications, board of directors, and strategic planning. Bank holding companies are, however, expected to support their subsidiary banks, and expenses incurred to serve the needs of the subsidiary banks, such as expenses incurred in raising capital for subsidiary banks, can appropriately be allocated to those subsidiary banks that benefit from the services provided, in proportion to the benefit received from the service.

All fees for services rendered should be supported by written agreements that describe the service, the fees to be charged, and the method of allocating the fees among the subsidiaries. The absence of such contracts between the subsidiaries of the holding company is considered inappropriate and an unsafe and unsound banking practice. Supervisory action should be taken, in a manner consistent with the financial condition of the holding company and the subsidiary bank, to eliminate the improper practices. The practices should be criticized in the inspection report and actions taken to see that the situation is satisfactorily resolved. If the practices are having a serious impact on the bank, or if they might reasonably be expected to have a severe impact given the bank's financial condition, formal administrative action should be considered in order to require the holding company to terminate the practices and make restitution to the subsidiary bank.

* "Management fees" does not include fees for such services as electronic data processing or auditing.

A bank's prepayment of service fees to the parent company and payment of expenses incurred primarily in conjunction with holding company activities unconnected with the bank also are cause for supervisory concern. In general, prepayment for services is inappropriate unless the bank holding company can demonstrate that prepayment is standard industry practice for nonbanking companies acquiring the same service. Prepayment of sums for services that are not to be provided in the immediate future (for example, prepayment of an entire year's fees for services to be rendered throughout the year) can have an adverse impact on the bank and is therefore inappropriate. These practices should be addressed by requiring timely and reasonable payments for services and reimbursement to the banks for what are essentially holding company expenses. If bank expenses are incurred substantially in support of a holding company activity, the bank should be reimbursed for that portion of its cash outlay that benefits the holding company. Reimbursement is necessary to ensure that bank resources are not diverted to a holding company affiliate with little or no benefit to the bank.

Aside from reasonable and timely fees for services rendered, the most appropriate way, from a supervisory standpoint, for funds to be paid to the parent company is through dividends. This principle applies, in general, to bank payment of funds to service holding company debt, even when the debt was initially incurred to raise equity capital for the subsidiary bank. It is an inappropriate banking practice for the subsidiary bank to pay management fees for the purpose of servicing holding company debt. Funds for servicing holding company debt should, as a general rule, be upstreamed in the form of dividends.

2020.6.1 TRANSACTIONS SUBJECT TO FEDERAL RESERVE ACT SECTION 23B

Section 23B of the FRA applies to any covered transaction with an ''affiliate,'' as that term is defined in section 23A of the FRA. Section 23B also applies to a number of transactions that are not covered by section 23A, for example, transactions that involve the payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise, or transactions in which an affiliate acts as an agent or a broker or receives a fee for its services. Although transactions between sister banks and banks that are part of a chain banking organization are exempt from section 23B, section 23A requires that covered transactions between a bank and an affiliate be conducted at arm's length. See section 2020.1.2 for other transactions that are covered by section 23B and the requirements that pertain to all such transactions. For examples of transactions that could violate section 23B, see section 3700.10, dealing with an application to provide armored car services through a bank holding company's nonbank subsidiary.

2020.6.2 INSPECTION OBJECTIVES

1. To determine whether the holding company and its subsidiaries charge fees to bank subsidiaries based on value received and fair market value.
2. To determine whether the subsidiaries are actually receiving these services.
3. To determine that the timing of fee payments is appropriate.
4. To determine whether there is an agreement between the entities relating to specific services and fees charged.
5. To determine if any fees result in an unsafe or unsound condition in any subsidiary bank.

Once the management policy underlying the fee structure is clearly understood, it is important for the examiner to determine that practice is consistent with policy. For example, if management indicates that fees charged are based on the fair market value of services received but the fee structure is actually geared to the bank subsidiary's asset size, an inconsistency exists. Assuming either that all of the bank subsidiaries have access to the same or similar markets for the services being provided by the bank holding company or that cost is used consistently to determine pricing, the established pricing structure should be used for all subsidiaries. Deviations from established policy intended to channel a greater proportion of income from financially sound banks to financially weak ones should be noted.

When it has been established that the fee structure is reasonable and is consistently followed, a final question remains. Are the bank subsidiaries actually receiving the services for which they are charged? This may be difficult to ascertain in many cases, but serious efforts must be made.

It is important that the basic business principles of an arm's-length transaction be applied to

all transactions between banks and their affiliates. This approach provides protection for all the interests involved. In addition, payment should be made within a reasonable time of the rendering of the services. It is inequitable for the bank subsidiary to pay fees far in advance in order to suit the parent's cash needs. A clearly understood agreement between the holding company and its bank subsidiaries detailing the duties and responsibilities of each party and the method to be used for fee assessment is also important to the servicing arrangement.

2020.6.3 INSPECTION PROCEDURES

1. Review and analyze the policy regarding management and other services provided to bank subsidiaries and the method of assessing fees.
2. Determine the basis for valuation.
3. Review the actual pricing structure as it is applied.
4. Verify the following:
   a. Fees are charged in accordance with pricing structure.
   b. Pricing structure is consistently applied for all bank subsidiaries.
   c. Bank subsidiaries are actually receiving services for which they are assessed. Determine whether fee payments have caused the institution to become undercapitalized.
   d. Payments are made in a timely manner.
5. Review examination reports on bank subsidiaries for comments on fee assessment.
6. Analyze the parent company's cash flow and income statements for intercompany fees.
7. Review recordkeeping.

A review of management's written or stated policy regarding services provided subsidiaries and fee assessment is a logical starting point for the analysis of this area. The policy should be discussed with the holding company's officers to ensure that the examiner has a clear understanding of the purpose and basic underlying philosophy. Any policy that calls for fee assessment based on standards other than fair market value or the cost of providing the services requires discussion with management and comment on page 1 of the report.

The determination of fair market value or cost of providing services is the responsibility of the holding company. The examiner should review the market or cost information used to justify the pricing of services and be satisfied that the data presented actually supports the fee structure. Request a copy of the pricing schedule as it is applied, and determine that it is actually based on the valuation of the services received and consistent with stated policy. Any variations from the basic structure among the bank subsidiaries would also require support from the market or cost data furnished.

Once the holding company's policy, valuation data, and pricing structure are analyzed, they should be verified. Check the service at the bank-subsidiary level. The verification process can be modified as deemed appropriate by the examiner.

Note the timing of payment for services. Fees for services should be billed and paid as they are received, just as they would be with an unaffiliated servicer. Prepayments are inappropriate in most cases.

Written service agreements should be in effect specifically detailing the types and extent of services being rendered and the method of pricing. Any significant exceptions found during the verification process merit follow-up and comments in the report.

Thus far, these inspection procedures for management and service fees have emphasized a review of management's stated intent and the actual fees charged on the individual bank-subsidiary level and have been somewhat oriented toward micro-level analysis. An overall view of the parent company's cash flow and income statements can also provide certain indicators of appropriateness of fees. The parent company should be servicing its debt and paying dividends from sources other than management fees and service fees collected from bank subsidiaries. If the ratio of management and service fees to parent-company salaries and other expenses significantly exceeds 100 percent, the holding company could be charging fees that are unrelated to the value of the service. This situation would call for further investigation.

2020.6.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Statement of practice and procedure in reference to unsound banking practices; diversion-of-bank-income practices (SR-79-533, March 19, 1979)			4–876	
Potential violations of section 23B of the Federal Reserve Act: 1. Proposal by a bank holding company to provide armored car services to its banking subsidiary through a de novo nonbank subsidiary. The cost of the service would be more than the cost of armored car services currently received from an unaffiliated provider. 2. Proposal whereby the bank holding company's de novo nonbanking subsidiary would pay a flat fee based on a percentage of its direct operating expenses to cover all the back-office services provided by the holding company's banking subsidiary.				1993 FRB 352

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The transfer of low-quality loans or other assets from one depository institution to another can be reason for supervisory concern. Such transfers may be made to avoid detection and classification during regulatory examinations, and may be accomplished through participations, purchases/sales, and asset swaps with other affiliated or nonaffiliated financial institutions. Section 23A of the Federal Reserve Act prohibits bank purchases of low-quality assets from an affiliate. Examiners should be alert to situations where an institution's intention appears to be the concealment of low quality assets for the purpose of avoiding examination scrutiny and possible classification.

During bank holding company inspections, examiners are requested to identify situations where low-quality assets have been transferred between the institution being examined and another depository institution. Low-quality loans broadly defined include loans which are classified or specially mentioned, or if subjected to review would most likely be classified or specially mentioned, past due loans, nonaccrual loans, loans on which the terms have been renegotiated because of a borrower's poor financial condition, and any other loans which the examiner feels are of questionable quality. Other assets of questionable quality would include depreciated or sub-investment grade securities and other real estate. The transfer of assets to avoid supervisory review is a highly improper and unsound banking practice and may be a violation of section 23A of the Federal Reserve Act that should be addressed through formal supervisory enforcement action, if necessary.

Any situations involving the transfer of low-quality or questionable assets should be brought to the attention of Reserve Bank supervisory personnel who, in turn, should notify the local office of the primary Federal regulator(s) of the other depository institution(s) involved in the transaction. For example, Reserve Banks should notify the primary Federal regulator of any depository institution to whom a State member bank or holding company is transferring or has transferred low quality loans. Reserve Banks should also notify the primary regulator of any depository institution from which a State member bank or holding company is acquiring or has acquired low-quality loans. This procedure applies to transfers involving savings and loan associations and savings banks, as well as commercial banking organizations.

If it is determined that a transfer of assets was undertaken for legitimate reasons, the examiner should make certain that the assets have been properly recorded on the books of the acquiring institution at fair market value. If the transfer was with the parent holding company or a nonbank affiliate, determine that the transaction is also properly recorded on the books of the affiliate. Refer to SR Letter 83–24 (FIS).

2020.7.1 INSPECTION OBJECTIVES

1. To ensure that loan transfers involving state member banks, bank holding companies, and nonbank affiliates are carefully evaluated to determine if they were carried out to avoid classification, and to determine the effect of the transfer on the condition of the institution and to ascertain whether the transfer was consistent with the requirements of Section 23A. Under section 23A of the Federal Reserve Act, an asset purchase is a "covered transaction." All "covered transactions" by a bank with a single affiliate and with all affiliates combined may not exceed 10 percent and 20 percent, respectively, of a bank's capital and surplus.
2. To ensure that the primary regulator of the other financial institution involved in the transfer is notified.

2020.7.2 INSPECTION PROCEDURES

1. Investigate any situations where assets were transferred prior to the date of examination to determine if any were transferred to avoid possible criticism during the examination.
2. Determine whether any of the loans transferred were nonperforming at the time of transfer, classified at the previous examination, or for any other reason were considered to be of questionable quality.
3. Review the policies and procedures to determine whether or not assets or participations purchased are given an independent, complete and adequate credit evaluation. If a bank is a holding company subsidiary or a member of a chain banking organization, review asset purchases or participations from affiliates or other known members of the chain to determine if the asset purchases are given an *arms-length* and *independent* credit evaluation by the purchasing bank.
4. Determine whether or not any purchases

of assets from an affiliate are in conformance with section 23A which generally prohibits purchases of low-quality assets from an affiliate and limits asset purchases and all other "covered transactions" by a bank from a single affiliate and all affiliates combined to 10 percent and 20 percent, respectively, of a bank's capital and surplus.

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

6. Determine that transactions involving transfers of low- quality assets to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and the holding company affiliate.

7. If poor quality assets were transferred to or from another financial institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary Federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:

- Name of originating and receiving institutions.
- Type of assets involved and type of transfer (i.e., participation, purchase/sale, swap).
- Date(s) of transfer.
- Total number and dollar amount of assets transferred.
- Status of the assets when transferred (e.g., nonperforming, classified, etc.)
- Any other information that would be helpful to the other regulator.

Intercompany Transactions (Trade Name or Royalty Fees) Section 2020.8

A bank holding company may be assessing trade-name or royalty fees on its subsidiary banks for their use of the holding company's name. Such holding companies may assert that the trade name-licensing agreements were created to achieve certain state tax benefits. They may also claim that such agreements were implemented to establish a basis for any damages that the company might seek if its trade name is used by an unauthorized third party. Further, consultants may try to market this practice to other bank holding companies.

Such payments are unlikely to bear any reasonable or justifiable relationship to any tangible asset or service provided by a holding company to a subsidiary bank. They are thus considered an improper diversion of bank income. If this practice is found during the course of an inspection, the practice should be stopped and examiners should direct the parent company to reimburse subsidiary banks for the fees paid. Depending on the materiality of the trade name or royalty fees, the Reserve Bank may also require restatement of regulatory filings. See SR-91-3.

Split-dollar life insurance is a type of life insurance in which the purchaser of the policy pays at least part of the insurance premiums and is entitled to only a portion of the cash surrender value, or death benefit, or both. See SR-93-37 and its attachments for further discussion of the Federal Reserve's position on such arrangements between bank holding companies and their subsidiary banks.

2020.9.1 SPLIT-DOLLAR LIFE INSURANCE POLICY ARRANGEMENTS

Certain split-dollar life insurance policy arrangements involving banks and their parent bank holding companies raise legal and safety-and-soundness concerns. These arrangements fall into two general categories: (1) those in which the subsidiary bank owns the policy, pays all or substantially all of the premiums and is reimbursed for the premium payments (if at all) at some time in the future (endorsement plans) and (2) those in which the parent holding company owns the policy, and pays the premium, but uses the insurance policy as collateral for loans from its subsidiary bank (collateral assignment plans).

2020.9.1.1 Split-Dollar Life Insurance Endorsement Plan

Under an endorsement plan, the subsidiary bank purchases a policy in which its parent bank holding company or an officer, director, or principal shareholder thereof is the primary beneficiary, rather than the bank or one of its officers or directors. In this instance, the subsidiary bank receives only a limited portion of the death benefit—usually an amount equal to its premium payments plus interest. The primary beneficiary—the holding company or one of its officers, directors, or principal shareholders—receives a majority of the insurance proceeds but pays little or nothing for the benefit. Many of the policies in this category are single-premium universal life policies, whereby the subsidiary bank pays one large lump sum premium payment for the policy. Generally, a subsidiary bank involved in an endorsement plan records the cash surrender value of the policy as an asset on its books; the bank holding company does not record anything at the parent-only level.

A variation of the endorsement plan is an arrangement in which the bank pays an annual premium towards the policy and the parent holding company reimburses the bank for a nominal amount of the annual premium payments. These amounts are substantially lower than the premium payments made by the subsidiary bank and therefore do not accurately reflect the economic benefit derived by the holding company as primary beneficiary of the insurance policy.

2020.9.1.2 Split-Dollar Life Insurance Collateral Assignment Plan

Under a collateral assignment plan, the parent bank holding company owns the policy and pays the entire premium. The subsidiary bank makes annual loans to the bank holding company in an amount equal to the annual increase in the cash surrender value of the policy (or, in some cases, in amounts equal to premiums paid) with the policy itself serving as collateral for the loan. The loans are repayable at either the termination of employment or the death of the insured employee, and will be paid using the death benefits available from the policy.

2020.9.2 COMPLIANCE WITH APPLICABLE LAWS

2020.9.2.1 Compliance with Sections 23A and 23B of the FRA

Both of the aforementioned types of split-dollar life insurance policy arrangements may be inappropriate if they are inconsistent with sections 23A or 23B of the Federal Reserve Act (FRA). Section 23A places quantitative restrictions and other requirements on certain transactions, including loans, between banks and their affiliates. The statute also requires that loans between banks and their affiliates be secured with collateral having a specified market value that depends on the type of collateral used to secure the loan. Under an endorsement plan, where the subsidiary bank pays all or substantially all of the insurance premiums, an unsecured extension of credit from the subsidiary bank to its parent holding company generally results because the subsidiary bank has paid the bank holding company's portion of the premium, and the bank

will not be reimbursed fully for its payment until sometime in the future.

Under a collateral assignment plan, if the insurance policy held by the parent bank holding company serves as collateral to secure a loan from its subsidiary bank, the loan may be a violation of section 23A unless it meets the quantitative requirements of section 23A and the cash surrender value of the insurance policy used as security is equal to 130 percent of the amount of the loan. Thus, a bank loan to the parent bank holding company that equals the cash surrender value of the insurance policy that is serving as collateral would not be adequately secured under section 23A, unless additional collateral was provided.

Both categories of split-dollar life insurance policy arrangements may also lead to violations of section 23B of the Federal Reserve Act, which requires that certain transactions involving a bank and its affiliates be on terms and under circumstances substantially the same or at least as favorable to the bank as those prevailing at the time for comparable transactions with or involving nonaffiliated companies. Because the bank holding company is the beneficiary of the life insurance policy, it is a participant in a transaction between a bank and a third party; therefore, the split-dollar life insurance transaction must meet the standards of section 23B.[1] In order to conform to the statutory restrictions of section 23B, the return to the bank from ownership of the policy should be commensurate with the size and nature of its financial commitment. In most split-dollar insurance arrangements, the bank makes an investment in the policy not for the purpose of insuring itself against risk but for the purpose of obtaining insurance for its holding company. The only return that the bank will get from its participation in ownership of the policy is the return of its initial investment and possibly some interest. However, the insurance company deducts the cost of maintaining the insurance coverage from interest that would otherwise be credited to the equity in the policy. These costs include policy loads, surrender charges, and mortality costs. The holding company should fully reimburse the bank for all of these charges. Examiners should carefully evaluate these arrangements because, in many cases, the reimbursement the bank receives from the holding company is based on an implied value of the insurance coverage received by the holding company that is less than the assessments made to the policy equity.

In the process of evaluating split-dollar insurance arrangements, examiners should keep in mind the fact that the advances made by a bank to purchase the insurance are the equivalent of a loan to the holding company. Therefore, to comply with section 23B, the terms of the loan, such as its duration and interest rate, must be on market terms.

1. The Federal Deposit Insurance Corporation has taken the same position in a published interpretive letter, FDIC 92-40, dated June 18, 1992.

2020.9.2.2 Investment Authority Under the National Bank Act

Participation by bank holding companies and their state-chartered and national bank subsidiaries in split-dollar life insurance policy arrangements may also raise concerns whether the policies are permissible bank investments under section 24(7) of the National Bank Act. The Office of the Comptroller of the Currency's interpretation of this provision of the National Bank Act (OCC Banking Circular 249, May 9, 1991).[2] In addition, under section 24 to the Federal Deposit Insurance Act, a state-chartered bank generally may not, without the FDIC's permission, engage in any activity that is impermissible for a national bank.[3]

2020.9.3 SAFETY-AND-SOUNDNESS CONCERNS

The purchase of a split-dollar life insurance policy may also constitute an unsafe and unsound banking practice involving the diversion of bank income or assets. If a subsidiary bank pays the entire insurance premium but is not the beneficiary, it provides an economic benefit to its parent holding company or other beneficiary for which it is not being adequately reimbursed or compensated. In this instance, the bank loses the opportunity to use its assets productively. Generally, the bank pays the premium in return for the insurance company's payment of the entire proceeds. When the bank receives less than the entire proceeds, it has, in effect,

2. National banks may not purchase life insurance as an investment. See OCC Banking Circular 249, for the tests under which life insurance may be purchased and held for noninvestment purposes.

3. SR-92-97 (FIS) and SR-92-98 (FIS), dated December 16 and 21, 1992, respectively, describe the provisions of section 24 of the Federal Deposit Insurance Act.

paid a higher than market price for whatever limited benefit it may receive. This is also the case when the primary beneficiary of the policy is an officer, director, or principal shareholder of the parent holding company. Such an arrangement is not consistent with safe and sound banking practices because the subsidiary bank is conferring an economic benefit on an insider of the parent bank holding company without receiving adequate compensation.

2020.9.4 EXAMINER REVIEW OF SPLIT-DOLLAR LIFE INSURANCE

Examiners should be fully aware of the problems inherent in split-dollar life insurance policy arrangements between bank holding companies and their subsidiary banks. During the course of all bank examinations and bank holding company inspections, examiners should review corporate life insurance policy arrangements for compliance with applicable banking laws and safety-and-soundness standards.[4] If a split-dollar life insurance policy arrangement exists in either a bank holding company or a state member bank, it should be reviewed and modified if it does not comply fully with the law and principles of safe and sound banking. If a bank holding company or a state member bank fails to take appropriate action to bring its split-dollar life insurance policy arrangements into compliance, then the Reserve Bank should consider appropriate follow-up supervisory action (including a formal enforcement action) against the banking organization or its institution-affiliated parties, or both.

2020.9.5 INSPECTION OBJECTIVES

1. To determine if split-dollar life insurance arrangements between the parent holding company and its subsidiary banks are consistent with the provisions of sections 23A and 23B of the FRA.

4. Examiners conducting examinations of U.S. branches and agencies of foreign banks and Edge corporations should also be alerted to the problems associated with split-dollar life insurance arrangements because these institutions could purchase insurance for the benefit of a parent foreign bank or company, or one of the parent's officers or directors. In addition, section 7(h) of the International Banking Act of 1978 prohibits state-licensed branches or agencies from engaging in any activity that is impermissible for a federal branch unless the Board determines that such activity is consistent with "sound banking practice" and, in the case of an FDIC-insured branch, the FDIC determines that the activity poses no significant risk to the deposit insurance fund.

2. To ascertain whether participation by bank holding companies and their national bank or state-chartered bank subsidiaries is consistent with section 24(7) of the National Bank Act and section 24 of the Federal Deposit Insurance Act.

3. To verify the cash surrender values of split-dollar life insurance policies and to establish whether those values have been impaired by loans to, liens by, or assignments to, third parties or by unauthorized borrowings or cancellations.

2020.9.6 INSPECTION PROCEDURES

1. Review corporate life insurance policy arrangements between the parent company and its subsidiary banks.
   a. Determine if there are split-dollar life insurance arrangements between any subsidiary bank and the parent company or officers or directors of the parent company.
   b. If any such insurance arrangement exists, establish if the plan is either an endorsement plan or a collateral assignment plan.
   c. Review arrangements involving a split-dollar life insurance policy purchased by the parent company.
      (1) Review external documentation evidencing the cash surrender value. If no documentation exists, ask the audit committee and its internal auditors—
         (a) to obtain external documentation verifying its value and
         (b) to verify that there are no outstanding loans, liens, or assignments against the insurance policies.
      (2) Establish whether the parent company's board of directors has established policies and implemented procedures for transactions between the insurance carrier and the parent company to prevent unauthorized borrowing or cancellation of any insurance policy that has a cash surrender value.
      (3) Determine whether the corporate life insurance policy arrangements are consistent with applicable safety-and-soundness standards.
      (4) Verify that the recorded value of the respective asset is equal to the unimpaired cash surrender value of the asset.

2. If an endorsement plan arrangement is purchased by a subsidiary bank, establish whether the bank holding company is the beneficiary. If the parent company is the beneficiary, such an arrangement may result in an unsecured exten-

sion of credit when the subsidiary bank pays all or substantially all of the insurance premiums but is not reimbursed until some time in the future. Ascertain if the investment return to the bank from ownership of the policy is commensurate with the size and nature of its financial commitment.

3. If a collateral assignment plan (when the insurance policy held by the parent company serves as collateral to secure a loan from a subsidiary bank), ascertain whether the cash surrender value of the insurance policy is equal to 130 percent of the amount of the loan.

4. For both types of split-dollar life insurance:

a. Determine if the investment return from ownership of the policy is commensurate with the size and nature of the financial commitment, including all costs incurred for maintaining the insurance coverage.

b. Determine if the terms (duration and market interest rate) of the advances made to purchase the insurance are on market terms.

c. If the bank holding company is the beneficiary of a bank insurance policy and a bank is a participant in the purchase of the insurance from a third party, determine if the transaction was on terms and under circumstances that were substantially the same as or at least as favorable to the bank as those then prevailing for comparable transactions with or involving nonaffiliated companies.

2020.9.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Split-dollar life insurance:				
1. Endorsement plan: When a subsidiary bank has paid all the BHC's portion of the premium and the bank will not be reimbursed until some time in the future, a loan results that must be secured.	371c, FRA section 23A			
2. Collateral assignment plan securing a loan: Cash surrender value must be 130 percent of the loan.	371c, FRA section 23A			
3. Both plans:				
a. Transactions must be on terms and under circumstances substantially the same as those prevailing for third-party transactions.	371c, FRA section 23B			

2020.9.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
b. When the BHC is the beneficiary, the bank's investment return from the split-dollar life insurance policy should be commensurate with the size and nature of the financial commitment.	371c-1, FRA section 23B			
Split-dollar life insurance premiums paid by a bank on behalf of an executive officer of the bank are not deemed an extension of credit for purposes of Regulation O, if the officer reported the premiums as taxable compensation to the IRS.			Regulation O staff opinion 3-1081.3	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The history of bank holding company legislation reflects a principle that banking and commerce should be separated in order to prevent abuses in the distribution of credit. The 1956 Act generally required companies to divest their nonbank activities and shares within two years. In the 1970 Amendments, the same requirement applied to companies formed in the future. However, one-bank holding companies in existence at the time of these amendments were given a "grace period" to comply with divestiture requirements of the legislation. Those companies whose bank and nonbank interests had been combined on or before June 30, 1968, were permitted to continue the existing combination for an indefinite period (indefinite or permanent grandfather privileges). But those BHCs which existed at the time of the 1970 Amendments, but whose bank was acquired or whose nonbank activity was initiated after June 30, 1968, were permitted to continue their nonbank activities for only 10 years until December 31, 1980. An exception to the divestiture deadline existed with respect to certain real estate holdings.

Because of Congressional concern about the effectiveness of a divestiture, Congress included section 2(g) in the Act, and particularly subsection 2(g)(3) which treats the transfer of control. In this section, care is taken to eliminate possible control relationships between the company and its divested assets.

Although indefinitely grandfathered companies may continue to engage in nonbanking activities, these grandfather privileges are subject to review by the Federal Reserve Board at the time when a company's banking assets exceed $60 million.[1]

2030.0.1 INDEFINITE GRANDFATHER PRIVILEGES

Under the provisions of section 4(a)(2) of the Act, as amended in 1970, relating to grandfather privileges for certain nonbanking activities of bank holding companies, the Reserve Banks have been delegated the authority to determine that termination of grandfathered activities of a particular bank holding company is not warranted; provided, the Reserve Bank is satisfied that all of the following conditions are met:

1. The company or its successor is ''a company covered in 1970;''
2. The nonbanking activities for which indefinite grandfather privileges are being sought do not present any significant unsettled policy issues; and
3. The bank holding company was lawfully engaged in such activities as of June 30, 1968 and has been engaged in such activities continuously thereafter.

A company covered in 1970 is defined in section 2(b) of the Act as ''a company which becomes a bank holding company as a result of the enactment of the Bank Holding Company Act Amendments of 1970 and which would have been a bank holding company on June 30, 1968, if those amendments had been enacted on that date.'' The Board has also determined that the company must have owned at least 25 percent of the voting shares of the same subsidiary bank on June 30, 1968, and December 31, 1970, in order to qualify as a company covered in 1970. If a company was not actively engaged in a nonbank activity prior to June 30, 1968, either directly, or indirectly through a subsidiary, it may still qualify for indefinite grandfather privileges if the company had entered into a binding contract prior to June 30, 1968. The binding contract must be a written document which specifies that the company (or its subsidiary) or persons representing the company will purchase another company which is already engaged in the activity.

Within two years after the subsidiary bank of an indefinitely grandfathered company attains banking assets in excess of $60 million, the status of the company's grandfather privileges is subject to review to determine whether the rights should remain in effect or be terminated. The Board or Reserve Bank may also review any company's grandfather privileges and terminate them if it determines that such action is necessary to prevent (1) undue concentration of resources, (2) decreased or unfair competition, (3) conflicts of interests, or (4) unsound banking practices. Moreover, when a company applies for approval of an acquisition, it may expect the Board or Reserve Bank to review the legitimacy of its grandfather privileges.

1. Effective October 20, 1981 the Board amended its Rules Regarding Delegation of Authority to delegate to the Reserve Banks authority to make these determinations regarding indefinite grandfather privileges.

2030.0.2 ACTIVITIES AND SECURITIES OF NEW BANK HOLDING COMPANIES

A company that becomes a bank holding company may, for a period of two years, engage in nonbanking activities and control voting securities or assets of a nonbank subsidiary, if the bank holding company engaged in such activities or controlled such voting securities or assets on the date it became a bank holding company. The Board can grant requests for up to three one-year extensions of the two-year period. This is in accordance with a December 1983 revision to Regulation Y (12 C.F.R. 225.22(e)). The regulatory provision implements Section 4(a)(2) of the BHC Act.

2030.0.3 LIMITATIONS ON EXPANSION OF GRANDFATHER RIGHTS FOR INSURANCE AGENCY NONBANKING ACTIVITIES OF BANK HOLDING COMPANIES

Refer to Manual section 3170.0.3.4.1.

2030.0.4 SUCCESSOR RIGHTS

When a bank holding company transfers its bank shares to another company in a manner that produces no substantial change in the control of the bank, the transferee qualifies under section 2(e) of the Act as a ''successor.'' The ''successor'' provision prevents a bank holding company from transferring its bank to some other organization. A successor is considered a bank holding company from the date the transferor became a bank holding company. Thus, it may hold the same grandfather privileges as its predecessor. By the same token, it becomes subject to any conditions or restrictions, such as divestiture requirements, imposed by the System upon its predecessor. For example, an irrevocable declaration filed by the predecessor would be binding upon the successor.

2030.0.5 EXPANSION OF GRANDFATHER ACTIVITIES

Grandfather privileges apply to activities, not to companies. As a general rule, these activities are permitted to be expanded through internal growth; however, there are a few exceptions. See Appendix 1 in this section.

In Appendix 1 it is important to distinguish between a purchase in the ordinary course of business and a purchase, in whole or in part, of a going concern. Each of the following conditions must be satisfied in order for the transaction to be in the ''ordinary course of business,'' which is permissible: (1) less than a substantial amount of the assets of the company to be acquired must be involved; (2) the operations of the purchased company must not be terminated or substantially discontinued; (3) the assets acquired must not be significant in relation to the size of the same line of nonbank activity already in the holding company (an acquisition is deemed significant if the book value of the acquired nonbank assets exceeds 50 percent of the book value of the nonbank assets of the holding company or nonbank subsidiary comprising the same line of activity); (4) if the transaction involves the acquisition of assets for resale, the sale must be a nominal business activity of the acquiring company; and (5) the major purpose of the transaction must not be to hire essentially all of the seller's principal employees who are expert, skilled and experienced in the business of the company being acquired. If any of these five conditions is not satisfied, the transaction may be considered to be an acquisition of a going concern, which is not permissible without prior approval. Refer to 12 C.F.R. 225.132.

2030.0.6 DIVESTITURES *(also see Manual section 2090.6)*

The act specifies the time in which a company must divest of any impermissible activity. Any company becoming a bank holding company subsequent to the 1970 Amendments has two years in which to divest its impermissible activity. The Act allowed a temporarily grandfathered company ten years from December 31, 1970, to divest of its impermissible activities, except certain real estate holdings discussed earlier; and allows indefinitely grandfathered companies ten years from the date on which grandfather privileges are terminated by the Board or Reserve Bank, should they be terminated for good cause.

As mentioned earlier, reviews of a company's grandfather privileges may be precipitated by such circumstances as: (1) a subsidiary bank of an indefinitely grandfathered company attaining assets in excess of $60 million (reviewed within two years); (2) a company seeking approval to engage in another activity or acquire another

bank; (3) a company which violates the Act; or (4) a company operating in a manner which results in an undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices.

When a company has filed an application requiring the Board's or Reserve Bank's approval, the Board or Reserve Bank may approve the application subject to the condition that the company divest of certain grandfathered shares or assets within a specified time period. The specified time period generally will be shorter than the aforementioned time periods stipulated in the Act.

The plan of divestiture should have provided for the removal of any control relationship between the company and its divested activities. These control requirements, as outlined in section 2(g) of the Act, include one or more of the following: (1) no interlocking directorates; (2) ownership of less than 25 percent of the voting shares by the BHC and related parties; (3) no interlocking management positions in policymaking functions; (4) no indebtedness between the transferor and the transferee; (5) no agreement or understanding which restricts the voting privileges of shares. Further discussion of these and other control requirements and issues is found in Manual sections 2090.1 and 2090.6.

2030.0.7 INSPECTION OBJECTIVES

1. To determine when the company acquired its subsidiary bank.
2. To determine when the company commenced its nonbanking activities and whether these activities were conducted continuously thereafter.
3. To determine if the banking assets of a bank controlled by a holding company with indefinite grandfather privileges have reached $60 million.
4. To determine if a change of ownership or control of the company has taken place, and whether the transferee qualifies as a "successor."
5. To determine if expansions of grandfathered activities occurred in accordance with the Act.

2030.0.8 INSPECTION PROCEDURES

1. If necessary, examine the subsidiary bank's stock certificate book to determine when the company acquired 25 percent or more of the bank.
2. Review the minute books and historical financial records of the company and its subsidiaries for evidence of the date of commencement of any nonbank activity and its continuation thereafter. In particular, the financial records should reflect the activity's impact as either an asset and/or an income item. From these records, also determine whether there has been expansion of the activity and whether such expansion complies with the Act.
3. If necessary, review the latest quarterly Call Report of Condition for the subsidiary bank to determine whether total assets exceeded $60 million. If appropriate, advise management that its grandfather status is subject to review.
4. If necessary, examine the stock certificate records and minutes of the bank or BHC to determine if the bank's shares have been transferred from one bank holding company to another in such a manner that the transferee qualifies as a successor.
5. Upon review of the aforementioned records, discuss the status of the company's grandfather privileges with the Reserve Bank's management, if necessary.
6. If divestment is required, encourage its execution as soon as possible during the divestment period. Request a divestment plan which specifies the manner by which divestment will be accomplished, the specific steps necessary to effect the divestment, and the time schedule for taking such steps. Advise management that failure to divest within the prescribed time period will be viewed as a violation of the Act.

2030.0.9 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Divestment of activities which are temporarily grandfathered			S-2346 February 15, 1977	
Escrow agreements used in divestiture				1976 FRB 151
Companies with temporarily grandfathered activities encouraged to submit plans by June 30, 1978				1977 FRB 962
Divestment policies	4(a)(2)			1977 FRB 263
Denial of grandfather rights for activities which were shifted from subsidiary bank to nonbank subsidiary				Whitney Holding Corporation, New Orleans, Louisiana; April 27, 1973
Denied continued ownership of a savings and loan association, despite permanent grandfather rights				D.H. Baldwin Company, Cincinnati, Ohio; February 22, 1977
Discussion of indefinite grandfather rights acquired through the indirect power to exercise a controlling influence				Patagonia Corporation, Tucson, Arizona; February 24, 1977
Denial of grandfather rights on additional stock acquired after June 30, 1968, for lack of a controlling influence over the subsidiary as of June 30, 1968				Patagonia Corporation, Tucson, Arizona; July 6, 1973
Successor rights				Republic of Texas Corporation, Dallas, Texas; October 25, 1973

Subject	Laws [1]	Regulations [2]	Interpretations [3]	Orders
Interprets "Company covered in 1970" and "Successor"				American Security Corporation, Washington, D.C.; July 21, 1976
Review of grandfather rights as a result of subsidiary bank reaching $60 million in total assets				Colorado Funding Company, Denver, Colorado; September 9, 1977
Review of grandfather rights as a result of subsidiary bank reaching $60 million in total assets—charitable trust involved				General Education Fund, Inc., Burlington, Vermont; September 13, 1977
Companies going out of business are not going concerns				Senate Report 90–1084, page 5524
Failing companies are not going concerns				1974 FRB 725
Ownership of less than 25 percent of a nonbanking company represents an investment rather than a subsidiary				1973 FRB 539
Divestitures		225.138 and 225.140		
Extension of divestiture deadline for real estate interests	Monetary Control Act of 1980 Section 701(b)			
Delegation of authority to Reserve Banks re: Indefinite Grandfathered activities		265.2(f)(42)		1981 FRB 856 and 860

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Activities and securities of new bank holding companies		225.22(e)		
Denial of a BHC acquisition—"successor"				1984 FRB 667
Acquisition of assets		225.132		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

2030.0.10 APPENDIX 1—EXPANSION OF GRANDFATHERED ACTIVITIES

Permissible Type of Expansion	*Without Approval*	*Requires Approval*
FOR COMPANIES WITH AN INDEFINITELY GRANDFATHERED NONBANK ACTIVITY		
1. Opening of additional offices of existing subsidiary	X	
2. Acquisition of assets in the "ordinary course of business" as defined	X	
3. Acquisition of a going concern:		
a. Additional shares of the grandfathered nonbanking subsidiary	X	
b. Additional shares of a nonbanking company which is regarded as an investment (generally companies in which the holding company has an interest of between 5 and 25 percent)		X
c. Initial acquisition of shares of any other company engaging in the activity		X

Commitments to the Federal Reserve

Section 2040.0

Commitments to the Board arise most often through the application process. Many commitments are included within the text of accompanying Board orders or letters transmitted to the applicants. Commitments can also arise through the supervisory process. Commitments should be specific and furnished in written form.

The most common type involves a commitment to inject capital (either equity or debt capital) into the company or subsidiary to be acquired or possibly into other subsidiaries of the bank holding company. The required injections may be for a specific dollar amount or for an unspecified amount necessary to achieve a predetermined capital relationship. Determining compliance with such commitments is generally not difficult since an agreed upon quantifiable result must be achieved.

Types of commitments made to the Board in the past include: divestiture of nonpermissible stock holdings or activities; introduction of new services; and reduction or elimination of dividends or management fees from subsidiaries.

Several of the above forms of commitments are rather difficult to monitor due to their inexact nature. The examiner should determine in such cases whether good faith compliance efforts have been made. Where an order approving an application imposes specific conditions, however, compliance is of the utmost importance since a conditional order is based on the theory that such conditions were necessary to eliminate or outweigh adverse factors. Willful noncompliance in these cases might necessitate the use of cease-and-desist powers to prevent evasion of the purposes of the Act. Pursuant to the Board's request, each Reserve Bank reports semi-annually on the status of all outstanding commitments made by holding companies in its District.

2040.0.1 INSPECTION OBJECTIVES

1. To determine that the bank holding company is taking the necessary steps to fulfill any outstanding commitments as scheduled.
2. To determine whether additional commitments or conditions should be imposed to achieve complete compliance.
3. To determine whether a request for an extension of time to fulfill any outstanding commitment is warranted.

2040.0.2 INSPECTION PROCEDURES

1. Review semi-annual commitment reports to the Board for commitments fulfilled since the last inspection. Determine whether such commitments were completed as required.
2. Review with management any actions taken to comply with outstanding commitments or plans to effect fulfillment.
3. If warranted, initiate action to consider an extension for compliance on outstanding commitments.

2050.0.1 BHC OFFICIAL AND RELATED INTEREST TRANSACTIONS BETWEEN THE PARENT COMPANY OR ITS NONBANK SUBSIDIARIES

Business transactions between a parent bank holding company or its nonbank subsidiary and a BHC official or a BHC official's related interests require close supervisory review. "Bank holding company official" is defined as any director, executive officer, or principal shareholder of the parent company or any of its subsidiaries, excluding the subsidiary bank's nonbank subsidiaries.

Most of these transactions are soundly structured and have a legitimate business purpose that result in equitable treatment for all parties. However, examiners should pay close attention to all extensions of credit by a BHC or its nonbank subsidiary to a BHC official or related interest to ensure that the terms of the credit, particularly interest-rate and collateral terms, are not preferential, and that the credit does not involve more than a normal risk of repayment.

An extension of credit by a BHC or nonbank subsidiary may be considered abusive or self-serving if its terms are unfavorable to the lender, or if the credit would not have been extended on the same terms absent the official relationship; that is, it would be improbable that each party to the credit would have entered into the credit transaction under the same terms if the relationship did not exist. When a transaction appears questionable, a complete inquiry into the facts and circumstances should be undertaken so that a legal determination can be obtained.

2050.0.2 TRANSACTIONS INVOLVING OTHER PROPERTY OR SERVICES

Other transactions involving BHC officials, their related interests, and the BHC and nonbank subsidiary that should be reviewed by the examiner include the—

1. purchase of assets or services from the BHC or nonbank subsidiary, particularly if at a discount or on preferential terms;
2. sale of assets or services to the BHC or nonbank subsidiary, particularly if at a premium;
3. lease of property to or from the BHC or nonbank subsidiary; and
4. use of BHC or nonbank subsidiary property or personnel by a BHC official or related interest.

As with loans and other extensions of credit to BHC officials on preferential terms, abusive or self-serving insider transactions involving other property or services deprive the BHC or nonbank subsidiary of higher returns or gains that may have been achieved had the same transaction been at a fair market price. A fair market price would be that price charged or received from an unaffiliated party.

A fair market price is often difficult to determine because the assets or services involved may be unique to a given situation and individuals. In general, the fair market price of even unique assets or services can be approximated by the cost of the assets or services to the party selling or furnishing them, if appropriate. The value of services or properties provided by a BHC or nonbank subsidiary should be established and justified either by policy or on a case-by-case basis, and appropriate documentation should be available to the examiner.

Services provided by a BHC official or a related interest to a BHC or nonbank subsidiary, while not unusual, may be most difficult to value. In part because of the problem of valuation, this type of transaction is among the most susceptible to abuse. The cost of providing services is frequently derived by placing value on the time of the individuals providing the services. When services are provided by a BHC official who normally places a very high billing value on time provided, the benefits to the BHC must be assessed in order to form a basis for determining a fair price. The BHC official may be a highly regarded professional whose time and services have great value to the organization. However, when the BHC requires routine clerical services, officials should not charge the BHC a professional-level rate for such services. Under these or similar circumstances, the BHC would be considered imprudent in paying such rates and could be subject to critical comment.

2050.0.3 REGULATION O

For ease of reference, certain Regulation O definitions and limitations, as revised by the Federal Deposit Insurance Corporation Improve-

ment Act of 1991 (FDICIA), are presented here, some in abbreviated form. A thorough review of the entire regulation (found at FRRS 3–960), and the Board's press releases pertaining to Regulation O, is necessary for a complete understanding of the regulation. (Note that section 108 of the Financial Institutions Regulatory Act of 1978 amended section 18(j) of the Federal Deposit Insurance Act to make section 22(h) of the Federal Reserve Act applicable to nonmember insured banks.)

Purpose of Regulation O. Regulation O governs any extension of credit by a member bank and its subsidiaries (based on amendments contained in FDICIA, Regulation O also applies to nonmember insured depository institutions) to an executive officer, director, or principal shareholder of (1) the member bank, (2) a bank holding company of which the member bank is a subsidiary, and (3) any other subsidiary of that bank holding company. It also applies to any extension of credit by a member bank to (1) a company controlled by such a person and (2) a political or campaign committee that benefits or is controlled by such a person.

Supervision of BHCs and their nonbank subsidiaries. Regulation O deals exclusively with extensions of credit by banks and their subsidiaries, not extensions of credit by BHCs and their nonbank subsidiaries. However, because the regulations curtail or eliminate abusive transactions, they can be used as a guide or model in providing standards for the supervisory review of extensions of credit by BHCs and nonbank subsidiaries. Although a direct extension of credit by a BHC could not be determined to be a *violation* of Regulation O, if the credit fails to meet the requirements that Regulation O establishes for banks, it may be possible to conclude that the BHC is engaging in either an unsafe or unsound practice that exposes the entire banking organization to undue risk and exposure to loss. Regulation O limits credit extensions by a bank to officials of that bank and their related interests; therefore, examiners should be especially alert to credit extensions from BHCs and nonbank subsidiaries. If credit extensions appear to circumvent the intent of Regulation O, they should be identified and discussed with management, and noted in the inspection report for follow-up review and possible formal corrective action by regulatory authorities.

2050.0.3.1 FDICIA and BHC Inspection Guidance for Regulation O

On April 22, 1992, the Board adopted amendments to Regulation O, effective May 18, 1992, to implement the changes required by section 306 of FDICIA. Section 306 amended section 22(h) of the Federal Reserve Act and replaced the language of section 22(h) with the provisions of the Board's Regulation O. Section 306 also made several substantive modifications to section 22(h) that required revisions to Regulation O. These changes are outlined in the Board's press release and *Federal Register* notice of May 28, 1992 (57 FR 22417).

The following are some of the more significant changes that were made effective May 18, 1992:[1]

1. *Aggregate lending limit (section 215.4(d)).* The aggregate limit on the total amount that a bank can lend to its insiders and their related interests as a class was changed. In general, this amount is equal to the bank's unimpaired capital and unimpaired surplus. The Board also decided as a one-year interim measure to permit banks with deposits under $100 million to adopt a higher limit, not to exceed 200 percent of the bank's unimpaired capital and unimpaired surplus. (This interim period was extended twice by the Board, extending the higher limit through February 18, 1994, when the higher limit became permanent.)

2. *Lending limits for directors and related interests (section 215.4(c)).* Loans to directors (and their related interests) are subject to the same lending limit that is applicable to executive officers and principal shareholders (and their related interests). There had previously been no limit on the amount that directors and their related interests could borrow from banks.

3. *Credit standards (section 215.4(a)).* When lending to an insider[2] a bank must follow credit underwriting procedures that are as stringent as those applicable to comparable transactions by the bank with persons outside the bank.

4. *Definition of "principal shareholder" (section 215.2(m)(1)).* The definition of "principal shareholder" was tightened for banks located in small communities. The previously existing 10 percent limitation was made applica-

1. The Regulation O cites are to the February 18, 1994, amendment.

2. Effective with the amendment of February 18, 1994, the term "insider" refers to any insider of the bank or insider of its affiliates.

ble to all banks, regardless of the size of the communities in which they were located.[3]

5. *Definition of "member bank" (section 215.2(j)).* The term "member bank" was redefined to include any subsidiary of the member bank. This revision clarified that an extension of credit from a subsidiary of a member bank is subject to the same insider restrictions as an extension of credit from a member bank itself.

6. *Coverage of all companies that own banks (section 215.2(b)).* All companies that own banks became subject to Regulation O, regardless of whether they are technically bank holding companies.

7. *Prohibition on knowingly receiving unauthorized extensions of credit (section 215.6).* Insiders are prohibited from knowingly receiving (or permitting their related interests to receive) any extension of credit not authorized by section 22(h) of the Federal Reserve Act.

8. *Reporting requirement for certain credit (section 215.12).* Executive officers and directors of member banks that do not have publicly traded stock are required to report annually to their institutions the outstanding amount of any credit secured by shares of the insider's institution.

In a February 18, 1994, press release, the Federal Reserve Board announced its approval of a final rule that further amended several provisions of Regulation O, effective on that date. Some of the provisions carried out or further refined provisions of FDICIA. The amendments were designed to increase the ability of banks to make extensions of credit that pose minimal risk of loss, to eliminate recordkeeping requirements that impose a paperwork burden, and to remove certain transactions from the regulation's coverage consistent with bank safety and soundness. The amendments were expected to increase the availability of credit, particularly in communities served by small banks. The following is a discussion of some of the rule's primary provisions.

1. *Aggregate lending limit—exception for small, adequately capitalized banks (section 215.4(d)).* This revision of Regulation O made permanent an interim rule increasing the aggregate lending limit for small, adequately capitalized banks from 100 percent of the bank's unimpaired capital surplus to 200 percent, provided the bank satisfies three conditional criteria.

2. *Exceptions to the general limits on lending (section 215.4(d)(3)).* The Board adopted certain exceptions to the general restrictions on lending to insiders. The exceptions apply to loans fully secured by—

a. obligations of the United States or other obligations fully guaranteed as to principal and interest by the United States;

b. commitments or guarantees of a department or agency of the United States; or

c. a segregated deposit account with the lending bank.

An exception is also made for loans arising from the discount of installment consumer paper by an insider with full or partial recourse endorsement or guarantee by the insider, if the maker of the paper is not an insider and the loan was made relying primarily on the maker and this is properly documented. Such loans continue to be subject to the prohibitions against preferential lending.

3. *Including closing costs in the refinancing of home mortgage loans (section 215.5(c)(2)).* Section 22(g) of the Federal Reserve Act allows a bank to make a loan to its executive officer, without restrictions on the amount, if the loan is secured by a first lien on a dwelling that is owned and used by the executive officer as a residence after the loan is made. The Board's amendment includes the refinancing of home mortgage loans in this category only if the proceeds are used to pay off the previous home mortgage loan or for the other purposes listed in this section. The regulation states that closing costs can be included as part of the exempt portion of a home mortgage refinancing.

4. *Prior approval of home mortgage loans (section 215.5(c)).* This section was revised to mirror section 22(g) of the Federal Reserve Act. It provides that a bank's board of directors must specifically approve in advance a home mortgage loan to an executive officer. This requirement is in addition to the general requirements for insiders. Section 22(g) was recently amended to eliminate this prior-approval requirement, and the requirement in Regulation O is no longer in effect.

3. The Board amended the definition of "principal shareholder of a member bank," effective December 17, 1992, so that it does not include a company of which a member bank is a subsidiary. This amendment excludes from Regulation O loans to a company that owns, controls, or exercises a controlling influence over a member bank, as those relationships are defined in section 2(d) of the Bank Holding Company Act, as well as the related interests of such a parent bank holding company. The definition of "principal shareholder" for purposes of reporting obligations under section 215.11 and subpart B of Regulation O was not changed as a result of the Housing and Community Development Act of 1992 because those portions of Regulation O implement provisions of law in addition to section 22(h) of the Federal Reserve Act.

5. *Alternative recordkeeping procedures (section 215.8).* Banks are permitted to follow alternative recordkeeping procedures on loans to insiders of affiliates. The amendment allows a bank to decide on its own how to gather information on related interests, so long as its method is effective. For example, a nonbank credit card bank or other bank that does not make commercial loans could decide not to keep records on related interests. For banks that make commercial loans, one of two acceptable methods is required, unless a bank can demonstrate that another method is equally effective: (a) the "survey" method or (b) the "borrower inquiry" method. Every bank, regardless of the recordkeeping method it selects, must conduct an annual survey to identify *its own insiders*, but not those of its holding company affiliates. Every bank is expected to check this short list before extending credit, even if it is using the borrower-inquiry method of recordkeeping for affiliates in lieu of the survey method.

6. *Tangible-economic-benefit rule (section 215.3(f)).* This rule was similar to a provision in section 23A of the Federal Reserve Act and was adopted at a time when the Board was required by section 22(h) of the Federal Reserve Act to use the definition of "extension of credit" found in section 23A. However, the definition of extension of credit in section 22(h) is no longer tied to section 23A. The Board has therefore revised the tangible-economic-benefit rule to clarify that it does not reach certain transactions that may benefit an insider. The Board explicitly provided that the rule does not apply to an arm's-length extension of credit by a bank to a third party where the proceeds of the credit are used to finance the bona fide acquisition of property, goods, or services from an insider or an insider's related interest.

2050.0.3.2 Definitions in Regulation O (abbreviated listing)

NOTE: Regulation O definitions, prohibitions, and exceptions and exemptions are particularly detailed and complex. Therefore, inspection staff should consult with Reserve Bank or Board supervisory or legal staff before discussing with management or presenting in an inspection report any BHC inspection findings that rely upon Regulation O.

(a) "Affiliate" means any company of which a member bank is a subsidiary or any other subsidiary of that company.

(b) "Company" means any corporation, partnership, trust (business or otherwise), association, joint venture, pool syndicate, sole proprietorship, unincorporated organization, or any other form of business entity. The term, however, does not include (1) an insured bank (as defined in 12 U.S.C. 1813) or (2) a corporation the majority of the shares of which are owned by the United States or by any state.

(c)(1) "Control of a company or bank" means that a person directly or indirectly, or acting through or in concert with one or more persons (i) owns, controls, or has the power to vote 25 percent or more of any class of voting securities of the company or bank; (ii) controls in any manner the election of a majority of the directors of the company or bank; or (iii) has the power to exercise a controlling influence over the management or policies of the company or bank. (Note: If a company does not have voting securities (i.e., a partnership), review the degree of interest in the company to determine control.)

(2) A person is presumed to have control, including the power to exercise a controlling influence over the management or policies, of a company or bank if (i) the person is an executive officer or director of the company or bank and directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank; or (ii) the person directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank, and no other person owns, controls, or has the power to vote a greater percentage of that class of voting securities.

(3) An individual is not considered to have control, including the power to exercise a controlling influence over the management or policies, of a company or bank solely by virtue of the individual's position as an officer or director of the company or bank.

(d) "Director" of a member bank or company means any director of a member bank or company, whether or not receiving compensation.[3a] An advisory director is not con-

3a. Extensions of credit to a director of an affiliate of a bank are not subject to the general prohibitions (section 215.4), the prohibitions on knowingly receiving unauthorized extensions of credit (section 215.6), and the alternative recordkeeping procedures (section 215.8) if—

(1) the director of the affiliate is excluded, by resolution of the board of directors or by the bylaws of the bank, from participation in major policymaking functions of the bank,

sidered a director if the advisory director (1) is not elected by the shareholders of the bank or company, (2) is not authorized to vote on matters before the board of directors, and (3) provides solely general policy advice to the board of directors.

(e)(1) "Executive officer" of a company or bank means a person who participates or has authority to participate (other than in the capacity of a director) in major policymaking functions of the company or bank, whether or not the officer has an official title; the title designates the officer an assistant; or the officer is serving without salary or other compensation.[4] The chairman of the board, the president, every vice president, the cashier, the secretary, and the treasurer of a company or bank are considered executive officers, unless the officer is excluded, by resolution of the board of directors or by the bylaws of the bank or company, from participation (other than in the capacity of a director) in major policymaking functions of the bank or company, and the officer does not actually participate therein.

(2) Extensions of credit to an executive officer of an affiliate of a member bank (other than a company that controls the bank) are not subject to sections 215.4, 215.6, and 215.8 of Regulation O if—

(i) the executive officer of the affiliate is excluded, by resolution of the board of directors or by the bylaws of the bank, from participation in major policymaking functions of the bank, and the executive officer does not actually participate in those functions;

(ii) the affiliate does not control the bank; and

(iii) as determined annually, the assets of the affiliate do not constitute more than 10 percent of the consolidated assets of the company that controls the bank and is not controlled by any other company, and the executive officer of the affiliate is not otherwise subject to sections 215.4, 215.6, and 215.8 of Regulation O.

If the executive officer of the affiliate is excluded, by resolution of the board of directors or by the bylaws of the bank, from participation in major policymaking functions of the bank, a resolution of the board of directors or a corporate bylaw may (i) include the executive officer (by name or by title) in a list of persons excluded from participation in such functions; or (ii) not include the executive officer in a list of persons authorized (by name or by title) to participate in such functions.

(f) "Immediate family" means the spouse of an individual, the individual's minor children, and any of the individual's children (including adults) residing in the individual's home.

(g) "Insider" means an executive officer, director, principal shareholder, and any related interest of such person.

(h) The "lending limit" for a member bank is an amount equal to the limit on loans to a single borrower established by section 5200 of the Revised Statutes,[5] 12 U.S.C. 84. This amount is 15 percent of the bank's unimpaired capital and unimpaired surplus in the case of loans that are not fully secured, and an additional 10 percent of the bank's unimpaired capital and unimpaired surplus in the case of loans that are fully secured by readily marketable collateral having a market value, as determined by reliable and continuously available price quotations, at least equal to the amount of the loan. The lending limit also includes any higher amounts that are permitted by section 5200 of the Revised Statutes for the types of obligations listed therein as exceptions to the limit.

A member bank's *unimpaired capital* and *unimpaired surplus* equals the (1) member bank's tier 1 and tier 2 capital included in the

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and the director does not actually participate in those functions;

(2) the affiliate does not control the bank; and

(3) as determined annually, the assets of the affiliate do not constitute more than 10 percent of the consolidated assets of the company that controls the bank and is not controlled by any other company, and the director of the affiliate is not otherwise subject to sections 215.4, 215.6, and 215.8 of Regulation O.

If the director of the affiliate is excluded, by resolution of the board of directors or by the bylaws of the bank, from participation in major policymaking functions of the bank, a resolution of the board of directors or a corporate bylaw may (1) include the director (by name or by title) in a list of persons excluded from participation in such functions or (2) not include the director in a list of persons authorized (by name or by title) to participate in such functions.

4. The term "executive officer" is not intended to include persons who may have official titles and may exercise a certain measure of discretion in the performance of their duties, including discretion in the making of loans, but who do not participate in determining major policies of the bank or company and whose decisions are limited by policy standards fixed by the senior management of the bank or company. For example, the term does not include a manager or assistant manager of a branch of a bank unless that individual participates, or is authorized to participate, in major policymaking functions of the bank or company.

5. Where state law establishes a lending limit for a state member bank that is lower than the amount permitted in section 5200 of the Revised Statutes, the lending limit established by the applicable state laws shall be the lending limit for the state member bank.

bank's risk-based capital, under the capital guidelines of the appropriate federal banking agency, and (2) balance of the member bank's allowance for loan and lease losses that was not included in the bank's tier 2 capital. This computation is based on the bank's risk-based capital under the capital guidelines of the appropriate federal banking agency, based on the bank's most recent consolidated report of condition filed under 12 U.S.C. 1817(a)(3).

(i) "Member bank" means any banking institution that is a member of the Federal Reserve System, including any subsidiary of a member bank. The term does not include any foreign bank that maintains a branch in the United States, whether or not the branch is insured (within the meaning of 12 U.S.C. 1813(s)) and regardless of the operation of 12 U.S.C. 1813(h) and 12 U.S.C. 1828(j)(3)(B).

(j) "Person" means an individual or a company.

(k) "Principal shareholder"[6] means an individual or a company (other than an insured bank) that directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote more than 10 percent of any class of voting securities of a member bank or company. Shares owned or controlled by a member of an individual's immediate family are considered to be held by the individual. A principal shareholder of a member bank includes (1) a principal shareholder of a company of which the member bank is a subsidiary and (2) a principal shareholder of any other subsidiary of that company, exclusive of nonbank subsidiaries of member banks.

(*l*) "Related interest" means (1) a company that is controlled by a person or (2) a political or campaign committee that is controlled by a person or the funds or services of which will benefit a person.

(m) "Subsidiary" has the meaning given in section 2(d) of the BHC Act, but does not include a subsidiary of a member bank.

6. On October 28, 1992, in section 955 of the Housing and Community Development Act of 1992, Congress amended section 22(h) of the Federal Reserve Act to exclude from the definition of "principal shareholder" a company of which a member bank is a subsidiary. Regulation O was amended, effective December 17, 1992, to implement this change. As a result of the amendment, extensions of credit by a bank to its holding company and to any related interests of its subsidiary are governed solely by sections 23A and 23B of the Federal Reserve Act.

2050.0.3.2.1 Extension of Credit

For the purposes of Regulation O, an "extension of credit" is a making or renewal of any loan, a granting of a line of credit, or an extending of credit in any manner whatsoever, and includes—

(1) a purchase under repurchase agreement of securities, other assets, or obligations;

(2) an advance by means of an overdraft, cash item, or otherwise;

(3) issuance of a standby letter of credit (or other similar arrangement regardless of name or description) or an ineligible acceptance;

(4) an acquisition by discount, purchase, exchange, or otherwise of any note, draft, bill of exchange, or other evidence of indebtedness upon which an insider may be liable as maker, drawer, endorser, guarantor, or surety;

(5) an increase of an existing indebtedness, but not if the additional funds are advanced by the bank for its own protection for (i) accrued interest or (ii) taxes, insurance, or other expenses incidental to the existing indebtedness;

(6) an advance of unearned salary or other unearned compensation for a period in excess of 30 days; and

(7) any other similar transaction as a result of which a person becomes obligated to pay money (or its equivalent) to a bank, whether the obligation arises directly or indirectly, or because of an endorsement on an obligation or otherwise, or by any means whatsoever.

An extension of credit *does not* include—

(1) an advance against accrued salary or other accrued compensation, or an advance for the payment of authorized travel or other expenses incurred or to be incurred on behalf of the bank;

(2) a receipt by a bank of a check deposited in or delivered to the bank in the usual course of business unless it results in the carrying of a cash item for or the granting of an overdraft (other than an inadvertent overdraft in a limited amount that is promptly repaid under terms that are not more favorable than those offered to the general public).

(3) an acquisition of a note, draft, bill of exchange, or other evidence of indebtedness through (i) a merger or consolidation of banks or a similar transaction by which a bank acquires assets and assumes liabilities of another bank or similar organization, or (ii) foreclosure on collateral or similar proceeding for the protection of the bank, provided that such indebtedness is not held for a period of more than three years from the date of the acquisition, subject to

extension by the appropriate federal banking agency for good cause;

(4)(i) an endorsement or guarantee for the protection of a bank of any loan or other asset previously acquired by the bank in good faith or (ii) any indebtedness to a bank for the purpose of protecting the bank against loss or of giving financial assistance to it;

(5) indebtedness of $15,000 or less arising by reason of any general arrangement by which a bank (i) acquires charge or time credit accounts or (ii) makes payments to or on behalf of participants in a bank credit card plan, check credit plan, or similar open-end credit plan, provided—

(A) the indebtedness does not involve prior individual clearance or approval by the bank other than for the purposes of determining authority to participate in the arrangement and compliance with any dollar limit under the arrangement, and

(B) the indebtedness is incurred under terms that are not more favorable than those offered to the general public;

(6) indebtedness of $5,000 or less arising by reason of an interest-bearing overdraft credit plan (see Regulation O, section 215.4(e)); or

(7) a discount of promissory notes, bills of exchange, conditional sales contracts, or similar paper, without recourse.

Non-interest-bearing deposits to the credit of a bank are not considered loans, advances, or extensions of credit to the bank of deposit. Also, the giving of immediate credit to a bank upon collected items received in the ordinary course of business is not considered to be a loan, advance, or extension of credit to the depositing bank.

An extension of credit by a member bank (for the purposes of section 215.4 of Regulation O) is considered to have been made at the time the bank enters into a binding commitment to make the extension of credit. A participation without recourse is considered to be an extension of credit by the participating bank, not by the originating bank.

Tangible-economic-benefit rule. In general, an extension of credit is considered made to an insider to the extent that the proceeds are transferred to the insider or are used for the tangible economic benefit of the insider. An extension of credit is not considered made to an insider if—

(1) the credit is extended on terms that would satisfy the standard set forth in section 215.4(a) of Regulation O for extensions of credit to insiders; and

(2) the proceeds of the extension of credit are used in a bona fide transaction to acquire property, goods, or services from the insider.

2050.0.3.3 General Prohibitions and Limitations of Regulation O

(a) *Terms and creditworthiness.* No member bank may extend credit to any insider of the bank or insider of its affiliates unless the extension of credit (1) is made on substantially the same terms (including interest rates and collateral) as, and following credit-underwriting procedures that are not less stringent than, those prevailing at the time for comparable transactions by the bank with other persons that are not covered by Regulation O and who are not employed by the bank; and (2) does not involve more than the normal risk of repayment or present other unfavorable features.

Nothing stated above (as to ''terms and creditworthiness'') should prohibit any extension of credit made in accordance with a benefit or compensation program that—

1. is widely available to employees of the member bank, and in the case of extensions of credit to an insider of its affiliates, is widely available to employees of the affiliates at which that person is an insider; and
2. does not give preference to any insider of the member bank over other employees of the member bank and, in the case of extensions of credit to an insider of its affiliates, does not give preference to any insider of its affiliates over other employees of the affiliates of which that person is an insider.

(b) *Prior approval.* A member bank may not extend credit (including granting a line of credit) to any insider of the bank or insider of its affiliates in an amount that, when aggregated with the amount of all other extensions of credit to that person and to all related interests of that person, exceeds the higher of $25,000 or 5 percent of the member bank's unimpaired capital and unimpaired surplus, but in no event can it exceed $500,000. This provision applies unless (1) the extension of credit or line of credit has been approved in advance by a majority of the entire board of directors of that bank and (2) the interested party has abstained from participating directly or indirectly in the voting.

The board of directors' approval is not required for an extension of credit that is made pursuant to a line of credit that was approved by

the board of directors within 14 months of the date of the extension of credit. Participation in the discussion, or any attempt to influence the voting, by the board of directors regarding an extension of credit constitutes indirect participation in the voting by the board of directors on an extension of credit.

(c) *Individual lending limit*. A member bank may not extend credit to any insider of the bank or insider of its affiliates in an amount that, when aggregated with the amount of all other extensions of credit by the member bank to that person and to all related interests of that person, exceeds the lending limit described above in section 2050.0.3.2 (paragraph h). This prohibition does not apply to an extension of credit by a member bank to a company of which the member bank is a subsidiary or to any other subsidiary of that company.

(d) *Aggregate lending limit.*

(1) *General limit*. A member bank may not extend credit to any insider of the bank or insider of its affiliates unless the extension of credit is in an amount that, when aggregated with all outstanding extensions of credit to all such insiders, would exceed the bank's unimpaired capital and unimpaired surplus as defined in section 215.2(i) of Regulation O (see section 2050.0.3.2, paragraph h).

(2) A member bank with deposits of less than $100,000,000 may by an annual resolution of its board of directors increase the general limit (specified above) to a level that does not exceed two times the bank's unimpaired capital and unimpaired surplus if the board of directors determines that such higher limit is consistent with prudent, safe, and sound banking practices in light of the bank's experience in lending to its insiders and is necessary to attract or retain directors or to prevent the restriction of the availability of credit in small communities.

The board of directors' resolution must set forth the facts and reasoning on which it bases its finding, including the amount of the bank's lending to its insiders as a percentage of the bank's unimpaired capital and unimpaired surplus as of the date of the resolution. In addition, the bank must meet or exceed, on a fully phased-in basis, all applicable capital requirements established by the appropriate federal banking agency. The bank would also have had to receive a satisfactory composite rating in its most recent bank examination report.

If a member bank has adopted a resolution authorizing a higher limit and subsequently fails to meet the above-listed requirements, the member bank cannot extend any additional credit (including a renewal of any existing extension of credit) to any insider of the bank or its affiliates unless the extension or renewal is consistent with the general limit.

(3) *Exceptions to the general limit.* Effective May 3, 1993, the general limit, described in manual section 2050.0.3.3 (paragraph d) and specified in section 215.4(d)(1) of the Board's Regulation O does not apply to—

(i) extensions of credit secured by a perfected security interest in bonds, notes, certificates of indebtedness, or Treasury bills of the United States or in other such obligations fully guaranteed as to principal and interest by the United States;

(ii) extensions of credit to or secured by unconditional takeout commitments or guarantees of any department, agency, bureau, board, commission, or establishment of the United States or any corporation wholly owned directly or indirectly by the United States;

(iii) extensions of credit secured by a perfected security interest in a segregated deposit account in the lending bank; or

(iv) extensions of credit arising from the discount of negotiable installment consumer paper that is acquired from an insider and carries a full or partial recourse endorsement or guarantee by the insider,[7] provided that—

(A) the financial condition of each maker of such consumer paper is reasonably documented in the bank's files or known to its officers;

(B) an officer of the bank designated for that purpose by the board of directors of the bank certifies in writing that the bank is relying primarily upon the responsibility of each maker for the payment of the obligation and not upon any endorsement or guarantee by the insider; and

(C) the maker of the instrument is not an insider.

(e) *Overdrafts.* A member bank may not pay an overdraft of an executive officer or director of the bank[8] on an account at the bank, unless the payment of funds is made in accordance

7. The exceptions to the aggregate lending limit pertaining to extensions of credit secured in the manner described above (i through iii) apply only to the amounts of such extensions of credit that are secured in such manner.

8. This prohibition does not apply to the payment by a member bank of an overdraft of a principal shareholder of the member bank, unless the principal shareholder is also an executive officer or director. This prohibition also does not apply to the payment by a member bank of an overdraft of a related interest of an executive officer, director, or principal shareholder of the member bank.

with (1) a written, preauthorized, interest-bearing extension of credit plan that specifies a method of repayment; or (2) a written, preauthorized transfer of funds from another account of the account holder at the bank.

The prohibition above does not apply to payment of inadvertent overdrafts on an account in an aggregate amount of $1,000 or less, provided (1) the account is not overdrawn for more than five business days; and (2) the member bank charges the executive officer or director the same fee charged any other customer of the bank in similar circumstances.[8a]

2050.0.3.4 Additional Restrictions on Loans to Executive Officers of Member Banks

The following restrictions on extensions of credit by a member bank to any of its executive officers are in addition to any restrictions on extensions of credit by a member bank to insiders of itself or its affiliates. The restrictions listed below apply only to the executive officers of the member bank and not to the executive officers of its affiliates.

A member bank may not extend credit to any of its executive officers, and no executive officer of a member bank can borrow from or otherwise become indebted to the bank, except in the amounts, for the purposes, and upon the conditions specified in items 3 and 4 below.

A member bank is authorized to extend credit to any executive officer of the bank—

(1) in any amount to finance the education of the executive officer's children;

(2) in any amount to finance or refinance the purchase, construction, maintenance, or improvement of a residence of the executive officer, provided—

(i) the extension of credit is secured by a first lien on the residence and the residence is owned (or expected to be owned after the extension of credit) by the executive officer; and

(ii) in the case of refinancing, that only the amount used to repay the original extension of credit, together with the closing costs of the refinancing, and any additional amount thereof used for any of the purposes enumerated in item 2 above, are included within this category of credit;

(3) in any amount, if the extension of credit is secured in a manner described in the first three exceptions to the general limit of the aggregate lending limit (see section 2050.0.3.3, paragraph d, subparagraphs i to iii); and

(4) for any other purpose (not specified in items 1 through 3 above), if the aggregate

8a. The requirement that the member bank charge the executive officer or director the same fee charged any other customer of the bank in similar circumstances does not prohibit the member bank from charging a fee provided for in a benefit or compensation program that satisfies the requirements detailed in section 2050.0.3.3, item (a).

amount of loans to that executive officer does not exceed, at any one time, the higher of 2.5 percent of the bank's unimpaired capital and unimpaired surplus or $25,000, but in no event more than $100,000.

Any extension of credit by a member bank to any of its executive officers must be—

(1) promptly reported to the member bank's board of directors;

(2) in compliance with the general prohibitions of section 215.4 of Regulation O (manual section 2050.0.3.3);

(3) preceded by the submission of a current detailed financial statement of the executive officer; and

(4) made subject to the condition in writing that the extension of credit will, at the option of the member bank, become due and payable at any time that the officer is indebted to any other bank or banks in an aggregate amount greater than the amount specified for a category of credit that may be made available by a member bank to any of its executive officers.

No member bank may extend credit in an aggregate amount greater than the amount permitted for general-purpose loans to an executive officer (section 215.5(c)(4) of Regulation O) to a partnership in which one or more of the bank's executive officers are partners and, either individually or together, hold a majority interest. The total amount of credit extended by a member bank to such partnership is considered to be extended to each executive officer of the member bank who is a member of the partnership.

Prohibition on knowingly receiving unauthorized extensions of credit. Insiders are prohibited from knowingly receiving (or permitting their related interests to receive) any extensions of credit not authorized by section 22(h) of the Federal Reserve Act and by Regulation O.

2050.0.3.5 Grandfathering Provisions

(a) *Under FDICIA.* FDICIA provided that the amendments to Regulation O would not affect extensions of credit entered into on or before the effective date of the regulation. Therefore, extensions of credit, including lines of credit, made on or before May 18, 1992, are not required to comply with either the individual-borrower limit made applicable to directors and their related interests, or with the aggregate limit on all loans to insiders. All extensions of credit, loan renewals, and loan rollovers made after May 18, 1992, must comply with all of the provisions of Regulation O. In other words, banks cannot make new loans or renew outstanding extensions of credit in amounts that, when aggregated with all other outstanding loans to insiders, would exceed either of the new limits.

(b) *Extensions of credit outstanding on March 10, 1979.* Any extension of credit that was outstanding on March 10, 1979, and that would have, if made on or after March 10, 1979, violated the individual lending limit, had to be reduced in amount by March 10, 1980, to be in compliance with the aggregate lending limit of Regulation O. Any renewal or extension of such a credit extension on or after March 10, 1979, must have been made only on terms that would have brought it into compliance with the aggregate lending limit by March 10, 1980. However, any extension of credit made before March 10, 1979, that bears a specific maturity date of March 10, 1980, or later, had to be repaid in accordance with the repayment schedule in existence on or before March 10, 1979.

2050.0.3.6 Reports by Executive Officers

Each executive officer of a member bank who becomes indebted to any other bank or banks in an aggregate amount greater than the amount specified for a category of credit in section 215.5(c) of Regulation O (manual section 2050.0.3.4) must make a written report to the board of directors of the officer's bank within 10 days of the date the indebtedness reaches such a level. The report must state the lender's name, the date and amount of each extension of credit, any security for it, and the purposes for which the proceeds have been or are to be used.

Report on credit secured by BHC stock. In addition to the report required above, each executive officer or director of a member bank the shares of which are not publicly traded must report annually to the bank's board of directors the outstanding amount of any credit that was extended to the executive officer or director that is secured by shares of the member bank. (See also Regulation Y section 225.4(f) for the identical restriction on executive officers and directors of a bank holding company with loans secured by shares of the bank holding company.)

2050.0.3.7 Report on Credit to Executive Officers

Each member bank must include with (but not as part of) each report of condition (and copy

thereof) filed pursuant to 12 U.S.C. 1817(a)(3) a report of all extensions of credit made by the member bank to its executive officers since the date of the bank's previous report of condition.

2050.0.3.8 Disclosure of Credit from Member Banks to Executive Officers and Principal Shareholders

(a) *Definitions.* For the purposes of this section, the following definitions apply:

(1) "Principal shareholder of a member bank" means a person (individual or a company), other than an insured bank, or branch or representative office of a foreign bank as defined in 12 U.S.C. 3101(7)[9] that, directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has power to vote more than 10 percent of any class of voting securities of the member bank or company. The term includes an individual or company that controls a principal shareholder (for example, a person that controls a bank holding company). Shares of a bank (including a foreign bank), bank holding company, or other company owned or controlled by a member of an individual's immediate family are considered to be held or controlled by the individual for the purposes of determining principal shareholder status.[10]

(2) "Related interest" means (i) any company controlled by a person; or (ii) any political or campaign committee the funds or services of which will benefit a person or that is controlled by a person. A related interest does not include a bank or a foreign bank (as defined in 12 U.S.C. 3101(7)).

(b) *Public disclosure.* Upon receipt of a written request from the public, a member bank shall make available the names of each of its executive officers (with the exception of any executive officer of a bank holding company of which the member bank is a subsidiary or of any other subsidiary of that bank holding company unless the executive officer is also an executive officer of the member bank) and each of its principal shareholders to whom, or to whose related interests, the member bank had outstanding at the end of the latest previous quarter of the year, an extension of credit that, when aggregated with all other outstanding extensions of credit at that time from the member bank to such person and to all related interests of such person, equaled or exceeded 5 percent of the member bank's capital and unimpaired surplus or $500,000, whichever amount is less. No disclosure under this paragraph is required if the aggregate amount of all extensions of credit outstanding at that time from the member bank to the executive officer or principal shareholder of the member bank and to all related interests of such a person does not exceed $25,000.

A member bank is not required to disclose the specific amounts of individual extensions of credit.

(c) *Maintaining records.* Each member bank is required to maintain records of all requests for the information described above and the disposition of the requests. These records may be disposed of two years after the date of the request.

2050.0.3.9 Civil Penalties of Regulation O

Any member bank, or any officer, director, employee, agent, or other person participating in the conduct of the affairs of the bank, that violates any provision of Regulation O is subject to a civil penalty, as specified in section 29 of the Federal Reserve Act.

2050.0.3.10 Records of Member Banks (and BHCs)

To help inspection and examination personnel identify BHC officials, Regulation O requires each member bank to maintain records necessary to monitor compliance with this regulation. BHCs and nonbank subsidiaries should be given access to the records identifying "bank officials." Each state member bank is required to (1) identify, through an annual survey, all insiders of the bank itself; and (2) maintain records of all extensions of credit to insiders of the bank itself, including the amount and terms of each such extension of credit.

9. A "foreign bank" means any company organized under the laws of a foreign country, a territory of the United States, Puerto Rico, Guam, American Samoa, or the Virgin Islands that engages in the business of banking, or any subsidiary or affiliate, organized under such laws, of any such company. This includes foreign commercial banks, foreign merchant banks, and other foreign institutions that engage in banking activities usual in connection with the business of banking in the countries where such foreign institutions are organized or operating.

10. See footnote 3.

2050.0.3.10.1 Recordkeeping for Insiders of the Member Bank's Affiliates

A member bank is required to maintain records of extensions of credit to insiders of the member bank's affiliates by:

(1) A "survey" method, which identifies, through an annual survey, each of the insiders of the member bank's affiliates. Under the survey method, the member bank must maintain records of the amount and terms of each extension of credit by the member bank to such insiders; or

(2) A "borrower inquiry" method, which requires, as part of each extension of credit, the borrower to indicate whether the borrower is an insider of an affiliate of the member bank. Under this method, the member bank must maintain records that identify the amount and terms of each extension of credit by the member bank to borrowers so identifying themselves.

Alternative recordkeeping method for insiders of affiliates. A member bank may use a recordkeeping method other than those identified above if the appropriate federal banking agency determines that the bank's method is at least as effective.

2050.0.3.10.2 Special Rule for Noncommercial Lenders

A member bank that is prohibited by law or by an express resolution of the bank's board of directors from making an extension of credit to any company or other entity that is covered by Regulation O as a company is not required to maintain any records of the related interests of the insiders of the bank or its affiliates or to inquire of borrowers whether they are related interests of the insiders of the bank or its affiliates.

2050.0.3.11 Section 23A Ramifications

Loans to a holding company parent and its affiliates are governed by section 23A of the Federal Reserve Act and are not subject to Regulation O.

2050.0.4 REMEDIAL ACTION

Self-serving and abusive transactions deprive a BHC of opportunities and benefits that may otherwise have been available and may strip a BHC of its ability to serve as a source of financial and managerial strength to its subsidiary banks. Even if not extended on preferential terms, self-serving loans and other extensions of credit to insiders may be an imprudent business practice and may reduce the lender's liquidity or otherwise overextend the BHC. In such situations, formal or informal remedial measures by the Federal Reserve may be necessary. Formal enforcement action is provided for in the 1974 amendments to the Financial Institutions Supervisory Act of 1966 (12 U.S.C. 1818), which grant the Board authority to issue cease-and-desist orders in appropriate situations. For complete details on formal corrective actions, see section 2110.0.

2050.0.5 INSPECTION OBJECTIVES

1. To determine if any transactions between BHC officials, their related interests, and the BHC or its nonbank subsidiaries are based on preferential treatment.
2. To determine if any transactions between BHC officials, their related interests, and the BHC or its nonbank subsidiaries result in any undue loss exposure to the BHC or its subsidiaries.
3. To determine if any BHC or nonbank extension of credit to a BHC official or related interest is in the spirit of Regulation O's requirements or whether it is an attempt to circumvent Regulation O's prohibition on various bank extensions of credit to similar parties.
4. To determine that BHC officials are aware of Regulation O's limitations and prohibitions and have established internal policies and procedures for the bank subsidiaries to ensure compliance by the banks.
5. To determine that the BHC has arranged to make available, upon request, a listing or some other form of information sufficient to identify all "BHC officials" and to make certain that such information is available to the bank subsidiaries in particular.

2050.0.6 INSPECTION PROCEDURES

1. Review the balance sheets and other records of the parent-only and nonbank subsidiaries to determine if there are any loans or other extensions of credit to BHC officials.
2. Review the income statements and supporting records of the parent-only and nonbank

subsidiaries to determine if any interest income, other income, or expense is associated with a transaction with a BHC official or a related interest.

3. Ask management to identify all such transactions and to provide supporting documentation.

4. Review management's familiarity with Regulation O's limitations and the steps they have taken to establish policies for the internal administration of their subsidiary banks' extensions of credit to BHC officials.

5. Review any information prepared by management that presents a listing of all BHC officials and their related interests.

6. Review any corporate resolutions declaring an individual not to be an "executive officer" for purposes of Regulation O and, if necessary, confirm the individual's nonparticipation in the formulation of corporate policy.

2050.0.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Loans and extensions of credit to executive officers, directors, and principal shareholders	375a and 375b (sections 22(g) and 22(h) of F.R. Act)	215.4 215.5 (Reg. O)		
Granting of below-market interest rate mortgage loans to executives of BHC subsidiaries as compensation			4–514 3–1094	
Loans from correspondents		215.22 215.23		
Loans to correspondents	1972	215.20		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Management Information Systems (General) Section 2060.0

Management Information Systems refers to the policies and operating procedures, including systems of internal control, that the board of directors of a bank holding company initiates to monitor and ensure control of its operations and activities, while maintaining and improving the financial strength and objectives of the overall organization. These policies should focus on the overall organizational structure with respect to identifying, monitoring, and managing risks. Subsequent sections of the manual focus on the essential elements of various management information systems. Included are inspection objectives and procedures to be used by Federal Reserve Bank examiners when conducting inspections of bank holding companies.

See 2060.05 Internal Audit Function and Its Outsourcing
2060.1 Audit
2060.2 Budget
2060.3 Records and Statements
2060.4 Reporting
2060.5 Insurance
5052.0 Targeted MIS Inspection

Effective internal control[1] is a foundation for the safe and sound operation of a banking organization (bank holding companies, banking institutions, or savings associations). The board of directors and senior managers are responsible for ensuring that the system of internal control operates effectively. Their responsibility *cannot* be delegated to others within the organization or to outside parties. An important element of an effective internal control system is an internal audit function. When properly structured and conducted, internal audit provides directors and senior management with vital information about weaknesses in the system of internal control. The directors and management can use this information to take prompt, remedial action.

The Federal Reserve System and other federal banking agencies' long-standing examination and inspection policies have called for examiners to review a banking organization's internal audit function and to recommend any needed improvements. More recently, the federal banking agencies adopted Interagency Guidelines Establishing Standards for Safety and Soundness, pursuant to section 39 of the Federal Deposit Insurance Act (FDI Act).[2] Under these guidelines, each institution should have an internal audit function that is appropriate to its size and the nature and scope of its activities.

In addressing various quality and resource issues, many banking institutions have been engaging independent public accounting firms and other outside professionals (hereafter referred to as outsourcing venders) to perform work that has traditionally been done by internal auditors. These arrangements are often called "internal audit outsourcing," "internal audit assistance," "audit co-sourcing," and "extended audit services" (hereafter, collectively referred to as outsourcing).

Such outsourcing may be beneficial to a banking organization if it is properly structured, carefully conducted, and prudently managed. However, the federal banking agencies have concerns that the structure, scope, and management of some internal audit outsourcing arrangements may not contribute to the organization's safety and soundness. Furthermore, these agencies want to ensure that these arrangements with outsourcing venders do not leave directors and senior managers with the impression that they have been relieved of their responsibility for maintaining an effective system of internal controls and for overseeing the internal audit function.

On December 22, 1997, an interagency policy statement was adopted by the Federal Reserve Board and the other federal bank regulatory agencies that provides interagency guidance on sound practices for managing the internal audit function and the use of outsourcing venders for audit activities. This policy statement applies to bank holding companies and their subsidiaries, FDIC-insured banks and savings associations, and U.S. operations of foreign banking organizations (all subsequently referred to as institutions). See SR-97-35 and sections 2124.0.2.4, 2060.1, 3230.0.10.2.5, 5010.7, and 5030.0 (page 7).

The joint policy statement focuses on issues that directors should consider in establishing and maintaining an internal audit function. Such issues involve—

1. organizational structure;
2. internal audit management, staff, and quality;
3. scope; and
4. communication.

When the internal audit function is outsourced, the directors need to ensure that these principles continue to be addressed. Furthermore, when the internal audit function has shifted from an employee/employer relationship to a vender contractual agreement, additional issues must be considered. The institution and the vender also must make provisions that allow examiners to have access to the vender's audit reports and related workpapers.

The policy statement provides examiners with guidance for assessing the quality and effectiveness of an internal audit function. It guides the examiner in appraising how well the organiza-

1. In summary, internal control is a process, brought about by a banking organization's board of directors, management, and other personnel, designed to provide reasonable assurance that the institution will achieve the following internal control objectives: efficient and effective operations, including safeguarding of assets; reliable financial reporting; and compliance with applicable laws and regulations. Internal control consists of five components that are a part of the management process: control environment, risk assessment, control activities, information and communication, and monitoring activities. The effective functioning of these components is essential to achieving the internal control objectives.

2. For national banks, appendix A to part 30; for state member banks, appendix D to part 208; for state nonmember banks, appendix A to part 364; for savings associations, appendix A to part 570.

tion has responded to the issues raised in the policy statement for managing its internal audit function. When the internal audit function is outsourced to a vender, the examiner will appraise how the arrangement affects the quality of the internal audit function. In addition, the policy statement provides guidance on how these outsourcing arrangements may affect an examiner's assessment of internal control. It also discusses the effect these arrangements may have on the independence of an external auditor who is also providing internal audit services to a banking organization. Finally, this statement provides guidance to examiners concerning their reviews of internal audit functions and related matters.

2060.05.1 INTERNAL AUDIT FUNCTION

2060.05.1.1 Director and Senior Management Responsibilities for Internal Audit

The board of directors and senior management are responsible for having an effective system of internal control—including an effective internal audit function—and for ensuring that the importance of internal control is understood and respected throughout the institution. This overall responsibility *cannot* be delegated to anyone else. The board and senior management may, however, delegate the design, implementation, and monitoring of specific internal controls to lower-level management and the testing and assessment of internal controls to others. In discharging their responsibilities, directors and senior management should have reasonable assurance that the system of internal control prevents or detects inaccurate, incomplete, or unauthorized transactions; deficiencies in the safeguarding of assets; unreliable financial and regulatory reporting; and deviations from laws, regulations, and the institution's policies.

Some institutions have chosen to rely on so-called "management self-assessments" or "control self-assessments," wherein business-line managers and their staff evaluate the performance of internal controls within their purview. Such reviews help to underscore management's responsibility for internal control, but they are not impartial. Directors and senior managers who rely too much on these reviews may not learn of control weaknesses until they have become costly problems—particularly if directors are not intimately familiar with the institution's operations. Therefore, institutions generally should also have their internal controls tested and assessed by units without business-line responsibilities, such as internal audit groups.

Directors should be confident that the internal audit function meets the demands posed by the institution's current and planned activities. Directors and senior managers should ensure that the following matters are reflected in their internal audit function.

2060.05.1.1.1 Internal Audit Placement and Structure within the Organization

Careful thought should be given to placement of the audit function in the institution's management structure. The function should be positioned so that directors have confidence that the internal audit function will perform its duties with impartiality and not be unduly influenced by managers of day-to-day operations. Accordingly, the manager of internal audit should report directly to the board of directors or its audit committee, which should oversee the internal audit function.[3] The board or its audit committee should develop objective performance criteria to evaluate the work of the internal audit function.[4]

2060.05.1.1.2 Internal Audit Management, Staffing, and Audit Quality

The directors should assign responsibility for the internal audit function to a member of management (hereafter referred to as the manager of internal audit or internal audit manager) who understands the function and has no responsibilities for operating the business. The manager of internal audit should be responsible for control risk assessments, audit plans, audit programs, and audit reports.

1. A control risk assessment (or risk assessment methodology) documents the internal auditor's understanding of the institution's sig-

3. Institutions subject to section 36 of the FDI Act must maintain independent audit committees (that is, comprised of directors that are not members of management). For institutions not subject to an audit committee requirement, the board of directors can fulfill the audit committee responsibilities discussed in this policy statement.

4. For example, the performance criteria could include the timeliness of each completed audit, a comparison of overall performance to plan, and other measures.

nificant business activities and their associated risks. These assessments typically analyze the risks inherent in a given business line and potential risk due to control deficiencies. They should be updated as needed to reflect changes to the system of internal control or work processes and to incorporate new lines of business.
2. The audit plan is based on the control risk assessment and includes a summary of key internal controls within each significant business activity, the timing and frequency of planned internal audit work, and a resource budget.
3. An audit program describes the objectives of the audit work and lists the procedures that will be performed during each internal audit review.
4. An audit report generally presents the purpose, scope, and results of the audit, including findings, conclusions, and recommendations. Workpapers should be maintained that adequately document the work performed and support the audit report.

The manager of internal audit should oversee the staff assigned to perform the internal audit work and should establish policies and procedures to guide the audit staff.[5] The internal audit function should be competently supervised and staffed by people with sufficient expertise and resources to identify the risks inherent in the institution's operations and assess whether internal controls are effective. Institutions should consider conducting their internal audit activities in accordance with professional standards, such as the Institute for Internal Auditors' (IIA) *Standards for the Professional Practice of Internal Auditing*. These standards address the independence, professional proficiency, scope of work, performance of audit work, and management of internal audit.

2060.05.1.1.3 Internal Audit Frequency and Scope

The frequency and extent of internal audit review and testing should be consistent with the nature, complexity, and risk of the institution's on- and off-balance-sheet activities. At least annually, the audit committee should review and approve the internal audit manager's control risk assessment and the scope of the audit plan, including how much the manager relies on the work of an outsourcing vender. It should also periodically review internal audit's adherence to the audit plan. The audit committee should consider requests for expansion of basic internal audit work when significant issues arise or when significant changes occur in the institution's environment, structure, activities, risk exposures, or systems.[6]

2060.05.1.1.4 Communication of Internal Findings to the Directors, Audit Committee, and Management

To properly discharge their responsibility for internal control, directors and senior management should foster forthright communications and critical examination of issues so that they will have knowledge of the internal auditor's findings and operating management's solutions to identified internal control weaknesses. Internal auditors should report internal control deficiencies to the appropriate level of management as soon as they are identified. Significant matters should be promptly reported directly to the board of directors (or its audit committee) and senior management. In periodic meetings with management and the manager of internal audit, the audit committee should assess whether internal control weaknesses or other exceptions are being resolved expeditiously by management. Moreover, the audit committee should give the manager of internal audit the opportunity to discuss his or her findings without having management present.

2060.05.1.2 U.S. Operations of Foreign Banking Organizations

The internal audit function of a foreign banking organization (FBO) should cover its U.S. operations in its risk assessments, audit plans, and audit programs. The internal audit of the U.S.

5. The form and content of policies and procedures should be consistent with the size and complexity of the department and the institution: Many policies and procedures may be communicated informally in small internal audit departments, while many larger departments require more formal and comprehensive written guidance.

6. Major changes in an institution's environment and conditions may compel changes to the internal control system and also warrant additional internal audit work. These include (1) new management; (2) areas or activities experiencing rapid growth; (3) new lines of business, products, or technologies; (4) corporate restructurings, mergers, and acquisitions; and (5) expansion or acquisition of foreign operations (including the impact of changes in the related economic and regulatory environments).

operations normally is performed by its U.S.-domiciled audit function, head-office internal audit staff, or some combination thereof. Internal audit findings (including internal control deficiencies) should be reported to the senior management of the U.S. operations of the FBO and the audit department of the head office. Significant, adverse findings also should be reported to the head office's senior management and the board of directors or its audit committee.

2060.05.1.3 Internal Control Systems and the Audit Function for Small Financial Institutions

An effective system of internal control, including an independent internal audit function, is a foundation for safe and sound operations, regardless of an institution's size. Section 39 of the FDI Act requires each institution to have an internal audit function that is appropriate to its size and the nature and scope of its activities. The procedures assigned to this function should include adequate testing and review of internal controls and information systems.

It is management's responsibility to carefully consider the level of auditing that will effectively monitor the internal control system after taking into account the audit function's costs and benefits. For many institutions that have reached a certain size or complexity of operations, the benefits derived from a full-time manager of internal audit or auditing staff more than outweigh its costs. However, for certain smaller institutions with fewer employees and less complex operations, these costs may outweigh the benefits. Nevertheless, a small institution without an internal auditor can ensure that it maintains an objective internal audit function by implementing a system of independent reviews of key internal controls. The employee conducting the review of a particular function should be independent of the function and be able to report findings directly to the board or audit committee.

2060.05.2 INTERNAL AUDIT OUTSOURCING ARRANGEMENTS

The guidance provided within the previous subsections also applies to internal audit outsourcing arrangements which are further discussed below.

2060.05.2.1 Examples of Internal Audit Outsourcing Arrangements

An outsourcing arrangement is a contract between the institution and an outsourcing vender to provide internal audit services. Outsourcing arrangements take many forms and are used by institutions of all sizes. The services under contract can be limited to helping internal audit staff in an assignment for which they lack expertise. Such an arrangement is typically under the control of the institution's manager of internal audit, and the outsourcing vender reports to him or her. Institutions often use outsourcing venders for audits of areas requiring more technical expertise, such as audits of electronic data processing and capital-markets activities. Such uses are often referred to as "internal audit assistance" or "audit co-sourcing."

Some outsourcing arrangements may require an outsourcing vender to perform virtually all internal audit work. Under such an arrangement, the institution may maintain a manager of internal audit and a very small internal audit staff. The outsourcing vender assists staff in determining risks to be reviewed, recommends and performs audit procedures as approved by the internal audit manager, and reports its findings jointly with the internal audit manager to either the full board or its audit committee.

2060.05.2.2 Additional Inspection and Examination Considerations for Internal Audit Outsourcing Arrangements

Even when outsourcing venders provide internal audit services, the board of directors and senior managers of an institution are responsible for ensuring that the system of internal control (including the internal audit function) operates effectively. When negotiating the outsourcing arrangement with an outsourcing vender, an institution should carefully consider its current and anticipated business risks in setting each party's internal audit responsibilities. The outsourcing arrangement should not increase the risk that a breakdown of internal control can occur.

To clearly set forth its duties from those of the outsourcing vender, the institution should have a written contract, often referred to as an engagement letter. At a minimum, the contract should accomplish the following:

1. set the scope and frequency of work to be performed by the vender

2. set the manner and frequency of reporting to senior management and directors about the status of contract work
3. establish the protocol for changing the terms of the service contract, especially for expansion of audit work if significant issues are found
4. state that internal audit reports are the property of the institution, that the institution will be provided with any copies of the related workpapers it deems necessary, and that employees authorized by the institution will have reasonable and timely access to the workpapers prepared by the outsourcing vender
5. specify the locations of internal audit reports and the related workpapers
6. state that examiners will be granted immediate and full access to the internal audit reports and related workpapers prepared by the outsourcing vender
7. prescribe the method for determining who bears the cost of consequential damages arising from errors, omissions, and negligence
8. state that outsourcing venders that are subject to the independence guidance below will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of an employee

2060.05.2.2.1 Management of Outsourced Internal Audit Function

Directors and senior management should ensure that the outsourced internal audit function is competently managed. For example, larger institutions should employ sufficient competent staff members in the internal audit department to assist the manager of internal audit in overseeing the outsourcing vender.

2060.05.2.2.2 Communication of Outsourced Internal Audit Findings to Directors and Senior Management

Communication between the internal audit function and directors and senior management should not diminish because the bank engages an outsourcing vender. All work by the outsourcing vender should be well documented, and all findings of control weaknesses should be promptly reported to the institution's manager of internal audit. Decisions not to report the outsourcing vender's findings to directors and senior management should be the mutual decision of the internal audit manager and the outsourcing vender. In deciding what issues should be brought to the board's attention, the concept of "materiality," as the term is used in financial audits, is generally *not* a good indicator of which control weakness to report. For example, when evaluating an institution's compliance with laws and regulations, any exception may be important.

2060.05.2.2.3 Competence of Outsourced Internal Audit Vender

Before entering an outsourcing arrangement, the institution should perform enough due diligence to satisfy itself that the outsourcing vender has sufficient staff who are qualified to perform the contracted work. Because the outsourcing arrangement is a personal services contract, the institution's internal audit manager should have confidence in the competence of the staff assigned by the outsourcing vender and receive prior notice of staffing changes. Throughout the outsourcing arrangement, management should ensure that the outsourcing vender maintains sufficient expertise to effectively perform its contractual obligations.

2060.05.2.2.4 Contingency Planning to Avoid Discontinuity in Internal Audit Coverage

When an institution enters into an outsourcing arrangement (or significantly changes the mix of internal and external resources used by internal audit), it increases its operating risk. Because the arrangement might be suddenly terminated, the institution should have a contingency plan to mitigate any significant discontinuity in audit coverage, particularly for high-risk areas. Planning for a successor to the prospective outsourcing vender should be part of the negotiations for the prospective vender's service contract.

2060.05.2.3 Independence of the External Auditor

This section of the policy statement applies only to an outsourcing vender who is a certified public accountant (CPA) and who performs a financial-statement audit or some other service for the institution that requires independence

under American Institute of Certified Public Accountants (AICPA) rules.[7]

Many institutions engage certified public accounting firms to audit their financial statements and furnish other attestation services requiring independence. A certified public accounting firm that provides other services for its client (such as consulting, benefits administration, or acting as an outsourcing vender) risks compromising the independence necessary to perform attestation services. The professional ethics committee of the AICPA has issued rulings and interpretations specifically addressing whether a certified public accountant that furnishes both audit outsourcing and external audit or other attestation services to a client can still be considered independent.[8]

Section 36 of the FDI Act and associated regulations require the management of every insured depository institution with total assets of at least $500 million—

1. to obtain an annual audit of its financial statements by an independent public accountant,
2. to report to the banking agencies on the effectiveness of the institution's internal controls over financial reporting and on the institution's compliance with designated laws and regulations (management report), and
3. to obtain a report from an external auditor attesting to management's assertion about these internal controls (internal control attestation report).

To satisfy these requirements, the institution's board of directors must select an external auditor that will satisfy the independence requirements established by the AICPA and the relevant requirements and interpretations of the Securities and Exchange Commission.

Questions have been raised about whether external auditors who perform an audit of the institution's financial statements or provide any other service that requires independence can also perform internal audit services and still be considered independent. The federal banking agencies are concerned that outsourcing arrangements may involve activities that compromise, in fact or appearance, the independence of an external auditor.

The AICPA has issued guidance to CPAs (Interpretation 101-13 and related rulings) on independence that addresses these issues. Under Interpretation 101-13, the CPA's performance of services required by the outsourcing arrangement "would not be considered to impair independence with respect to [an institution] for which the [CPA] also performs a service requiring independence, provided that [the CPA or the CPA's firm] does not act or appear to act in a capacity equivalent to a member of [the institution's] management or as an employee." The interpretation lists activities that would be considered to compromise a CPA's independence. Included are activities that involve the CPA's "authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of the client."[9]

Also, the AICPA's Ruling No.103 sets forth three criteria that must be met when evaluating the independence of a CPA who concurrently provides internal audit outsourcing services and the internal control attestation report under section 36 of the FDI Act. One of those criterion requires that management "does not rely on [the CPA's] work as the primary basis for its asser-

7. Although outsourcing arrangements involving CPAs who are not performing external audit or attestation services for a client are not subject to this independence guidance, they are subject to the other sections of this policy statement.

8. In May 1997, the AICPA and the Securities and Exchange Commission announced the formation of the Independence Standards Board (ISB), a private-sector body intended to establish independence standards for auditors of public companies. Any future standards established by the ISB should be considered in initiating or evaluating outsourcing arrangements with CPAs.

9. Other examples of outsourcing activities that would compromise a CPA's independence that are listed in Interpretation 101-13 include—

- performing ongoing monitoring activities or control activities (that is, reviewing loan originations as part of the client's approval process or reviewing customer credit information as part of the customer's sales authorization process) that affect the execution of transactions or ensure that transactions are properly executed, accounted for, or both, and performing routine activities in connection with the client's operating or production processes that are equivalent to those of an ongoing compliance or quality control function;
- reporting to the board of directors or audit committee on behalf of management or the individual responsible for the internal audit function;
- preparing source documents on transactions;
- having custody of assets;
- approving or being responsible for the overall internal audit work plan, including the determination of the internal audit risk and scope, project priorities, and frequency of performance of audit procedures; and
- being connected with the client in any capacity equivalent to a member of client management or as an employee (for example, being listed as an employee in client directories or other client publications, permitting himself or herself to be referred to by title or description as supervising or being in charge of the client's internal audit function, or using the client's letterhead or internal correspondence forms in communications).

tion and accordingly has (a) evaluated the results of its ongoing monitoring procedures built into the normal recurring activities of the entity (including regular management and supervisory activities) and (b) evaluated the findings and results of the [CPA's] work and other separate evaluations of controls, if any." Accordingly, a CPA's independence would be impaired if the CPA provides the *primary* support for management's assertion on the effectiveness of internal control over financial reporting.

2060.05.2.3.1 Agencies' Views on Independence

The agencies believe that other actions compromise independence in addition to those in Interpretation 101-13. Such actions include the following:[10]

1. contributing in a decision-making capacity or otherwise actively participating (for example, advocating positions or actions rather than merely advising) in committees, task forces, and meetings that determine the institution's strategic direction
2. contributing in a decision-making capacity to the design, implementation, and evaluation of new products, services, internal controls, or software that are significant to the institution's business activities

2060.05.3 INSPECTION AND EXAMINATION OBJECTIVES

1. To determine whether the banking organization has an adequate system of internal controls that forms a foundation for safe and sound operations.
2. To determine if the internal audit function and the internal audit outsourcing arrangements of the parent company and its subsidiaries are adequately managed by the board of directors and senior management.
3. To determine whether the internal audit function provides management with vital information about weaknesses in the system of internal controls and that management takes prompt remedial action when weaknesses exist.
4. To determine the adequacy of the internal audit function (including its use of outsourced internal audit venders) as to organizational structure, prudent management, staff having sufficient expertise, audit quality, and the ability of auditors to directly and freely communicate internal audit findings to the board of directors, its audit committee, and senior management.

10. The agencies believe that this guidance is consistent with the AICPA interpretation.

2060.05.4 INSPECTION AND EXAMINATION PROCEDURES

Examiners should have full and timely access to an institution's internal audit resources, including personnel, workpapers, risk assessments, work plans, programs, reports, and budgets. A delay may require examiners to widen the scope of their examination work and may subject the institution to follow-up supervisory actions.

2060.05.4.1 Internal Audit Function Examination and Inspection Procedures

1. Assess the quality and scope of the internal audit work, regardless of whether it is performed by the institution's employees or by an outsourcing vender. Consider whether—
   a. the board of directors (or audit committee) promotes the internal audit manager's impartiality and independence by having him or her directly report audit findings to it;
   b. the internal audit function's risk assessment, plans, and programs are appropriate for the institution's activities;
   c. the internal audit function is adequately managed to ensure that audit plans are accomplished, programs are carried out, and results of audits are promptly communicated to the managers and directors;
   d. the institution has promptly responded to identified internal control weaknesses;
   e. management and the board of directors use reasonable standards when assessing the performance of internal audit;
   f. the internal audit plan and program have been adjusted for significant changes in the institution's environment, structure, activities, risk exposures, or systems;
   g. the activities of internal audit are consistent with the long-range goals of the institution and are responsive to its internal control needs; and
   h. the audit function provides high-quality advice and counsel to management and

the board of directors on current developments in risk management, internal control, and regulatory compliance.

2. Assess the competence of the institution's internal audit staff and management by considering the education and professional background of the principal internal auditors.

2060.05.4.2 Additional Aspects of the Examiner's Review of Outsourcing Arrangements

1. Determine whether—
   a. the outsourcing arrangement maintains or improves the quality of the internal audit function and the institution's internal control;
   b. key employees of the institution and the outsourcing vender clearly understand the lines of communication and how any internal control problems or other matters noted by the outsourcing vender are to be addressed;
   c. the scope of work is revised appropriately when the institution's environment, structure, activities, risk exposures, or systems change significantly;
   e. the directors have ensured that the outsourced internal audit function is effectively managed by the institution;
   f. the arrangement with the outsourcing vender compromises its role as external auditor; and
   g. the institution has performed sufficient due diligence to satisfy itself of the vender's competence before entering into the outsourcing arrangement and has adequate procedures for ensuring that the vender maintains sufficient expertise to perform effectively throughout the arrangement.
2. Adjust the scope of the inspection if the outsourcing arrangement has diminished the quality of the institution's internal audit. If the quality of the internal audit is diminished, inform senior management and the board of directors and consider it in the institution's management and composite ratings.

2060.05.4.3 Assessment of Auditor Independence

1. Ask the institution and the external auditor to demonstrate that the outsourcing of the internal audit arrangement has not compromised the auditor's independence, if the initial review of the arrangement raises doubt about the external auditor's independence.
2. Discuss the matter with appropriate Federal Reserve System management and staff, if the independence issue is not adequately addressed.
3. If Federal Reserve System management and staff concur that the independence of the external auditor appears to be compromised, discuss the findings and determine what appropriate actions the Federal Reserve should take with the institution's senior management, board of directors (or audit committee), and the external auditor. Note: These actions may include referring the external auditor to the state board of accountancy and the AICPA for possible ethics violations, and barring the external auditor from engagements with regulated institutions. Moreover, the Federal Reserve may conclude that the organization's external auditing program is inadequate and that it does not comply with auditing and reporting requirements, including section 36 of the FDI Act and related guidance and regulations.

Audit is an independent appraisal activity which serves as a managerial control within an organization. The primary responsibility for the maintenance of sound systems of internal controls and an adequate internal audit program rests with the directorate of the bank holding company. Included among the objectives of a comprehensive audit program are the detection of irregularities; the determination of compliance with applicable laws and regulations; and the appraisal of the soundness and adequacy of accounting, operating, and administrative controls designed to ensure prompt and accurate recording of transactions and a proper safeguarding of assets. At a minimum, an audit program should ensure that adequate systems of checks and balances are in effect to deter fraud and detect control deficiencies.

The size and complexity of a bank holding company operation are major determinants in the scope and extent of the audit program that is developed. In the smaller, less sophisticated organizations, such as holding company shells for small banks, it may not be feasible to employ an auditor or implement an audit program. In some cases, such as those in which banking assets represent virtually all of the parent company's assets and a comprehensive, effective audit program is being implemented in the various subsidiaries, neither an internal nor an external audit program may be necessary at the parent company level.

The development and implementation of an internal audit program should be delegated to a qualified staff large enough to meet the functional requirements of the job under the guidance and leadership of the auditor. When evaluating the effectiveness of an internal audit program, the examiner may want to consider the size of audit staffs of banking organizations of a similar size and complexity. To ensure freedom of access to corporate records and complete independence and objectivity in administering the audit program, the auditor should report directly to the directorate or a committee thereof. Administratively, the internal auditor is usually responsible to an officer at a major policy-making level.

To supplement the internal audit activities, external accountants-auditors may be engaged to certify and/or audit the financial statements or specified activities of the bank holding company and its subsidiaries. Each top-tier bank holding company with total consolidated assets of $500 million or more must engage independent public accountants to perform audits and report on its annual financial statements in accordance with generally accepted accounting principles. The scope of the audit engagement must be sufficient to permit such accountant to determine and report whether the financial statements are presented fairly and in accordance with generally accepted accounting principles. Bank holding companies do not have to submit audited financial statements as part of the requirements for the FR-6 annual report. The Federal Reserve may request audited consolidated financial statements from any bank holding company with total consolidated assets of less than $500 million if deemed warranted for supervisory purposes.

The internal and external auditors should work together in establishing the scope and frequency of audits to be performed. In addition to performing some of the basic functions of the internal auditor, the external auditor should review the internal auditing program to assess its scope and adequacy. When a bank holding company is perhaps too small to employ an internal audit staff, but the complexities and activities of the organization suggest the need for an audit, the holding company should consider hiring an external auditor. Independence and objectivity are mandatory in any audit program, and these are difficult to maintain if the audit function is a part-time responsibility. When external auditors are employed to perform the internal audit function, they should be permitted to establish the scope of their audits and schedule surprise audits. They also should be given responsibility for suggesting systems and organizational duty assignments for maximum control consistent with the size of the organization.

2060.1.1 EXTERNAL AUDITORS AND THE RELEASE OF REQUIRED INFORMATION

The enactment of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) on August 9, 1989, requires that FDIC-insured depository institutions that are being audited provide their independent auditors with information concerning their financial condition and any supervisory actions being taken against them. Specifically, section 7(a) of the

Federal Deposit Insurance Act (12 U.S.C. 1817(a)(8)(A)) requires an insured depository institution, which has engaged the services of an independent auditor to perform an audit within the past two years, to provide the auditor with—

1. ". . . A copy of the most recent report of condition made by such depository institution (pursuant to the . . . FDIC Act . . . or any other provision of law) and a copy of the most recent report of examination received by such depository institution";
2. ". . . A copy of any supervisory memorandum of understanding with such depository institution and any written agreement between a Federal or State banking agency and the depository institution which is in effect during the period covered by the audit"; and
3. ". . . A report of any action initiated or taken by a Federal banking agency during . . . the period . . . covered by the audit . . . under subsection (a), (b), (c), (e), (g), (I), or (s) of section 8 . . . of the Federal Deposit Insurance Act . . . or of any similar action taken by a State banking agency under State law, or any other civil money penalty assessed under any other provision of law with respect to . . ." the depository institution or any affiliated party.

External auditors who are serving as agents of a bank holding company may, with the approval of the organization, review examination/inspection reports and supervisory correspondence received and communicate with examiners. Examiners should remind external auditors of their responsibility to maintain the confidentiality of the reports and other supervisory communications reviewed as part of their engagement. Reference should also be made to the Board's rules on the release of confidential supervisory information (see 12 C.F.R. 261, subpart C).

2060.1.2 EXTERNAL AUDITOR INQUIRIES

In some situations, examiners may not be able to fully respond to external auditors' inquiries on certain matters relating to examinations still in progress. The examiners' findings may be incomplete or may be under review by higher supervisory authorities within the Federal Reserve System. In addition, as a general practice, examiners will normally only discuss with external auditors issues and inspection findings that have been presented to the bank holding company's management. These situations relate primarily to the timing of the auditors' inquiries in relation to the stage of inspection work and, thus, should not automatically preclude an auditor from expressing an opinion on the organization's financial statements.

2060.1.3 INSPECTION OBJECTIVES

1. To review the operations of bank holding companies that do not have an audit program to ascertain if such a program should be developed.
2. To determine the adequacy of the scope and frequency of the audit program.
3. To determine that audit reports and findings receive appropriate attention, including follow-up responses to exceptions or weaknesses disclosed during an audit.
4. To determine the respective roles of internal and external auditors and to evaluate the procedures employed in carrying out their assigned responsibilities.
5. To determine the independence of those who administer the audit function.
6. To determine compliance with section 7(a) of the FDIC Act with regard to FDIC-insured depository institution examinations and other designated supervisory reports and correspondence which are required to be released to external auditors.

2060.1.4 INSPECTION PROCEDURES

The primary thrust of the inspection should be directed toward the audit activities that relate to the parent company and all subsidiaries. An assessment of the audit function as it pertains to the bank(s) is primarily the responsibility of the regulatory agency that examines that particular bank. The examiner should review the latest bank examination reports to note comments and deficiencies cited concerning internal controls and the audit function. In addition to providing an input into the overall assessment of the audit function, review of the bank examination reports may provide a basis for determining areas of investigation during the inspection. Further, if matters cited in the latest bank examination report are deemed to be significant and indications are that corrective action has not been taken, the examiner should mention the facts to senior management of the bank holding com-

pany and note the details in the inspection report.

To judge the adequacy of the audit program, including scope and frequency, the following procedures, with equal emphasis being placed on the parent, bank, and nonbank subsidiaries, are recommended as minimum guidelines for the inspection:

1. Review the parent company and nonbank operations and the audit comments in the bank examination reports to ascertain the adequacy of the existing audit program or the need for developing such a program, if the organization currently lacks one.
2. Review the scope of the audit function to ensure that procedures are in place to cover adequately those areas that may be susceptible to exposure. When reviewing the audit scope, determine whether the auditor was able to perform all the procedures necessary to complete the audit. If not—
   a. establish whether the scope limitations were imposed by the directorship or management and
   b. determine whether the auditor established and documented the reasons why the scope limitations were imposed.
      (1) Was the auditor able to quantify the effects of the scope limitation on the financial statements and the audit results, and if not pervasive, was a qualified opinion or disclaimer of opinion issued?
      (2) Did the auditor evaluate all possible effects on his ability to express an opinion on the financial statements?
      (3) Were there any external circumstances that imposed limitations on the audit's scope?
      (4) Were alternative procedures used to accomplish the same audit objectives? If so, did the use of the alternative procedures justify issuance of an unqualified opinion?
3. Review the audit schedule to determine that the audits are satisfactorily spaced and that all functions are audited with adequate frequency.
4. Review audit workpapers and reports on a test-check basis for adequacy of content, satisfactory maintenance, and conformance to audit guidelines outlined by the board of directors.
5. Determine the qualifications and background of the auditor and others participating in the audit function.
6. To establish that the auditor has a direct communication line to the board of directors and freedom of access to all records for audit purposes, review audit reports and minutes of meetings held by directors or a committee thereof.
7. Determine the entity responsible for maintaining the audit function. If a bank provides audit services to affiliates, indicate the manner in which the bank is reimbursed for the cost of such services.
8. Determine whether audit reports are submitted on a timely basis to—
   a. the directors and senior management and
   b. management in the area being audited.
9. Review responses to exceptions and recommendations noted in audit reports.
10. Check on the relationship between the internal and external auditors to determine whether their activities are coordinated in a manner that effects comprehensive coverage of the organization and at the same time avoids duplication of effort.
11. Review the letter addressed to management by the external auditor and determine that steps have been taken to correct any deficiencies noted. If no deficiencies were noted in the letter, inquire as to whether such comments were communicated to management by any other means.
12. Ascertain that the audit program is annually reviewed and approved by the directors.
13. Scan the external auditor's engagement letter and reports noting any qualifications contained therein. If new external auditors have been engaged, ascertain the reasons for such change.
14. Determine if the parent company or nonbank subsidiaries have reported any defalcations. If so, determine if adequate controls have been initiated to lessen any further risk and exposure.
15. Determine if the external auditors received copies of the FDIC-insured institution's examination and other designated supervisory reports and correspondence required by section 7(a) of the FDIC Act.
16. Review the engagement letter between the board of directors and the external auditor to determine the scope of the audit and the degree of reliance on internal audit staff. Letters requesting opinions from external auditors should also be reviewed to determine that the opinion obtained was not influenced by management.
17. Determine the degree of independence of the external audit firm by reviewing any

financial ties between the bank, audit firm, and any of its partners or employees. Also review any other relationships or potential conflicts of interest that may exist.

The independence of the internal auditor should be evaluated by ascertaining whether the following conditions exist: (1) reports are distributed directly to the board or a committee thereof or, less desirably, to an officer not connected with the area being reviewed; (2) there are no relationships within the organization which are incompatible with the internal audit function; and (3) severe restrictions are not placed on the program or scheduling by management. In order to maintain the degree of objectivity essential to the audit function, the examiner should establish that the internal audi tor does not install procedures, originate and approve entries, or otherwise engage in any activity which would be subject to audit review and appraisal.

The examiner should consider meeting with the auditor and, subsequently, with senior bank holding company management to communicate conclusions concerning the adequacy of the scope and frequency of the audit program. During the discussions, the examiner should concentrate on detailing criticisms or deficiencies noted. The auditor and senior bank holding company management should be made fully cognizant of the examiner's analyses and the comments concerning the audit function that will appear on the relevant pages in the inspection report.

An assessment of management's strategic plans and its success in meeting previously established budgetary goals is one of the factors considered in evaluating a BHC's management, operations, financial condition, and prospects.[1] Through review of the budget figures, insight can be gained concerning an organization's future plans and other matters such as capital adequacy, liquidity, sources and applications of funds, level and quality of earnings, and performance of management.

The budget is a coordinated financial plan used to estimate and control all or a few of the activities of the various divisions or subsidiaries in a bank holding company. Based on an assessment of future economic developments and conditions, management formulates a plan of action and indicates anticipated changes in the balance-sheet accounts and profitability (predicated on implementation of the plan). The budget is a significant management tool in that it projects expected results and also serves as an important check on management decisions and performance by providing a basis for comparison and corrective action on a timely basis. The comparison of actual performance to budget allows management to give careful attention to various possible courses of action and to choose the course which should result in the greatest benefit. Budgeting is also useful in measuring the performance of individuals and the departments they manage. Further, the comparison of budget totals to actual changes in activities such as loans, investments, and deposits assists in decision making and can promote coordination and cooperation among affiliates. The variance indicated by the comparison process may be construed as a measure of management's performance and planning record and its relationship to the organization's goals and objectives. It should be noted that some significant variances may be caused by factors beyond management's control or factors that could not reasonably be anticipated.

1. The *stragetic planning process* focuses on intermediate and long-term strategic goals and is the vehicle used to determine the overall direction and focus of the organization. The *budgeting process* refers to the tactical decisions required to meet goals and objectives. The budget is a subset of the strategic plan. While smaller bank holding company organizations may not always have formal written budgets, all organizations should have a strategic planning process, which determines overall corporate direction, general resource allocation, and balance-sheet relationships with respect to capital needs, growth, asset mix, and risk.

While various individuals may be responsible for input to the budget process, the chief executive officer typically has the ultimate responsibility for preparation and implementation of the formal budget. The time period covered by a budget typically encompasses one year, although it often covers longer periods in the larger, more sophisticated bank holding companies. The longer the budget period, the greater are the prospects for increased variances from original budget figures. In some cases in which four- or five-year projections are made, bank holding companies may formulate several forecasts based on different sets of assumptions. In such instances, the examiner should work with the "most likely" situation that may evolve based on economic trends, history, and experience of the organization, but should also give serious consideration to the "worst-case" projections.

Many bank holding companies, particularly the smaller organizations, may not have formal written budgets or plans. In small shell companies, while it is not essential to have a formal budget, budgeting procedures should be encouraged where appropriate. Budgeting at the parent level could be appropriately limited to debt-servicing and dividend considerations.

2060.2.1 INSPECTION OBJECTIVES

1. To determine the extent of an organization's financial planning and budget program.
2. To indicate to management of organizations that are without formal planning procedures the advantages of adopting a budget.
3. To understand the institution's decision-making process as it relates to the budget.
4. To determine the causes of significant variances between the budget and actual performance.
5. To assess the reasonableness of projected figures, including controls over the data throughout the budgeting process.
6. To assess the impact of the budget on the present condition and future prospects of the bank holding company.
7. To determine whether the plan outlined in the budget is supported by the financial and managerial resources of the holding company.

2060.2.2 INSPECTION PROCEDURES

1. Familiarity with a bank holding company's financial condition and results of operations should begin before the start of the inspection with a review of the annual report to shareholders, financial reports submitted to the Federal Reserve System, and other financial documentation contained in the files. The more significant accounts, statistical data, and pertinent ratios should be compared on a period-to-period basis to highlight significant changes and discern trends.

2. The examiner also should become familiar with current and projected economic conditions, both nationally and locally, including general industry conditions.

3. Based on a review of the aforementioned data, the examiner should be in a position to substantiate the reasonableness of budgeted figures without a systematic examination of all of the transactions affecting the figures presented. Further, such an analysis provides a better understanding of the operation and highlights matters of interest and potential problem areas to be investigated during the inspection.

4. Throughout the review process, the examiner must maintain a sense of perspective to avoid spending excessive time on relatively immaterial amounts.

5. The examiner should meet with the officer responsible for the preparation of the budget to determine the scope of the organization's financial plans. The extent of senior management's and the board of directors' involvement in the strategic planning and budgeting process should also be ascertained in this preliminary meeting.

6. Workpapers which document or illustrate the rationale for the budget data should be reviewed and discussed with budget personnel, including the existence and extent of internal controls over the data.

7. The examiner should evaluate plans, projections, and forecasts in light of market-area characteristics and the present condition and history of the organization.

8. The examiner should determine whether the accounting principles of major importance have been applied consistently and, if not, the impact of the alternative accounting treatment on the budget totals.

9. The sources of input for the budget should be reviewed and the frequency and procedures for effecting revision should be ascertained.

10. When there are significant budget variances, the examiner should seek documented explanations. Review any such documentation to determine if management policy or factors beyond management control were responsible for the variances.

11. A final summary discussion should be held with management to discuss goals which the examiner believes may be unattainable and to communicate conclusions concerning the budget. Due consideration should be given to management's views, whether or not in concurrence with the examiner's conclusions. If management indicates future changes which could have a significant impact on the organization, the matter should be noted in the inspection report. Further, management's assessment of the effect of contemplated action on the operations and financial condition of the bank holding company should be noted.

12. For those bank holding companies that do not have formal written plans, the examiner should obtain from senior management information on their plans for matters such as growth and expansion, capital injections, debt retirement, and changes in sources of funding. Except for small, shell companies, the examiner should recommend adoption of a budget program and emphasize the need for strategic planning by indicating how management methods may be improved as a result of a logically conceived and properly operated budget. Budgets and planning are especially important in cases in which a bank holding company is losing its share of the market or in which inefficiencies are depressing profitability.

Adequate and accurate records and financial statements are an integral part of a sound bank holding company operation. Records should be maintained to allow preparation of financial statements in accordance with generally accepted accounting principles and to ensure proper accountability for all assets, liabilities, income, and expenses. Generally, an independently certified statement inspires greater confidence than a statement prepared internally. Moreover, an unqualified, independently certified statement may act as a check on management recordkeeping policies and procedures, and provide more assurance that transactions are being properly recorded and that books accurately reflect overall financial condition.

Management may exercise reasonable discretion in selecting and adopting the type of books and records it uses and in formulating accounting systems and bookkeeping procedures. From the examiner's viewpoint, the test of a bank holding company's records is one of adequacy, consistency, and accuracy. The financial statements of every bank holding company must accurately reflect financial condition and operating results. This principle is applicable whether a bank holding company is small and has a relatively simple bookkeeping system or whether it is a larger institution with a fully automated system. A recordkeeping system that is capable of generating a wide variety of pertinent internal data and other information facilitates problem solving and decision making and, thus, contributes to the efficiency of a bank holding company's operations. Further, such a system serves as a convenient tool to provide directors, stockholders, and other interested parties with information on conditions in a bank holding company.

2060.3.1 INSPECTION OBJECTIVES

1. To determine whether financial statements are prepared in accordance with generally accepted accounting principles and are sufficiently detailed to accurately portray the company's financial condition.
2. To determine that sufficient records are maintained to provide detail on material balance-sheet items, income-statement items, and various contingent liabilities and off-balance-sheet risks that permit the preparation of appropriate financial information.
3. To recommend corrective action when policies and procedures employed have resulted in inadequate or inaccurate records and financial statements.

2060.3.2 INSPECTION PROCEDURES

1. The examiner should review the sections relating to audit and records in the prior inspection report and the latest examination reports of the subsidiary banks to note any comments or deficiencies cited concerning records, including any MIS deficiencies. In addition to providing an input into the overall assessment of the quality of records, the review may provide a basis for determining areas of emphasis and follow-up during the inspection.
2. The examiner should discuss recommendations and criticisms contained in such reports with an appropriate officer to ascertain what changes, if any, have taken place.
3. The examiner should review the external auditing firm's management letter, giving particular attention to comments concerning recordkeeping. Determine if any corrective actions were recommended by the external auditors and the extent to which the cited items have been corrected.
4. In those situations when it appears that records are deficient or financial statements are inaccurate, a thorough investigation of applicable transactions may be required. The purpose of the investigation is to obtain information needed in outlining improved controls over MIS, accounting methods, and records so that the financial data presented are in accordance with generally accepted accounting principles. Thus, information is provided which will better serve bank holding company management. The investigation should not necessarily involve a review of every transaction, but should involve a check of a sufficient number of transactions to ensure the examiner that the records, as checked, reflect an accurate financial condition. The extent of the review will depend largely on the procedures and controls over MIS and the condition and adequacy of the books and underlying records. During the investigative process, the examiner should be careful to distinguish between documented facts and statements of intent or interpretations set forth by company representatives.

Management of Information Systems (Structure and Reporting) Section 2060.4

The directorate and management of bank holding companies have a responsibility to contribute to the health and growth of the organization they serve. To carry out this responsibility effectively, they must be kept fully informed of conditions throughout the organization and trends within the banking industry. Reporting is the process of developing and communicating information internally to directors and management and externally to shareholders and regulatory authorities. Management and the board of directors must recognize that as a company develops and grows, its environment, strategic goals, and information needs change. The guidelines and requirements for reports flowing to management and the board of directors should be established and allow for change, recognizing the fact that informational needs can vary, including those at different levels of the organization.

Informational needs will also be dictated by the particular type of management structure in place—centralized, decentralized, legal entity, or business line. The ultimate decision-making responsibility rests with the corporation's board of directors, and the responsibility for implementing their decisions rests with designated board committees, executive management, or other designated management committees or individuals. As such, examiners should make an assessment of the qualifications of the persons on the board of directors, executive management staff, and the board and executive management committees to ensure that they have the necessary knowledge, experience, and expertise to understand the information presented and to act on it constructively. The assessment should include a review of reporting lines to identify information flows and the various decision-making levels involved or needed.

All reports flowing to executive management, board committees, and the board of directors should be analyzed for clarity, consistency, timeliness, quality, and coverage of crucial areas of the organization. A review of board and committee minutes should reveal if participants had any questions or whether there were any uncertainties as to the meaning of the data presented.

Each bank holding company prepares various reports for submission to its management and directors; an effective internal reporting system facilitates their ability to analyze a situation and to make informed decisions. Although such reports may vary in content from company to company, emphasis is generally placed on the financial data generated. The important consideration is whether each company is providing sufficient data to keep the interested parties informed of the financial condition and performance of all the divisions or entities. The frequency of the reporting and the detail of information provided can be categorized as being on a need-to-know basis. The form of reports ranges from consultations and meetings to submission of printed material for study and review. The scope and size of the operations will have an effect on the frequency and detail of the information submitted. In the larger, more sophisticated companies, frequent meetings and consultations are held to discuss the performance of various entities, the impact of performance on the organization's goals and objectives, and policies and strategies to be followed. Written reports outlining important matters and summarizing various financial data are typically reviewed and discussed regularly.

The number and variety of reports depends on the size and sophistication of the bank holding company operation. For smaller bank holding companies, the extent of their reports may be limited to annual statements, as more frequent periodic reports may not be necessary under normal conditions. The larger holding companies normally prepare monthly comparative balance sheets and income statements covering similar periods for two consecutive years. Thus, any significant deviation from the prior year's data can be readily detected. Generally, reports detailing the extent of delinquent and nonaccrual loans are prepared monthly. Facts and figures pertaining to the adequacy of the loan-loss provision are presented periodically. Additional reports containing information on budgets, cash flow, liquidity, and capital adequacy are prepared to assist management in assessing the organization's overall financial condition and performance. Summaries of internal audit reports and reports of examinations of subsidiary banks are brought to management's attention. Data relative to other bank holding companies or banks in the same peer groups are assembled, when available, so that comparisons with similarly sized organizations are possible. All of the aforementioned information may be prepared for directors, although not necessarily in as much detail as that submitted to management. On occasion, key management personnel of the holding company attend directors' meetings to expand on the topics being discussed.

Reports to shareholders usually consist of quarterly and annual reports which detail the company's financial condition and results of operations. Additional information may include the chief executive officer's overall assessment of the company, future plans, and other financial and analytical data. The financial information is used for public disclosure and enables investors, depositors, and creditors to make informed judgments concerning the financial condition of the bank holding company. Bank holding companies whose securities have been registered pursuant to the Securities and Exchange Act of 1934 are required to prepare various reports containing specific financial information.

2060.4.1 INSPECTION OBJECTIVES

1. To review the organizational structure to determine the various levels of decision-making and reporting lines, including board and executive management committees.
2. To determine whether the bank holding company has written policies and procedures, and internal controls covering the types of reports required to be submitted to management and the directors.
3. To determine that the required reports are adequate to accurately reflect the financial condition and performance within the organization's divisions and units and whether the reporting systems and reports are adequate to monitor the risks therein.
4. To evaluate whether the reports and reporting systems are adequate to measure and reflect the company's financial position and performance in all areas, to measure the company's progress in meeting its financial and business goals, and to monitor inherent risks.
5. To determine that the contents of the reports are complete and submitted on a timely basis.
6. To recommend corrective action when reporting practices, policies, or procedures are deficient.
7. To evaluate management's procedures for reacting to elevated risk, weaknesses, or deficiencies disclosed by reporting systems, and to evaluate the system's ability to adapt to change caused by regulatory and accounting issues or other market conditions.

2060.4.2 INSPECTION PROCEDURES

1. Review the organizational structure to determine reporting lines and the various levels of decision making, risk assessment, and controls.
2. Ascertain whether any corporate policies address risk managment or internal reporting requirements and determine:
   a. the types of reports required to be submitted and
   b. the adequacy of such reporting requirements in light of a company's particular circumstances.

   Comment: In a holding company with a decentralized system of control over subsidiaries, the existence of written policies and procedures is important since each subsidiary operates as a relatively autonomous unit.
3. Obtain a listing of internal reports that are submitted to corporate executive management and the board of directors (including packages for the board of directors and executive committees).
4. Randomly sample, based on a material risk focus, the individual as well as the various types of management reports and determine whether they are adequately prepared in accordance with established policies and procedures and submitted to the appropriate individuals on a timely basis. Determine whether the management reports are sufficient to measure the company's progress in achieving its financial and business goals and forecasts.
5. Identify and document management procedures for reacting to elevated risk, weaknesses, or deficiencies disclosed by MIS. Also evaluate the ability of the information system to handle regulatory and accounting issues and to adapt to change.
6. At the conclusion of the review process, the examiner should discuss with management, as appropriate, topics such as—
   a. the lack of established policies and procedures and internal controls,
   b. inadequate reporting requirements, and
   c. noncompliance with reporting requirements and/or the untimely submission of reports.

2060.4.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Registration, reports, and examinations or inspections		225.5		
Reporting requirements emanating from the Securities Exchange Act of 1934	15 USC 78a et seq.			

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

2060.5.1 INTRODUCTION

In establishing an insurance program, a bank holding company should be aware of where it is exposed to loss, the extent to which insurance is available to cover potential losses and the cost of such insurance. These various factors should be weighed to determine how much risk the bank holding company will assume directly. In assessing the extent of risk an organization is willing to assume, it is important to analyze the impact of an uninsured loss not only on the entity where the loss occurs, but also on the affiliates and the parent. Once appropriate coverage has been acquired, procedures should be established for the periodic review of the program to assure the continuing adequacy of the coverage. Particularly for larger BHCs, these procedures should include at least an annual review of the program by the board of directors of the parent organization.

Insurance is a highly specialized field and no attempt is made here to discuss all the various types and forms of insurance coverage that are available to financial institutions. Examiners are not expected to be insurance experts; however, examiners should recognize that a financial organization's primary defenses against loss include adequate internal controls and procedures and that insurance is intended to complement, not replace, an effective system of internal controls. Thus, an overall appraisal of the control environment becomes a significant consideration in assessing the adequacy of the insurance program. To the extent controls are lacking, the need for additional coverage increases.

2060.5.2 BANKER'S BLANKET BOND

The most important and comprehensive insurance coverage available is the bankers' blanket bond which is usually extended to encompass all the entities in a bank holding company structure. Generally, the scope of the blanket bond contract is intended to cover risks of loss due to criminal acts, such as embezzlement, burglary, robbery, theft, larceny, forgery, etc., but in addition it provides indemnity for loss of property through damage, destruction, misplacement and mysterious, unexplainable disappearance. The most important item of protection under the bond, however, is the blanket fidelity coverage for officers and employees.

2060.5.3 TYPES OF BLANKET BONDS

While there are several similar forms of blanket bonds in use, those commonly found are the Financial Institutions Bond Standard Form No. 24, the Bankers Blanket Bond Standard Form No. 2, and Lloyd's Banks' and Trust Companies' Policy HAN Form (C). Under these blanket forms, every employee is usually covered for the total amount of the bond. Typically, new employees and new offices are automatically covered and no notice is required for an increase in the number of employees or in the number of offices established, unless such increases result from a merger or consolidation with another institution. The word "blanket," however, refers to the over-all amount that applies to the several specified risks covered under the bond and is not intended to mean "all risks" coverage. A most important feature of the bankers' blanket bond is the "discovery rider." The rider, which converts the blanket bond from a "loss sustained basis" to a "discovery basis," provides indemnity against any loss sustained by the insured entity at any time but discovered after the effective date of the bond and prior to the termination or cancellation of the bond, even though lower amounts of insurance and more restrictive coverage may have been carried when the loss was actually sustained.

2060.5.4 DETERMINING THE COVERAGE NEEDED

One of the most difficult insurance problems management faces is the determination of the amount of blanket bond coverage that should be maintained. An estimate of the maximum amount of money and securities that may be lost through burglary or robbery can be calculated with reasonable accuracy, but the potential loss resulting from dishonest acts of officers and employees is not easily measured. The Insurance and Protective Committee of the American Bankers Association has conducted several studies of the problems of determining adequate coverage and has concluded that total deposits represent the most appropriate item in bank financial statements upon which to base an estimate of a reasonable or suitable amount of blanket bond coverage.

In a bank holding company structure, the amount of blanket bond coverage is generally determined by the deposits of the largest bank and the amount of suggested coverage in the ABA's schedule. Such an amount is considered to be a minimum and other factors such as a rapidly expanding operation, excessive cash on hand, or inferior audit and control practices may suggest the need for larger coverage. Since coverages are generally extended to include the nonbank subsidiaries and such subsidiaries usually operate on a smaller scale than their affiliated banks, the question concerning the adequacy of the amount of the blanket bond coverage for a nonbank subsidiary is more easily addressed and is typically a function of the parent's and the bank's coverage.

2060.5.5 NOTIFICATION OF LOSS

When submitting a claim, most blanket bonds have provisions which require a report to be submitted within a specified period after a reportable item comes to the attention of management. Occasionally, items are not reported to the bonding company because of uncertainty as to whether the incident constitutes a reportable item. Failure to report in a timely manner could invalidate the claim and jeopardize existing coverages. Thus, it should be emphasized to management that any questionable items should be reported.

2060.5.6 DIRECTORS' AND OFFICERS' LIABILITY INSURANCE

Directors' and Officers' Liability Insurance ("DOL Insurance") insures the Directors and Officers against *personal* liability resulting from claims of alleged negligence, wrongful acts, errors and omissions, etc. This insurance is not included in the blanket bond or other standard fidelity coverage.

2060.5.7 INSPECTION OBJECTIVES

1. To determine the scope and extent of insurance coverages for the various entities in the organization.
2. To determine the adequacy of insurance coverage after giving due consideration to the overall control environment and factors such as the organization's claim experience and costs associated with various coverages.
3. To ascertain that a comprehensive review of the insurance program is conducted periodically by management and at least annually by the board of directors and entered into the minutes.
4. To determine the entity(ies) responsible for paying the premiums and the manner in which such payments are allocated among the affiliates that receive the coverage benefits.
5. To determine if procedures are in place to assure that claims are filed promptly.

2060.5.8 INSPECTION PROCEDURES

1. The prior year's inspection report should be reviewed for comments relative to controls and insurance. The examiner should note the types and extent of coverages, comments concerning the control environment and any deficiencies related to the administration of the insurance program and the coverages in force.
2. A similar review encompassing the latest examination reports of all major affiliated banks should be conducted. The review process is intended to provide a basis for determining areas of emphasis and follow-up during the inspection. The examiner need not re-examine the insurance program or the controls in force in the individual banks.
3. The examiner should meet with the officer responsible for maintaining the insurance policies and related documentation and ascertain the location of such policies and documentation. Review any independent review of coverages and any deficiencies that may have been cited by the internal or external auditors.
4. Review the manner and frequency of presentations to the board of directors of the insurance coverage.

Working with borrowers who are experiencing financial difficulties may involve formally restructuring their loans and taking other measures to conform the repayment terms to the borrowers' ability to repay. Such actions, if done in a way that is consistent with prudent lending principles and supervisory practices, can improve the prospects for collection. Generally accepted accounting principles (GAAP) and regulatory reporting requirements provide a framework for reporting that may alleviate certain concerns that lenders may have about working constructively with borrowers who are having financial difficulties.

Interagency policy statements and guidance, issued on March 1, 1991; March 10, 1993; and June 10, 1993, clarified supervisory policies regarding nonaccrual assets, restructured loans, and collateral valuation (additional clarification guidance may be found in SR-95-38 and in the glossary of the reporting instructions for the bank call report and the FR-Y-9C, the consolidated bank holding company report). When certain criteria[1] are met, (1) interest payments on nonaccrual assets can be recognized as income on a cash basis without first recovering any prior partial charge-offs; (2) nonaccrual assets can be restored to accrual status when subject to formal restructurings, according to Financial Accounting Standards Board (FASB) Statement Nos. 15 and 114, "Accounting by Debtors and Creditors for Troubled Debt Restructurings" (SFAS 15) and "Accounting by Creditors for Impairment of a Loan" (SFAS 114); and (3) restructurings that specify a market rate of interest would not have to be included in restructured loan amounts reported in the years after the year of the restructuring. These supervisory policies apply to federally supervised financial institutions. The board of directors and management of bank holding companies should therefore incorporate these policies into the supervision of their federally supervised financial institution subsidiaries.

2065.1.1 CASH-BASIS INCOME RECOGNITION ON NONACCRUAL ASSETS

Current regulatory reporting requirements do not preclude the cash-basis recognition of income on nonaccrual assets (including loans that have been partially charged off), if the remaining book balance of the loan is deemed fully collectible. Interest income recognized on a cash basis should be limited to that which would have been accrued on the recorded balance at the contractual rate. Any cash interest received over this limit should be recorded as recoveries of prior charge-offs until these charge-offs have been fully recovered.

2065.1.2 NONACCRUAL ASSETS SUBJECT TO SFAS 15 AND SFAS 114 RESTRUCTURINGS

A loan or other debt instrument that has been formally restructured to ensure repayment and performance need not be maintained in nonaccrual status. When the asset is returned to accrual status, payment performance that had been sustained for a reasonable time before the restructuring may be considered. For example, a loan may have been restructured, in part, to reduce the amount of the borrower's contractual payments. It may be that the amount and frequency of payments under the restructured terms do not exceed those of the payments that the borrower had made over a sustained period, within a reasonable time before the restructuring. In this situation, if the lender is reasonably assured of repayment and performance according to the modified terms, the loan can be immediately restored to accrual status.

Clearly, a period of sustained performance, whether before or after the date of the restructuring, is very important in determining whether there is reasonable assurance of repayment and performance. In certain circumstances, other information may be sufficient to demonstrate an improvement in the borrower's condition or in economic conditions that may affect the borrower's ability to repay. Such information may reduce the need to rely on the borrower's performance to date in assessing repayment prospects. For example, if the borrower has obtained substantial and reliable sales, lease, or rental contracts or if other important developments are expected to significantly increase the borrower's cash flow and debt-service capacity and strength, then the borrower's commitment to repay may be sufficient. A preponderance of such evidence may be sufficient to warrant

1. A discussion of the criteria is found within the corresponding subsections that follow.

returning a restructured loan to accrual status. The restructured terms must reasonably ensure performance and full repayment.

It is imperative that the reasons for restoring restructured debt to accrual status be documented. A restoration should be supported by a current, well-documented evaluation of the borrower's financial condition and prospects for repayment. This documentation will be reviewed by examiners.

The formal restructuring of a loan or other debt instrument should be undertaken in ways that will improve the likelihood that the credit will be repaid in full in accordance with reasonably restructured repayment terms.[2] Regulatory reporting requirements and GAAP do *not* require a banking organization that restructures a loan to grant excessive concessions, forgive principal, or take other steps not commensurate with the borrower's ability to repay, in order to use the reporting treatment specified in SFAS 15. Furthermore, the restructured terms may include prudent contingent payment provisions that permit an institution to obtain appropriate recovery of concessions granted in the restructuring, if the borrower's condition substantially improves.

2065.1.3 RESTRUCTURINGS RESULTING IN A MARKET INTEREST RATE

An SFAS 114 restructuring that specifies an effective interest rate that is equal to or greater than the rate the lending banking organization is willing to accept at the time of the restructuring, for a new loan with comparable risk (assuming the loan is not impaired by the restructuring agreement), does not have to be reported as a troubled-debt restructuring after the year of restructuring.

2065.1.4 NONACCRUAL TREATMENT OF MULTIPLE LOANS TO ONE BORROWER

As a general principle, whether to place an asset in nonaccrual status should be determined by an assessment of the individual asset's collectibility. One loan to a borrower being placed in nonaccrual status does not automatically have to result in all other extensions of credit to that borrower being placed in nonaccrual status. When a single borrower has multiple extensions of credit outstanding and one meets the criteria for nonaccrual status, the lender should evaluate the others to determine whether one or more of them should also be placed in nonaccrual status.

2065.1.4.1 Troubled-Debt Restructuring—Returning a Multiple-Note Structure to Accrual Status

On June 10, 1993, interagency guidance was issued to clarify a March 10, 1993, interagency policy statement on credit availability. The guidance addresses a troubled-debt restructuring (TDR) that involves multiple notes (sometimes referred to as A/B note structures). An example of a multiple-note structure is when the first, or A, note would represent the portion of the original-loan principal amount that would be expected to be fully collected along with contractual interest. The second part of the restructured loan, or B note, represents the portion of the original loan that has been charged off.

Such TDRs generally may take any of three forms: (1) In certain TDRs, the B note may be a contingent receivable that is payable only if certain conditions are met (for example, if there is sufficient cash flow from the property). (2) For other TDRs, the B note may be contingency-forgiven (note B is forgiven if note A is paid in full). (3) In other instances, an institution would have granted a concession (for example, a rate reduction) to the troubled borrower but the B note would remain a contractual obligation of the borrower. Because the B note is not reflected as an asset on the institution's books and is unlikely to be collected, the B note is viewed as a contingent receivable for reporting purposes.

Financial institutions may return the A note to accrual status provided the following conditions are met:

1. *The restructuring qualifies as a TDR as defined by SFAS 15 and there is economic substance to the restructuring.* (Under SFAS 15, a restructuring of debt is considered a TDR if "the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.")

2. A restructured loan may not be restored to accrual status unless there is reasonable assurance of repayment and performance under its modified terms in accordance with a reasonable repayment schedule.

2. *The portion of the original loan represented by the B note has been charged off.* The charge-off must be supported by a current, well-documented evaluation of the borrower's financial condition and prospects for repayment under the revised terms. The charge-off must be recorded before or at the time of the restructuring.

3. *The institution is reasonably assured of repayment of the A note and of performance in accordance with the modified terms.*

4. *In general, the borrower must have demonstrated sustained repayment performance (either immediately before or after the restructuring) in accordance with the modified terms for a reasonable period prior to the date on which the A note is returned to accrual status.* Sustained payment performance generally would be for a minimum of six months and involve payments in the form of cash or cash equivalents.

The A note would be initially disclosed as a TDR. However, if the A note yields a market rate of interest and performs in accordance with the restructured terms, the note would not have to be disclosed as a TDR in the year after the restructuring. To be considered a market rate of interest, the interest rate on the A note at the time of the restructuring must be equal to or greater than the rate that the institution is willing to accept for a new receivable with comparable risk. (See SR-93-30.)

2065.1.4.2 Nonaccrual Loans That Have Demonstrated Sustained Contractual Performance

Certain borrowers have resumed paying the full amount of scheduled contractual interest and principal payments on loans that are past due and in nonaccrual status. Although prior arrearages may not have been eliminated by payments from the borrowers, some borrowers have demonstrated sustained performance over a time in accordance with contractual terms. The interagency guidance of June 10, 1993, announced that such loans may henceforth be returned to accrual status, even though the loans have not been brought fully current. They may be returned to accrual status if (1) there is reasonable assurance of repayment of all principal and interest amounts contractually due (including arrearages) within a reasonable period and (2) the borrower has made payments of cash or cash equivalents over a sustained period (generally a minimum of six months) *in accordance with the contractual terms.* When the federal financial institution regulatory reporting criteria for restoration to accrual status are met, previous charge-offs taken would not have to be fully recovered before such loans are returned to accrual status. Loans that meet this criteria should continue to be disclosed as past due as appropriate (for example, 90 days past due and still accruing) until they have been brought fully current. (See SR-93-30.)

2065.1.5 ACQUISITION OF NONACCRUAL ASSETS

Banking organizations (or the receiver of a failed institution) may sell loans or debt securities maintained in nonaccrual status. Such loans or debt securities that have been acquired from an unaffiliated third party should be reported by the purchaser in accordance with AICPA Practice Bulletin No. 6. When the criteria specified in this bulletin are met, these assets may be placed in nonaccrual status.[3]

2065.1.6 TREATMENT OF NONACCRUAL LOANS WITH PARTIAL CHARGE-OFFS

Whether partial charge-offs associated with a nonaccrual loan that has not been formally restructured must first be fully recovered before the loan can be restored to accrual status is an issue that has not been explicitly addressed by GAAP and bank regulatory reporting requirements. In accordance with the instructions for the bank call report and the bank holding company reports (FR-Y series), restoration to accrual status is permitted when (1) the loan has been brought fully current with respect to principal and interest and (2) it is expected that the full contractual balance of the loan (including any amounts charged off) plus interest will be fully collectible under the terms of the loan.[4]

3. AICPA Practice Bulletin No. 6, "Amortization of Discounts on Certain Acquired Loans." American Institute of Certified Public Accountants, August 1989.

4. The instructions for the call reports and "Y reports" discuss the criteria for restoration to accrual status in the glossary entries for "nonaccrual status." This guidance also permits restoration to accrual status for nonaccrual assets that are both well secured *and* in the process of collection. In addition, this guidance permits restoration to accrual status, when certain criteria are met, of formally restructured debt and acquired nonaccrual assets.

Thus, in determining whether a partially charged-off loan that has been brought fully current can be returned to accrual status, it is important to determine whether the banking organization expects to receive the full amount of principal and interest called for by the terms of the loan.

When a loan has been brought fully current with respect to contractual principal and interest and the borrower's financial condition and economic conditions that could affect the borrower's ability to repay have improved to the point that repayment of the full amount of contractual principal (including any amounts charged off) and interest is expected, the loan may be restored to accrual status even if the charge-off has not been recovered. However, this treatment would not be appropriate if the charge-off reflects continuing doubt about the collectibility of principal or interest. Because loans or other assets are required to be placed in nonaccrual status when full repayment of principal or interest is not expected, such loans could not be restored to accrual status.

It is imperative that the reasons for the restoration of a partially charged-off loan to accrual status be supported by a current, well-documented evaluation of the borrower's financial condition and prospects for full repayment of contractual principal (including any amounts charged off) and interest. This documentation will be subject to review by examiners.

A nonaccrual loan or debt instrument may have been formally restructured in accordance with SFAS 15 so that it meets the criteria for restoration to accrual status presented in section 2065.1.2 addressing restructured loans. Under GAAP, when a charge-off was taken before the date of the restructuring, it does not have to be recovered before the restructured loan can be restored to accrual status. When a charge-off occurs after the date of the restructuring, the considerations and treatments discussed earlier in this section are applicable.

2065.1.7 IN-SUBSTANCE FORECLOSURES

FASB Statement No. 114, "Accounting for Creditors for Impairment of Loans," addresses the accounting for impaired loans and clarifies existing accounting guidance for in-substance foreclosures. Under the impairment standard and related amendments to SFAS 15, a collateral-dependent real estate loan[5] would be reported as "other real estate owned" (OREO) only if the lender had taken possession of the collateral. For other collateral-dependent real estate loans, loss recognition would be based on the fair value of the collateral if foreclosure is probable.[6] Such loans would remain in the loan category and would not be reported as OREO. For depository institution examinations, any portion of the loan balance on a collateral-dependent loan that exceeds the fair value of the collateral and that can be identified as uncollectible would generally be classified as a loss and be promptly charged off against the ALLL.

A collateralized loan that becomes impaired is not considered "collateral dependent" if repayment is available from reliable sources other than the collateral. Any impairment on such a loan may, at the depository institution's option, be determined based on the present value of the expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, on the loan's observable market price.

Consistent with FFIEC interagency guidance, the Federal Reserve will not automatically require an additional allowance for credit losses for impaired loans over and above what is required on these loans under SFAS 114. However, an additional allowance on impaired loans may be necessary based on consideration of factors specific to the depository institution, such as historical loss experience compared with estimates of such losses and concerns about the reliability of cash-flow estimates, the quality of an institution's loan review function, and controls over its process for estimating its SFAS 114 allowance. When an institution's reported ALLL does not meet the objectives for an adequate ALLL set forth in the Interagency Policy Statement on the Allowance for Loan and Lease Losses (see section 2010.7), the depository institution must restore the level of the ALLL to an adequate level as of the evaluation date. Refer to SR-95-38.

Losses must be recognized on real estate loans that meet the in-substance foreclosure criteria with the collateral being valued according to its fair value. Such loans do not have to be reported as OREO unless possession of the

5. A collateral-dependent real estate loan is a loan for which repayment is expected to be provided solely by the underlying collateral and there are no other available and reliable sources of repayment.

6. The fair value of the assets transferred is the amount that the debtor could reasonably expect to receive for them in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale.

underlying collateral has been obtained. (See SR-93-30.)

2065.1.8 LIQUIDATION VALUES OF REAL ESTATE LOANS

In accordance with the March 10, 1993, interagency policy statement, "Credit Availability," loans secured by real estate should be based on the borrower's ability to pay over time, rather than on a presumption of immediate liquidation. Interagency guidance issued on June 10, 1993, emphasizes that it is *not* regulatory policy to value collateral that underlies real estate loans on a liquidation basis. (See SR-93-30.)

Determining an Adequate Level for the Allowance for Loan and Lease Losses Section 2065.2

The adequacy of a banking organization's allowance for loan and lease losses (ALLL) (including amounts based on an analysis of the commercial real estate portfolio) must be based on a careful, well-documented, and consistently applied analysis of the loan and lease portfolio.[1] The determination of the adequacy of the ALLL should be based on management's consideration of all current significant conditions that might affect the ability of borrowers (or guarantors, if any) to fulfill their obligations to the institution. While historical loss experience provides a reasonable starting point, historical losses or even recent trends in losses are not sufficient, without further analysis, to produce a reliable estimate of anticipated loss.

In determining the adequacy of the ALLL, management should consider factors such as changes in the nature and volume of the portfolio; the experience, ability, and depth of lending management and staff; changes in credit standards; collection policies and historical collection experience; concentrations of credit risk; trends in the volume and severity of past-due and classified loans; and trends in the volume of nonaccrual loans, specific problem loans, and commitments. In addition, this analysis should consider the quality of the organization's systems and management in identifying, monitoring, and addressing asset-quality problems. Furthermore, management should consider external factors such as local and national economic conditions and developments, competition, and legal and regulatory requirements, as well as reasonably foreseeable events that are likely to affect the collectibility of the loan portfolio.

Management should adequately document the factors that were considered, the methodology and process that were used in determining the adequacy of the ALLL, and the range of possible credit losses estimated by this process. The complexity and scope of this analysis must be appropriate to the size and nature of the organization and provide for sufficient flexibility to accommodate changing circumstances.

Examiners will evaluate the methodology and process that management has followed in arriving at an overall estimate of the ALLL to ensure that all of the relevant factors affecting the collectibility of the portfolio have been appropriately considered. In addition, the overall estimate of the ALLL and the range of possible credit losses estimated by management will be reviewed for reasonableness in view of these factors. The examiner's analysis will also consider the quality of the organization's systems and management in identifying, monitoring, and addressing asset-quality problems.

The value of the collateral will be considered by examiners in reviewing and classifying a commercial real estate loan. However, for a performing commercial real estate loan, the supervisory policies of the agencies do not require automatic increases to the ALLL solely because the value of the collateral has declined to an amount that is less than the loan balance.

In assessing the ALLL, it is important to recognize that management's process, methodology, and underlying assumptions require a substantial degree of judgment. Even when an organization maintains sound loan administration and collection procedures and effective internal systems and controls, the estimation of losses may not be precise due to the wide range of factors that must be considered. Further, the ability to estimate losses on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. When management has (1) maintained effective systems and controls for identifying, monitoring, and addressing asset-quality problems and (2) analyzed all significant factors affecting the collectibility of the portfolio, examiners should give considerable weight to management's estimates in assessing the adequacy of the overall ALLL.

Examiners and bank holding company management should give consideration to the impact of the Financial Accounting Standards Board's (FASB) Statement No. 114, "Accounting by Creditors for Impairment of a Loan" (FAS 114) (as amended by FASB Statement No. 118, "Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures") on the ALLL estimating process. FAS 114 sets forth guidance for estimating the impairment of a loan for general financial reporting purposes.

1. The estimation process described in this section permits a more accurate estimate of anticipated losses than could be achieved by assessing the loan portfolio solely on an aggregate basis. However, it is only an estimation process and does not imply that any part of the ALLL is segregated for, or allocated to, any particular asset or group of assets. The ALLL is available to absorb overall credit losses originating from the loan and lease portfolio. The balance of the ALLL is management's estimation of potential credit losses, synonymous with its determination as to the adequacy of the *overall* ALLL.

Under FAS 114, a loan is *impaired* when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement.

When a creditor has determined that a loan is impaired, FAS 114 requires that an allowance be established based on the present value of the expected future cash flows of the loan discounted at the loan's effective interest rate (that is, the contract rate, as adjusted for any net deferred loan fees or costs, premiums, or discounts) or, as a practical expedient, at the loan's observable market price or at the fair value of the collateral if the loan is collateral dependent. Since the allowances under FAS 114 apply only to a subset of loans,[2] FAS 114 does not address the adequacy of a creditor's *overall* ALLL or how the creditor should assess the adequacy of its ALLL. Examiners should not focus unduly on the adequacy of this or any other portion of the ALLL established for a subset of loans. Bank holding companies are required to follow FAS 114 (as amended by FAS 118) when reporting in the FR Y-9C report for the holding company on a consolidated basis.

2065.2.1 INSPECTION OBJECTIVES

1. To evaluate the methodology and process that management employs in compiling an *overall* estimate of the allowance for loan and lease losses.
2. To understand and evaluate the nature of the external (economic and social climate, and the extent of competition) and internal lending environment (credit strategies, levels of acceptable credit risk, lending policies and procedures) and how they might influence management's estimate of the allowance for loan and lease losses.
3. To determine the accuracy and reasonableness of management's estimate of the *overall* allowance for loan and lease losses.
4. To evaluate the quality of the BHC's systems and management performance in identifying, monitoring, and resolving asset-quality problems.

2. FAS 114's guidance on impairment does not apply to "large groups of smaller balance homogeneous loans that are collectively evaluated for impairment," loans that are measured at fair value or at the lower of cost or fair value, or leases and debt securities as defined in FAS 115, "Accounting for Certain Investments in Debt and Equity Securities." FAS 114 does apply to loans that are restructured in a troubled-debt restructuring involving a modification of terms.

2065.2.2 INSPECTION PROCEDURES

1. Determine whether the banking organization has carefully documented and applied an accurate and consistent method of analysis for estimating the *overall* allowance for loan and lease losses. When making such a determination, ascertain whether—
   a. management has considered all significant factors and conditions that might affect the collectibility of the loan, including the borrower's repayment practices, the value of accessible underlying collateral, and other factors (i.e., those factors listed in this section);
   b. management has documented all factors that were considered and the methodology and process that were used to evaluate the adequacy of the allowance; and
   c. the complexity and scope of the analysis are appropriate for the size and nature of the organization.
2. Evaluate the methodology and process that management has followed in arriving at an overall estimate of the allowance for loan and lease losses.
3. Determine the reasonableness of management's consolidated estimate of the allowance for loan and lease losses, including the range of possible credit losses. Determine whether management has properly evaluated the overall composition of the loan portfolio at all organizational levels by—
   a. identifying potential problem loans, including loans classified by all bank regulatory agencies;
   b. determining trends with respect to loan volume (growth (in particular, rapid growth), levels of delinquencies, nonaccruals, and nonperforming loans);
   c. considering the previous loss and recovery experience including the timeliness of charge-offs;
   d. evaluating the performance of concentrations of credit (related interests, geographic regions, industries, lesser developed countries (LDC), highly leveraged loans, and size of credit exposures (few large loans versus numerous small loans));
   e. determining the amount of loans and problem loans (delinquent, nonaccrual, and nonperforming) by lending officer or committee; and
   f. evaluating the levels and performance of loans involving related parties.

4. For each level of the organization, determine the percentage of past-due loans to the loan portfolio and compare it with prior periods. The examiner may find it beneficial to compute the ratio for groups of loans by type, size, or risk levels.

5. Compare the loans classified during regulatory examinations/BHC inspections with the previous examinations/inspections and also those classified by management prior to the regulatory examinations/inspections. Investigate the current status of previously classified loans.

6. Compute the percentage of the allowance for loan and lease losses to average outstanding loans and compare those results with those of the previous inspection. Investigate the reasons for variations between those periods.

7. Assess the quality of the organization's systems and internal controls in identifying, monitoring, and addressing asset-quality problems.

A holding company and its depository institution subsidiaries may generally file a consolidated group income tax return. For bank regulatory purposes, however, each depository institution is viewed as, and reports as, a separate legal and accounting entity. Each holding company subsidiary that participates in filing a consolidated tax return should record its tax expenses or tax benefits as though it had filed a tax return as a separate entity. The amount and timing of any intercompany payments or refunds to the subsidiary that result from its being a part of the consolidated return group should be no more favorable than if the subsidiary was a separate taxpayer. A consolidated return permits the parent's and other subsidiaries' taxable losses to be offset against other subsidiaries' taxable income, with the parent most often providing the principal loss. This can be illustrated with the following example:

	Parent Only	*Bank*	*Non-bank A*	*Non-bank B*	*Consolidated*
Contribution to consolidated net taxable income (loss):	$(100)	$2,000	$500	$(50)	$2,350
Assumed tax rate	40%	40%	40%	40%	40%
Tax payment/ (benefit)	$(40)	$ 800	$200	$(20)	$ 940

In this example, the parent, as the representative of the consolidated group to the Internal Revenue Service, would collect $800 from the bank subsidiary and $200 from Nonbank Subsidiary A, and pay $20 to Nonbank Subsidiary B. In return, the parent would remit to the tax authorities $940, resulting in a net cash retention of $40 by the parent.

Bank holding companies employ numerous methods to determine the amount of estimated payments to be received from their subsidiaries. Although the tax-accounting methods to be used by bank holding companies are not prescribed by the Federal Reserve System, the method employed must afford subsidiaries equitable treatment compared with filing separate returns. In general terms, tax transactions between any subsidiary and its parent should be conducted as though the subsidiary was dealing directly with state or federal taxing authorities.

In 1978 the Board of Governors addressed the issue of intercorporate income tax settlements by issuing a formal Policy Statement Regarding Intercorporate Income Tax Accounting Transactions of Bank Holding Companies and State-Chartered Banks That Are Members of the Federal Reserve System. The statement was revised and replaced by the December 1998 Policy Statement on Income Tax Allocation in a Holding Company Structure, which does not materially change any of the guidance previously issued.

The tax structure of bank holding companies becomes more complicated when deferred taxes are considered in the intercorporate tax settlements.[1] Deferred taxes occur when taxable income, for financial reporting purposes, differs from taxable income as reported to the taxing authorities. This difference is due to timing differences between financial-statement income and tax income for loan-loss provisions and other items, such as foreign tax credits. In addition, differences result from the use of the cash basis of accounting for tax purposes, as opposed to the accrual basis of accounting used in financial reporting. The different bases are chosen by management.

An example of deferred income taxes follows, using an estimated tax rate of 40 percent.

	Financial Reporting	*Tax Return*
Pre-tax income	$200	$150
Currently payable	60	60
Deferred portion	20	—
TOTAL	80	60
Net income	$120	$90

The deferred portion represents the tax effect of delaying the recognition of income or taking more of a deduction for tax-return purposes (40% x $50). This is a temporary difference since over the ''life'' of the bank holding company, income and deductions should theoretically equalize for both book and tax purposes.

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1. The issue becomes more complex because of GAAP-based tax expenses versus actual taxes paid under relevant tax laws (the difference between the two expenses is either a deferred tax liability or asset on the balance sheet). If the sharing agreement is based on the tax expense on the statement of income, more funds may be transferred to the paying agent than are required to settle the actual taxes owed.

ment No. 109 (FASB 109), "Accounting for Income Taxes," provides guidance on many aspects of accounting for income taxes, including the accounting for deferred tax liabilities and assets. FASB 109 describes how a bank holding company should record (1) taxes payable or refundable for the current year and (2) deferred tax liabilities and assets for the future tax consequences of events that have been recognized in the banking organization's financial statements or tax returns.

Generally, all bank holding companies must file annual income tax returns. The bank holding company can pay the entire amount of tax (that is, the amount still due after estimated tax payments) on or before the due date for filing, or it can elect to pay by the extension deadline if one is granted. Bank holding companies may receive extensions from taxing authorities to file their returns later. For the federal tax return, a six-month extension may be granted.

Bank holding companies generally pay estimated taxes throughout the year. The most common payment dates will be as follows (assuming calendar period):

April 15 —first estimate (25%)
June 15 —second estimate (25%)
September 15 —third estimate (25%)
December 15 —fourth estimate (25%)
March 15 —Due date for income tax return for U.S. corporations or foreign corporations with offices in the United States. Last day for filing for the automatic six-month extension.
September 15 —Due date of return if six-month extensions were granted.

The bank holding company will calculate the amount of the estimated payments to the Internal Revenue Service by using one of two methods: (1) prior year's tax liability (most commonly used) or (2) 90 percent of the estimated tax based on the current year's estimated taxable income.

Bank holding companies have engaged in intercorporate income tax settlements that have the effect of transferring assets and income from a bank subsidiary to the parent company in excess of those settlements that would be consistent with the Board's 1978 policy statement. The Board will apply appropriate supervisory remedies to situations that are considered inequitable or improper. These remedies may include, under certain circumstances, the Board's cease-and-desist powers.

On occasion, bank holding companies have used deferred tax assets as a vehicle to transfer cash or other earning assets of subsidiaries, principally from the bank, into the parent company. The Board's opinion is that each deferred tax asset or liability must remain on the books of the subsidiary. If deferred tax assets have been transferred to the parent, regardless of when the transfer may have occurred, immediate arrangements must be made to return the asset to the appropriate subsidiary. Instances of transferring deferred tax assets to the parent are worthy of inclusion in the Examiner's Comments and Matters Requiring Special Board Attention, page one of the inspection report.

2070.0.1 INTERAGENCY POLICY STATEMENT ON INCOME TAX ALLOCATION IN A HOLDING COMPANY STRUCTURE

The federal bank and savings association's regulatory agencies (the agencies) issued the following policy statement to provide guidance to banking organizations and savings associations regarding the allocation and payment of taxes among a holding company and its subsidiaries. A holding company and its subsidiaries will often file a consolidated group income tax return. However, for bank regulatory purposes, each depository institution of the consolidated group is viewed as, and reports as, a separate legal and accounting entity. Accordingly, each depository institution's applicable income taxes, reflecting either an expense or benefit, should be recorded as if the institution had filed as a separate tax-paying entity.[2] The amount and timing of payments or refunds should be no less favorable to a subsidiary than if it was a separate taxpayer. Any practice that is not consistent with this policy statement may be viewed as an unsafe and unsound practice prompting either informal or formal corrective action. See SR-98-38.

2070.0.1.1 Tax-Sharing Agreements

A holding company and its subsidiary institutions are encouraged to enter into a written,

2. Throughout the policy statement, the terms "separate entity" and "separate taxpayer" are used synonymously. When a depository institution has subsidiaries of its own, the institution's applicable income taxes on a separate-entity basis include the taxes of the subsidiaries *of the institution* that are included with the institution in the consolidated group return.

comprehensive tax-allocation agreement tailored to their specific circumstances. The agreement should be approved by the respective boards of directors. Although each agreement will be different, tax-allocation agreements usually address certain issues common to consolidated groups.

Therefore, such an agreement should—

1. require a subsidiary depository institution to compute its income taxes (both current and deferred) on a separate-entity basis;
2. discuss the amount and timing of the institution's payments for current tax expense, including estimated tax payments;
3. discuss reimbursements to an institution when it has a loss for tax purposes; and
4. prohibit the payment or other transfer of deferred taxes by the institution to another member of the consolidated group.

2070.0.1.2 Measurement of Current and Deferred Income Taxes

Generally accepted accounting principles, instructions for the preparation of both the Thrift Financial Report and the federally supervised bank Reports of Condition and Income, and other guidance issued by the agencies require depository institutions to account for their current and deferred tax liability or benefit.

When the depository-institution members of a consolidated group prepare separate bank regulatory reports, each subsidiary institution should record current and deferred taxes as if it files its tax returns on a separate-entity basis, regardless of the consolidated group's tax-paying or -refund status. Certain adjustments for statutory tax considerations that arise in a consolidated return, e.g., application of graduated tax rates, may be made to the separate-entity calculation as long as they are made on a consistent and equitable basis among the holding company affiliates.

In addition, when an organization's consolidated income tax obligation arising from the alternative minimum tax (AMT) exceeds its regular tax on a consolidated basis, the excess should be consistently and equitably allocated among the members of the consolidated group. The allocation method should be based upon the portion of tax preferences, adjustments, and other items generated by each group member which causes the AMT to be applicable at the consolidated level.

2070.0.1.3 Tax Payments to the Parent Company

Tax payments from a subsidiary institution to the parent company should not exceed the amount the institution has properly recorded as its current tax expense on a separate-entity basis. Furthermore, such payments, including estimated tax payments, generally should not be made before the institution would have been obligated to pay the taxing authority had it filed as a separate entity. Payments made in advance may be considered extensions of credit from the subsidiary to the parent and may be subject to affiliate transaction rules, i.e., sections 23A and 23B of the Federal Reserve Act.

A subsidiary institution should not pay its deferred tax liabilities or the deferred portion of its applicable income taxes to the parent. The deferred tax account is not a tax liability required to be paid in the current reporting period. As a result, the payment of deferred income taxes by an institution to its holding company is considered a dividend subject to dividend restrictions,[3] not the extinguishment of a liability. Furthermore, such payments may constitute an unsafe and unsound banking practice.

2070.0.1.4 Tax Refunds from the Parent Company

An institution incurring a loss for tax purposes should record a current income tax benefit and receive a refund from its parent in an amount no less than the amount the institution would have been entitled to receive as a separate entity. The refund should be made to the institution within a reasonable period following the date the institution would have filed its own return, regardless of whether the consolidated group is receiving a refund. If a refund is not made to the institution within this period, the institution's primary federal regulator may consider the receivable as either an extension of credit or a dividend from the subsidiary to the parent. A parent company may reimburse an institution more than the

3. These restrictions include the prompt-corrective-action provisions of section 38(d)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1831o(d)(1)) and its implementing regulations: for insured state nonmember banks, 12 CFR 325, subpart B; for national banks, 12 CFR section 6.6; for savings associations, 12 CFR 565; and for state member banks, 12 CFR 208.45.

refund amount it is due on a separate-entity basis. Provided the institution will not later be required to repay this excess amount to the parent, the additional funds received should be reported as a capital contribution.

If the institution, as a separate entity, would not be entitled to a current refund because it has no carry-back benefits available on a separate-entity basis, its holding company may still be able to utilize the institution's tax loss to reduce the consolidated group's current tax liability. In this situation, the holding company may reimburse the institution for the use of the tax loss. If the reimbursement will be made on a timely basis, the institution should reflect the tax benefit of the loss in the current portion of its applicable income taxes in the period the loss is incurred. Otherwise, the institution should not recognize the tax benefit in the current portion of its applicable income taxes in the loss year. Rather, the tax loss represents a loss carry-forward, the benefit of which is recognized as a deferred tax asset, net of any valuation allowance.

Regardless of the treatment of an institution's tax loss for regulatory reporting and supervisory purposes, a parent company that receives a tax refund from a taxing authority obtains these funds as agent for the consolidated group on behalf of the group members.[4] Accordingly, an organization's tax-allocation agreement or other corporate policies should not purport to characterize refunds attributable to a subsidiary depository institution that the parent receives from a taxing authority as the property of the parent.

2070.0.1.5 Income-Tax-Forgiveness Transactions

A parent company may require a subsidiary institution to pay it less than the full amount of the current income tax liability that the institution calculated on a separate-entity basis. Provided the parent will not later require the institution to pay the remainder of the current tax liability, the amount of this unremitted liability should be accounted for as having been paid with a simultaneous capital contribution by the parent to the subsidiary.

In contrast, a parent cannot make a capital contribution to a subsidiary institution by "forgiving" some or all of the subsidiary's deferred tax liability. Transactions in which a parent "forgives" any portion of a subsidiary institution's deferred tax liability should not be reflected in the institution's regulatory reports. These transactions lack economic substance because each member of the consolidated group is jointly and severally liable for the group's potential future obligation to the taxing authorities. Although the subsidiaries have no direct obligation to remit tax payments to the taxing authorities, these authorities can collect some or all of a group liability from any of the group members if tax payments are not made when due.

4. See 26 CFR 1.1502-77(a).

2070.0.2 QUALIFYING SUBCHAPTER S CORPORATIONS

The Small Business Job Protection Act of 1996 made changes to the Internal Revenue Code (the code). On October 29, 1996, the FFIEC issued a bulletin notifying all federally insured banks and thrifts of the impact of these changes. Thrift organizations may qualify for Subchapter S corporation status under the code's revisions and could generally receive pass-through tax treatment for federal income tax purposes if certain criteria are met.

The bulletin states that no formal application is required to be filed with the federal bank and thrift regulatory agencies merely as a result of an election by a bank, thrift, or parent holding company to become a Subchapter S corporation. However, if an institution takes certain steps to meet the criteria to qualify for this tax status, particularly the code's limitations on the number and types of shareholders, applications or notices to the agencies may be required.

The FFIEC bulletin also states that any distributions made by the Subchapter S banking organization to its shareholders, including distributions intended to cover shareholders' personal tax liabilities for their shares of the income of the institution, will continue to be regarded as dividends and subject to any limitations under relevant banking law. See SR-96-26.

2070.0.3 INSPECTION OBJECTIVES

1. To determine whether the supervisory and accounting guidance set forth in FASB 109, other tax-accounting standards, and the 1998 interagency policy statement on income tax allocation has been appropriately, equitably, and consistently applied.

2. To verify that the parent's intercorporate tax policy contains a provision requiring the subsidiaries to receive an appropriate refund from the parent when they incur a loss, and that such a refund would have been receivable from the tax authorities if the subsidiary was filing a separate return.
3. To ascertain that tax payments and tax refunds between financial institution subsidiaries and the parent company have been limited to no more than what the institution might have paid to or received from the tax authorities, if it had filed its tax returns on a timely, separate-entity basis.[5]
4. To determine that no deferred tax liability, corresponding asset, or the deferred portion of its applicable income taxes has been transferred from a bank subsidiary to the parent company.
5. To verify that there has been proper accountability for tax-forgiveness transactions between the parent company and its financial institution subsidiaries.
6. To substantiate that corporate practices are consistent with corporate policies.

2070.0.4 INSPECTION PROCEDURES

1. Obtain and discuss with the bank holding company's management its intercorporate income tax policies and tax-sharing agreements. Obtain and retain a copy of the intercorporate tax policies and agreements in the workpaper files. Review the written intercorporate tax-settlement policy and ascertain that it includes the following:
   a. a description of the method(s) used in determining the amount of estimated taxes paid by each subsidiary to the parent
   b. an indication of when payments are to be made
   c. a statement that deferred taxes are maintained on the affiliate's general ledger
   d. procedures for handling tax claims and refunds

Bank holding companies should also have written tax-sharing agreements with their subsidiaries that specify intercorporate tax-settlement policies. The Board encourages bank holding companies to develop such agreements. For tax-sharing agreements, the following inspection procedures should be followed:
   a. Determine whether each subsidiary is required to compute its income taxes (current and deferred) on a separate-entity basis.
   b. Ascertain if the amount and timing of payments for current tax expense, including estimated tax payments, are discussed.
   c. Determine if reimbursements are discussed when an institution has a loss for tax purposes.
   d. Determine if there is a prohibition on the payment or other transfer of deferred taxes by an institution to another member of the consolidated group.
2. Review briefly the parent's intercompany transaction report; general ledger income tax accounts; cash receipts and disbursements; and, if necessary, tax-return workpapers and other pertinent corporate documents.
   a. Ascertain that the taxes collected by the parent company from each depository institution subsidiary do not exceed the amount that would have been paid if a separate return had been filed.
   b. When depository institution subsidiaries are making their tax payments directly to the taxing authorities, determine whether other subsidiaries are paying their proportionate share.
3. Review the separate regulatory reports for depository institution members of the holding company that are included in the filing of a consolidated tax return.
   a. Verify that each subsidiary institution is recording current and deferred taxes as if it was filing its own tax returns on a separate-entity basis.
   b. Ascertain that any adjustments for statutory tax considerations, arising from filing a consolidated return, are also made to the separate-entity calculations consistently and equitably among the holding company affiliates.
4. Determine if any excess amounts (tax benefits), resulting from the filing of a consolidated return, are consistently and equitably allocated among the members of the consolidated group.
5. Review the tax payments that are made from the bank and the nonbank subsidiaries to the parent company.

5. The term ''separate-entity basis'' recognizes that certain adjustments, in particular tax elections in a consolidated return, may, in certain periods, result in higher payments by the bank than would have been made if the bank was unaffiliated.

a. Determine that payments, including estimated payments, that are being requested do not significantly precede the time that a consolidated or estimated current tax liability would be due and payable by the parent to the tax authorities.
b. Verify with management that the tax payments to the parent company were not in excess of the amounts recorded by its depository institution subsidiaries as current tax expense on a separate-entity basis.
c. Determine that subsidiary institutions are not paying their deferred tax liabilities on the deferred portions of their applicable income taxes to the parent company.
d. Ascertain that the parent company is not deriving tax monies from depository institution subsidiaries that are used for other operating needs.

6. When a subsidiary incurs a loss, review the tax system to determine that bank and nonbank subsidiaries are receiving an appropriate refund from the parent company, that is, an amount that is no less than what would have been received if the tax return had been filed on a separate-entity basis.
   a. Verify that the refund(s) are received no later than the date the institutions would have filed their own returns and that the refund is not characterized as the parent company's property.
   b. If the parent company does not require a subsidiary to pay its full amount of current tax liability, ascertain that the amount of the tax liability is recorded as having been paid and that the corresponding credit is recorded as a capital contribution from the parent company to the subsidiary.
7. Determine that the deferred tax accounts of each bank subsidiary are maintained on its books and that they are not transferred to the parent organization.
8. Determine if the Internal Revenue Service or other tax authorities have assessed any additional tax payments on the consolidated group, and whether the holding company has provided an additional reserve to cover the assessment.
9. Complete the Other Supervisory Issues page of the Report of Bank Holding Company Inspection (FR 1225 and FR 1241).
10. Verify the accuracy of the FR Y-8, Report of Intercompany Transactions, pertaining to the information on tax settlements.

2070.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
FFIEC Policy Statement on Income Tax Allocation in a Holding Company Structure			4-870	1999 FRB 111

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The purpose of this Section is to discuss the types of funding ordinarily found in holding companies and to analyze their respective characteristics. It is not intended that this section include an analysis of the inter-relationships of these factors because that will be addressed in the various subsections of Section 4000 of the Manual.

The three major types of funding are short-term debt, long-term debt and equity. The ideal "hypothetical" holding company balance sheet would reflect sufficient equity to fund total bank and nonbank capital needs.

The complexity of the debt and/or equity financing will depend greatly upon the size and financial status of the holding company as well as the access to certain capital markets. The small holding company will be limited in the type and/or sophistication of financing instruments available for its use, and probably would look to local sources for its debt and equity needs. This would include sale of equity and debt instruments to owners of the holding company. The medium-sized holding company has access to public markets through investment bankers and occasionally may issue its own corporate notes in the commercial paper market. The large holding company has a wide range of choices depending upon its financial condition and the economic climate at the time of any offering. It also has the ability to place debt privately as an alternate to dealing with public markets. In summary, the type of financing needed by a holding company will vary with the size and nature of its banking and nonbanking operations. The following subsections address those issues.

A key principle underlying the Federal Reserve's supervision of bank holding companies is that such companies should be operated in a way that promotes the soundness of their subsidiary banks. Holding companies are expected to avoid funding strategies or practices that could undermine public confidence in the liquidity or stability of their banks. Consequently, bank holding companies should develop and maintain funding programs that are consistent with their lending and investment activities and that provide adequate liquidity to the parent company and its nonbank subsidiaries.

2080.05.1 FUNDING AND LIQUIDITY

A principal objective of a parent bank holding company's funding strategy should be to support capital investments in subsidiaries and long-term assets with capital and long-term sources of funds. Long-term or permanent financing not only reduces funding and liquidity risks, but also provides an organization with investors and lenders that have a long-run commitment to its viability. Long-term financing may take the form of term loans, long-term debt securities, convertible debentures, subordinated debt, and equity.

In general, liquidity can be measured by the ability of an organization to meet its maturing obligations, convert assets into cash with minimal loss, obtain cash from other sources, or roll over or issue new debt obligations. A major determinant of a bank holding company's liquidity position is the level of liquid assets available to support maturing liabilities. The use of short-term debt, including commercial paper, to fund long-term assets can result in unsafe and unsound banking conditions, especially if a bank holding company does not have alternative sources of liquidity or other reliable means to refinance or redeem its obligations. In addition, commercial paper proceeds should not be used to fund corporate dividends or pay current expenses. Funding mismatches can exacerbate an otherwise manageable period of financial stress or, in the extreme, undermine public confidence in an organization's viability. For this reason, bank holding companies, in managing their funding positions, should control liquidity risk by maintaining an adequate cushion of liquid assets to cover short-term liabilities. Holding companies should at all times have sufficient liquidity and funding flexibility to handle any runoff, whether anticipated or unforeseen, of commercial paper or other short-term obligations—without having an adverse impact on their subsidiary banks.

This objective can best be achieved by limiting the use of short-term debt to funding assets that can be readily converted to cash without undue loss. It should be emphasized, however, that the simple matching of the maturity of short-term debt with the stated or nominal maturity of assets does not, by itself, adequately ensure an organization's ability to retire its short-term obligations if the condition of the underlying assets precludes their timely sale or liquidation. In this regard, it is particularly important that parent company advances to subsidiaries be considered a reliable source of liquidity only to the extent that they fund assets of high quality that can readily be converted to cash. Consequently, effective procedures to monitor and ensure on an ongoing basis the quality and liquidity of the assets being funded by short-term debt are critical elements of a holding company's overall funding program.

Bank holding companies should establish and maintain reliable funding and contingency plans to meet ongoing liquidity needs and to address any unexpected funding mismatches that could develop over time. Such plans could include reduced reliance on short-term purchased funds, greater use of longer-term financing, appropriate internal limitations on parent company funding of long-term assets, and reliable alternate sources of liquidity. It is particularly important that bank holding companies have reliable plans or backup facilities to refinance or redeem their short-term debt obligations in the event assets being funded by these obligations cannot be liquidated in a timely manner when the debt must be repaid. In this connection, holding companies relying on backup lines of credit for contingency plan purposes should seek to arrange standby facilities that will be reliable during times of financial stress, rather than facilities that contain clauses which may relieve the lender of the obligation to fund the borrower in the event of a deterioration in the borrower's financial condition.

In developing and carrying out funding programs, bank holding companies should avoid overreliance or excessive dependence on any single short-term or potentially volatile source of funds, such as commercial paper, or any single maturity range. Prudent internal liquidity

policies and practices should include specifying limits for, and monitoring the degree of reliance on, particular maturity ranges and types of short-term funding. Special attention should be given to the use of overnight money since a loss of confidence in the issuing organization could lead to an immediate funding problem. Bank holding companies issuing overnight liabilities should maintain on an ongoing basis a cushion of superior quality assets that can be immediately liquidated or converted to cash with minimal loss. The absence of such a cushion or a clear ability to redeem overnight liabilities when they become due should generally be viewed as an unsafe and unsound banking practice.

2080.05.2 ADDITIONAL SUPERVISORY CONSIDERATIONS

Bank holding companies and their nonbank affiliates should maintain sufficient liquidity and capital strength to provide assurance that outstanding debt obligations issued to finance the activities of these entities can be serviced and repaid without adversely affecting the condition of the affiliated bank(s). In this regard, bank holding companies should maintain strong capital positions to enable them to withstand potential losses that might be incurred in the sale of assets to retire holding company debt obligations. It is particularly important that a bank holding company not allow its liquidity and funding policies or practices to undermine its ability to act as a source of strength to its affiliated bank(s).

The principles and guidelines outlined above constitute prudent financial practices for bank holding companies and most businesses in general. Holding company boards of directors should periodically assure themselves that funding plans, policies and practices are prudent in light of their organizations' overall financial condition. Such plans and policies should be consistent with the principles outlined above, including the need for appropriate internal limits on the level and type of short-term debt outstanding and the need for realistic and reliable contingency plans to meet any unanticipated runoff of short-term liabilities without adversely affecting affiliated banks.

2080.05.3 EXAMINER'S APPLICATION OF PRINCIPLES IN EVALUATING LIQUIDITY AND IN FORMULATING CORRECTIVE ACTION PROGRAMS

Reserve Bank examiners should be guided by these principles in evaluating liquidity and in formulating corrective action programs for bank holding companies that are experiencing earnings weaknesses or asset-quality problems, or that are otherwise subject to unusual liquidity pressures. In particular, bank holding companies with less than satisfactory parent or consolidated supervisory ratings (that is, 3 or worse), or any other holding companies subject to potentially serious liquidity or funding pressures, should be asked to prepare a realistic and specific action plan for reducing or redeeming entirely their outstanding short-term obligations without directly or indirectly undermining the condition of their affiliated bank(s).[1] Such contingency plans should be reviewed and evaluated by Reserve Bank supervisory personnel during or subsequent to on-site inspections. Any deficiencies in the plan, if not addressed by management, should be brought to the attention of the organization's board of directors. If the liquidity or funding position of such a company appears likely to worsen significantly, or if the company's financial condition worsens to a sufficient degree, the company should be expected to implement on a timely basis its plan to curtail or eliminate its reliance on commercial paper or other volatile, short-term sources of funds. Any decisions or steps taken by Reserve Banks in this regard should be discussed and coordinated with Board staff.

Reference should also be made to other manual sections that address funding, cash flow, or liquidity (for example, 2010.1, 2080.0, 2080.1, 2080.2, 2080.4, 2080.5, 2080.6, 4010.0, 4010.1, 4010.2, 5010.27, and 5010.28).

1. It is important to note that there are securities registration requirements under the Securities Act of 1933 related to the issuance of commercial paper. A bank holding company should have procedures in place to ensure compliance with all applicable securities and SEC requirements. Refer to manual section 2080.1.

Commercial paper is a generic term that is generally used to describe short-term unsecured promissory notes issued by well-recognized and generally financially sound corporations. The largest commercial paper issuers are finance companies and bank holding companies which use the proceeds as a source of funds in lieu of fixed rate borrowing.

Generally accepted limitations on issuances and uses of commercial paper derive from Section 3(a)(3) of the Securities Act of 1933 (1933 Act). Section 3(a)(3) exempts from the registration requirements of the 1933 Act "any note . . . which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions and which has a maturity at the time of issuance not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited. . . ." The Securities and Exchange Commission (SEC) has rulemaking authority over the issuance of commercial paper.

The five criteria, as set forth in an SEC interpretation (SA Release #33–4412, September 20, 1961), that are deemed necessary to qualify securities for the commercial paper exemption are that the commercial paper must:

- Be of prime quality and negotiable;
- Be of a type not ordinarily purchased by the general public;
- Be issued to facilitate current operational business requirements;
- Be eligible for discounting by a Federal Reserve Bank;
- Have a maturity not exceeding nine months.

2080.1.1 MEETING THE SEC CRITERIA

The above criteria are discussed below.

2080.1.1.1 Nine-Month Maturity Standard

Although roll-over of commercial paper proceeds on maturity is common, the SEC has stated that obligations that are payable on demand or have provisions for automatic roll-over do not satisfy the nine-month maturity standard. However, the SEC staff has issued "no action" letters for commercial paper master note agreements which allow eligible investors to make daily purchases and withdrawals (subject to a minimum amount of $25,000) as long as the note and each investor's interest therein, does not exceed nine months. Such master note agreements may permit prepayment by the issuer, or upon demand of the investor, at any time.

2080.1.1.2 Prime Quality

Most commercial paper is rated by at least one of five nationally recognized statistical rating organizations. The SEC has not clearly articulated the line at which it will regard a specific rating of commercial paper as being "not prime" and, indeed, there is no requirement that a rating be obtained at all in order to qualify. SEC staff has issued a series of "no-action" letters to individual bank holding companies based on specific facts and circumstances even where it does not appear that a rating was obtained. However, where commercial paper is downgraded to below what is generally regarded as "investment quality" (ratings of less than medium grade—refer to the *Commercial Bank Examination Manual*, section 203.1), or a rating is withdrawn, BHCs may not be able to issue commercial paper based on the Section 3(a)(3) exemption, in the absence of a marked significant improvement in the issuer's financial condition.

2080.1.1.3 Current Transactions

There have been considerable interpretative problems arising out of the current transactions concept. The SEC staff has issued a partial laundry list of activities which would not be deemed suitable for investment of commercial paper proceeds, namely:

1. The discharge of existing indebtedness, unless such indebtedness is itself exempt under section 3(a)(3) of the 1933 Act;
2. The purchase or construction of a plant or the purchase of durable machinery or equipment;
3. The funding of commercial real estate development or financing;
4. The purchase of real estate mortgages or other securities;
5. The financing of mobile homes or home improvements; or

6. The purchase or establishment of a business enterprise.

The SEC has opined that commercial paper, which is used as bridge financing by a bank holding company to fund a permanent acquisition within the 270-day maturity period of the paper, will meet the current transactions criterion. The amount of a bank holding company's commercial paper cannot exceed the aggregate amount of "current transactions" of the bank holding company and its subsidiaries *on a consolidated basis*. For this purpose, "current transactions" include dividends, interest, taxes and short-term loan repayments. In summary, in most cases, the "current transactions" requirement will not be a significant limitation on issuances of commercial paper by bank holding companies.

In addition to meeting SEC requirements, a bank holding company must meet funding and liquidity criteria prescribed by the Board. For a detailed discussion on acceptable use of commercial paper in connection with a bank holding company overall funding strategies, see Sections 2080.05 and 2080.6.

2080.1.1.4 Sales to Institutional Investors

Commercial paper is generally marketed only to institutional investors (corporations, pension funds, insurance companies, etc.) although sales to individuals are not prohibited. It is clear, however, from the legislative history of the Section 3(a)(3) exemption that commercial paper was not to be marketed for sale to the general public. Currently, SEC staff will not issue a no-action letter if the minimum denomination of the commercial paper to be issued is less than $25,000. One of the underlying premises of the Section 3(a)(3) exemption is that purchasers of commercial paper have sufficient financial sophistication to make informed investment decisions without the benefit of the information provided by a registration statement. It is, therefore, generally recognized today that any individual purchaser of commercial paper should meet the "accredited investor" criteria of commercial paper set forth in SEC Regulation D (17 C.F.R 230.501(a)). To qualify as an "accredited investor", an individual can meet one of two tests—a net worth test or an income test. To qualify under the net worth test, an individual or an individual and his or her spouse must have a net worth at the time of purchase in excess of $1 million. The alternative test requires $200,000 in income for each of the last two years ($300,000 if the spouse's income is included) and a reasonable expectation of reaching the same income level in the current year.

For additional information on marketing of commercial paper, see the next subsection.

2080.1.2 MARKETING OF COMMERCIAL PAPER

The sale of bank holding company (or nonbank subsidiary) commercial paper by an affiliated bank to depositors or other investors raises a number of supervisory issues. Of particular concern is the possibility that individuals may purchase holding company paper with the misunderstanding that it is an insured deposit or obligation of the subsidiary bank. The probability of this occurring is increased when a bank subsidiary is actively engaged in the marketing of the paper of its holding company or nonbank affiliate, or when the holding company or nonbank affiliate has a name similar to the name of the commercial bank subsidiary.

It is a long-standing policy of the Federal Reserve (refer to letters SR 90–19 and SR–620) that debt obligations of a bank holding company or a nonbank affiliate should not be issued, marketed or sold in a way that conveys the misimpression or misunderstanding that such instruments are either: 1) federally-insured deposits, or 2) obligations of, or guaranteed by, an insured depository institution. The purchase of such holding company obligations by retail depositors of an affiliated depository institution can, in the event of default, result in losses to individuals who believed that they had acquired federally-insured or guaranteed instruments. In addition to the problems created for these individuals, such a situation could impair public confidence in the affiliated depository institution and lead to unexpected withdrawals or liquidity pressures.

Events surrounding the sale of uninsured debt obligations of holding companies to retail customers of affiliated depository institutions have focused attention on the potential for problems in this area. In view of these concerns, the Federal Reserve emphasizes that this policy applies to the sale of both long- and short-term debt obligations of a bank holding company and any nonbank affiliate, as well as to the sale of uninsured debt securities issued by a state member bank or its subsidiaries. Debt obligations covered by this supervisory policy include commercial paper and all other short-term and long-

term debt securities, such as thrift notes and subordinated debentures.

Bank holding companies and nondepository affiliates that have issued or plan to issue uninsured obligations or debt securities should not market or sell these instruments in any public area of an insured depository institution where retail deposits are accepted, including any lobby area of the depository institution. Bank holding companies and any affiliates that are engaged in issuing debt obligations should establish appropriate policies and controls over the marketing and sale of the instruments. In particular, internal controls should be established to ensure that the promotion, sale, and subsequent customer relationship resulting from the sale of uninsured debt obligations is separated from the retail deposit-taking functions of affiliated depository institutions.

State member banks, including their subsidiaries, may also be engaged in issuing nondeposit debt securities (such as subordinated debt), and it is equally important to ensure that such securities are not marketed or sold in a manner that could give the purchaser the impression that the obligations are federally-insured deposits. Consequently, state member banks and their subsidiaries that have issued or plan to issue nondeposit debt securities should not market or sell these instruments in any public area of the bank where retail deposits are accepted, including any lobby area of the bank. Consistent with long-standing Federal Reserve policy, debt obligations of bank holding companies or their nonbank affiliates, including commercial paper and other short- or long-term debt securities, should prominently indicate that: 1) they are not obligations of an insured depository institution; and 2) they are not insured by the Federal Deposit Insurance Corporation. In cases where purchasers do not take physical possession of the obligation, the purchasers should be provided with a printed advice that conveys this information. Employees engaged in the sale of bank holding company debt obligations should be instructed to relate this information verbally to potential purchasers. In addition, with respect to the sale of holding company debt obligations, the instruments or related documentation should not display the name of the affiliated bank in such a way that could create confusion among potential purchasers about the identity of the obligor. State member banks involved in the sale of uninsured nondeposit debt securities of the bank should establish procedures to ensure that potential purchasers understand that the debt security is not federally-insured or guaranteed.

Federal Reserve examiners are responsible for monitoring compliance with this supervisory policy; and, as part of the examination of state member banks and bank holding companies, are expected to continue to review the polices and internal controls relating to the marketing and sale of debt obligations and securities. Examiners should determine whether the marketing and sale of uninsured nondeposit debt obligations are sufficiently separated and distinguished from retail banking operations, particularly the deposit-taking function of the insured depository affiliate.

In determining whether the activities are sufficiently separated, examiners should take into account: 1) whether the sale of uninsured debt obligations of a holding company affiliate or uninsured nondeposit debt securities of a state member bank is physically separated from the bank's retail-deposit taking function, including the general lobby area[1]; 2) whether advertisements that promote uninsured debt obligations of the holding company also promote insured deposits of the affiliated depository institution in a way that could lead to confusion; 3) whether similar names or logos between the insured depository institution and the issuing nonbank affiliate are used in a misleading way to promote securities of a nonbank affiliate without clearly identifying the obligor; 4) whether retail deposit-taking employees of the insured depository institution are engaged in the promotion or sale of uninsured debt securities of a nonbank affiliate; 5) whether information on the sale of uninsured debt obligations of a nonbank holding company affiliate is available in the retail banking area; and 6) whether retail deposit statements for bank customers also promote information on the sale of uninsured debt obligations of the bank holding company or a nonbank affiliate.

The Board's policy is that the manner in which commercial paper is sold should not lead bank customers or investors to construe commercial paper as an insured obligation or an instrument which may be higher in yield but equal in risk to insured bank deposits. All purchasers of commercial paper should clearly understand that such paper is an obligation of the parent company or nonbank subsidiary and not an obligation of the bank and that the quality

1. This policy is not intended to preclude the sale of holding company affiliate obligations from a bank's money market desk, provided that the money market function is separate from any public area where retail deposits are accepted, including any lobby area.

of the investment depends on the risks and operating characteristics associated with the overall holding company and its nonbanking activities.

2080.1.3 THRIFT NOTES AND SIMILAR DEBT INSTRUMENTS

In the event a bank holding company or nonbanking affiliate issues thrift notes or other debt obligations which do not fall within the generally accepted definition of commercial paper, examiners should be guided by the Board's 1978 position on the issuance of small denomination debt obligations by bank holding companies and their nonbanking affiliates. At that time, the Board was considering thrift notes issued by a nonbanking subsidiary of a bank holding company and concluded that such obligations should prominently indicate in bold type on their face that the obligations are not obligations of a bank and are not FDIC insured. The Board also stated that the obligations should not be sold on the premises of affiliated banks. Where there is substantial reliance on the sale of thrift notes to fund the operations of a bank holding company or nonbanking subsidiary, other than an industrial bank, a violation of the Glass–Steagall Act may be involved. Such cases should be discussed with Reserve Bank counsel.

2080.1.4 OTHER SHORT-TERM INDEBTEDNESS

A company's access to bank credit is almost universal, and most small to medium-sized companies will reflect this type of debt on their balance sheets. An important point to remember about bank debt is that maturities of the bank notes are usually short-term while the proceeds of the borrowings are often applied to long-term assets, that is, investment in the bank's capital and/or long-term debt accounts. The note may be subject to renewal on an annual basis, and the creditor may have the opportunity to call the note at renewal if the financial condition of the company has deteriorated. Rates of interest on short- term bank notes are usually pegged to the creditor's prime rate plus some fraction thereof. The principal is often repaid over a period of years as the notes are rolled over despite their short-term maturity.

2080.1.5 CURRENT PORTION OF LONG-TERM DEBT

This type of debt has many of the short-term characteristics of bank debt, with possibly one additional important feature. Such debt is usually tied to a written agreement between creditor and debtor, and encompasses certain minimum standards of performance to be adhered to by the company. The examiner must review the agreement to determine that the company is operating within the parameters of the covenants laid out in the agreement. Failure to abide by the covenants can trigger default provisions of the agreement and escalate the repayment of the total loan balance outstanding.

2080.1.6 INSPECTION OBJECTIVES

1. To determine the company's policy and actual practices with respect to the sale of uninsured debt obligations and securities issued by bank holding companies, nonbank affiliates or State member banks. More often than not, an informal policy evolves from practice. It then becomes important to interview senior officers in charge of this function to determine if they are adequately aware of the statutory and regulatory constraints with respect to appropriate usage of commercial paper.
2. To review the company's funding and liquidity strategy with a view to determining whether it has sufficient liquid assets to support maturing liabilities and whether there are any funding mismatches. (See Manual sections 2080.05, 4010.2.3, 4010.2.7, and 5010.24.1)
3. To determine compliance with the Federal Reserve System's supervisory policy with regard to the marketing of commercial paper, thrift notes or similar type debt instruments (refer to Board letter S 2427 dated June 27, 1980, and supervisory letters SR 90–19 and SR 620).
4. To identify potential weaknesses in corporate policy and practices.

2080.1.7 INSPECTION PROCEDURES

1. Review the bank holding company's procedures for authorizing the issuance of commercial paper and other uninsured debt obligations and securities of the holding company and/or its nonbank affiliates.
2. Review the board of directors' resolution authorizing the issuance of commercial paper and other uninsured debt obligations and securities.

3. Determine whether the company has sought a "no action" letter from the SEC. A "no action" letter indicates the SEC has reviewed the company's issuance of commercial paper and plans "no action" to require the registration of the commercial paper as "securities." Some companies rely on the opinion of their own counsel that their paper is not subject to SEC registration requirements. If the company does not have a "no action" letter there should be a legal opinion on file from the holding company's attorney regarding exemption from registration under section 5 of the 1933 Act.

4. Obtain a copy of the holding company's written policy on paper usage to compare with resolution and practice.

5. Review to determine the extent to which the commercial paper and other uninsured debt obligations are supported by back-up lines of credit provided by unaffiliated banks. These lines are established to cover any unexpected run-off of paper at maturity. Commitments for lines of credit should be in writing and have expiration dates. Commitment fees substantiate the enforceability of the commitment whereas compensating balances tend to indicate that the lending commitment is less formal. The examiner should determine whether material adverse change clauses exist in back-up line of credit agreements which may affect their reliability. Comment if it appears that those provisions might be utilized.

Compensating balance arrangements should be disclosed. A company may commit to a compensating balance, but if it relies on its bank subsidiary to provide the funds the bank should be compensated for utilization of its funds.

Reciprocal back-up lines may be established. This may eliminate the need for fees or compensating balances and may provide a certain comfort level for company management.

6. Obtain a listing of commercial paper and other uninsured debt obligation holders from management to the extent known. In the case of larger BHCs, there is a choice between issuing paper on a local level or placing it nationally through the auspices of an investment banking firm. In the latter case, there is likely to be no record of who purchases the paper because the paper is usually sold on a bearer basis. Holding companies looking for a wider market, national recognition, and higher ratings place their paper through an investment banking firm. However, it should be recognized that the market for commercial paper placed in this manner is more sophisticated and knowledgeable and therefore more sensitive to adverse developments than a local market. The smaller company can be content to sell its paper on a local level through its corporate headquarters, knowing its customer profile and limiting the amount to any one paperholder, thereby limiting its exposure to refinancing problems caused by large scale redemptions.

7. Review for potential weaknesses in corporate policy and practices. Any amounts in excess of 10 percent in the hands of one paperholder should be discussed with management and noted in the report. A large paperholder could refuse to purchase new paper at maturity (rollover) and place the company in a liquidity squeeze, requiring sell-off of assets or draw down of back-up lines.

Rollovers are prohibited under the 1933 Act. The instrument must have a definite date of maturity with no automatic provision for reinvestment of proceeds. Companies must abide by the 270-day provision and if the paperholder elects to reinvest the funds, a new instrument should be executed.

8. Request a copy of the commercial paper, thrift note or similar type instrument, and any printed advice to the purchasing customer for review. These documents should be checked for compliance with the standards set forth under the captions "Marketing of Commercial Paper" and "Thrift Notes and Similar Debt Instruments" in this section of the Manual.

9. If a bank sells the commercial paper and/or other uninsured debt obligations of its holding company or nonbanking affiliate, review the procedures to separate their sale from the retail operations of the bank.

This segregation should be reviewed as part of all holding company inspections. Examiner judgment must be relied upon, to a large extent, to determine whether the marketing activities of commercial bank subsidiaries for the bank holding company's commercial paper and other uninsured debt obligations are sufficiently separated and distinguished from retail banking operations, particularly the deposit- taking function. In making this determination, the examiner should consider whether:

a. The sale of uninsured debt obligations of a holding company affiliate or uninsured non-deposit debt securities of a state member bank is physically separated from the bank's retail-deposit taking function, including the general lobby area;

b. Advertisements that promote uninsured debt obligations of the holding company also

promote insured deposits of the affiliated depository institution in a way that could lead to confusion;

c. Similar names or logos between the insured depository institution and the issuing nonbank affiliate are used in a misleading way to promote securities of a nonbank affiliate without clearly identifying the obligor;

d. Retail deposit-taking employees of the insured depository institution are engaged in the promotion or sale of uninsured debt securities of a nonbank affiliate;

e. Information on the sale of uninsured debt obligations of a nonbank holding company affiliate is available in the retail banking area; and

f. Retail deposit statements for bank customers also promote information on the sale of uninsured debt obligations of the bank holding company or a nonbank affiliate.

In those cases where the bank holding company or nonbanking affiliates issue thrift notes or similar type debt instruments, ascertain that these obligations are not being sold on the premises of affiliated banks.

10. The procedures in Nos. 8 and 9 address the manner in which bank holding companies (or nonbanking subsidiaries) market their commercial paper, thrift notes or similar type debt instruments; consequently, implementation will necessitate review of marketing procedures of all holding companies (or nonbanking subsidiaries), regardless of the type of charter or the identity of the primary supervisor of the subsidiary (affiliate) bank. Exceptions to the policies on the marketing of such paper should be noted on the ‘‘Commercial Paper and Lines of Credit’’ pages and discussed on the ‘‘Examiner's Comments’’ page of the inspection report. The managements of all bank holding companies must be fully informed of the Federal Reserve's policy with respect to the marketing of holding company debt obligations, as in SR Letter 90–19, and exceptions should be addressed in the supervisory follow-up process.

Long-term debt represents an alternative financing method to short-term debt and equity funds. Before choosing this type of funding the bank holding company will need to determine how the advantages and disadvantages of long-term debt apply to its financial position and funding needs. Interest on long-term debt is an expense item and therefore is tax deductible. The company issuing debt effectively pays approximately "half-price" (interest expense net of tax deduction) on debt while the company issuing equity pays the full dividend rate without a tax benefit. Counterbalancing the tax advantage is the fact that long-term debt must be serviced and retired to prevent default and cannot be used as an offset for losses.

The issuance of long-term debt will be relatively advantageous to the holding company whose price/earnings ratio is low and whose stock is selling significantly below book value. In this instance, the cost to the company of equity funding rises proportionately to the drop in the price of the stock since less funds are obtained for an equal number of shares, yet the dividend per share remains the same.

A major factor influencing a bank holding company's decision to issue long-term debt instead of equity is the dilution impact of new equity. Straight debt will not dilute ownership and is typically retired from cash flow, whereas new equity dilutes earnings per share (more so than the impact of the debt's interest expense on earnings).

Preferred stock can be retired through a sinking fund and is sometimes convertible to common shares. Convertible stock adds to the dilution effect when the conversion is exercised and prior to conversion, "fully diluted" earnings per share must be reported that assume full conversion. The bank holding company will consider both stockholder and market reaction to any dilution effects of long-term financing. The BHC may view debt financing as the best alternative if it feels that a diluted earnings per share would drive down the market price of its stock and contribute to stockholder discontent.

Inherent in any financing are intangible costs. While it is evident that on the surface debt financing is cheaper than equity financing, it would be hard to quantify the effects of potential missed interest payment or default associated with debt instruments. The bank holding company also will be concerned with its additional "debt capacity" if the present issuance of debt pushes the debt/equity ratio beyond acceptable limits.

Theoretically, "straight debt" is a direct secured or unsecured obligation requiring repayment at maturity and generally taking a senior position in the claim on assets. Principal is sometimes payable in a lump sum, often through the use of a sinking fund, while interest is paid at stated periods throughout the life of the note.

2080.2.1 CONVERTIBLE SUBORDINATED DEBENTURE

A convertible subordinated debenture is an unsecured debt that is subordinate to other debt and convertible to common stock at a certain date or price. The essential provision of this debt is that it may eventually be retired by equity and inherently has the potential for dilution. With this type of financing, the creditor typically has the right to convert the bond into a stated number of shares of common stock at some future time. Usually the conversion price is 10 to 15 percent above the market price of the stock. This encourages the bondholder to keep the bond until the market price meets or surpasses the conversion price. In many convertible debt agreements, the bank holding company issuing debt will have the option to call the issue when the conversion price equals the market price.

The bank holding company will issue a convertible subordinated debenture when its stock price is depressed. The convertibility provision is added as a "sweetner" to the issue and counteracts the negative aspect of its subordinated position. The subordinated nature of this issue will help a bank holding company with prior debt which includes covenants that dictate against additional senior debt.

2080.2.2 CONVERTIBLE PREFERRED DEBENTURE

This debt instrument is similar to straight convertible debt except it is convertible into preferred stock. This alternative is open to the bank holding company which needs to add a "sweetner" to this issue in order to market it, but does not want dilution of "common" ownership.

2080.2.3 NEGATIVE COVENANTS

The lender will be concerned with the borrower's debt structure when offering financing. If the borrower's debt/equity ratio is approaching an unacceptable level, the lender will try to assure that the bank holding company does not overextend itself. While the lender may demand the right to approve future equity issues, the lender is likely to be more willing to give such approval than to allow more debt because the equity issue adds to the capital base, and this base is a possible source of funds for the payment of debt.

Closely related to the restriction on further debt is the position of the lender in the liquidation of assets. The holder of a straight debt issue will usually demand to be senior to other debt holders. This characteristic is particularly suited to straight debt because straight debt is more vulnerable to default than convertible debt and doesn't have other sweetners such as a conversion right or a right to participate in distributions of earnings. The examiner will want to determine how the covenants affect future debt financing and if the effect is positive or negative.

The lender is likely to seek to insure that neither the structure nor policies of the bank holding company are altered without its approval during the life of the debt. The lender can insure this through other negative covenants attached to the debt. Some common covenants of this type include (1) limitations on capital expenditures and on the sale of assets, (2) restrictions on the BHC's redemption of its own stock, (3) restrictions on investments in general, (4) restrictions on dividend payment without prior approval, and (5) the imposition of loan to capital ratios, deposit to capital ratios and asset to capital ratios.

2080.2.4 INSPECTION OBJECTIVES

1. To determine the existence of and adherence to policies on long-term debt.
2. To review the use of long-term funds.
3. To determine the existence of debt covenants and compliance by the holding company.

2080.2.5 INSPECTION PROCEDURES

1. Review the parent-only balance sheet and income statement for debt and interest expense captions.
2. Review the consolidated balance sheet and income statement for debt and interest expense captions.
3. Review any written policies and procedures available as part of an overall capital plan. If no plan or policies exist, the examiner should encourage management to develop them, and in large BHCs, to put them in writing.
4. Determine that the bank holding company does not finance long-term assets with short-term debt, as this leaves the holding company vulnerable to rising interest rates and the possibility of a credit crunch. On the other hand, it may be beneficial for the holding company to finance short-term assets with long-term debt. This is particularly true during periods of rising interest rates because the bank holding company can get higher yields on loans financed by lower cost long-term debt, than it can with commercial paper that has to be turned over at generally increasing rates. In any event, the bank holding company will need to insure that it has ample capacity to finance additional long-term assets with long-term debt when the opportunity presents itself.
5. Review any sinking fund provisions usually found with straight debt and straight preferred issues if the issue is not going to be refinanced by further debt or by an equity issue. Since payments to the fund will directly drain cash reserves, it is imperative that the bank holding company have adequate annual cash flow to service both the interest and add to the sinking fund. The larger the debt, the more the lender will look for a sinking fund feature as a means of precluding a default when maturity occurs and refinancing is not available. When a sinking fund exists the examiner will need to analyze the parent's cash flow statement to see that payments do not produce an adverse cash drain.

The capacity of the holding company to serve as a source of financial strength to its bank subsidiaries is a major consideration of the Federal Reserve Board in supervising a bank holding company. The cornerstone of this financial strength is capital adequacy.

The financial structure of banking organizations allows for the use of substantial leverage. If capital is large in relation to debt, additional borrowing is relatively inexpensive. However, because of added risk to lenders, the cost of borrowing increases as new obligations are assumed. At some point, therefore, equity financing becomes less costly and may become the only alternative available for needed funds.

Basically, a holding company's financial structure can be viewed in two ways: the ''single entity'' approach, whereby the holding company is considered an integrated entity and financial strength is assessed on the basis of its consolidated totals, and the ''building block'' approach, wherein the holding company is seen as a collection of individual components. In the latter view, the company's financial strength is assessed primarily in terms of the financial structure of each component.

When applying the ''building block'' approach, the liability and capital structure of each subsidiary is compared to the norm of its particular industry. The use of the ''building block'' approach has some advantages:

1. Comparative statistics are usually available to measure the performance and strength of the individual subsidiaries.
2. It permits comparison of capitalization between holding companies engaged in differing activities.
3. It identifies the degree of leveraging within a single subsidiary of a bank holding company.

The parent should maintain a favorable balance of debt and equity so that it will be able to assist its subsidiaries when necessary through contributions of its own capital or through additional funds generated from debt or equity financing.

At times, however, sale of additional stock may not be a viable alternative for capital formation, even when a company can show a favorable debt/equity balance. Reluctance to enter into a new stock offering may stem from a desire to avoid further dilution of existing ownership interest or from an unfavorable market price of outstanding stock in relation to book value. In these instances, long-term quasi-capital funds may sometimes be obtained through other sources, such as convertible securities or subordinated debt.

2080.3.1 PREFERRED STOCK

Preferred stock is becoming a more acceptable alternative due to certain advantages. Through contracted covenants, it is senior to common stock because it usually has no voting voice in management as does common stock. Preferred stock usually carries a fixed dividend rate that is either cumulative or noncumulative. Cumulative preferred provides that unpaid dividends in prior years must be paid to preferred shareholders before common dividends can be paid. A noncumulative feature provides that dividends foregone during lean years are lost permanently. From the viewpoint of the bank holding company, a noncumulative preferred issue is more desirable, while investors would desire a cumulative feature.

Perpetual preferred stock does not have a stated maturity date and it may not be redeemed at the option of the holder. Advantages that preferred stock can offer the bank holding company are (1) avoidance of dilution of earnings per common share and (2) absence of voting rights. On the other hand, dividend payments, particularly cumulative dividends, are expensive since they are not a tax-deductible expense as is interest on debt. Cumulative dividends can be particularly draining on cash when they are declared after several years of suspended dividends and payment is then made in a lump sum.

Preferred stock is usually retired by refinancing with debt or through its own conversion feature. If the bank holding company feels that it can afford an equity issue in the future but not at present, it can issue a convertible preferred debenture to postpone the equity issue until a later date. On the other hand, if debt is the desired method of financing but the present debt/equity ratio is not acceptable, the bank holding company will issue preferred and refinance with debt at a more opportune time. However, the Board has expressed concern that in applications to form a BHC, preferred stock not be used as a debt substitute resulting in circumvention of its debt guidelines. On applications with preferred stock which has debt-like characteris-

tics, such stock may be treated as debt in the financial analysis.

2080.3.2 INSPECTION OBJECTIVES

1. To determine the existence of and adherence to parent company policies on capital adequacy within the subsidiaries and for the consolidated organization.
2. To review the use of proceeds of equity capital financings.
3. To review any debt covenants that pertain to a minimum acceptable capital position.

2080.3.3 INSPECTION PROCEDURES

1. Review any existing BHC policies regarding capital adequacy or capital planning.
2. Request any plans regarding proposed capital issues.

Earnings retention provides the most immediate source of capital formation and growth. Earnings retained after dividend payout can often be sufficient to keep pace with asset growth, thereby preserving the balance or relationship between equity capital and total assets. Often referred to as "internal funding," earnings retention should be carefully reviewed to assure that the BHC's capital base is keeping pace with asset growth.

Bank earnings retention should be reviewed carefully due to the dividend requirements often imposed on banks by their parent companies. Although a bank's board of directors must approve the declaration and payment of any bank dividend, often the bank's board is actually ratifying a decision determined at the parent level. The need for bank retention of earnings is particularly pronounced either during periods of expansion or periods of declining earnings or losses.

Parent company management may be under pressure from shareholders or "the market" to increase dividends or to maintain dividends at historic levels despite reversals in consolidated earnings trends. Examiners should be careful to point out to management that dividend pressures often serve to the detriment of the bank subsidiary(ies) which is often asked to supply the proceeds via a dividend to the parent company. As a regulator of banks (and bank holding companies), the Federal Reserve System is concerned with the preservation and maintenance of a sound banking system and in particular, soundly capitalized banks. Earnings retention contributes to capital growth and should be encouraged. For additional information on earnings retention and dividends see sections 2020.5.1, 4010.1, and 4020.1.

2080.4.1 PAYMENT OF DIVIDENDS BY BANK SUBSIDIARIES

Bank dividends can be determined to be excessive if they exceed the limitations imposed by either section 5199(b) or 5204 (also referred to as sections 56 and 60(b)) of the Revised Statutes and accordingly, should be reviewed with regard to those limitations. The Federal Reserve Board amended Regulation H on December 20, 1990, regarding the payment of dividends by state member banks [12 C.F.R. 208.19(a) and 208.19(b)]. These new regulations make the elements that are taken into account in determining a state member bank's dividend paying capacity more consistent with generally accepted accounting principles. Two different calculations are performed to measure the amount of dividends that may be paid, a Net Profits Test and an Undivided Profits Test.

2080.4.1.1 Net Profits Test

The approval of the Federal Reserve is required for dividends declared by a member bank that in any calendar year exceeds the net profits of the current year, combined with retained net profits for the two proceeding years (the "Net Profits Test"). Under the regulation, net profits of a year will equal net income. A member bank is required to use these rules in calculating net profits beginning in 1991 and thereafter.

2080.4.1.2 Undivided Profits Test

The parent company's bank subsidiaries must receive prior approval of the Federal Reserve before paying dividends in amounts greater than undivided profits then on hand, after deducting any bad debts in excess of the allowance for loan and lease losses. Under the regulations effective January 25, 1991, undivided profits then on hand include undivided profits plus the amount of "surplus surplus" that meets certain conditions. "Surplus surplus" is defined as the amount of capital surplus in excess of the amount required under applicable state law, and the regulations provide that a bank may include surplus surplus in undivided profits then on hand only if the bank can demonstrate that surplus surplus is from earnings of prior periods ("earned surplus surplus"). Transfers from surplus surplus to undivided profits must receive prior approval of the Federal Reserve. Bad debts in excess of the allowance for loan and lease losses must be subtracted from undivided profits then on hand in calculating the amount available for dividends. Bad debts are defined as debts due and unpaid for a period of six months unless well secured and in the process of collection.[1]

1. Because for most banks bad debts are less than the allowance for loan and lease losses, this subtraction will not apply to most banks.

Holding companies have turned to employee pension plans and, to a lesser degree, stock option plans as ways to provide added capital for holding company operations. While there may be a number of reasons for implementing such programs, one of the by-products is the flow of working capital into the holding company. The program usually involves a pre-tax contribution by the holding company to an employee benefit plan (e.g., profit sharing plan) and the resulting purchase by such plan of common or preferred shares of the holding company's stock. The holding company benefits through the use of the funds for working capital, and the plan provides for retirement benefits for employees as shareholders in the company. Since ESOPs are administered under the Employees Retirement Income Security Act of 1974 (ERISA), the guidelines delineated in SR 85–21 should be followed in determining whether possible ERISA violations exist. Reference should also be made to Manual section 4010.1.1.

2080.5.1 STOCK OPTION PROGRAMS

Employee stock option programs generate a nominal percentage of a holding company's financing needs to reward key employees for service rendered via the reduced price of the company's stock. While such programs constitute one method of available funding for a holding company, they generally may not be expected to add any capital amounts beyond nominal levels.

2080.5.2 EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)

Employee Stock Ownership Plans (ESOP) are an alternative holding company funding tool. An ESOP is a tax-qualified employee benefit plan which is designed to be invested primarily in employer stock. The concept of an ESOP is to encourage the establishment of employee benefit programs which expand the employees' share in company stock ownership. Participation in an ESOP may also significantly enhance employee motivation. The essential differences between an ESOP and other qualified stock bonus plans are that an ESOP is permitted, in certain circumstances, to incur liabilities in the acquisition of employer securities, and that an employer may receive additional tax credits for amounts contributed to ESOPs. Under limited circumstances, lenders to ESOP's may also receive benefits that result in reduced borrowing costs to the ESOP. As long as ESOP meets the IRS requirements for a qualified employee plan, it may invest up to 100% of its assets in "qualifying" employer securities. It is exempt from some of the self-dealing limitations applicable to most employee benefit plans, as it is viewed as a means of providing stock ownership interests for employees rather than as strictly a retirement plan. Furthermore, an ESOP may purchase the stock either from the employer company or from shareholders. Therefore, in addition to use as a tool of corporate finance, an ESOP may serve as a ready purchaser for outstanding stock, without a corresponding loss of voting control.

ESOPs are in some ways similar to deferred profit sharing plans. ESOPs are authorized under the same section, namely, section 401 of the Internal Revenue Code. Employer contributions (within limits based on a percentage of eligible payroll) are allowable deductions from the employer's pre-tax income. Contributions are held in trust, and benefits when paid out upon an employee's retirement, death, or termination of service, must be paid in company stock. The distinguishing feature of an ESOP lies in the fact that the direct purpose of the plan is to invest employer contributions in the stock of the company.

2080.5.2.1 Accounting Guidelines for Leveraged ESOP Transactions

Newly issued or existing shares of BHC stock are sometimes sold to the ESOP and paid for with money borrowed from a third party; these types of ESOPs are commonly referred to as "leveraged ESOPs." The borrowings are generally serviced with contributions by the employer, which are a tax deductible expense. The borrowing arrangement by the ESOP often includes a guarantee or commitment by the employer (the BHC or the subsidiary bank) to make future contributions to the ESOP sufficient to meet debt service requirements.

When this occurs, questions arise involving the appropriate accounting for the leveraged ESOP transaction. The Accounting Standards Executive Committee of the American Institute

of CPAs has issued a Statement of Position (SOP) 72–3 which discusses ESOP borrowing situations. Since the Federal Reserve applies generally accepted accounting principles, banks and bank holding companies should follow SOP 76–3. The SOP statement covers cases where the employer either guarantees the ESOP loan or commits to make future ESOP contributions sufficient to service the debt. For such cases, the SOP indicates that the employer should credit a liability account for the amount of the ESOP debt and offset that entry by reducing shareholders' equity. The liability recorded by the employer should be reduced as the ESOP makes payments on the debt. This liability is recorded because the guarantee or commitment is in substance the employer's debt. When there is no guarantee, the ESOP is treated like any other shareholder.

In other words, where there is a leveraged ESOP which has purchased BHC stock, and there is a guarantee, commitment, or other arrangement which is in effect a guarantee relative to the debt service of the ESOP, for analytical purposes the amount of ESOP debt will be considered as parent debt and thus parent equity will be reduced accordingly. This will affect debt to equity ratios as well as consolidated capital ratios, where applicable.

2080.5.2.2 Fiduciary Standards under ERISA Pertaining to ESOPs

There are also general fiduciary standards under ERISA pertaining to ESOPs which have been delineated largely through court decisions rather than issuance of regulations. Although exempted from ERISA's asset diversification requirement, ESOP transactions are still required to meet fiduciary standards of prudence, and must be designed and administered for the ''exclusive benefit'' of plan employees. (ERISA § 404(a) and 29 CFR 2550.407d–6). Yet, as stated above, ESOPs may have distinct advantages which inure primarily to the sponsoring company, its management and large shareholders. Due to these potential or actual conflicts of interest, it is important that the sponsoring employer and any other fiduciaries of a plan undertake every effort to assure full consideration of the best interests of plan employees.

The safeguarding of the statutory ''exclusive'' interests of plan employees pursuant to ERISA is within the jurisdiction of the IRS and the Department of Labor. The bank regulatory agencies also have some responsibility in their review and examination activities where employee benefit plans such as ESOPs are involved. In this connection, a Uniform Interagency Referral Agreement mandated by statute, has been in effect since 1980 whereby certain possible violations of the provisions of ERISA are referred to the DOL by the Division of Banking Supervision and Regulation, pursuant to delegated authority. SR 81–697 (SA) contains the procedures for making referrals to the Department of Labor. Attached to the SR letter is an exhibit, *ERISA Referral Format,* which lists the information necessary when making referrals. Holding company examiners can expedite the ERISA referral process by including that information in their reports.

2080.5.3 STATUS OF ESOP'S UNDER THE BHC ACT

On August 6, 1985, the Board determined (1985 FRB 804) that an ESOP that controls more than 25 percent of the voting shares of a bank or bank holding company is a bank holding company. The Board determined that the underlying trust which held the shares of the bank holding company is a ''business trust'' as defined in the BHC Act and was thus not excluded from the definition of a ''company'' under the terms of the Act.

2080.5.4 INSPECTION CONSIDERATIONS

Examiners should review unfunded pension liabilities of the BHC to determine their potential impact on the organization. In addition, examiners should review the soundness of any borrowings used to fund ESOP purchases of BHC stock. ESOP borrowings from an affiliated bank used to purchase BHC shares may result in an apparent increase in BHC capital which in fact turns out to have been funded with subsidiary bank funds, a practice considered suitable for in-depth review by examination staff. Section 401 (of the Internal Revenue Code) plan holdings of BHC stock need to be evaluated under the ''content'' provisions of the BHC Act, change in Bank Control Act, and Regulation Y.

When an ESOP is subject to the Change in Bank Control Act, this fact should be brought to the attention of a BHC's management. Section 225.41 of Regulation Y specifies transactions—acquisitions—that would require providing the

Board with 60 days prior written notice before acquiring control of a bank holding company (or a state member bank), unless the transaction is exempt under section 225.42 of the Regulation. In addition to the above, a determination should be made as to whether the ESOP is a bank holding company. The examiner may also refer to the Financial Accounting Standards Board's Statement No. 87, "Employers' Accounting for Pensions."

A key principle underlying the Federal Reserve's supervision of bank holding companies is that such companies should be operated in a way that promotes the soundness of their subsidiary banks. Holding companies are expected to avoid funding strategies or practices that could undermine public confidence in the liquidity or stability of their banks. Consequently, bank holding companies should develop and maintain funding programs that are consistent with their lending and investment activities and that provide adequate liquidity to the parent company and its nonbank subsidiaries.

2080.6.1 FUNDING BY SWEEPING DEPOSIT ACCOUNTS

A principal objective of a bank holding company's funding strategy should be to maintain an adequate degree of liquidity at the parent company and its subsidiaries. Funding mismatches can exacerbate an otherwise manageable period of financial stress and, in the extreme, undermine public confidence in an organization's viability. In developing and carrying out funding programs, bank holding companies should give special attention to the use of overnight or extremely short-term liabilities since a loss of confidence in the issuing organization could lead to an immediate funding problem. Accordingly, bank holding companies relying on overnight or extremely short-term funding sources should maintain a level of superior quality assets, namely, assets that can be immediately liquidated or converted to cash with minimal loss, that is at least equal to the amount of those funding sources.

A potential source of funding mismatch arises from the use of what has been commonly referred to as deposit sweeps. This practice is based upon an agreement with a subsidiary bank's deposit customers (typically corporate accounts) which permits these customers to reinvest amounts in their deposit accounts above a designated level in overnight obligations of the parent bank holding company. These obligations include such instruments as commercial paper, program notes, and master notes.

In view of the extremely short-term maturity of most sweep arrangements, banking organizations should exercise great care when investing the proceeds. Appropriate uses of the proceeds of deposit sweep arrangements are limited to short-term bank obligations, short-term U.S. Government securities, or other highly liquid, readily marketable, investment grade assets that can be disposed of with minimal loss of principal.[1] Use of such proceeds to finance mismatched asset positions, such as those involving leases, loans, or loan participations, can lead to liquidity problems at the parent company and are not considered appropriate. The absence of a clear ability to redeem overnight or extremely short-term liabilities when they become due should generally be viewed as an unsafe and unsound banking activity.

Reserve Bank supervisory and examination personnel are to ensure that bank holding companies and their state member banks are in compliance with this section and related supervisory letters addressing the marketing of uninsured debt instruments, including master notes and other sweep arrangements (refer to Manual sections 2080.05 and 2080.1). Banking organizations not in compliance should take the necessary steps to achieve full compliance within a reasonable period of time. Reserve Banks should provide copies of the supervisory letter SR 90–31 to any bank holding company engaged in sweep arrangements with their subsidiary banks, or to any other organization if necessary to facilitate compliance.

1. Some banking organizations have interpreted language in a 1987 letter signed by the Secretary of the Board as condoning funding practices that may not be consistent with the principles set forth in this supervisory letter and prior Board rulings. The 1987 letter involved a limited set of facts and circumstances that pertained to a particular banking organization; it did not establish or revise Federal Reserve policies on the proper use of the proceeds of short-term funding sources. In any event, banking organizations should no longer rely on the 1987 letter to justify the manner in which they use the proceeds of sweep arrangements. Banking organizations employing sweep arrangements are expected to ensure that these arrangements conform with the policies contained in this section and in the Manual section 2080.05 on bank holding company funding.

The control provisions of the Bank Holding Company Act (the act) are found in section 2(a)(1) and (2) (see 12 U.S.C. 1841(a)) under the definition of a bank holding company. A bank holding company is defined as ''any company which has control over any bank or over any company that is or becomes a bank holding company by virtue of the Act.''

The term ''company'' means any corporation, partnership, business trust, association, or similar organization, or any other trust.[1] Any corporation in which the majority of the shares are owned by the United States or by any state is not considered a company.

A ''company covered in 1970'' means a company that became a bank holding company as a result of the enactment of the Bank Holding Company Act Amendments of 1970 and which would have been a bank holding company on June 30, 1968, if those amendments had been enacted on that date.

2090.0.1 CONCLUSIVE PRESUMPTIONS OF CONTROL

The conclusive presumptions of control are established in section 2(a)(2)(A) and (B) of the act when—

1. a company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 percent or more of any class of voting securities of a bank or company or
2. a company controls in any manner the election of a majority of the directors or trustees of the bank or company.

''Acting through one or more other persons'' could include—

1. acting through the executive officer of a company, or a relative or business associate of that officer;
2. financing the purchase of shares of a bank or company when—
   a. the amount of credit approximates the purchase price,
   b. there is no definite maturity on the credit extended,
   c. the credit is obtained at a favorable rate of interest, and
   d. the bank whose shares are held as collateral maintains an excessive balance with the lending company;
3. by a resolution of a company's board of directors, guaranteeing an individual against any loss in relationship to his ownership in a bank or company when such ownership represents 25 percent or more of any voting class;
4. recognizing earnings from another company; or
5. participating in policy formation or daily operations of another company.

The ''power to vote'' includes the right to vote, to direct the voting of shares, or to immediately transfer shares to the name of the holder of such rights or the holder's nominee, pursuant to any proxy, contract, or agreement. However, when stock is held as collateral for a loan under an agreement which enables the lender to transfer the stock into the name of the lender or its nominee without the power to vote, the right to have the shares transferred does not in itself constitute control. To constitute control, the power to vote must be perfected along with the transfer of the stock into the name of the lender or its nominee.

2090.0.2 DIRECT CONTROL

Direct control exists when a company (as defined in section 2(b) of the act) owns 25 percent or more of any one class of voting securities of a bank (as defined in section 2(c) of the act) or company. ''Voting securities'' includes potential as well as actual voting authority.

2090.0.3 INDIRECT CONTROL

Indirect ownership or control is defined in section 2(g) of the act in subsections 1 and 2 as follows:

''(1) Shares owned or controlled by any subsidiary of a bank holding company shall be deemed to be indirectly owned or controlled by such bank holding company; and

''(2) Shares held or controlled directly or indirectly by trustees for the benefit of (A) a company, (B) the shareholders or members of a company, or (C) the employees

1. Unless the terms of the trust require it to terminate within 25 years or not later than 21 years and 10 months after the death of individuals living on the effective date of the trust.

(whether exclusively or not) of a company, shall be deemed to be controlled by such company."

To assist in the interpretation of the above subsections the following explanations are provided.

1. All shares owned by a subsidiary of a bank holding company are deemed to be controlled by the parent's ownership interest in the directly owned subsidiary.
2. Shares held in a trust for the benefit of a company are deemed to be controlled by such company regardless of whether the trustee or company votes the shares. A company is deemed to be the beneficial owner of shares which it does not vote if all other shareholders' rights are retained by such company (that is, dividends, or other rights).
3. Shares owned by a trustee for the benefit of a company's subsidiary (or the subsidiary's shareholders, members, or employees) are deemed to be controlled by both the subsidiary and its parent.
4. Shares held in a trust for the benefit of an individual "stockholder, member, or employee" are not deemed to be controlled by a company because such shares are held for the individual regardless of his or her relationship with the company. For a company to have control over the shares held for the benefit of a company's "stockholders, members, or employees," the shares must be held as a class.
5. If a trust meets the definition of a company, it is possible for such a trust to be a bank holding company. In addition, it is possible for a bank through the administration of a trust(s)(which does not meet the definition of a company) to become a bank holding company (that is, a bank which has control over various trusts whose shares aggregate to 25 percent or more of a bank or bank holding company could be deemed a bank holding company; a bank which administers a trust that owns 25 percent or more of a bank or bank holding company (and such trust does not meet the definition of a company) could be a bank holding company.

In addition to the above determinants involving conclusive presumptions of control, the Board has determined that whenever the transferability of 25 percent or more of any class of voting securities of a company is restricted, in any manner, upon the transfer of 25 percent or more of any class of voting securities of another company, the holders of the two securities affected by the restriction constitute a company for the purposes of the act. This determination applies unless one of the issuers of such securities is a subsidiary of the other and is so identified in a Board order or in a registration statement or report accepted by the Board under the act.

In any administrative or judicial proceedings regarding conclusive presumptions of control, a company would not be considered to control a bank or company at any given time unless that company, at the time in question, directly or indirectly owned, controlled, or had power to vote 5 percent or more of any class of voting securities of the bank or company.

2090.0.4 REBUTTABLE PRESUMPTIONS OF CONTROL

A rebuttable presumption of control exists when the Board determines, after notice and opportunity for hearings, that a company directly or indirectly exercises a controlling influence over the management or policies of a bank or company (section 2(a)(2)(C) of the act). With regard to the above, there is a presumption that any company which directly or indirectly owns, controls, or has power to vote less than 5 percent of any class of voting securities of a given bank or company does not have control over that bank or company (section 2(a)(3) of the act). This 5 percent presumption does not prohibit the Board from determining that a company exercises a "controlling influence" when such company owns, controls, or has power to vote less than 5 percent of any class of voting securities of another company or bank. However, in overcoming the presumption, the Board bears the burden of proving that such a controlling influence exists.

2090.0.4.1 Regulation Y Determinants of Control

The Board has established the following rebuttable presumptions of control in section 225.31 of Regulation Y for use in proceedings:

1. Control of voting securities.
   a. *Securities convertible into voting securities.* A company that owns, controls, or holds securities that are immediately convertible, at the option of the holder or owner, into voting securities of a bank

or other company controls the voting securities.

b. *Option or restriction on voting securities.* A company that enters into an agreement or understanding under which the rights of a holder of voting securities of a bank or other company are restricted in any manner controls the securities. This presumption does not apply where the agreement or understanding—
   (1) is a mutual agreement among shareholders granting to each other a right of first refusal with respect to their shares;
   (2) is incident to a bona fide loan transaction; or
   (3) relates to restrictions on transferability and continues only for the time necessary to obtain approval from the appropriate federal supervisory authority with respect to acquisition by the company of the securities.

2. Control over company.
   a. *Management agreement.* A company that enters into any agreement or understanding with a bank or other company (other than an investment advisory agreement), such as a management contract, under which the first company or any of its subsidiaries directs or exercises significant influence over the general management or overall operations of the bank or other company controls the bank or other company.
   b. *Shares controlled by company and associated individuals.* A company that, together with its management officials or principal shareholders (including members of the immediate families of either (as defined in 12 C.F.R. 206.2(k)) owns, controls, or holds with power to vote 25 percent or more of the outstanding shares of any class of voting securities of a bank or other company, if the first company owns, controls, or holds with power to vote more than 5 percent of the outstanding shares of any class of voting securities of the bank or other company.
   c. *Common management officials.* A company that has one or more management officials in common with a bank or other company controls the bank or other company, if the first company owns, controls, or holds with power to vote more than 5 percent of the outstanding shares of any class of voting securities of the bank or other company, and no other person controls as much as 5 percent of the outstanding shares of any class of voting securities of the bank or other company.
   d. *Shares held as fiduciary.* The presumptions of control in paragraphs 225.31(d)(2)(ii) and (iii) of Regulation Y do not apply if the securities are held by the company in a fiduciary capacity without sole discretionary authority to exercise the voting rights.

2090.0.4.2 Other Presumptions of Control

In addition to the rebuttable presumptions, there are a number of other circumstances that are indicative of control and may call for further investigation to uncover facts that support a determination of control. Such circumstances include the following:

1. A company owns at least 10 percent of each of two banks or at least 5 percent of each of three or more banks.
2. A company owns 5 percent or more of a bank or bank holding company and has been instrumental in the hiring or firing of one or more persons; establishing policies or places for branches; establishing hours of business; deciding on rates, terms, or acceptance of loans or deposits; following uniform advertising practices or using a common telephone system; or any other respects directing the activities of management or establishing the policies of the bank or company.
3. A company lends to a borrower on more favorable terms than it would have for a borrower of comparable credit standing to enable the borrower to acquire voting shares of a bank or other company.

If the Board proposes to make a determination based on the above indicators of control, the Board bears the burden of providing evidence that such a control situation exists.

2090.0.5 PROCEDURES FOR DETERMINING CONTROL

The question of whether a control situation exists may arise from information coming to the Board's attention or from a company's seeking to obtain the Board's opinion regarding a specific situation. When this question arises, the Board has instructed each Reserve Bank to make every effort to resolve the matter with the company without resorting to the procedures

outlined in this section. However, if the Reserve Bank is unsuccessful in resolving the matter, it is referred to the Board staff. If the Board staff feels the matter warrants Board consideration, it will recommend that the Board make a preliminary determination of control based on the available facts and so inform the company. (See section 225.31(a).) Following the preliminary determination of control, the company must, within 30 days (or longer as may be permitted by the Board), submit the information required by section 225.31(b).

If the company contests the Board's determination, it is entitled to a formal hearing at its request. (See section 225.31(c).)

Notwithstanding any other provision of the act, a company is not deemed to be a bank holding company by virtue of its control of—

1. ". . . shares [held] in a fiduciary capacity, except as provided in paragraphs (2) and (3) of subsection (g)" (section 2(a)(5)(A) of the act);
2. ". . . shares acquired by it in connection with its underwriting of securities if such shares are held only for such period of time as will permit the sale thereof on a reasonable basis" (section 2(a)(5)(B) of the act);
3. "[a] company formed for the sole purpose of participating in a proxy solicitation if the voting rights of the shares acquired by such company are acquired in the ordinary course of such a solicitation" (section 2(a)(5)(C) of the act);
4. ". . . shares acquired in securing or collecting a debt previously contracted in good faith, until two years after the date of acquisition" (section 2(a)(5)(D) of the act);

   (The Board is authorized upon application by a company to extend, from time to time for not more than one year at a time, the two-year period referred to herein for disposing of any shares acquired by a company in the regular course of securing or collecting a debt previously contracted in good faith, if, in the Board's judgment, such an extension would not be detrimental to the public interest, but no such extension shall in the aggregate exceed three years.)
5. ". . . any State-chartered bank or trust company which
   (i) is wholly owned by thrift institutions or savings banks; and
   (ii) is restricted to accepting—
      (I) deposits from thrift institutions or savings banks;
      (II) deposits arising out of the corporate business of thrift insitutions or savings banks that own the bank or trust company; or
      (III) deposits of public moneys." (section 2(a)(5)(E) of the act); and
6. ". . . a single . . . bank, if such . . . company is a trust company or mutual savings bank located in the same State as the bank and if . . . (i) such ownership or control existed on the date of enactment of the Bank Holding Company Act Amendments of 1970 and is specifically authorized by applicable State law, and (ii) the trust company or mutual savings bank does not after that date acquire an interest in any company that, together with any other interest it holds in that company, will exceed 5 percentum of any class of the voting shares of that company, except that this limitation shall not be applicable to investments of the trust company or mutual savings bank, direct and indirect, which are otherwise in accordance with the limitations applicable to national banks under section 5136 of the Revised Statutes (12 U.S.C. 24)" (section 2(a)(5)(F) of the act).

2090.0.6 INSPECTION OBJECTIVES

1. To determine whether any change in control of a bank holding company has resulted in a company (as defined by section 2(b) of the act) becoming a bank holding company in violation of section 3(a)(1) of the act.
2. To ascertain whether an existing bank holding company has acquired either directly or indirectly additional banking assets in violation of section 3(a)(3) of the act.
3. To establish whether a company which has purchased its own stock is in compliance with section 225.4(b) of Regulation Y. (See section 2090.3.)

2090.0.7 INSPECTION PROCEDURES

1. Review the company's stock records and the company's investment portfolio.
2. If there are any subsidiaries that are indirectly owned or controlled as defined in section 2(g) of the act, determine if such shares are held in a trust and, if so, whether the trust agreement contains any provisions that could potentially expose the holding company or any of its subsidiaries to financial or other liabilities.

2090.0.8 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Regulation Y		225		
Direct control voting securities				1978 FRB 121
Indirect control as trustee			Ltr. 1/14/76 to W. Lloyd, Chicago Fed Ltr. 10/16/73 to W. Lloyd, Chicago Fed	
Acting through others				1970 FRB 350 1974 FRB 865 1972 FRB 717 1974 FRB 130 1974 FRB 131
Transfer of shares				1974 FRB 875
Rebuttable presumption of control				
• nonvoting stock • other indicators of control				1972 FRB 487 136 *Fed. Reg.* 18945 (Sept. 24, 1971)
Procedures for determining control			S-2173 (Sept. 17, 1971) (at 4–191.1)	Patogonia vs. BOG 517 F. 2d 803 (9th Cir. 1975)
Nonvoting equity investments by BHCs		225.143		1982 FRB 413

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Control and Ownership (Qualified Family Partnerships) Section 2090.05

Section 2 (o) of the Bank Holding Company Act (the act) (as amended by section 2610 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996) exempts "qualified family partnerships" from the definition of "company" in the act.[1] Under this change to the act, a qualified family partnership would be able to own and control a bank holding company without the partnership becoming subject to the registration, source of strength, approval, reporting, or other requirements imposed on a bank holding company.

To qualify for the exemption, a qualified family partnership must have as partners only individuals who are related by blood, marriage, or adoption, or trusts for the primary benefit of those individuals. In addition, the partnership must—

- control any bank through a company that is itself a registered bank holding company subject to all of the provisions of the act;
- control only one registered bank holding company;
- not engage in any business activity except indirectly through ownership of other business entities (that is, the partnership must be an investment vehicle for the family and may not be an operating company);
- limit its investments to those permitted for a bank holding company under section 4 of the act; and
- not be obligated on any debt, either directly or as a guarantor.

Any partnership requesting qualification as a qualified family partnership must commit (1) to be subject to Federal Reserve Board examination to ensure compliance with the conditions for eligibility and (2) to be treated as a bank holding company for purposes of enforcement actions by the Board. In addition, while a qualified family partnership is exempt from the prior-approval requirements of section 3 of the act in connection with a bank acquisition, the partnership continues to be subject to the notice provisions of the Change in Bank Control Act.

As noted above, the primary benefits to becoming a qualified family partnership are (1) exemption from the capital requirements applicable to bank holding companies, (2) exemption from the reporting requirements applicable to a bank holding company, and (3) the freedom to make permissible nonbanking investments without prior Board approval. Because the qualified family partnership must use a single registered bank holding company to hold all of its bank investments, there continues to be a bank holding company subject to the requirements of the act in every case. This structure ensures that the cross-guarantee provisions of the Federal Deposit Insurance Act continue to apply to all banks controlled by a qualified family partnership.

1. Pub. L. 104-2089, section 2610; 110 Stat. 3009.

The Change in Bank Control Act of 1978 (CBC Act), title VI of the Financial Institutions Regulatory and Interest Rate Control Act of 1978, gives the federal bank supervisory agencies the authority to disapprove changes in control of insured depository institutions.[1] The Federal Reserve Board is the responsible federal banking agency for changes in control of bank holding companies and State member banks, and the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency are responsible for insured State nonmember and national banks, respectively.

The CBC Act requires any person (individual, partnership, corporation, trust, association, joint venture, pool, sole proprietorship, unincorporated organization) seeking to acquire control of any insured depository institution or bank holding company to provide 60 days' prior written notice to the appropriate federal banking agency. This requirement applies to all covered transactions that will be consummated after March 9, 1979. The act specifically exempts transactions that are subject to section 3 of the Bank Holding Company Act of 1956 or section 18 of the Federal Deposit Insurance Act, since these transactions are covered by existing regulatory approval procedures. Accordingly, changes in control due to acquisitions by bank holding companies and changes in control of insured depository institutions resulting from mergers, consolidations, or other similar transactions are not covered by the CBC Act.

The CBC Act describes the factors that the Federal Reserve and the other federal banking agencies are to consider in determining whether a transaction covered by the CBC Act should be disapproved. These factors include the financial condition, competence, experience, and integrity of the acquiring person (or persons acting in concert), the effect of the transaction on competition, the failure to provide all required information, and whether the proposed transaction would result in an adverse effect on the Bank Insurance Fund or the Savings Insurance Fund. The Federal Reserve Board's objectives in its administration of the CBC Act are to enhance and maintain public confidence in the banking system by preventing identifiable serious adverse effects resulting from anticompetitive combinations of interests, inadequate financial support, and unsuitable management in these institutions. The Board will review each notice to acquire control of a state member bank or bank holding company and will disapprove transactions that are likely to have serious harmful effects. It is the Board's intention to administer the CBC Act in a manner that will minimize delays and government regulation of private-sector transactions.

If the Board disapproves a change in control, the Board will notify the proposed acquiring party in writing within three days after its decision. The notice of disapproval will contain a statement of the basis for disapproval. The CBC Act provides that the acquiring party may request a hearing by the Board in the event of a disapproval and provides a procedure for further review by the courts.

Forms for filing notices of proposed transactions covered by the CBC Act are available from the Federal Reserve Banks. When a substantially complete notice is received by the Federal Reserve Bank, a letter of acknowledgement will be sent to the acquiring person indicating the date of receipt. The transaction may be completed 61 days or more after that date unless the acquiring person has been notified by the Board that the acquisition has been disapproved or that the 60-day period has been extended as provided for in subparagraph (j)(1) of the CBC Act. To avoid undue interference with normal business transactions, the Board may issue a notice of its intention not to disapprove a proposal, after consulting the relevant state banking authorities as the CBC Act requires.

2090.1.1 INFORMATION TO BE CONTAINED IN NOTICES

The CBC Act requires a "person" proposing to acquire control of a bank holding company or state member bank to file a notice with the Federal Reserve Board containing personal and biographical information, detailed financial information, details of the proposed acquisition, information on any structural or managerial changes contemplated for the institution, and other relevant information required by the Board.

1. The term "insured depository institution" includes any depository institution holding company and any *other* company which controls an insured depository institution. FIRREA substituted this term for banks in 1989. The CBC Act is found in 12 U.S.C. 1817(j)(1)–(18).

In order to be filed properly in accordance with the act, a notice must be substantially complete and responsive to every item specified in paragraph 6 of the CBC Act. When the acquiring party is an individual, or a group of individuals acting in concert, the requirement for five years' personal financial data is deleted in favor of a current statement of assets and liabilities, a brief income summary, and a statement of any material changes since the date thereof, but the Board reserves the right to require up to five years of financial data from any acquiring person. For complete details on the informational requirements of a change in control, see the System's "Notice of Change in Control" form.

2090.1.2 TRANSACTIONS REQUIRING SUBMISSION OF NOTICE

The CBC Act defines "control" as the power, directly or indirectly, to vote 25 percent or more of any class of voting securities, or to direct the management or policies of a bank holding company or insured depository institution. Therefore, any transaction, unless exempted by the CBC Act, that results in the acquiring party having voting control of 25 percent or more of any class of voting securities or that results in the power to direct the management or policies of such an institution would trigger the notice requirement. However, any person who on March 9, 1979, controls a bank holding company or state member bank shall not be required to file a notice to maintain or increase control positions in the same institution. In addition, the Board's regulations allow persons who on March 9, 1979, fall within a presumption described in the next paragraph to acquire additional shares of an institution without filing notice so long as they will not have voting control of 25 percent or more of the institution. In connection with transactions that would result in greater voting control, such persons may file the required notice or request that the Board make a determination that they already control the institution.

With respect to persons who have the power to vote less than 25 percent of an institution's shares, the Board has established the following rebuttable presumptions for purposes of the notice requirements under the CBC Act:

1. Where a transaction involving any class of voting securities of a bank holding company or state member bank would result in a person (or group of persons acting in concert) having voting control of 10 percent or more, and after the transaction the acquiring person would be the largest shareholder of that institution, the transaction results in control.

2. Where an institution has issued any class of securities subject to registration under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 781) (Regulation H banks) and a transaction would result in a person (or group of persons acting in concert) having voting control of 10 percent or more of any class of voting securities of that institution, the transaction results in control.

Other transactions resulting in a person's control of less than 25 percent of a class of voting shares of a bank holding company or state member bank would not result in control for purposes of the CBC Act. In addition, customary one-time proxy solicitations and the receipt of pro rata stock dividends are not subject to the CBC Act's notice requirements.

In some cases, corporations, partnerships, certain trusts, associations, and similar organizations that are not already bank holding companies may be uncertain whether to proceed under the CBC Act or under the Bank Holding Company Act with respect to a particular acquisition. These organizations should comply with the notice requirements of the CBC Act if they are not required to secure prior Board approval under the Bank Holding Company Act. However, some transactions, particularly foreclosures by institutional lenders, fiduciary acquisitions by banks, and increases of majority holdings by bank holding companies, described in sections 2(a)(5)(D) and 3(a)(A) and (B) of the Bank Holding Company Act, do not require the Board's prior approval, but they are considered subject to section 3 of the Bank Holding Company Act and, therefore, do not require notices under the CBC Act.

Persons contemplating an acquisition that would result in a change in control of a bank holding company or state member bank should request appropriate forms and instructions from the Federal Reserve Bank in whose district the affected institution is located. If there is any doubt whether a proposed transaction requires a notice, the acquiring person should consult the Federal Reserve Bank for guidance. The act places the burden of providing notice on the prospective acquiring person and substantial civil penalties can be imposed for willful violations.

2090.1.3 CONTROL TRANSACTIONS EXEMPT FROM PRIOR NOTICE REQUIREMENTS

The Board's regulations exempt the following transactions from the prior notice requirements of the Act:

1. A foreclosure of a debt previously contracted in good faith;
2. Testate or intestate succession; and
3. A bona fide gift.

Under these regulations, a person acquiring control in the situations described above is required to furnish certain information to the Federal Reserve Bank promptly after the transaction, and the affected institution must report promptly any changes or replacement of its chief executive officer or of any director, in accordance with paragraph 12 of the CBC Act.

Under these regulations, acquisitions of control of foreign bank holding companies are also exempt from the prior notice requirements of the Act, but this exemption does not extend to the reports and information required under paragraphs 9, 10, and 12 of the CBC Act.

2090.1.4 DISAPPROVAL OF CHANGES IN CONTROL

The CBC Act sets forth various factors to be considered in the evaluation of a proposal. The Board is required to review the competitive impact of the transaction, the financial condition of the acquiring person, and the competence, experience, and integrity of that person and the proposed management of the institution. In assessing the financial condition of the acquiring person, the Board will weigh any debt servicing requirements in light of the acquiring person's overall financial strength, the institution's earnings performance, asset condition, capital adequacy, future prospects, and the likelihood of an acquiring party making unreasonable demands on the resources of the institution.

2090.1.5 ADDITIONAL REPORTING REQUIREMENTS

As mentioned briefly above, paragraph 12 of the CBC Act requires that whenever a change in control of a bank holding company occurs, each insured depository institution is required to report promptly to the approporiate Federal banking agency any changes or replacement of its chief executive officer or of any director occurring in the next twelve-month period, including in its report a statement of the past and current business and professional affiliations of the new chief executive officer or directors.

Paragraph 9 of the CBC Act indicates that whenever any insured depository institution makes a loan secured by 25 percent or more of the outstanding voting stock of an insured depository institution (or bank holding company), the president or other chief executive officer of the lending bank shall promptly report such fact to the appropriate federal banking agency of the bank (or bank holding company) whose stock secures the loan. However, no report need be made where the borrower has been the owner of record of the stock for a period of one year or more or where the stock is that of a newly organized bank prior to its opening. Reports required by this paragraph shall contain information similar to the informational requirements of the Change in Control Notification form.

2090.1.6 STOCK REDEMPTIONS

A stock redemption by a BHC may result in an existing shareholder(s) then owning 25 percent or more of a class of voting securities which would require the filing of both a change in control and treasury stock notification. Furthermore, a stock redemption by a BHC may result in an existing shareholder(s) then owning between 10 percent and 25 percent of the outstanding shares and also being the largest shareholder thereby resulting in a rebuttable presumption of control. For additional information, see Manual section 2090.3 "Treasury Stock Redemptions."

2090.1.7 CORRECTIVE ACTION

Violations of the CBC Act are addressed through the same type of investigative and enforcement authority, and other formal corrective actions used in other administrative remedies (those specified in 12 U.S.C. 1818(b) through 1818(n)). The CBC Act also authorizes the assessment of civil money penalties for any violation of the CBC Act (see 12 U.S.C. 1817(j)(16)), and allows the Board to seek divestiture of a BHC or bank from any person or company who violates the CBC Act (12 U.S.C. 1817(j)(15)).

2090.1.8 INSPECTION OBJECTIVES

1. To determine that the BHC has complied with the prior notification requirements of the CBC Act and that changes in ownership between 10 percent and 25 percent have been reviewed for "rebuttable presumption" considerations.

2. To determine that the BHC has complied with the reporting requirements of paragraph 12 of the CBC Act regarding changes in its board of directors or its chief executive officer that occur within 12 months of a change in control.

3. To determine that the BHC has complied with the reporting requirements of paragraph 9 of the CBC Act regarding loans made directly by the BHC secured by 25 percent or more of the outstanding voting stock of an insured depository institution (or bank holding company).

2090.1.9 INSPECTION PROCEDURES

1. Review the BHC's stock certificate register or log to determine if any person (or group of persons acting in concert) has acquired 10 percent or more of any class of voting securities.

2. Review changes in control of between 10 percent and 25 percent of any class of voting securities to determine if the controlling party is the single largest shareholder.

3. When inspecting a BHC which was the subject of a change in control and a prior notification was filed, review the notification to determine that information submitted on management of the BHC is still valid. In cases where changes in directors or the chief executive officer occurred within 12 months of the change in control, determine if the BHC has reported such changes in compliance with paragraph 12 of the CBC Act.

4. When inspecting a BHC which has redeemed any of its own shares subsequent to March 9, 1979, thereby lowering the number of shares outstanding, determine whether the holdings of any individual shareholder has increased proportionally to greater than 10 percent, which might trigger the rebuttable presumption of control which in turn might have required prior notification of a change in control.

5. Review any loans made directly by the BHC that are secured by 25 percent or more of the outstanding shares of a bank (or bank holding company) and determine if the BHC has complied with the reporting requirements of paragraph 9 of the CBC Act.

2090.2.1 FORMATION OF A BANK HOLDING COMPANY AND CHANGES IN OWNERSHIP

The formation of a bank holding company and certain changes in the ownership of banks owned by a bank holding company come under the provisions of section 3 of the BHC Act. Section 3(a)(1) prohibits the formation of a bank holding company without prior Board approval. A company may receive approval pursuant to section 3(a)(1) to become either a one-bank holding company or a multibank holding company.

A primary reason for the formation of a one-bank holding company is to obtain income tax benefits.[1] These benefits include offsetting operating/capital losses of one corporation against the profits/capital gains of another.

Once a company becomes a bank holding company, either by the formation of a one-bank or multibank holding company, section 3(a)(3) of the act prohibits the direct or indirect acquisition of over 5 percent of any additional bank's or bank holding company's shares without prior Board approval. In addition to the above, section 3(a)(3) serves to prevent, without prior Board approval, an existing bank holding company from increasing its ownership in an existing subsidiary bank unless greater than 50 percent of the shares is already owned (section 3(a)(B)). A bank holding company which owns more than 50 percent of a bank's shares may buy and sell those shares freely without Board approval, provided the ownership never drops to 50 percent or less. If a bank holding company owns 50 percent or less of a bank's shares, prior Board approval is required before each additional acquisition of shares takes place until the ownership reaches more than 50 percent.

1. A corporation is entitled to a special deduction from gross income for dividends received from a taxable domestic corporation. There is (1) a 70 percent deduction for dividends received from a corporation that is less than 20 percent owned; (2) an 80 percent deduction for dividends received from a corporation that is 20 to less than 80 percent owned; (3) a 100 percent deduction for dividends received from members of the same affiliated group (i.e., a corporation that is 80 percent or more commonly owned); and (4) a 100 percent deduction for dividends received from small business investment corporations. There is also an overall limitation on dividends received. The recipient's aggregate amount is limited to 70 percent (80 percent for those corporations that are 20 to less than 80 percent owned) of taxable income. The manner in which the deduction is computed is also subject to further limitation.

2090.2.2 HISTORY OF APPLYING THE CAPITAL ADEQUACY GUIDELINES TO THE POLICY STATEMENT ON THE FORMATION OF SMALL BANK HOLDING COMPANIES

On March 28, 1980, the Board issued a policy statement with regard to the formations of small one-bank holding companies. The policy statement was included with the revision of Regulation Y (12 C.F.R. 225, appendix C) on January 5, 1984. Subsequent to this policy statement, capital adequacy standards were adopted for large multibank holding companies (on a consolidated basis[2]) in December 1981 (amended in June 1983, April 1985, and November 1986) that set minimum capital levels and capital zones relating to primary and total capital.[3] These were replaced in January 1989 (amended in October 1991) by the current minimum capital adequacy standards that use the risk-based capital and leverage capital measures.

Typically, a small bank holding company's capital position has not been evaluated on a consolidated basis. The evaluation of applications of small bank holding company formations for capital adequacy initially followed an 8 percent gross capital to total assets standard.[4] Subsequently, the 1981 guidelines established minimum 5.5 percent primary and 6.0 percent total capital ratios and the concept of capital zones above the minimum capital ratios. When analyzing bank capital for small bank holding company formations, December 1981's 7 percent (zone 1) total capital to assets leverage ratio (after adjusting for the addition of the allowance for loan and lease losses to the ratio's numerator and denominator) became the financial equivalent of 1980's 8 percent gross capital standard. For the bank, the change resulted in evaluating applications for capital adequacy based on a 7 percent total capital to total assets

2. Capital adequacy is evaluated on a bank-only basis for small bank holding companies.

3. Primary capital included common stockholders' equity, contingency and other capital reserves, the allowances for loan and lease losses, and the minority interest in the equity accounts of consolidated subsidiaries. It also included limited amounts of perpetual preferred stock, mandatory convertible securities, and perpetual debt.

4. The allowance for loan and lease losses was not added back to total assets. In other words, the ''total assets'' were net of the allowance for loan and lease losses, a contra asset.

ratio. Since most small banks did not have qualifying secondary capital, the practical effect of the change was that both the zone 1 primary and total capital ratios were at least 7 percent. In September 1990, a minimum tier 1 leverage ratio became effective. A tier 1 to total assets leverage ratio of 6 percent was applied as the financial equivalent of the former 7 percent total capital ratio.

Even though the components of the various capital ratios have changed over time, the capital standards used to evaluate capital positions of banks for small bank holding formations have not. The fundamental policy is still the same. In both instances, approximately the same percentage of small banks meets both ratios. It also should be noted that, if at any time, state or federal banking authorities or loan agreements require the banks of small bank holding company formations to satisfy higher capital standards, those standards will be used when evaluating capital adequacy.

Effective April 21, 1997, revisions to Regulation Y included revisions to the Board's one-bank holding company policy statement. The policy statement was revised to generalize its applicability beyond the formation of a bank holding company to include acquisitions by qualifying small bank holding companies. The policy statement incorporates previous informal policies that have evolved since the original publication of the statement. It also provides for streamlined processing of proposals that result in parent company debt-to-equity of less than 1.0 to 1 for small bank holding companies that are ''well managed'' and ''well capitalized.''

2090.2.3 SMALL BANK HOLDING COMPANY POLICY STATEMENT

In acting on applications filed under the act, the Board follows the principle that bank holding companies should serve as a source of strength for their subsidiary banks. When bank holding companies incur debt and rely on the earnings of their subsidiary banks as the means of repaying such debt, a question arises as to the probable effect on the financial condition of the holding company and its subsidiary bank or banks.

The Board believes that a high level of debt at the parent holding company level impairs the ability of a bank holding company to provide financial assistance to its subsidiary bank or banks, and, in some cases, the servicing requirements on such debt may be a significant drain on the bank's resources. For these reasons, the Board has not favored the use of acquisition debt in the formation of bank holding companies or in the acquisition of additional banks. Nevertheless, the Board has recognized that the transfer of ownership of small banks often requires the use of acquisition debt. The Board therefore has permitted the formation and expansion of small bank holding companies with debt levels that are higher than what would be permitted for larger bank holding companies. Approval of these applications has been given on the condition that the small bank holding companies demonstrate the ability to service the acquisition debt without straining the capital of their subsidiary banks and, further, that such companies restore their ability to serve as a source of strength for their subsidiary bank within a relatively short period of time.

In the interest of facilitating the transfer of ownership in banks without compromising bank safety and soundness, the Board has adopted the procedures and standards for the formation and expansion of small bank holding companies subject to the small bank holding company policy statement.

The policy focuses on the relationship between debt and equity at the parent holding company. The holding company has the option of improving the relationship of debt-to-equity by repaying the principal amount of its debt or through the retention of earnings, or both. Under these procedures, newly organized small one-bank holding companies are expected to reduce the relationship of their debt-to-equity over a reasonable period of time to a level that is comparable to that maintained by many large and multibank holding companies.

In general, this policy is intended to apply only to bank holding companies with pro forma consolidated assets of less than $150 million that (1) do *not* have significant leveraged nonbank activities and (2) do *not* have a significant amount of outstanding debt that is held by the general public. Although the policy statement applies to the formation of small bank holding companies, it also applies to existing bank holding companies that wish to acquire an additional bank or company and to transactions involving changes in control, stock redemptions, or other shareholder transactions. The criteria are described below.

In evaluating applications filed pursuant to section 3(a)(1) of the act, as amended, when the applicant intends to incur debt to finance the

acquisition of a small bank, the Board will take into account a full range of financial and other information, including the recent trend and stability of earnings of the bank, prospective growth of the bank, asset quality, the ability of the applicant to meet debt-servicing requirements without placing an undue strain on the resources of the bank(s), and the record and competency of management. In addition, the Board will require applicants to meet the minimum requirements set forth below. As a general rule, failure to meet any of these requirements will result in denial of an application; however, the Board reserves the right to make exceptions if the circumstances warrant.

1. *Minimum down payment.* The amount of acquisition debt should not exceed 75 percent of the purchase price of the bank(s) or company to be acquired. When the owner(s) of the holding company incur debt to finance the purchase of the bank(s) or company, such debt will be considered acquisition debt even though it does not represent an obligation of the bank holding company, unless the owner(s) can demonstrate that such debt can be serviced without reliance on the resources of the bank(s) or bank holding company.
2. *Maintenance of adequate capital.* Each insured depository subsidiary of a small bank holding company is expected to be well capitalized. Any institution that is not well capitalized is expected to become well capitalized within a brief period of time.
3. *Reduction in parent company leverage.* Small bank holding companies are to reduce their parent company debt consistent with the requirement that all debt be retired within 25 years of being incurred. The Board expects these bank holding companies to reach a debt-to-equity ratio of .30 to 1 or less within 12 years after incurrence of the debt. The bank holding company must also comply with debt-servicing and other requirements imposed by its creditors.

   The term "debt," as used in the ratio of debt to equity, means any borrowed funds (exclusive of short-term borrowings that arise out of current transactions, the proceeds of which are used for current transactions), and any securities issued by, or obligations of, the holding company that are the functional equivalent of borrowed funds. The term "equity," as used in the ratio of debt to equity, means total stockholders' equity of the bank holding company as defined in accordance with generally accepted accounting principles.[5] In determining the total amount of stockholders' equity, the bank holding company should account for its investments in the common stock of subsidiaries by the equity method of accounting.

   Ordinarily, the Board does not view redeemable preferred stock as a substitute for common stock in a small bank holding company. Nevertheless, to a limited degree and under certain circumstances, the Board will consider redeemable preferred stock as equity in the capital accounts of the holding company if the following conditions are met: (1) the preferred stock is redeemable only at the option of the issuer, and (2) the debt-to-equity ratio of the holding company would be at or remain below 30 percent following the redemption or retirement of any preferred stock. Preferred stock that is convertible into common stock of the holding company may be treated as equity.
4. *Dividend restrictions.* The bank holding company is not expected to pay any corporate dividends on common stock until such time as its debt-to-equity ratio is at 1.0 to 1 or less and it otherwise meets the requirements in sections 225.14(c)(1)(ii), 225.14(c)(2), and 225.14(c)(7) of Regulation Y. However, some dividends may be permitted, provided all of the following conditions are met: the dividends are (1) reasonable in amount, (2) do not adversely affect the ability of the bank holding company to service its debt in an orderly manner, and (3) do not adversely affect the ability of the subsidiary banks to be well capitalized.[6] Also, it is expected that dividends will be eliminated if the holding company is (1) not reducing its debt consistent with the requirement that the debt-to-equity ratio be reduced to 30 percent within 12 years of consummation of the proposal or (2) not meeting the requirements of its loan agreement(s).

5. Goodwill is defined as the excess of cost of any acquired company over the sum of the fair market values assigned to identifiable assets acquired less the fair market values of the liabilities assumed, in accordance with generally accepted accounting principles.

6. For bank holding companies with consolidated assets under $150 million, "well-capitalized" means that the bank holding company maintains a total risk-based capital ratio of 10.0 percent or greater and a tier 1 risk-based capital ratio of 6.0 percent or greater, and it is not subject to any written agreement, order, capital directive, or prompt-corrective-action directive issued by the Board to meet and maintain a specific capital level for any capital measure.

2090.2.4 CAPITAL CONSIDERATIONS IN SMALL MULTIBANK AND CHAIN BANK HOLDING COMPANY APPLICATIONS

Multibank holding companies and chain banking organizations (whether or not the chain members are banks or bank holding companies) with less than $150 million in combined assets that meet certain conditions will not be consolidated or combined for capital adequacy purposes. Rather, such organizations will be analyzed in the context of the standards described in the Board's policy statement on small bank holding companies (appendix C of Regulation Y) discussed previously in this section. A bank holding company application that seeks to expand a small bank holding company with or without creating or expanding a chain controlling assets of less than $150 million would be evaluated on the basis of the policy statement in the same manner as if the proposed bank holding company was not part of a chain.

The above application would be evaluated on the basis of the financial and managerial condition of the entire organization. Although the policy statement would generally be applied, the focus of the analysis would be as much on the organization as an operating entity as on the instant proposal. For example, it would be expected that the condition of the applicant organization and that of its subsidiaries would be consistent with expansion, one aspect of which is that each banking subsidiary generally would be expected to maintain capital well above the minimum levels. The policy statement would generally govern the payment of dividends by the applicant organization and any prospective use of preferred stock. The bank to be acquired would be expected to maintain above-minimum capital ratios consistent with those contemplated by the Board's capital adequacy guidelines.

An acquisition debt retirement period would apply with respect to each proposal and the acquisition debt/purchase price ratio limitation of 75 percent would generally apply to the instant application. A specific parent only debt/equity limit would not be applied. However, it would be expected that the ratio would decline over time.

In addition, the financial and managerial condition of the members of any chain thereby formed or expanded (including compliance considerations and general consistency with the capital adequacy guidelines, giving consideration to the need to maintain capital positions well above the minimum ratios) would be evaluated. The chain would not have to meet a specific combined, parent only debt/equity standard. However, there would be a general presumption that the debt/equity level of the chain would tend to decline after the initial leveraged approval. Although individual bank holding companies might be leveraged up to 3 to 1, over time the combined leverage of the chain would tend to be less than this level through increases in the equity or reductions in the debt of the organization. Proposals by banking organizations whose combined banking assets exceed $150 million would be evaluated for capital adequacy on the basis of an analysis of the consolidated organization. (The term "consolidated" as used with the analysis of large chains would involve actually consolidating each parent bank holding company with its subsidiary (or subsidiaries), and then combining each such consolidated entity as well as any other bank in the chain). An analysis of the capital adequacy of each constituent entity in a large banking organization would also continue to be assessed to determine whether the holding company would serve as a source of strength to its subsidiary banks.

2090.2.5 INSPECTION OBJECTIVE

To determine compliance with all commitments made in the application/notification process.

2090.2.6 INSPECTION PROCEDURE

Review all commitments made by the company and its shareholders to determine compliance therewith.

2090.2.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Capital adequacy guidelines Regulation Y—appendixes A and D		225	4–797 4–798 4–855	
Small BHC policy statement—appendix C			4–856	1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

"Bootstrapping" is the term generally used to describe a treasury stock transaction in which a company incurs debt to purchase or redeem its own outstanding shares. Bootstrapping is often used to facilitate a change in control whereby a shareholder or shareholder group need only buy few or no shares in order to gain control. The repurchase or redemption is often made in accordance with a written agreement made between a former controlling shareholder(s) and the new controlling shareholder(s).

Section 225.4(b) of Regulation Y requires a bank holding company to file prior written notice with the Board before a purchase or redemption of any of its own equity securities if the gross consideration for the purchase or redemption, when aggregated with the net consideration paid by the company for all such purchases or redemptions during the preceding 12 months, is equal to 10 percent or more of the company's consolidated net worth. (Net consideration is the gross consideration paid by the company for all of its equity securities purchased or redeemed during the period minus the gross consideration received for all of its equity securities sold during the period other than as a part of a new issue.)

Each notice shall furnish the following information:

- The purpose of the transaction, a description of the securities to be purchased or redeemed, the total number of each class outstanding, the gross consideration to be paid, and the terms of any debt incurred in connection with the transaction.
- A description of all equity securities redeemed within the preceding 12 months, the net consideration paid, and the terms of any debt incurred in connection with those transactions.
- A current and pro forma consolidated balance sheet if the bank holding company has total assets of over $150 million, or a current and pro forma parent-company-only balance sheet if the bank holding company has total assets of $150 million or less.

2090.3.1 CHANGE IN CONTROL ACT CONSIDERATIONS

As indicated earlier, treasury stock redemptions are often intended to facilitate a change in control of a bank holding company. By redeeming the shares held by an existing shareholder(s), the remaining shareholder(s) increases his proportionate ownership. If a "person's" share ownership should rise above 25 percent or more of the remaining outstanding shares (subsequent to March 9, 1979), that person would then "control" the BHC. Under these circumstances, a change in control notification would have to be filed. If the treasury stock redemption is for an amount sufficient to trigger the requirement for a prior notification of redemption, then dual notifications are called for (change in control and redemption of treasury shares).

Similarly, prior notification is also required if a treasury stock redemption should result in a shareholder's holdings rising to between 10 percent and 25 percent of the remaining outstanding shares, and if (a) that shareholder is the firm's largest single shareholder immediately after the acquisition; or (b) the institution is registered under section 12 of the Securities Exchange Act of 1934 (i.e., corporations having assets exceeding $1 million, more than 500 shareholders, and securities that are publicly traded). For additional information on change in control notification requirements, see section 2090.1.

Additional notices under the CIBC Act do not have to be filed if regulatory clearance had already been received to acquire 10 percent or more of the voting shares of a bank holding company, and subsequent treasury stock redemptions resulted in ownership of between 10 and 25 percent of the shares of the bank holding company. Refer to section 225.41(a)(2) of Regulation Y.[1]

2090.3.2 INSPECTION OBJECTIVES

1. To determine that a BHC that has redeemed shares of its own stock has complied with section 225.4(b) of Regulation Y.

2. To determine that any new controlling shareholder of a BHC that has redeemed shares of its own stock has complied with section 225.41(a) of Regulation Y.

3. To determine if a treasury stock transaction has taken place for the purpose of depleting the original 25 percent equity investment in the purchase price.

1. Revised by the Board, effective November 9, 1990.

2090.3.3 INSPECTION PROCEDURES

1. Review the BHC's reconcilement of stockholders' equity to determine if shares have been redeemed.
2. If shares have been redeemed, review for compliance with treasury stock redemption approval and reporting requirements.
3. Determine whether the BHC is using, repeatedly, the less than 10 percent ownership exemption to avoid notice requirements, thus undermining the capital position of the banking organization, resulting in an unsafe and unsound practice.
4. Determine if the less than 10 percent ownership exemption is being used by the bank holding company when it does not satisfy the requirements of the Board's capital guidelines for redemptions.

   The exemption should not be used by a bank holding company that does not meet the Board's capital guidelines for redemptions. Redemptions of permanent equity or other capital instruments before stated maturity could have a significant impact on an organization's overall capital structure. Use of the exemption could significantly reduce its capital. Consequently, an organization considering such a step should consult with the Federal Reserve before redeeming any equity (prior to maturity) if such redemption could have a material effect on the level or composition of the organization's capital base.

   The exemption should not be used by a small one-bank holding company if it would increase its debt-to-equity ratios significantly above those relied on by the Board in approving its application to become a bank holding company.
5. If shares have been redeemed, determine if any shareholder's holdings have risen to 25 percent or more of the outstanding shares.
6. If shares have been redeemed, determine if any shareholder's holdings have risen to between 10 percent and 25 percent of the outstanding shares. Furthermore, determine whether the shareholder is then the largest shareholder or the institution has registered securities under section 12 of the Securities Exchange Act of 1934.
7. If a stock redemption occurred recently in a bank holding company, determine if the shareholders have maintained a 25 percent equity investment.

On July 8, 1982, the Board issued a policy statement setting forth its concerns and providing guidance with respect to investments by bank holding companies in nonvoting shares of other bank holding companies or banks (refer to F.R.R.S. 4–172.1, 1982 FRB 413, and 12 C.F.R. 225.143). The statement notes considerations the Board will take into account in determining whether such investments are consistent with the Bank Holding Company Act, and describes the general scope of arrangements to be avoided in these agreements. The Board's statement was occasioned by the fact that a number of bank holding companies have made substantial equity investments in banks or bank holding companies located across state lines, in expectation of statutory changes that might make interstate banking permissible. The following is the text of the Board's statement:

In recent months, a number of bank holding companies have made substantial equity investments in a bank or bank holding company (the "acquiree") located in states other than the home state of the investing company through acquisition of preferred stock or nonvoting common shares of the acquiree. Because of the evident interest in these types of investments and because they raise substantial questions under the Bank Holding Company Act (the "Act"), the Board believes it is appropriate to provide guidance regarding the consistency of such arrangements with the Act.

This statement sets out the Board's concerns with these investments, the considerations the Board will take into account in determining whether the investments are consistent with the Act, and the general scope of arrangements to be avoided by bank holding companies. The Board recognizes that the complexity of legitimate business arrangements precludes rigid rules designed to cover all situations and that decisions regarding the existence or absence of control in any particular case must take into account the effect of the combination of provisions and covenants in the agreement as a whole and the particular facts and circumstances of each case. Nevertheless, the Board believes that the factors outlined in this statement provide a framework for guiding bank holding companies in complying with the requirements of the Act.

2090.4.1 STATUTORY AND REGULATORY PROVISIONS

Under section 3(a) of the Act, a bank holding company may not acquire direct or indirect ownership or control of more than 5 percent of the voting shares of a bank without the Board's prior approval (12 U.S.C. Para. 1842(a)(3)). In addition, this section of the Act provides that a bank holding company may not, without the Board's prior approval, acquire control of a bank: that is, in the words of the statute, "for any action to be taken that causes a bank to become a subsidiary of a bank holding company" (12 U.S.C. Para. 1842(a)(2)). Under the Act, a bank is a subsidiary of a bank holding company if:

1. The company directly or indirectly owns, controls, or holds with power to vote 25 percent or more of the voting shares of the bank;
2. The company controls in any manner the election of a majority of the board of directors of the bank; or
3. The Board determines, after notice and opportunity for hearing that the company has the power, directly or indirectly, to exercise a controlling influence over the management or policies of the bank (12 U.S.C. Para. 1841(d)).

In intrastate situations, the Board may approve bank holding company acquisitions of additional banking subsidiaries. However, where the acquiree is located outside the home state of the investing bank holding company, section 3(d) of the Act prevents the Board from approving any application that will permit a bank holding company to "acquire, directly or indirectly, any voting shares of, interest in, or all or substantially all of the assets of any additional bank" (12 U.S.C. 1842(d)(1)).

2090.4.2 REVIEW OF AGREEMENTS

In apparent expectation of statutory changes that might make interstate banking permissible, bank holding companies have sought to make substantial equity investments in other bank holding companies across state lines, but without obtaining more than 5 percent of the voting shares or control of the acquiree. These investments involve a combination of the following arrangements:

1. Options on, warrants for, or rights to convert nonvoting shares into substantial blocks of voting securities of the acquiree bank holding company or its subsidiary bank(s);
2. Merger or asset acquisition agreements

with the out-of-state bank or bank holding company that are to be consummated in the event interstate banking is permitted;

3. Provisions that limit or restrict major policies, operations or decisions of the acquiree; and
4. Provisions that make acquisitions of the acquiree or its subsidiary bank(s) by a third party either impossible or economically impracticable.

The various warrants, options, and rights are not exercisable by the investing bank holding company unless interstate banking is permitted, but may be transferred by the investor either immediately or after the passage of a period of time or upon the occurrence of certain events.

After a careful review of a number of these arrangements, the Board believes that investments in nonvoting stock, absent other arrangements, can be consistent with the Act. Some of the agreements reviewed appear consistent with the Act since they are limited to investments of relatively moderate size in nonvoting equity that may become voting equity only if interstate banking is authorized.

However, other agreements reviewed by the Board raise substantial problems of consistency with the control provisions of the Act because the investors, uncertain whether or when interstate banking may be authorized, have evidently sought to assure the soundness of their investments, prevent takeovers by others, and allow for sale of their options, warrants, or rights to a person of the investor's choice in the event a third party obtains control of the acquiree or the investor otherwise becomes dissatisfied with its investment. Since the Act precludes the investors from protecting their investments through ownership or use of voting shares or other exercise of control, the investors have substituted contractual agreements for rights normally achieved through voting shares.

For example, various covenants in certain of the agreements seek to assure the continuing soundness of the investment by substantially limiting the discretion of the acquiree's management over major policies and decisions, including restrictions on entering into new banking activities without the investor's approval and requirements for extensive consultations with the investor on financial matters. By their terms, these covenants suggest control by the investing company over the management and policies of the acquiree.

Similarly, certain of the agreements deprive the acquiree bank holding company, by covenant or because of an option, of the right to sell, transfer, or encumber a majority or all of the voting shares of its subsidiary bank(s) with the aim of maintaining the integrity of the investment and preventing takeovers by others. These long-term restrictions on voting shares fall within the presumption in the Board's Regulation Y that attributes control of shares to any company that enters into any agreement placing long-term restrictions on the rights of a holder of voting securities (12 C.F.R. Para. 225.31(d)(2).

Finally, investors wish to reserve the right to sell their options, warrants or rights to a person of their choice to prevent being locked into what may become an unwanted investment. The Board has taken the position that the ability to control the ultimate disposition of voting shares to a person of the investor's choice and to secure the economic benefits therefrom indicates control of the shares under the Act.[1] Moreover, the ability to transfer rights to large blocks of voting shares, even if nonvoting in the hands of the investing company, may result in such a substantial position of leverage over the management of the acquiree as to involve a structure that inevitably results in control prohibited by the Act.

2090.4.3 PROVISIONS THAT AVOID CONTROL

In the context of any particular agreement, provisions of the type described above may be acceptable if combined with other provisions that serve to preclude control. The Board believes that such agreements will not be consistent with the Act unless provisions are included that will preserve management's discretion over the policies and decisions of the acquiree and avoid control of voting shares.

As a first step towards avoiding control, covenants in any agreement should leave management free to conduct banking and permissible nonbanking activities. Another step to avoid control is the right of the acquiree to "call" the equity investment and options or warrants to assure that covenants that may become inhibiting can be avoided by the acquiree. This right makes such investments or agreements more like a loan in which the borrower has a right to escape covenants and avoid the lender's influence by prepaying the loan.

A measure to avoid problems of control aris-

1. See Board letter dated March 18, 1982, to C.A. Cavendes, Sociedad Financiera.

ing through the investor's control over the ultimate disposition of rights to substantial amounts of voting shares of the acquiree would be a provision granting the acquiree a right of first refusal before warrants, options or other rights may be sold and requiring a public and dispersed distribution of those rights if the right of first refusal is not exercised.

In this connection, the Board believes that agreements that involve rights to less than 25 percent of the voting shares, with a requirement for a dispersed public distribution in the event of sale, have a much greater prospect of achieving consistency with the Act than agreement involving a greater percentage. This guideline is drawn by analogy from the provision in the Act that ownership of 25 percent or more of the voting securities of a bank constitutes control of the bank.

The Board expects that one effect of this guideline would be to hold down the size of the nonvoting equity investment by the investing company relative to the acquiree's total equity, thus avoiding the potential for control because the investor holds a very large proportion of the acquiree's total equity. Observance of the 25 percent guideline will also make provisions in agreements providing for a right of first refusal or a public and widely dispersed offering of rights to the acquiree's shares more practical and realistic.

Finally, certain arrangements should clearly be avoided regardless of other provisions in the agreement that are designed to avoid control. These are:

1. Agreements that enable the investing bank holding company (or its designee) to direct in any manner the voting of more than 5 percent of the voting shares of the acquiree;
2. Agreements whereby the investing company has the right to direct the acquiree's use of the proceeds of an equity investment by the investing company to effect certain actions, such as the purchase and redemption of the acquiree's voting shares; and
3. The acquisition of more than 5 percent of the voting shares of the acquiree that "simultaneously" with their acquisition by the investing company become nonvoting shares, remain nonvoting shares while held by the investor, and revert to voting shares when transferred to a third party.

2090.4.4 REVIEW BY THE BOARD

This statement does not constitute the exclusive scope of the Board's concerns, nor are the considerations with respect to control outlined in this statement an exhaustive catalog of permissible or impermissible arrangements. The Board has instructed its staff to review agreements of the kind discussed in this statement and to bring to the Board's attention those that raise problems of consistency with the Act. In this regard, companies are requested to notify the Board of the terms of such proposed merger or asset acquisition agreements or nonvoting equity investments prior to their execution or consummation.

Pursuant to Section 3 of the Bank Holding Company Act, a bank holding company, directly or through its subsidiary banks, may not acquire more than 5 percent of the shares of an additional bank without the Board's prior approval. However, it is recognized that banks acting as trustee may acquire such shares without prior notice. Therefore, the Act requires a bank or banks which are subsidiaries of bank holding companies and acquire in excess of the 5 percent threshold limit, to file an application with the Board within 90 days after the shares exceeding the limit are acquired. The limit generally applies *only* to other bank shares over which the acquiring fiduciary exercises sole discretionary voting authority. Nevertheless, the Board has waived this application requirement under most circumstances in Section 225.12 of Regulation Y, unless—

1. the acquiring bank or other company has sole discretionary authority to vote the securities and retains the authority for more than two years; or
2. the acquisition is for the benefit of the acquiring bank or other company, or its shareholders, employees, or subsidiaries.

In determining whether the threshold limits have been reached, shares acquired prior to January 1, 1971 can ordinarily be excluded. On the other hand, shares of another bank held under the following circumstances should, in certain instances, be included in the 5 percent threshold, even though sole discretionary voting authority is not held:

1. Shares held by a trust which is a "company", as defined in Section 2(b) of the Bank Holding Company Act; and,
2. Shares held as trustee for the benefit of the acquiring bank or bank holding company, or its shareholders, employees or subsidiaries.

A bank holding company should have procedures for monitoring holdings of the stock of other banks and bank holding companies for compliance with the foregoing application requirements of the Act, for compliance with reporting requirements on form Y–6, and for compliance with certain similar reporting requirements under the federal securities laws. A general 5 percent threshold applies in all three situations, although differing requirements and exemptions apply.

Examiners specifically trained in trust examinations may need to conduct this portion of an inspection and, in appropriate circumstances, the examiner may need to consult with Federal Reserve Bank legal counsel. Trust examiners routinely review such matters in connection with individual trust examinations. The inspection objectives will be to determine whether the holdings of shares of other banks or bank holding companies, in a fiduciary capacity, are appropriately monitored to comply with section 3(a) of the Bank Holding Company Act with other reporting requirements for such holdings.

The spin-off or sale of property by a bank holding company may not sever the bank holding company's control relationship over such property for purposes of the Bank Holding Company Act. The factors which are normally considered in determining whether control has ceased include the presumptions of control listed in section 225.31(a) of Regulation Y and in sections 2(a)(2) and 2(g) of the Act, and certain ownership and voting rights.

Most of the irrebuttable and rebuttable presumptions of control were written to establish initially a control relationship between two companies. Only the provisions of section 2(g)(3) relate solely to a continued control relationship after an attempt has been made to end that control. However, all of the presumptions of control must be considered before presuming that a divestiture is effective. Irrebuttable control relationships are established, or continue to be recognized, when any of the conditions listed in section 225.2(e) of Regulation Y or sections 2(a)(2)(A), 2(a)(2)(B), 2(g)(1), or 2(g)(2) of the Act exist. Thus, a company is assumed to have irrebuttable control over a bank or another company without a Board determination if:

1. The company directly or indirectly owns, controls, or has power to vote 25 percent or more of the voting securities of the bank or other company;
2. The company controls in any manner the election of a majority of the directors or trustees of the bank or other company;
3. Trustees directly or indirectly hold or control shares of the bank or other company for the benefit of the company, the shareholders or members of the company, or the employees of the company.

Rebuttable presumptions of control are listed in section 225.31(d) of Regulation Y and in sections 2(a)(2)(C) and 2(g)(3) of the Act. These sections describe situations which are not as clearly defined as the irrebuttable presumptions. For example, a company which enters into a management contract that gives the company significant control over the operations or management of a bank or other company may be deemed to exercise a controlling influence over that bank or other company. Section 225.31(c) of Regulation Y and section 2(a)(2)(C) of the Act require a Board determination to establish that a company directly or indirectly exercises a controlling influence over the management or policies of a bank or other company. Thus, it is assumed that no control exists unless the Board determines that it does. Section 2(g)(3) of the Act, however, is "automatic" in the sense that an effective control relationship is assumed to continue without the need for a determination by the Board if certain conditions are met. This presumption is "rebuttable" because, at the request of the company, the Board later may determine that the control relationship in fact does not exist.

Section 2(g)(3) was added to the Act with the 1966 Amendments to provide the Board with an opportunity to consider the consequences of a transfer before it is deemed to be effective. It states that:

> "shares transferred after January 1, 1966, by any bank holding company (or by any company which, but for such transfer, would be a bank holding company) directly or indirectly to any transferee that is indebted to the transferor, or has one or more officers, directors, trustees, or beneficiaries in common with or subject to control by the transferor, shall be deemed to be indirectly owned or controlled by the transferor unless the Board, after opportunity for hearing, determines that the transferor is not in fact capable of controlling the transferee."

Section 2(g)(3) contains the factors most commonly cited as reasons for a control determination; i.e., the purchaser is indebted to the divesting company or has officers or directors in common with the divesting company. If the transferee is indebted to or has personnel in common with the transferor, an effective control relationship is assumed to continue at the date of the transfer without the need for an order or a determination by the Board. Control will continue to be presumed until either the condition causing the presumption is removed or the Board determines, that "the transferor is not in fact capable of controlling the transferee."

Although section 2(g)(3) refers to transfers of "shares" it is not limited to the disposition of corporate stock, but includes any transfer of a "significant volume of assets." Thus, when the transfer constitutes the disposition of all or substantially all of the assets of a subsidiary or a separate activity of the company, it is deemed to represent a transfer of "shares." General or limited partnership interests are included in this definition. A determination of whether the vol-

ume of assets transferred is "significant" will be made on an *ad hoc* basis. Included in the definition of "shares" are shares or other assets acquired in satisfaction of a debt previously contracted, or acquired as an incident to an essentially separate transaction.

The term "transferor" includes the bank holding company, its parent, and its subsidiaries. Likewise, "transferee" includes the parent and subsidiaries of any company to which assets are transferred. Thus, when the transferee, its parent, or its subsidiary is indebted to or has common personnel with the transferor, its parent, or its subsidiary, a presumption under section 2(g)(3) arises. For example, if a subsidiary of the transferee is indebted to the parent of the transferor, the presumption arises.

The term "transferee" has been interpreted also to include individuals. Thus, if property is transferred to an individual who holds a position with or is indebted to the transferor, its parent, or its subsidiaries, the presumption arises.

The indebtedness to which section 2(g)(3) refers may be debt incurred in connection with the transfer, or pre-existing debt. For instance, if a bank holding company transfers to an outside individual a subsidiary to which it had made a working capital loan, the presumption of control arises as a result of that debt. Although a presumption arises even when the debt was previously in existence, this factor may not be viewed as an indication of control in determinations pursuant to section 2(g)(3).

The statutory presumption of control in section 2(g)(3) will not apply in certain cases if the indebtedness of the transferee to the transferor or a subsidiary involves certain routine loans to companies (as defined in section 2(b) of the Act) in an aggregate amount not exceeding 10 percent of the total purchase price of the transferred asset; or certain personal loans to an individual such as a credit card balance, student loan or home mortgage loan. Such loans must have been made on normal terms in the ordinary course of business, and may not be secured by the transferred asset.

The phrase "officers, directors, trustees, or beneficiaries" has been interpreted to include policy-making employees or consultants, general partners in a partnership, or limited partners having a right to participate in management, and any person who performs (directly or through an agent, representative, or nominee) functions comparable to those normally associated with the foregoing offices or positions. The presumption is valid even if the position is held in an honorary or advisory capacity. The presumption is also valid even if the person involved does not hold the same type of position with the transferor as with the transferee or the transferred company. For example, if a bank holding company sells assets to a trust whose trustee is an officer of the holding company, the presumption is applicable.

When a divestiture takes place through the distribution of shares, quite often officers and directors will receive a portion of the shares. Because these individuals are considered to be transferees and because they are officers or directors of the transferor, a presumption of control under section 2(g)(3) results. However, the presumption will be of legal significance only when the shares subject to this presumption constitute more than 5 percent of the voting stock of a nonbanking company or 25 percent or more of the voting stock of a bank (5 percent if the transferor continues to be a bank holding company without reference to the shares transferred).

Finally, section 2(g)(3) provides that a Board determination will be made after opportunity for hearing. When the Board's General Counsel, acting under delegated authority, has determined that a control situation does continue to exist, the case will be referred to the Board for a decision and an opportunity for hearing will be made through publication of a notice in the *Federal Register.*

In addition to the review of the applicability of each of the conclusive and rebuttable presumptions of control, a review of certain ownership and voting rights will be made before a divestiture is considered effective. Generally, the Board has not regarded a divestiture of holdings of voting shares to less than 25 percent, but more than 5 percent, as effective though in most cases an acquisition of less than 25 percent of a company would not result in that company being regarded as a subsidiary. This policy pertains because the retention of such an economic interest in such a company could provide an incentive for the transferor to influence the management of the company. However, the reduction of ownership to less than 5 percent of the outstanding voting stock of a company usually is considered to be an effective divestiture. In addition, due to its continuing economic interest, a bank holding company cannot effectively divest of a company by converting its holdings of the company's voting shares to nonvoting shares or by agreeing not to vote the shares.

2090.6.1 INSPECTION OBJECTIVES

1. To determine whether or not the divesting company retained a significant voting or ownership interest in the divested property.
2. To determine whether section 2(g)(3) of the Act or any of the rebuttable presumptions of control listed in section 225.31(d) of Regulation Y raise a control issue with regard to the transferor and the transferee or the transferred property.
3. To determine whether section 2(g)(2) of the Act or any of the other irrebuttable presumptions of control listed in section 225.2(e) of Regulation Y raise a control issue with regard to the transferor and the transferee or the transferred property.

2090.6.2 INSPECTION PROCEDURES

The examiner should review the stock records of the transferor, the transferee, and the transferred entity, if possible. Management contracts, trust agreements, and any pertinent agreements among these parties also should be reviewed for any evidence of a control relationship. When following these procedures for a bank holding company which has divested or will divest of property, the examiner should be aware that the criteria for establishing a continuing control relationship are more stringent than those for establishing an initial control relationship. Thus, the examiner should review all ownership and voting rights rather than just those above 5 or 25 percent.

The examiner should review the records of the bank holding company, its parents, and its subsidiaries as well as the records of the company being divested and the company (and its parent and subsidiaries) acquiring the divested property for evidence of a continuing control relationship as described in section 2(g)(3) of the Act. If the transferee is an individual or if the records of the transferee are not available, the examiner should inquire whether any of the specific control relationships exist. Specifically, the examiner should determine whether the transferee, its parent, or its subsidiaries, are indebted to or have common personnel (officers, directors, trustees, beneficiaries, policy making employees, consultants, etc.) with the transferor, its parent, or its subsidiaries.

2090.6.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Presumptions of control	Sections 2(g)(1) and 2(g)(2) of the act	225.31(a) 225.139		
Statement of policy concerning divestitures		225.138		
Divestiture proceedings		225.32		
Rebuttable presumptions of control	Section 2(g)(3) of the act	225.31(d) 225.139		
Requirements placed on transferee and transferor to ensure a complete separation				Alfred I. duPont Testamentary Trust; September 21, 1977
Control is not terminated if a rebuttable presumption of control is applicable				Alfred I. duPont Testamentary Trust; October 3, 1977
Explanation of "transferor," "transferee," "shares," and procedures		225.139(c)(1)		1978 FRB 211

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
"Transferee" includes individuals		225.139 (footnote 4)		Summit Home Insurance Company, Minneapolis, Minnesota; August 30, 1978 The Moody Foundation, Galveston, Texas; January 16, 1968
Presumption of control through common directors, officers, etc.		225.139		GATX Corporation, Chicago, Illinois; February 21, 1978
Reduction of ownership to less than 5 percent of a subsidiary is an effective divestiture				Financial Securities Corporation, Lake City, Tennessee; August 29, 1972
Individual may be a transferee; an insignificant debt relationship may exist		225.139		Mercantile National Corporation, Dallas, Texas; June 2, 1975
Control terminated although shares were pledged as collateral on a note representing part of purchase price				Equimark Corporation, Pittsburgh, Pennsylvania; February 4, 1977
Application to retain control pursuant to rebuttable presumption; approved, but company not authorized to acquire additional shares				First Bancorp, Inc., Dallas, Texas; February 22, 1977
Application to divest control pursuant to rebuttable presumption; approved				Commanche Land and Cattle Company, Commanche, Texas; January 15, 1980
Indebtedness of transferee to transferor		225.139(c)(4)		1980 FRB 237

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

2090.7.1 CEBA AND FIRREA PROVISIONS FOR NONBANK BANKS

The Competitive Equality Banking Act (CEBA), effective August 10, 1987, amended section 2(c) of the BHC Act by expanding the definition of "bank" to include all FDIC-insured depository institutions. The definition also includes any other institution that (1) accepts demand deposits or other deposits that the depositor may make payable to third parties ("demand deposits") and (2) is engaged in the business of making commercial loans. The new definition covers institutions that were not previously covered by the BHC Act ("nonbank banks"). Thrift institutions that remain primarily residential mortgage lenders continue to be excepted from the definition of "bank."

CEBA amended section 4 of the BHC Act by adding a grandfather provision that permits a nonbanking company that on March 5, 1987, controlled an institution that became a bank under CEBA to retain the institution and not be treated as a bank holding company. A grandfathered company will lose its exemption, however, if it violates any of several prohibitions governing its activities. Among these prohibitions, a grandfathered company may not acquire control of an additional bank or a thrift institution or acquire more than 5 percent of the assets or shares of an additional bank or thrift.[1] In addition, no bank subsidiary of the grandfathered company may commence to accept demand deposits and engage in the business of making commercial loans. A bank subsidiary of the grandfathered company also may not permit an overdraft[2] (including an interday overdraft) or incur an overdraft on behalf of an affiliate[3] at a Federal Reserve Bank.[4]

If a grandfathered company no longer qualifies for an exemption, the company must divest control of all the banks it controls within 180 days after the date that the company receives notice from the Board that it no longer qualifies for the exemption. The exemption may be reinstated if, before the end of the 180-day notice period, the company (1) corrects the condition or ceases the activity that caused its exemption to end or submits a plan to the Board for approval to correct the condition or cease the activity within one year, and (2) implements procedures reasonably adapted to avoid a recurrence of the condition or activity.

The Board may examine and require reports of grandfathered companies and of the nonbank banks they control, but only to monitor or enforce compliance with the grandfather restrictions. The Board also may use civil enforcement powers, including cease-and-desist orders, to enforce compliance.

Grandfathered companies, their affiliates, and their nonbank banks also are subject to the anti-tying restrictions of the BHC Act and to the insider-lending restrictions of section 22(h) of the FRA and in Regulation O. Thus, for example, a nonbank bank may not condition a grant of credit on the purchase of a product or service from its grandfathered holding company, or vice versa, and it may not extend credit to insiders of the nonbank bank or its grandfathered holding company on preferential terms.

A bank holding company that controls a nonbank bank may retain it as long as the nonbank bank does not (1) engage in an activity[5] that

1. An exception to this prohibition is made for cases involving the acquisition of a failing thrift provided that (1) the thrift is acquired in an emergency acquisition and is either located in a state where the grandfathered company already controls a bank or has total assets of $500 million or more at the time of the acquisition; or (2) the thrift is acquired from the RTC, FDIC, or director of the OTS in an acquisition in which federal or state authorities find the institution to be in danger of default.

2. Section 225.52 of Regulation Y further defines the restrictions on overdrafts.

3. Section 225.52(b)(2)(ii) of Regulation Y provides that a nonbank bank (or industrial bank) incurs an overdraft on behalf of an affiliate when (1) the nonbank bank holds an account at a Federal Reserve bank for an affiliate from which third-party payments can be made, and (2) the posting of an affiliate's transactions to the nonbank bank's or industrial bank's account creates an overdraft or increases the amount of an existing overdraft in the account.

4. The overdraft prohibition does not apply if the overdraft (1) results from an inadvertent computer or accounting error that is beyond the control of both the bank and the affiliate; (2) is permitted or incurred on behalf of an affiliate that is monitored by, reports to, and is recognized as a primary dealer by the Federal Reserve Bank of New York and is fully secured, as required by the Board, by direct U.S. obligations, obligations fully guaranteed as to principal and interest by the United States, or securities or obligations eligible for settlement by the Federal Reserve book-entry system; or (3) is permitted or incurred by or on behalf of an affiliate in connection with an activity that is financial in nature or incidental to a financial activity and does not cause the bank to violate any provision of sections 23A or 23B of the Federal Reserve Act directly or indirectly or by virtue of section 18(j) of the Federal Deposit Insurance Act.

5. Previously, a nonbank bank could accept demand deposits *or* engage in the business of making commercial loans, but could not engage in both activities.

would have caused it to be a bank before the effective date of CEBA, or (2) increase the number of locations from which it does business after March 5, 1987. These limitations do not apply if (1) the nonbank bank is viewed as an additional bank subsidiary of the bank holding company, and (2) the BHC's acquisition of the nonbank bank would be permissible under the interstate banking provisions of the BHC Act.

2090.7.2 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Limitations on nonbank banks		225.52		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), effective August 9, 1990, provided [12 U.S.C. 1815 (e)] that any insured depository institution will be liable for any actual or reasonably anticipated loss incurred or to be incurred by the FDIC in connection with:

1. The default of a commonly controlled[1] depository institution; or
2. Any assistance provided by the FDIC to any commonly controlled insured depository institution.

2090.8.1 FIVE YEAR PROTECTION FROM LIABILITY (5-YEAR TRANSITION RULE)

Sister banks, for five years from the enactment of the law, are protected against losses due to the default of a thrift acquired before enactment. The law also grants a five- year protection to thrifts for loss due to the default of a bank acquired before the law's enactment.

2090.8.2 CROSS-GUARANTEE PROVISIONS

FIRREA contains cross-guarantee provisions. These provisions enable the FDIC to obtain reimbursement from insured depository institutions, in the event that the FDIC incurs a loss due to any assistance provided to, or a default of, a commonly controlled bank or thrift.

The FDIC will provide written notice when an insured depository institution is being held liable for losses sustained by the FDIC in connection with assistance to a commonly controlled bank or thrift. Upon receipt of the written notice from the FDIC, the insured depository institution is required to pay the amount specified. An insured depository institution is not liable for losses incurred by the FDIC, in connection with a commonly controlled institution, if the written notice is not received within two years from the date of the FDIC's loss.

The liability the insured depository institution has to the FDIC is senior to shareholders' claims and any obligation or liability owed to any affiliate of the depository institution.[2] Claims of the FDIC against the depository institution are subordinate to any deposit liabilities, secured obligations and obligations that are subordinated to depositors (i.e. subordinated debt).

The FDIC may grant an insured depository institution a waiver of the cross-guarantee provisions, if it determines that such an exemption is in the best interests of the either the Bank or Savings Association Insurance Funds. Limited partnerships and affiliates of limited partnerships (other than an insured depository institution, which is a majority owned subsidiary of such partnership) may also be exempted from the provisions, if the limited partnership or its affiliate has filed a registration statement with the Securities and Exchange Commission, on or before April 10, 1989. The registration statement must indicate that as of the date of the filing, the partnership intended to acquire one or more insured depository institutions. If an insured depository institution is granted an exemption from the cross-guarantee provisions, then the institution and all of its insured depository institution affiliates must comply with the restrictions of sections 23A and 23B of the Federal Reserve Act without regard to section 23A(d)(1) which provides for certain exemptions.

2090.8.3 EXCLUSION FOR INSTITUTIONS ACQUIRED IN DEBT COLLECTIONS

FIRREA provides an exclusion from the cross-guarantee provisions for an institution acquired in securing or collecting a debt previously contracted in good faith. However, during the entire exclusion period, the controlling bank and all of its insured depository institution affiliates must comply with sections 23A and 23B of the Federal Reserve Act (FRA),[3] for transactions with the insured depository institution involving acquisitions as a result of debts previously contracted in good faith.

1. Depository institutions are commonly controlled if:
   a. Such institutions are controlled by the same depository institution holding company (including any company, such as nonbank banks, that are required to file reports under [12 U.S.C. 1843(f)(6)]; or
   b. One depository institution is controlled by another depository institution.

2. Does not apply to any obligation to affiliates secured as of May 1, 1989.
3. Without regard to section 23A(d)(1) of the FRA.

Foreign Banking Organizations

Section 2100.0

The subsections following this introduction address the Board's supervisory authority over, and reporting requirements for foreign banking organizations. Supervisory policy statements issued by the Board or the Federal Financial Institutions Examination Council in conjunction with other federal financial institution regulatory agencies are also discussed. Foreign banks continue to expand their operations in the United States and are significant participants in the U.S. banking system. As of December 31, 1991, 313 foreign banks operated 529 state-licensed branches and agencies (of which 53 had FDIC insurance) and 84 branches and agencies licensed by the Office of the Comptroller of the Currency (of which 9 had FDIC insurance). Foreign banks also directly owned 11 Edge corporations and 13 commercial lending companies. In addition, foreign banks held an interest of at least 25 percent in 90 U.S. commercial banks. Together, these foreign banks controlled approximately 24 percent of U.S. banking assets.

The Federal Reserve has broad authority for the supervision and regulation of foreign banks that engage in banking in the United States through branches, agencies, and commercial lending companies. Foreign banks owning Edge corporations or U.S. banks are more directly subject to Federal Reserve supervision—in the former case as the Edge's chartering authority and in the latter as primary supervisor of bank holding companies. In all cases, the Board is primarily responsible for supervising the U.S. nonbanking operations of foreign banks with a U.S. banking presence.

Before the December 19, 1991 passage of the Federal Deposit Insurance Corporation Improvement Act, the Federal Reserve had residual authority to examine all branches, agencies, and commercial lending subsidiaries of foreign banks in the United States. The International Banking Act of 1978 instructed the Federal Reserve to use, to the extent possible, the examinations reports of other state and federal regulators. The FDICIA amended the International Banking Act and increased the Federal Reserve's authority with respect to these foreign bank operations, including representative offices, in the United States. The Federal Reserve may coordinate the examinations of foreign bank operations with other state and federal regulators. Branches and agencies are now required to be examined at least once during each twelve-month period in an on-site examination.

The FDICIA also authorized the Federal Reserve to terminate the operations of foreign banks in the United States under certain conditions. The legislation requires Federal Reserve approval to establish foreign bank branches, agencies, commercial lending subsidiaries, and representative offices in the United States.

2100.1.1 POLICY STATEMENT ON THE SUPERVISION AND REGULATION OF FOREIGN BANKING ORGANIZATIONS

On February 23, 1979, the Board issued a statement of policy on supervision and regulation of foreign banking organizations that control a U.S. subsidiary bank. The policies set forth in this statement continue to provide the framework within which the Board analyzes foreign bank acquisitions of U.S. banks. The Board has stated in a number of cases it has acted upon since 1984, that it views as "a negative factor" the failure of a foreign bank's stated capital ratio to meet the Board's capital adequacy guidelines. In addition to certain mitigating factors such as the existence of "hidden reserves" or a highly liquid funding position, the Board has relied upon assurances and commitments that the capital adequacy of the U.S. bank subsidiary will be maintained at a high level to offset this "negative factor." Following are major excerpts from the policy statement.

The Board of Governors has a number of supervisory responsibilities over the operations of foreign banking organizations in the United States under the Bank Holding Company Act and under the International Banking Act of 1978. In order to inform the public and the banking industry, the Board issued this statement setting forth its policy toward regulating foreign bank holding companies in the United States.

Bank supervision in the United States has as a principal objective, the promotion of the safety and soundness of banking institutions as going concerns serving depository and credit needs of their communities and the economy as a whole. To this end, a number of standards have been established governing domestic entry into the banking business and ongoing supervision of banking operations of domestic banks and bank holding companies.

In urging legislation to provide for federal regulation of foreign banks in the United States, the Board endorsed the principle of national treatment, or nondiscrimination, as a basis for the rules governing the entry and subsequent operations of foreign banks in this country. The International Banking Act of 1978 generally incorporates that principle in its provisions.

The Board continues to believe that the principle of national treatment should be the guiding rule in administering the Bank Holding Company Act and the International Banking Act of 1978 as they affect foreign banks. Following this rule, the Board believes that in general, foreign banks seeking to establish banks or other banking operations in the United States should meet the same general standards of strength, experience and reputation as required for domestic organizers of banks and bank holding companies. The Board also believes that foreign banks should meet on a continuing basis these standards of safety and soundness if they are to be a source of strength to their U.S. banking operations.

At the same time, the Board is cognizant that foreign banks operate outside the United States in accordance with different banking practices and traditions and in different legal and social environments. The Board also recognizes that its supervisory responsibilities are for the safety and soundness of U.S. banking operations. Its supervisory concerns for the operations and activities of foreign banks outside the United States are, therefore, limited to their possible effects on the ability of those banks to support their operations inside the United States. As embodied in both the Bank Holding Company Act and the International Banking Act of 1978, it is the general policy of the Board not to extend U.S. bank supervisory standards extraterritorially to foreign bank holding companies. The Board will give due regard to these factors in applying the principle of national treatment.

The Board has jurisdiction over foreign entry in the case of foreign organizations seeking to acquire U.S. banks. Whenever a foreign bank applies to become a bank holding company, the Board will seek to assure itself of the foreign bank's ability to be a source of financial and managerial strength and support to the U.S. subsidiary bank. In reaching this judgment, the Board will analyze the financial condition of the foreign organization, evaluate the record and integrity of management, assess the role and standing of the bank in its home country, and request the views of the bank regulatory authorities in the home country. In connection with its financial analysis, the Board will require sufficient information to permit an assessment of the financial strength and operating performance of the foreign organization. Information will consist of reports prepared in accordance with local practices together with an explanation and reconciliation of major differences between local accounting standards and U.S. generally ac-

cepted accounting procedures including full information on earnings, capital, charge-offs, and reserves. The Board will also continue to work with bank supervisory authorities of other major countries to improve overall cooperation in international bank regulation.

Once a foreign bank holding company has been established, Board supervisory procedures will be primarily directed at promoting the safety and soundness of the subsidiary U.S. banks. Examinations carried out by the relevant federal and/or State supervisory authority will continue to be the primary instrument for this purpose. Special attention will be given to transactions and correspondence between the U.S. subsidiary bank and its foreign parent and to monitoring credits by the U.S. bank to parties that are also customers of the parent. In particular, federal bank supervisors will expect the U.S. bank to maintain sufficient information on all borrowers to permit both the U.S. bank and bank examiners to make an independent appraisal of the bank's credits. In addition to the examination process, the Board will require foreign bank holding companies to report semiannually on transactions between the U.S. subsidiary bank and its foreign parent.

The Board requires submission of sufficient financial information to enable it to assess the operations and general condition of the parent institution. In particular, full information on earnings, reserves and capital will be required along with an explanation of major material differences between U.S. and foreign accounting practices. In its use and handling of the information, the Board will take into account the fact that much of the information required may be confidential commercial information that is not generally disclosed and the parent's majority owned subsidiaries.

2100.1.2 INTERAGENCY POLICY STATEMENT ON THE SUPERVISION OF U.S. BRANCHES AND AGENCIES OF FOREIGN BANKS

A second policy statement was issued on July 20, 1979, through the Federal Financial Institutions Examination Council on the supervision of U.S. branches and agencies of foreign banks. Principal excerpts from this statement are as follows:

The International Banking Act of 1978 gives the three Federal bank regulatory agencies expanded supervisory authority and responsibility with respect to the operations of foreign banks' U.S. branches, agencies, and commercial lending companies.[1] It provides for the establishment of Federal branches and agencies by the Office of the Comptroller of the Currency and permits U.S. branches to apply for insurance coverage by the Federal Deposit Insurance Corporation. It also subjects these U.S. offices to many provisions of the Federal Reserve and Bank Holding Company Acts.

In order to insure adequate supervision of these offices within the present Federal-State regulatory framework, the IBA provides that the Comptroller, the FDIC, and the various State authorities will have primary examining authority over the offices within their jurisdictions. Additionally, the Act gives the Federal Reserve Board residual examining authority over all U.S. banking operations of foreign banks, similar to its existing authority over U.S. subsidiary banks of bank holding companies. This distribution of responsibilities calls for close coordination of the efforts of the relevant authorities. Accordingly, the Comptroller, the FDIC, and the Board, in coordination with the Federal Financial Institutions Examination Council (FFIEC), issued this joint statement to inform the public and the banking industry of their supervisory policy toward these U.S. offices.

The agencies' supervisory interests in the operations of U.S. branches and agencies of foreign banks are directed to the safety and soundness of those operations in serving the needs of borrowers and depositors and other creditors in the United States. For this reason, the regulatory agencies place primary emphasis on assessing the financial well-being of the U.S. offices. They are also concerned with adherence to U.S. law and regulation by these offices.

At the same time, the agencies recognize that, even more than in the case of U.S. bank subsidiaries of foreign banks, the strength of these branches and agencies devolves from their head offices and organizations outside the United States and that ultimate responsibility for branch and agency activities resides in head offices overseas. Consequently, the agencies will seek to assure themselves that the parent institutions are financially sound. To this end, they will collect information on the consolidated operations of the foreign banks and expand their contacts with senior managements of the banks.

1. The term "commercial lending companies" is intended to refer to investment companies organized under Article XII of the New York State Banking Law, and any similar corporations that may be organized under the laws of other States.

Additionally, United States authorities are working and will continue to work with bank supervisory authorities of other nations to improve both the coordinated exchange of banking information and the compatibility of international banking regulation.

The International Banking Act of 1978 mandates that the Federal regulatory agencies cooperate closely with State banking authorities in examining U.S. offices of foreign banks. In furtherance of this mandate, a uniform approach to examining these offices has been developed through the FFIEC in order to minimize dual examinations and to facilitate joint Federal-State examinations, when desirable. In exercising their responsibilities, the agencies will ensure that each U.S. office of a foreign bank is examined regularly by either State or Federal authorities.

2100.1.3 BOARD REPORTING REQUIREMENTS FOR FOREIGN PARENT INSTITUTIONS

To gain information on the consolidated bank, the Board has developed reporting requirements for the foreign parent institutions. These information requirements are the same as those for foreign bank holding companies, including disclosure of specific information on earnings, reserves, and capital, and an explanation for material differences between U.S. and foreign accounting practices. In use and handling of this information, the (Board) will take into account the fact that some of the information required may be confidential commercial information that is not generally disclosed.

2110.0.1 INTRODUCTION

2110.0.1.1 Changes Resulting from the Enforcement Provisions and Other Related Sections of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (“FIRREA”) and the Comprehensive Thrift and Bank Fraud Act of 1990 (the “Bank Fraud Act”)

The provisions of Title IX of FIRREA and several provisions of the Bank Fraud Act granted the Board of Governors, as well as the other federal financial institutions supervisory agencies, numerous new or enhanced enforcement powers over financial institutions and individuals associated with them. The new or enhanced enforcement powers granted, under FIRREA and the Bank Fraud Act, to the Board of Governors and the new responsibilities of banking organizations (and individuals associated with them) that are supervised by the Federal Reserve are as follows:[1]

1. In order to simplify the numerous and lengthy references to “directors, officers, employees, agents and persons participating in the conduct of the affairs of a financial institution” contained in the enforcement statutes and to expand the banking agencies’ jurisdiction over individuals associated with financial institutions, the term “institution-affiliated party” is substituted in the law each time there is a reference to one of the aforementioned individuals. Thus, the Board has enforcement powers, such as cease and desist, removal, prohibition and civil money penalty assessment authority, now over certain financial institutions and institution-affiliated parties including controlling shareholders.

   In addition, the term “institution-affiliated party” has been expanded to include independent attorneys, appraisers, and accountants, as well as other independent contractors, who knowingly or recklessly participate in any law or regulation violation, any breach of fiduciary duty or any unsafe or unsound practice that causes (or is likely to cause) more than a minimal financial loss to, or a significant adverse effect on, a financial institution.[2] In this manner, the Board has added responsibilities for monitoring and addressing through enforcement actions, where necessary, the activities of whole new categories of persons who work with or for financial institutions subject to our regulatory jurisdiction.

2. The Bank Fraud Act provides that all of the enforcement powers that the Federal Reserve has against domestic financial institutions and their institution-affiliated parties, such as the authority to initiate cease and desist, civil money penalty assessment and removal and prohibition actions, are applicable to foreign financial institutions and their branches and agencies doing business in the United States and their institution-affiliated parties.

3. The Bank Fraud Act provides for criminal penalties against anyone who corruptly obstructs or attempts to obstruct the examination of a financial institution by the financial institution’s supervisory agency.

4. The power to suspend and remove an institution-affiliated party who has been indicted (section 8(g) of the Federal Deposit Insurance Act (the “FDI Act”)) from a state member bank has been expanded so that it now covers institution-affiliated parties associated with bank holding companies, nonbank subsidiaries of bank holding companies and foreign entities subject to the Board’s jurisdiction, such as Edge or agreement Act corporations, and certain branches and agencies.

   The Board’s general power to suspend, remove and permanently prohibit an institution-affiliated party from a state member bank or bank holding company (section 8(e) of the FDI Act) was expanded to cover individuals associated with the foreign entities described above, provided that the activities that give rise to the bases for the suspension, removal, or permanent prohibition action took place in the United States.

5. The requirement that the Board initiate a cease and desist action against a state member bank when recurrent violations of the Bank Secrecy Act and internal control deficiencies relating to compliance with that act are uncovered (section 8(s) of the FDI Act) has been

1. To the extent possible, the description of the provisions of Title IX of FIRREA follow the sequence of the sections in Title IX. They are not being listed in any order of importance.

2. The Board is also authorized to issue regulations further defining which individuals should be considered as institution-affiliated parties due to their participation in the conduct of the affairs of an institution. Similarly, the Board can make a determination whether a person is an institution-affiliated party due to his or her participation in the conduct of the affairs of an institution on a case-by-case basis.

expanded to cover the same institutions described in item 4 above.

6. When the Board issues a cease and desist order or a Federal Reserve Bank executes a written agreement, they may not only order the institution to ''cease and desist'' from its illegal activities or unsafe or unsound practices, but they can, under the law (sections 8(b) and (c) of the FDI Act), also order the entity or individual to take ''affirmative action'' to correct the conditions resulting from its violations or practices. Under FIRREA, the term ''affirmative action'' has been clarified to include certain enumerated powers. These now include the power to order (a) restitution or reimbursement in those instances where there was unjust enrichment or a reckless disregard for the law, (b) restrictions on growth, (c) the disposal of a loan or other asset, (d) the rescission of an agreement or a contract, and (e) the employment of a qualified officer or employee at a financial institution, who may be, at the option of the Board, subject to approval by the Federal Reserve.

Under the Board's cease and desist and temporary cease and desist powers (sections 8(b) and (c) of the FDI Act), the Board can also now issue an order (or execute a written agreement) that places ''limitations on the activities or functions'' of a financial institution or an institution-affiliated party.

7. The grounds for the issuance of a temporary order to cease and desist (section 8(c) of the FDI Act) were modified to reduce somewhat the burden on the Board. This was done by replacing the term ''substantial financial loss'' with the term ''significant financial loss'' and eliminating the modifying word ''seriously'' from the term ''seriously prejudice the interests of the'' bank's depositors. The Board now needs to determine, among other statutory factors needed in order to initiate a temporary cease and desist action, that the institution's or individual's unsafe or unsound practice or law or regulation violation is likely to cause ''significant financial loss'' to the institution or ''prejudice'' the interests of the bank's depositors.

The statutory bases for the issuance of a temporary cease and desist order were also expanded to authorize the issuance of such an order if the Board determines that a financial institution's books and records are so incomplete that the financial condition of the institution or the purpose for a transaction cannot be determined.

8. The Bank Fraud Act authorizes the FDIC to prohibit or limit, by order or regulation, any golden parachute payment or indemnification payment made by an insured depository institution or bank holding company to any institution-affiliated party of an insured depository institution.

The term ''golden parachute'' is generally defined as any payment or any agreement to make a payment to an institution-affiliated party that is contingent on the termination of the party's affiliation with the institution or holding company and is received on or after the date which the institution (a) is declared insolvent; (b) is notified by the appropriate federal banking agency that the institution is in a troubled condition; (c) has been assigned a CAMELS composite rating of 4 or 5; or (d) is subject to a termination of insurance proceeding by the FDIC. Several other factors are considered in determining if a payment is a ''golden parachute.''

The term ''indemnification payment'' is defined to include any payment or any agreement to make a payment by any insured depository institution or bank holding company for the benefit of any person, who is an institution-affiliated party, to pay or reimburse such person for any liability or legal expense with regard to any administrative proceeding or civil action initiated by a federal banking agency that results in the issuance of a final cease and desist, civil money penalty assessment, or removal or prohibition order.

While the Bank Fraud Act does not specifically authorize the Board to prohibit these payments, the Board refers these matters to the FDIC for action whenever the Board becomes aware of such payments by a bank holding company or a state member bank. Also, the Board may use its general cease and desist authority to prohibit such payments if they are deemed to be an unsafe or unsound practice.

9. The statutory language relating to the removal and suspension of an institution-affiliated party (old sections 8(e)(1) and (2) of the FDI-Act) were merged and simplified. Now, the statutory bases are the same whether the Board removes or suspends an individual from an institution based on conduct at his or her present employer or based on conduct at the individual's prior place of employment. In addition, the necessity for determining that an individual's conduct caused ''substantial'' financial loss or ''seriously'' prejudiced the bank's depositors

has been eliminated by the deletion of the terms "substantial" and "seriously".

10. 12 U.S.C. 1818(e)(7) now has a provision that makes one banking agency's suspension, removal or prohibition order universally effective against the individual subject to the order. That is, in the event that the Board removes an individual from a state member bank, that individual cannot work for any other financial institution that is subject to the regulatory jurisdiction of the federal financial institutions supervisory agencies without prior approval of the agency that issued the order in the first place and the regulator of the new employer institution. Violations by any individual of his or her suspension, removal or prohibition order (e.g., the removed individual goes to work for another financial institution without the requisite agency approvals) are now punishable as a felony, with a potential fine of up to $1 million and a prison term of up to five years (section 8(j) of the FDI Act).

A provision of Title IX of FIRREA modified the Board's suspension, removal and prohibition powers. It contemplates the issuance of a suspension, removal or prohibition order against a "corporation, firm, or other business enterprise" in addition to the issuance of such an order against an institution-affiliated party.

11. 12 U.S.C. 1818 (i)(3) corrected the problem relating to jurisdiction for removal and prohibition actions in the event that an individual leaves a financial institution prior to the initiation of the action. With respect to all formal enforcement actions that the Board can take—including cease and desist, removal, prohibition and civil money penalty assessment—the law now provides that the resignation, termination of employment or separation caused by the closing of an institution will not affect the Board's enforcement powers over an individual, provided that any notice (such as a notice of intent to remove from office and of prohibition) is served on an individual before the end of a six-year period starting when he or she left the financial institution, regardless of whether or not such date occurs before, on or after August 9, 1989.

The Board basically retains enforcement jurisdiction over any institution-affiliated party that leaves an institution, voluntarily or involuntarily, so long as we initiate our cease and desist, removal, prohibition or civil money penalty assessment action within six years of the individual's departure from the institution.

12. 12 U.S.C. 1818 (i)(2) includes many changes to the Board's civil money penalty assessment authority. The statutory bases for the assessment of fines were expanded and the amounts of the potential penalties were increased.

Civil money penalties can be assessed for (a) any violation of law or regulation,[3] (b) any violation of a final cease and desist, temporary cease and desist, suspension, removal or prohibition order, (c) any violation of a condition imposed in writing by the Board in connection with the granting of an application or other request, and (d) any violation of a written agreement.

The amounts of the potential fines vary. The Board can assess a fine of up to $5,000 per day for any of the violations described in the aforementioned paragraph. A fine of up to $25,000 per day can be assessed for any violation set forth above, if the violator (e.g., the financial institution or the institution-affiliated party) recklessly engages in an unsafe or unsound practice in conducting the affairs of the institution, or an individual breaches his or her fiduciary duty, where such violation, practice or breach is part of a pattern of misconduct, causes or is likely to cause more than a minimal loss or results in pecuniary gain or other benefit for the violator. A civil money penalty of up to $1 million per day can be assessed for any violation described in the paragraph above, if the violator knowingly committed the violation, knowingly engaged in the unsafe or unsound practice, or knowingly breached his or her fiduciary duty, and, in so doing, knowingly or recklessly caused a substantial loss to the financial institution or received substantial pecuniary gain or other benefit.

The modified civil money penalty assessment provisions of Title IX of FIRREA apply with respect to conduct engaged in by any person *after* August 9, 1989. There is an exception however—the increased maximum penalties of $5,000 and $25,000 per day may apply to conduct engaged in *before* August 9, 1989, if the conduct is not already subject to a notice issued by the Board *and* the conduct occurred after the completion of the last report of examination of the institution (which examination took place before August 9, 1989).

13. Violations of the Change in Bank Control Act can now be addressed through the same

3. Note that this provision is very broad. The violation of *any* law or regulation that is applicable to a financial institution or an institution-affiliated party subject to the Board's jurisdiction can expose the institution or the individual to a potential civil money penalty.

type of civil money penalty assessment proceedings that are used for all other penalty actions. That is, the requirement that an institution or individual assessed a fine for a violation of the Change in Bank Control Act be granted a full scale trial in a U.S. District Court has been eliminated.

14. The criminal penalties for violations of the Bank Holding Company Act (the ''BHC Act'') were increased to $100,000 per day for knowingly violating the BHC Act and to $1 million per day in the event that the violations involved an intent to deceive, defraud or profit significantly.

Violations of the BHC Act, which do not rise to the level of criminal offenses, can be addressed through civil money penalty assessments of not more than $25,000 per day.[4]

15. Section 19 of the FDI Act, which prohibits an individual who has been convicted of a felony involving dishonesty or a breach of trust from working for an insured bank without the Federal Deposit Insurance Corporation's approval, was amended to increase the potential fine for a knowing violation of the section to $1 million per day or five years imprisonment. This law now provides that the criminal penalty will apply to both the individual who is employed without the appropriate approval and to the employing institution. Section 19 also applies to a convicted felon's *indirect* involvement with an insured depository institution; therefore, such individuals associated with bank holding companies or their nonbank subsidiaries need to seek FDIC approval of their employment. The Bank Fraud Act has further expanded this prohibition to exclude convicted individuals from serving as an institution-affiliated parties and from owning or controlling, directly or indirectly, an insured depository institution without the FDIC's prior approval.

16. The Bank Protection Act was amended by FIRREA to eliminate the requirement that financial institutions file periodic reports concerning the installation, maintenance and operation of security devices and procedures.

17. Title IX of FIRREA adds new provisions authorizing civil money fines for the submission of false or misleading Call Reports and reports required by the BHC Act and Regulation Y of the Board of Governors. In the event that a financial institution maintains procedures that are reasonably adapted to avoid inadvertent errors and an institution unintentionally fails to publish any report or submits any false or misleading report or information or is minimally late with the report, it could be assessed a fine of up to $2,000 per day. The financial institution has the burden of proving that the error was inadvertent under these circumstances. In the event that the error was not inadvertent, a penalty of up to $20,000 per day can be assessed for all false or misleading reports or information submitted to the Board. If the submission was done in a knowing manner or with reckless disregard for the law, a fine of up to $1 million or one percent of the institution's assets can be assessed for each day of the violation.

Civil money penalties for the submission of late, false or misleading reports or information to the Board relate only to conduct engaged in after the effective date of FIRREA (August 9, 1989).

18. 12 U.S.C. 1818(u) requires that the Board publish and make publicly available any final order issued with respect to any administrative enforcement proceeding initiated by the Board, as well as any modification or termination of such an order. Publication of final enforcement orders and written agreements can only be delayed if the Board makes a determination, in writing, that the publication of any final order would seriously threaten the safety or soundness of an insured depository institution. In the event that the Board can make such a determination, the publication of the final order can be delayed for a ''reasonable time''. The Bank Fraud Act requires that administrative hearings on the record, including cease and desist, civil money penalty, and suspension, removal and prohibition actions, are to be open to the public.

19. After August 9, 1989, each insured depository institution that was chartered within two years after that date, all financial institutions that have undergone a change in control within two years after that date, and all financial institutions that are not in compliance with the minimum capital adequacy guidelines or regulations of its federal regulator, and each financial institution that is in an otherwise troubled condition must provide 30-days prior written notice to its appropriate federal regulator before the institution can add an individual to its board of directors or employ a senior executive officer.[5]

4. There is an inconsistency between the Board's authority to assess fines of up to $1 million per day for violations of any law or regulation and this $25,000 limitation on the amount of fines under the BHC Act.

5. The banking agencies have issued regulations defining the terms ''troubled condition'' and ''senior executive officer'' for the purposes of this law.

The Board, and the other federal financial institutions supervisory agencies, have a 30-day period within which to review each individual's competence, experience, character and integrity; and, in the event that they are not acceptable, the Board or the other agencies, where appropriate, can issue a notice of disapproval of an individual.

20. The federal financial institutions supervisory agencies are required to hire a pool of administrative law judges and to develop uniform rules of procedures for all administrative proceedings within 24 months from August 9, 1989.

21. The correction period afforded to an insured depository institution subject to a termination of federal deposit insurance proceeding initiated by the Federal Deposit Insurance Corporation was reduced to 30 days from 120 days. The Federal Deposit Insurance Corporation is also authorized to issue a temporary suspension of deposit insurance order in the event that it determines, after consultation with the Board or the Office of the Comptroller of the Currency, where applicable, that an insured depository institution has no tangible capital under the capital adequacy guidelines or regulations of the banking agencies.

22. Title IX of FIRREA contains a "whistleblower" protection provision. Under this provision, no insured depository institution may discharge or discriminate against an employee because he or she provided information to a banking agency or to the United States Attorney General (e.g., the Department of Justice, a U.S. Attorney's Office or the Federal Bureau of Investigation) about a possible law violation by the institution or one of its officers, directors or employees. In the event that an institution does discharge or discriminate against such an employee, he or she may sue the institution in U.S. District Court, and the individual must also file a copy of his or her lawsuit with the appropriate banking agency.

23. The federal financial institutions supervisory agencies may, with the concurrence of the United States Attorney General, pay a reward for the provision of information that leads to the recovery of a civil money penalty of in excess of $50,000 (or the forfeiture of property in excess of such an amount). The reward may not exceed 25 percent of the fine or forfeiture or $100,000, whichever is less.

As described above, Title IX of FIRREA contains numerous new or enhanced enforcement powers, as well several significant new responsibilities for the Board and the financial institutions that it supervises. While all of these powers and responsibilities are important, the following enforcement action-related provisions of Title IX are highlighted:

1. All new final enforcement orders and written agreements are to be made public.

2. All new directors and senior executive officers (and all promotions to the senior executive officer level) at financial institutions that were chartered within the last two years (if the institutions are state member banks), underwent a change in control within the last two years, have inadequate capital levels, or are otherwise in a troubled condition will have to file a notice form with the Board and await a 30-day review period before they can be appointed to the board of directors or retained as a senior executive officer.

3. The enforcement powers of the Board are applicable to a broader range of individuals who are associated with the financial institutions that the Board supervises—these include shareholders, attorneys, appraisers, and accountants.

4. The Board's removal and prohibition powers have been clarified in order to enable the continuation (or initiation) of such actions against persons who have left the financial institutions where they engaged in wrongdoing or who were associated with failed state member banks or defunct bank holding companies.

5. Cease and desist orders and written agreements can contain provisions requiring the employment of qualified officers and employees, who can be subject to the prior approval of the Federal Reserve, and they can also contain provisions that place limitations on the functions and activities of an institution or an institution-affiliated party.

6. The bases for the assessment of civil money penalties has been greatly expanded to cover, *inter alia*, all violations of law and regulation.

7. The potential civil money penalty assessment against a financial institution or an institution-affiliated party has been increased substantially—up to $1 million a day under some circumstances.

2110.0.1.2 Statutory Tools Available for Formal Supervisory Action

Including changes resulting from the enactment of FIRREA and the Bank Fraud Act, the following statutory tools are available to the Board of Governors in the event formal supervisory ac-

tion is warranted against a BHC or its nonbank subsidiary or certain individuals associated with either of them. The objective of formal actions is to correct practices that the regulators believe to be unlawful, or unsafe or unsound. The initial consideration and determination of whether formal action is required usually results from the inspection process.

Presented below is information on:

1. Board jurisdiction under the law;
2. Actions or practices that may trigger the statutory remedies;
3. Board staff procedures;
4. The elements of a corrective order;
5. Temporary orders;
6. Written Agreements;
7. Suspensions and removals;
8. Enforcement of orders; and
9. Civil money penalties; and
10. Termination of certain nonbank subsidiary activities or ownership.

2110.0.2 TYPES OF CORRECTIVE ACTIONS

Generally, under 12 U.S.C. 1818(b) the Board may use its cease and desist authority and other enforcement tools against (a) a bank holding company, (b) a nonbank subsidiary of a bank holding company, and (c) any institution-affiliated party, including any director, officer, employee, controlling shareholder (other than a bank holding company), agent, person who has filed or is required to file a change in control notice, consultant, joint venture partner, or other person who participates in the conduct of the affairs of a bank holding company or nonbank subsidiary, and any independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly participates in any violation of law or regulation, any breach of fiduciary duty, or any unsafe or unsound practice that causes or is likely to cause more than a minimal financial loss to, or a significant adverse effect on, the institution. Cease and desist action may be initiated when there is a finding that an offender is engaging, has engaged or may engage in an unsafe or unsound practice in conducting the business of the institution. An action may also be deemed necessary due to a finding that the offender is violating, has violated or may violate a law, rule or regulation, or any condition imposed in writing by the Board in connection with the granting of any application or any written agreement.

2110.0.2.1 Cease and Desist Orders

When Board staff, in conjunction with the appropriate Federal Reserve Bank, determines that a cease and desist action is necessary, the Board may issue a "notice of charges and of hearing" to the offending institution or person. The notice of charges will contain a statement describing the facts constituting the alleged violations or unsafe or unsound practices. The issuance of the notice of charges and of hearing starts a formal process that may include the convening of an administrative hearing (within 30–60 days) to be conducted before an Administrative Law Judge, who makes a recommended decision to the Board. At the conclusion of the hearing process and after consideration of the proceeding by the Board, the Board may issue a final cease and desist order. Institutions and individuals who are subject to cease and desist orders that were issued as a result of contested proceedings can appeal the Board's issuance of the order to federal courts of appeal.

In order to abbreviate the period of litigation, the offending party or institution is permitted an opportunity to "consent" to the issuance of a cease and desist order without the need for the notice and an administrative hearing. Board staff has the option of first drafting a proposed cease and desist order and presenting the matter to the offenders for their "consent" prior to submission of the case to the Board. In the event the parties voluntarily agree to settle the case by the issuance of a consent cease and desist order, the terms of the settlement will be presented to the Board for its ratification and formal issuance of the order at which time the order will be final and binding. Note that BHC personnel should have legal counsel present at all discussions concerning formal corrective actions.

Once issued by the Board, a cease and desist order may require the persons or entity subject to the order to (a) cease and desist from the practices or violations or (b) take affirmative action to correct the violations or practices. Affirmative actions might include returning the holding company to its "original condition" prior to the practice or violation or having an individual reimburse the company for unauthorized or improper payments received or both. Affirmative actions may also include: restitution, reimbursement, indemnification, or guarantee against loss if the person or entity was unjustly enriched by the violation or practice, or the violation or practice involved a reckless disregard for the law or applicable regulations or prior order; restrictions on growth; disposition of any loan or asset; rescission of agree-

ments or contracts; employment of qualified officers or employees; and any other action the Board determines to be appropriate.

12 U.S.C. 1818(b)(3) makes it clear that the cease and desist authority contained in section 8(b) of the Federal Deposit Insurance Act also applies to BHCs and Edge and Agreement Corporations, as well as all institution-affiliated parties associated with them.

2110.0.2.2 Temporary (Emergency) Cease and Desist Orders

In the event that a violation of law, rule or regulation, or the undertaking of an unsafe or unsound practice meets the test that it is likely to cause the insolvency of a subsidiary bank or company, cause the significant dissipation of a subsidiary bank's or BHC's assets or earnings, or weaken the condition of the subsidiary bank or company, or otherwise seriously prejudice the interests of depositors, the Board may issue a temporary (emergency) cease and desist order to effect immediate correction pursuant to 12 U.S.C. 1818(c). The Board may also issue a temporary order if the Board determines that the institution's books and records are so incomplete that the institution's financial condition or the details or purpose of any transaction cannot be determined through the normal supervisory process. The temporary order may require the same corrections as an order issued either on consent or after the full administrative process. Its advantage is that it is effective immediately upon service on the entity or individual. A hearing must be held within 30–60 days, during which time the temporary order stays in effect. Within 10 days of the service of the temporary order, the subject may appeal to a U.S. District Court for relief from the order.

2110.0.2.3 Written Agreements

When circumstances warrant a less severe form of formal supervisory action, a formal written agreement may be used. A written agreement may be with either the Board or with the Reserve Bank under delegated authority (12 C.F.R. 265.2(f)(26)). All written agreements must be approved by the Board's Staff Director of the Division of Banking Supervision and Regulation and the General Counsel. The provisions of a written agreement may relate to any of the problems found at the institution or involving related individuals.

2110.0.2.4 Removal Authority

In addition to its cease and desist authority, the Board is also authorized by 12 U.S.C. 1818(e) to suspend and remove current or former institution-affiliated parties of bank holding companies and their nonbank subsidiaries for certain violations and activities and to prohibit permanently their future involvement with insured depository institutions, BHC's and nonbank subsidiaries. The Board is authorized to issue a written notice of its intention to remove from office or prohibit from further participation (or under certain conditions to suspend immediately), any institution-affiliated party of a BHC whenever:

1. The institution-affiliated party has directly or indirectly:
   a. Committed any violation of law, regulation, or cease and desist order, condition imposed in writing, or any written agreement; or
   b. Engaged in any unsafe or unsound practice; or
   c. Breached a fiduciary duty; *and*
2. The Board determines:
   a. That the institution has suffered or will suffer financial loss or other damage; or
   b. That interests of depositors have been or could be prejudiced by the violation or practice; or
   c. That the institution-affiliated party has received financial gain or other benefit from the violation or practice; and
3. Such violation or practice:
   a. Involves personal dishonesty; or
   b. Demonstrates a willful or continuing disregard for the safety or soundness of the institution.

In the event that an institution-affiliated party's actions warrant immediate attention, the Board is authorized to temporarily suspend the person pending the outcome of the complete administrative process. Note also that an institution-affiliated party presently associated with a BHC may be suspended or removed for cause based on actions taken while formerly associated with a different insured depository institution, BHC or "other business institution." "Other business institution" is not specifically defined in the statute so that it may be interpreted to include any other business interests of the institution-affiliated party.

12 U.S.C. 1818(g) authorizes the appropriate federal banking agency to suspend from office or prohibit from further participation any

institution-affiliated party charged or indicted for the commission of a crime involving personal dishonesty or breach of trust that is punishable by imprisonment for a term exceeding one year under State or Federal law if the continued participation might threaten either the interests of depositors or public confidence in the bank. The suspension can remain in effect until the criminal action is disposed of or until the suspension is terminated by the agency.

2110.0.2.5 Termination of Nonbank Activity

The Board is authorized by 12 U.S.C. 1844(e) to order a bank holding company to terminate certain activities of its nonbank subsidiary (other than a nonbank subsidiary of a bank) or to sell its shares of the nonbank subsidiary. When the Board has reasonable cause to believe that the continuation by a bank holding company of any activity or of ownership or control of any of its nonbank subsidiaries constitutes a serious risk to the: (a) financial safety, (b) soundness or (c) stability of the holding company; *and* the activity, ownership or control is (a) inconsistent with sound banking principles, or (b) inconsistent with the purposes of the Bank Holding Company Act, or (c) inconsistent with the Financial Institutions Supervisory Act of 1966, the Board may order the bank holding company to terminate the activity or sell control of the nonbank subsidiary.

2110.0.2.6 Violations of Final Orders and Written Agreements

When any of the various types of formal enforcement orders discussed above has been violated, the Board may apply to a U.S. District Court for enforcement of the action, and the court may order and require compliance.

Violations of final orders and written agreements may also give rise to the assessment of civil money penalties against the offending institution or its institution-affiliated parties, as the circumstances warrant. The amount of the civil money penalty is the same as that described below in the civil money penalty section.

Any institution-affiliated party who violates a suspension or removal order is subject to a criminal fine of up to $1 million or imprisonment for up to five years or both, as well as to a civil money penalty assessment or federal court action.

2110.0.2.7 Civil Money Penalties

The Board may assess civil money penalties against any institution or institution-affiliated party for: (a) any violation of law or regulation, (b) any violation of a final cease and desist, temporary cease and desist, suspension, removal or prohibition order, (c) any violation of a condition imposed in writing by the Board in connection with the granting of an application or other request, and (d) any violation of a written agreement.

The Board can assess a fine of up to $5,000 per day for any of these violations. A fine of up to $25,000 per day can be assessed for any of these violations if the offender recklessly engages in an unsafe or unsound practice in conducting the affairs of the institution, or an individual breaches his or her fiduciary duty, where such violation, practice or breach is part of a pattern of misconduct, causes or is likely to cause more than a minimal loss or results in pecuniary gain or other benefit for the offender. A civil money penalty of up to $1 million per day can be assessed for any of these violations if the offender knowingly committed the violation, knowingly engaged in the unsafe or unsound practice, or knowingly breached his or her fiduciary duty, and, in so doing, knowingly or recklessly caused a substantial loss to the financial institution or received substantial pecuniary gain or other benefit.

The Board may also assess civil money penalties for the submission of any late, false, or misleading reports required by the BHC Act and Regulation Y of the Board of Governors. If a financial institution maintains procedures that are reasonably adapted to avoid inadvertent errors and an institution unintentionally fails to publish any report or submits any false or misleading report or information or is minimally late with the report, it can be assessed a fine of up to $2,000 per day. The financial institution has the burden of proving that the error was inadvertent under these circumstances. In the event that the error was not inadvertent, a penalty of up to $20,000 per day can be assessed for all false or misleading reports or information submitted to the Board. If the submission was done in a knowing manner or with reckless disregard for the law, a fine of up to $1 million or one percent of the institution's assets can be assessed for each day of the violation.

Notwithstanding the above, note that viola-

tions of the BHC Act (with the exception of late, false, or inaccurate report violations described above) may be addressed by the assessment of civil money penalties of not more than $25,000 per day.

2110.0.2.8 Publication

The Board is required to publish and make publicly available any final order issued with respect to any administrative enforcement proceeding initiated by the Board. These orders include: cease and desist, removal, prohibition, and civil money penalties. The Board is also required to publish and make publicly available any written agreement, effective November 29, 1990 or after, or other written statement that may be enforced by the Board.

2110.0.2.9 Public Hearings

All hearings on the record, including contested cease and desist, removal, and civil money penalty proceedings, are open to the public. Transcripts of all testimony and copies of all documents, which could include examination and inspection reports and supporting documents, (except those filed under seal) are made available to the public. These documents could include examiner's workpapers, file memorandums, reports of examination and inspection, and correspondence between a problem institution or wrongdoer and the Federal Reserve Bank. Appropriate actions should always be taken to ensure that all written material prepared in connection with any supervisory matter be accurate and free of insupportable conclusions or opinions.

2110.0.2.10 Subpoena Power

12 U.S.C. 1818(n), which is made applicable to BHCs by 12 U.S.C. 1818(b)(3), and 1844(f), gives the Board the authority to issue subpoenas directly or through its delegated representatives and to administer oaths or take depositions in connection with an examination or inspection. An examiner may find it necessary to apply some of these enforcement powers in order to collect certain information from unwilling sources.

2110.0.2.11 Interagency Notification

Any Federal banking regulatory agency that initiates formal enforcement action against a commercial bank must notify the other Federal financial institution regulatory agencies (including the OTS) that such action is being taken and the Board must take similar steps in connection with actions against bank holding companies, their nonbank subsidiaries, and all institution-affiliated parties. This policy pertains to formal administrative actions taken by the Federal banking agencies pursuant to the Financial Institutions Supervisory Act of 1966, as amended and to informal corrective actions such as Memoranda of Understanding. All such notifications must be in writing and must be transmitted by or received by both the regional and head offices of the agencies.

With respect to Federal-State agency coordination, the Federal Reserve provides the appropriate State supervisory authority with notice of its intent to institute a formal corrective action against a bank holding company. Pursuant to 12 U.S.C. 1818(m), the Federal regulatory agencies are required to provide the appropriate State supervisory authority with notice of their intent to institute a formal corrective action against a State chartered bank. This requirement is made applicable to bank holding companies, their nonbank subsidiaries, and all institution-affiliated parties by 12 U.S.C. 1818(b)(3).

2120.0.1 INTRODUCTION

On January 17, 1978, the three federal bank supervisory agencies issued a joint policy statement to address their concern with regard to the potential for improper payments by banks and bank holding companies in violation of the Foreign Corrupt Practices Act and the Federal Election Campaign Act.

While not widespread, the federal bank supervisory agencies were concerned that such practices could reflect adversely on the banking system and constitute unsafe and unsound banking practices in addition to their possible illegality.

The potential devices for making political payments in violation of the law could include compensatory bonuses to employees, designated expense accounts, fees or salaries paid to officers, and preferential interest rate loans. In addition, political contributions could be made by providing equipment and services without charge to candidates for office. Refer to F.R.R.S. at 3–447.1 and 4–875.

2120.0.2 SUMMARY OF THE FEDERAL ELECTION CAMPAIGN ACT

The Federal Election Campaign Act (FECA), enacted in 1971, was designed to curb potential abuses in the area of federal election financing. In general, FECA regulates the making of campaign contributions and expenditures in connection with primary and general elections to federal offices. Since 1907, federal law has prohibited national banks from making contributions in connection with political elections. FECA does not specifically address the making of contributions and expenditures by banks or other corporations to advocate positions on issues that are the subjects of public referenda. As originally enacted, FECA required disclosure of contributions received or expenditures made; however, amendments to the law in 1974 and 1976 imposed additional limitations on contributions and expenditures as well. The 1974 amendments also established the Federal Election Commission (Commission) to administer FECA's provisions. The Commission is responsible for adopting rules to carry out FECA, for rendering advisory opinions, and for enforcing the Act. The Commission was reorganized as a result of the FECA Amendments of 1976, and it has issued regulations interpreting the statute (11 C.F.R.).

2120.0.3 BANKS AND THE FECA

National banks and other federally chartered corporations are specifically prohibited from making contributions or expenditures in connection with *any* election; other corporations, including banks and bank holding companies, may not make contributions or expenditures in connection with *federal* elections. However, corporations may establish and solicit contributions to ''separate segregated funds'' to be used for political purposes; these are discussed in greater detail below.

State member banks and bank holding companies may make contributions or expenditures that are consistent with state and local law in connection with state or local elections. Because many states have laws that prohibit or limit political contributions or expenditures by banks, familiarization with applicable state and local laws is a necessity. According to the joint policy statement of the three banking agencies, a political contribution must meet not only the requirement of legality but also the standards of safety and soundness. Thus, a contribution or expenditure, among other things, must be recorded properly on the bank's books, may not be excessive relative to the bank's size and condition, and may not involve self-dealing.

Banks may make loans to political candidates provided the loans satisfy the requirements set out below.

2120.0.4 CONTRIBUTIONS AND EXPENDITURES

The words ''contribution'' and ''expenditure'' are defined broadly by FECA and the Commission's regulations to include any loan, advance, deposit, purchase, payment, distribution, subscription or gift of money or anything of value which is made for the purpose of influencing the nomination or election of any person to federal office. The payment by a third party of compensation for personal services rendered without charge to a candidate or political committee is also treated as a contribution by FECA, although the term does *not* include the value of personal services provided by an individual without compensation on a volunteer basis.

Although loans are included in the definitions of contribution and expenditure under FECA, a

specific exemption is provided for bank loans made in the ordinary course of business and in accordance with applicable banking laws and regulations. The Commission's regulations provide, further, that in order for extensions of credit to a candidate, political committee or other person in connection with a federal election to be treated as a loan and not a contribution, they must be on terms substantially similar to those made to non-political debtors and be similar in risk and amount. The regulations also provide that a debt may be forgiven only if the creditor has treated it in a commercially reasonable manner, including making efforts to collect the debt which are similar to the efforts it would make with a non-political debtor. In considering whether a particular transaction is a contribution or a loan, it is expected that a factor would be the extent to which the creditor may have departed from its customary credit risk analysis.

FECA and the implementing regulation permit certain limited payments to candidates or their political committees. For example, payment of compensation to a regular employee who is providing a candidate or political committee with legal or accounting services which are solely for the purpose of compliance with the provisions of the FECA is exempt from the definitions of contribution and expenditure. The Commission's regulations also permit occasional use of a corporation's facilities by its shareholders and employees for volunteer political activity; however, reimbursement to the corporation is required for the normal rental charge for anything more than occasional or incidental use.

2120.0.5 SEPARATE SEGREGATED FUNDS AND POLITICAL COMMITTEES

FECA allows the establishment and administration by corporations of "separate segregated funds" to be utilized for political purposes. While corporate monies may not be used to make political contributions or expenditures, corporations may bear the costs of establishing and administering these separate segregated funds, including payment of rent for office space, utilities, supplies and salaries. These costs need not be disclosed under FECA. Commission regulations also permit a corporation to exercise control over its separate segregated fund.

In practice, most corporate segregated funds are administered by a group of corporate personnel, which, if the fund receives any contributions or makes any expenditures during a calendar year, constitutes a "political committee," as defined by FECA. As such, it is required to file a statement of organization with the Commission, to keep detailed records of contributions and expenditures, and to file with the Commission reports identifying contributions in excess of $200 and candidates who are recipients of contributions from the fund.

Solicitation of contributions to corporate segregated funds by political committees must be accomplished within the precise limits established by FECA. All solicitations directed to corporate employees must satisfy the following requirements: (1) the contribution must be entirely voluntary; (2) the employee must be informed of the political purposes of the fund at the time of the solicitation; and (3) the employee must be informed of his right to refuse to contribute without reprisal. Beyond those basic requirements, FECA distinguishes between "executive and administrative" personnel and other employees. The former and their families may be solicited any number of times, while the latter and their families may only be solicited through a maximum of two written solicitations per year, and these solicitations must be addressed to the employees at their homes. Solicitations may also be directed to corporate stockholders and their families in the same manner as to executive and administrative personnel.

Although a corporation, or a corporation and its subsidiaries, may form several political committees, for purposes of determining the statutory limitations on contributions and expenditures, all committees established by a corporation and its subsidiaries are treated as one. Thus, the total amount which all political committees of a corporation and its subsidiaries may make to a single candidate is $5,000 in any federal election (provided that the committees are qualified multicandidate committees under FECA).

2120.0.6 INSPECTION OBJECTIVES

1. To determine if the company has made improper or illegal payments in violation of either of these statutes, and regardless of legality, and whether they constitute an unsafe and unsound banking practice.

2. To determine if controls have been established to prevent unproper payments in violation of these statutes.

2120.0.7 INSPECTION PROCEDURES

1. Determine whether the company and its nonbank subsidiaries have a policy prohibiting improper or illegal payments, bribes, kickbacks, or loans covered by either the Foreign Corrupt Practices Act or the Federal Election Campaign Act.

2. Determine how the policy, if any, has been communicated to officers, employees, or agents of the organization.

3. Review any investigation or study performed by, or on behalf of, the board of directors that evaluates policy or operations associated with the advancement of funds in possible violation of the statutes mentioned above. In addition, ascertain whether the organization has been investigated by any other government agency in connection with possible violations of the statutes and, if this is the case, review available materials associated with the investigation.

4. Review and analyze any internal or external audit program employed by the organization to determine whether the internal and external auditors have established appropriate routines to identify improper or illegal payments under the statutes. In connection with the evaluation of the adequacy of any audit program, the examiner should:

a. Determine whether the auditor is aware of the provisions of the Foreign Corrupt Practices Act and the Federal Election Campaign Act and whether audit programs are in place which check for compliance with these laws;

b. Review such programs and the results of any audits; and

c. Determine whether the program directs the auditor to be alert to unusual entries or charges which might indicate that improper or illegal payments have been made to persons or organizations covered by the statutes.

5. Analyze the general level of internal control to determine whether there is sufficient protection against improper or illegal payments being irregularly recorded on the organization's books.

6. Both the examiner and assistants should be alert in the course of their usual inspection procedures for any transactions, or the use of organization services or equipment, which might indicate a violation of the statutes. Examination personnel should pay particular attention to:

a. Commercial and other loans (including participations), which may have been made in connection with a political campaign, to assure that any such loans were made in the ordinary course of business in accordance with applicable laws.

b. Income and expense ledger accounts for unusual entries including unusual debit entries (reductions) in income accounts or unusual credit entries (reductions) in expense accounts, significant deviations from the normal amount of recurring entries, and significant entries from an unusual source, such as a journal entry.

Procedure 7, following here, should only be undertaken in cases in which the examiner believes that there is some sufficient evidence indicating that improper or illegal payments have occurred. Such evidence would justify the implementation of these additional procedures.

7. Verification of audit programs and internal controls.

a. Randomly select charged-off loan files and determine whether any charged-off loans were made to (i) foreign government officials or other persons or organizations covered by the Foreign Corrupt Practices Act, or (ii) persons or organizations covered under the Federal Election Campaign Act.

b. For those significant income and expense accounts on which verification procedures have not been performed: (i) prepare an analysis of the account for the period since the last examination, preferably by month, and note any unusual fluctuations for which explanations should be obtained, and (ii) obtain an explanation for significant fluctuations or any unusual items through discussions with organization personnel and review of supporting documents.

2120.0.8 APPARENT VIOLATIONS OF THE STATUTES

Where violations of law or unsafe and unsound banking practices result from improper payments, the Federal Reserve System should exercise its full legal authority, including cease-and-desist proceedings and referral to the appropriate law enforcement agency for further action, to ensure that such practices are terminated. In appropriate circumstances, the fact that such payments have been made may reflect so adversely on an organization's management as to be a relevant factor in connection with the consideration of applications submitted by the organization.

In addition, the Reserve Bank should forward any information on apparent violations of the Federal Election Campaign Act to the Federal

Election Commission. The Federal Election Commission is authorized to enforce FECA. The Commission may be prompted to investigate possible illegal payments by either a sworn statement submitted by an individual alleging a violation of the law, or on its own initiative based on information it has obtained in the course of carrying out its supervisory responsibilities. When the Commission determines that there is probable cause to believe a violation has occurred or is about to occur, it endeavors to enter into a conciliation agreement with the violator. If, however, it finds probable cause to believe that a willful violation has occurred or is about to occur, it may refer the matter directly to the Department of Justice for possible criminal prosecution, without having first attempted conciliation.

If informal means of conciliation fail, the Commission may begin civil proceedings to obtain relief. Should the Commission prevail, a maximum penalty of a fine equal to the greater of $10,000 or 200 percent of the amount of the illegal payment may be imposed. Knowing and willful violations involving over $1,000 may subject the violator to a fine, up to the greater of $25,000 or 300 percent of the illegal payment, and imprisonment for up to one year.

2120.0.9 ADVISORY OPINIONS

Any person, including a bank or a corporation, may request an advisory opinion concerning the application of FECA or of the Commission's regulations to a specific transaction or activity in which that person wishes to engage. The Commission must render such advisory opinion within 60 days from receipt of a complete request. Banks or bank employees wishing to engage in activity which may be regulated by FECA are encouraged to request advisory opinions from the Commission.

Techniques, practices, and tools for credit-risk management are evolving rapidly, as are the challenges that banking organizations face in their business-lending activities. For larger institutions, the number and geographic dispersion of their borrowers make it increasingly difficult for such institutions to manage their loan portfolios simply by remaining closely attuned to the performance of each borrower. As a result, one increasingly important component of the systems for controlling credit risk at larger institutions is the identification of gradations in credit risk among their business loans, and the assignment of internal credit-risk ratings to loans that correspond to these gradations.[1] The use of such an internal rating process is appropriate and necessary for sound risk management at large institutions. See SR-98-25.

Certain elements of internal rating systems are necessary to support sophisticated credit-risk management. Supervisors and examiners, both in their on-site inspections and other contacts with banking organizations, need to emphasize the importance of development and implementation of effective internal credit-rating systems and the critical role such systems should play in the credit-risk-management process at sound large institutions. See SR-98-18 with regard to lending standards for commercial loans.

Internal rating systems are currently being used at large institutions for a range of purposes. At one end of this range, they are primarily used to determine approval requirements and identify problem loans. At the other end, they are an integral element of credit-portfolio monitoring and management, capital allocation, the pricing of credit, profitability analysis, and the detailed analysis to support loan-loss reserving. Internal rating systems being used for these latter purposes should be significantly richer and more robust than systems used for the purposes such as approval requirements and identifying problem loans.

As with all material financial institutional activities, a sound risk-management process should adequately illuminate the risks being taken. It should also cause management to initiate and apply appropriate controls that will allow the institution to balance risks against returns. Furthermore, the process should provide information as to the institution's overall appetite for risk, giving due consideration to the uncertainties faced by lenders and the long-term viability of the institution. Accordingly, large banking organizations should have strong risk-rating systems which should take proper account of gradations in risk. They should also consider (1) the overall composition of portfolios in originating new loans, (2) assessing overall portfolio risks and concentrations, and (3) reporting on risk profiles to directors and management. Moreover, such rating systems should also play an important role in (1) establishing an appropriate level for the allowance for loan and lease losses, (2) conducting internal analyses of loan and relationship profitability, (3) assessing capital adequacy, and possibly (4) administering performance-based compensation.

Examiners should evaluate the adequacy of internal credit-risk-rating systems, including ongoing development efforts, when assessing both asset quality and the overall strength of risk management at large institutions. Recognizing that a strong risk-rating system is an important element of sound credit-risk management for such institutions, examiners should specifically evaluate the adequacy of internal risk-rating systems at large institutions as one factor in determining the strength of credit-risk management. In doing so, examiners should be cognizant that an internal risk-identification and -monitoring system should be consistent with the nature, size, and complexity of the banking organization's activities.

2122.0.1 APPLICATION TO LARGE BANK HOLDING COMPANIES

The guidance provided in this section should be applied to all "large" bank holding companies. For this purpose, examiners should treat an institution as being "large" if its lending activities are sufficient in scope and diversity such that informal processes that rely on keeping track of the condition of individual borrowers are inadequate to manage its loan portfolio. In this context, those institutions with significant involvement in relevant secondary-market credit activities, such as securitization of business loans or credit derivatives, should have more elaborate and formal approaches for managing

1. For information on current practices in risk rating among large banking organizations, see "Credit Risk Rating at Large U.S. Banks," *Federal Reserve Bulletin,* November 1998, pp. 897–921.

the risks associated with these activities.[2] Whether or not they are active in such secondary-market credit activities, however, larger and complex institutions typically would require a more structured and sophisticated set of arrangements for managing credit risk than smaller regional or community institutions. In performing their evaluation, examiners should also consider whether other elements of the risk-management process might compensate for any specific weaknesses attributable to an inadequate rating system.

In addition, examiners should review internal management information system reports to determine whether the portion of loans in lower-quality pass grades has grown significantly over time, and whether any such change might have negative implications for the adequacy of risk management or capital at the institution. Examiners should also consider whether a significant shift toward higher-risk pass grades, or an overall large proportion of loans in a higher-risk pass grade, should have negative implications for the institution's asset-quality rating, including the adequacy of the loan-loss reserve. To some extent, such reviews are already an informal part of the current inspection process. Examiners should also continue the long-standing practice of evaluating trends in categories associated with problem assets.

Examiners should discuss these issues, including plans to enhance existing credit-rating systems, with bank management and directors. Inspection comments on the adequacy of risk-rating systems and the credit quality of the pass portfolio should be incorporated within the inspection report, noting deficiencies where appropriate.

2122.0.2 SOUND PRACTICES IN FUNCTION AND DESIGN OF INTERNAL RATING SYSTEMS

A consistent and meaningful internal risk-rating system is a useful means of differentiating the degree of credit risk in loans and other sources of credit exposure. This consistency and meaning is rooted in the design of the risk-grading system itself. Although assigning such risk ratings—as with ratings issued by public rating agencies—necessarily involves subjective judgment and experience, a properly designed rating system will allow this judgment to be applied in a structured, more or less formal manner.

Credit-risk ratings are designed to reflect the quality of a loan or other credit exposure, and thus, explicitly or implicitly, the loss characteristics of that loan or exposure. Increasingly, large institutions link definitions to one or more measurable outcomes such as the probability of a borrower's default or expected loss (which couples the probability of default with some estimate of the amount of loss to be incurred in the event a default occurs). In addition, credit-risk ratings may reflect not only the likelihood or severity of loss but also the variability of loss over time, particularly as this relates to the effect of the business cycle. Linkage to these measurable outcomes gives greater clarity to risk-rating analysis and allows for more consistent evaluation of performance against relevant benchmarks. The degree of linkage varies among institutions, however.

Although the degree of formality may vary, most institutions distinguish the risks associated with the borrowing entity (essentially default risk) from the risks stemming from a particular transaction or structure (more oriented to loss in event of default). In documenting their credit-administration procedures, institutions should clearly identify whether risk ratings reflect the risk of the borrower or the risk of the specific transaction. In this regard, many large institutions currently assign both a borrower and facility rating, requiring explicit analysis of both the loan's obligor and how the structure and terms of the particular loan being evaluated (that is, collateral or guarantees) might strengthen or weaken the quality of the loan.

The rating scale chosen should meaningfully distinguish gradations of risk within the institution's portfolio so that there is clear linkage to loan quality (and/or loss characteristics), rather than just to levels of administrative attention.[3]

2. Secondary-market credit activities generally include loan syndications, loan sales and participations, credit derivatives, and asset securitizations, as well as the provision of credit enhancements and liquidity facilities to such transactions. Such activities are described further in section 2129.05 and in SR-97-21.

3. See the December 1993 Interagency Policy Statement on the Allowance for Loan and Lease Losses in section 2010.7. The policy does not apply to bank holding companies directly. As they supervise their respective FDIC-insured financial institution subsidiaries, bank holding companies are advised to apply this supervisory guidance. Internal risk-rating systems and/or supporting documentation should be sufficient to enable examiners to reconcile the totals for the various internal risk ratings under the institution's system to the federal banking agencies' categories for those loans graded below "pass" (that is, loans classified as special mention, substandard, doubtful, or loss).

To do so, the rating system should be designed to address the range of risks typically encountered in the underlying businesses involving the institution's loan portfolio. One reflection of this degree of meaning is that there should be a fairly wide distribution of portfolio outstandings or exposure across grades, unless the portfolio is genuinely homogeneous. Many current rating systems include grades intended solely to capture credits needing heightened administrative attention, such as so-called "watch" grades. Prompt and systematic tracking of credits in need of such attention is an essential element of managing credit risk. However, to the extent that loans in need of attention vary in the risk they pose, isolating them in a single grade may detract from that system's ability to indicate risk. One alternative is the use of separate or auxiliary indicators for those loans needing such administrative attention.

Institutions whose risk-rating systems are least effective in distinguishing risk use them primarily to identify loans that are classified for supervisory purposes or that bank management otherwise believes should be given increased attention (that is, "watch" loans). Such systems contribute little or nothing to evaluating the bulk of loans in the portfolio—that is, loans for which no specific difficulties are present or foreseen. In some cases these institutions might also establish one or two risk grades for loans having very little perceived risk, such as those collateralized by cash or liquid securities or those to "blue-chip" private firms. Although the foregoing gradations are well-defined in terms of the relative credit risk they represent, the consequence for these least effective systems is that the bulk of the loan portfolio falls into one or two remaining broad risk grades—representing "pass" loans that are neither extremely low risk nor current or emerging problem credits—even though such grades may encompass many different levels of underlying credit risk.

2122.0.3 SOUND PRACTICES IN ASSIGNING AND VALIDATING INTERNAL RISK RATINGS

Experience and judgment, as well as more objective elements, are critical both in making the credit decision and in assigning internal risk grades. Institutions should provide clear and explicit criteria for each risk grade in their credit policies, as well as other guidance to promote consistency in assigning and reviewing grades. Criteria should be specified, even when addressing subjective or qualitative considerations, that allow for consistent assignment of risk grades to similarly risky transactions. Such criteria should include guidance both on the factors that should be considered in assigning a grade and how these factors should be weighed in arriving at a final grade.

Such criteria can promote consistency in assessing the financial condition of the borrower and other objective indicators of the risk of the transaction. One vehicle for enhancing the degree of consistency and accuracy is the use of "guidance" or "target" financial ratios or other objective indicators of the borrower's financial performance as a point of comparison when assigning grades. Banking organizations may also provide explicit linkages between internal grades and credit ratings issued by external parties as a reference point, for example, senior public debt ratings issued by one or more major ratings agencies. The use of default probability models, bankruptcy scoring, or other analytical tools can also be useful as supporting analysis. However, the use of such techniques requires institutions to identify the probability of default that is "typical" of each grade. The borrower's primary industry may also be considered, both in terms of establishing the broad characteristics of borrowers in an industry (for example, degree of vulnerability to economic cycles or long-term favorable or unfavorable trends in the industry) and of a borrower's position within the industry.

In addition to quantitative indications and tools, credit policies and ratings definitions should also cite qualitative considerations that should affect ratings. These might include factors such as (1) the strength and experience of the borrower's management, (2) the quality of financial information provided, and (3) the access of the borrower to alternative sources of funding. Addressing qualitative considerations in a structured and consistent manner when assigning a risk rating can be difficult. It requires experience and business judgment. Nonetheless, adequate consideration of these factors is important to assessing the risk of a transaction appropriately. In this regard, institutions may choose to cite significant and specific points of comparison for qualitative factors in describing how such considerations can affect the rating (for example, whether a borrower's financial statements have been audited or merely compiled by its accountants, or whether collateral has been independently valued).

Although the rating process requires the exercise of good business judgment and does not

lend itself to formulaic solutions, some formalization of the process can be helpful in promoting accuracy and consistency. For example, the use of a ''risk-ratings analysis form'' can be important (1) in providing a clear *structure* for identifying and addressing the relevant qualitative and quantitative elements to be considered in determining internal risk grades, and (2) for *documenting* how those grades were set by requiring analysis or discussion of key quantitative and qualitative elements of a transaction.

Risk ratings should be reviewed, if not assigned, by independent credit-risk management or loan-review personnel both at the inception of a transaction and periodically over the life of the loan.[4] Such independent reviewers should reflect a level of experience and business judgment that is comparable to that of the line staff responsible for assigning and reviewing initial risk grades. Among the elements of such independent review should be whether risk-rating changes (and particularly downgrades) have been timely and appropriate. Such independent reviews of individual ratings support the discipline of the rating assignments by allowing management to evaluate the performance of those individuals assigning and reviewing risk ratings. If an institution relies on outside consultants, auditors, or other third parties to perform all or part of this review role, such individuals should have a clear understanding of the institution's ''credit culture'' and its risk-rating process, in addition to commensurate experience and competence in making credit judgments.

Finally, institutions should track performance of grades over time to gauge migration, consistency, and default/loss characteristics to allow for evaluation of how well risk grades are being assigned. Such tracking also allows for *ex post* analysis of the loss characteristics of loans in each risk grade.

Because ratings are typically applied to different types of loans—for example, to both commercial real estate and commercial loans—it is important that each grade retains the same meaning to the institution (in terms of overall risk) across the exposure types. Such comparability allows management to treat loans in high-risk grades as a potential concentration of credit risk and to manage them accordingly. It also allows management and supervisors to monitor the overall degree of risk, and changes in the risk makeup, of the portfolio. Such consistency further permits risk grades to become a reliable input into portfolio credit-risk models.[5]

2122.0.4 APPLICATION OF INTERNAL RISK RATINGS TO INTERNAL MANAGEMENT AND ANALYSIS

As noted earlier, robust internal credit-rating systems are an important element in several key areas of the risk-management process. Although nearly all large institutions currently use risk ratings, many of the institutions need to further develop these systems so that they provide accurate and consistent indications of risk and sufficient granularity—finer distinctions among risks, especially for riskier assets. Described below are approaches to risk management and analysis that are based on robust internal risk-rating systems and that are currently being used at some banking organizations. These techniques appear to be emerging as sound practices in the use of risk ratings.

2122.0.4.1 Limits and Approval Requirements

Many large institutions have different approval requirements and thresholds for different internal grades, allowing less scrutiny and greater latitude in decision making for loans with lesser risk.[6] While this appears reasonable, institutions should also consider whether the degree of eased approval requirements (or the degree to which limits are higher) is supported by the degree of reduced risk and uncertainty associated with these lower-risk loans. If not, lesser requirements may provide incentives to rate loans too favorably, particularly in the current benign economic environment, with resulting underassessment of transaction risks.

2122.0.4.2 Reporting to Management on Credit-Risk Profile of the Portfolio

As part of reports that analyze the overall credit risk in the institution's portfolio, management

4. See section 2010.10 regarding internal loan review.

5. For a discussion of these models and the role played by internal credit-risk ratings, see the May 1998 Federal Reserve System report, ''Credit Risk Models at Major U.S. Banking Institutions: Current State of the Art and Implications for Assessments of Capital Adequacy,'' prepared by the Federal Reserve System Task Force on Internal Credit-Risk Models.

6. See section 2160.0 for more general guidance involving risk evaluation and control.

and directors should receive information on the profile of actual outstanding balances, exposures, or both by internal risk grade.[7] Such information can thus be one consideration among others, such as concentrations in particular industries or borrower types, in evaluating an institution's appetite for originating various types of new loans. Portfolio analysis may range from simple tallies of aggregates by risk grade to a formal model of portfolio behavior that incorporates diversification and other elements of the interaction among individual loan types. In this more complex analysis, gradations of risk reflect only one among many dimensions of portfolio risk, along with potential industry concentrations, exposure to an unfavorable turn in the business cycle, geographical concentrations, and other factors.

2122.0.4.3 Allowance for Loan and Lease Losses

The makeup of the loan portfolio and the loss characteristics of each grade—including individual pass grades—should be considered, along with other factors, in determining the adequacy of an institution's allowance for loan and lease losses.[8]

2122.0.4.4 Pricing and Profitability

In competitive marketplaces, it is properly the role of bankers rather than supervisors to judge the appropriateness of pricing, particularly with regard to any single transaction or group of transactions. One way that some institutions choose to discipline their overall pricing practices across their portfolio is by incorporating risk-rating-specific loss factors in the determination of the minimum profitability requirements (that is, "hurdle rates"). Following this practice may render such institutions less likely to price loans well below the level indicated by the long-term risk of the transaction. Given that bank lending, particularly pricing, can be highly competitive, the application of appropriate disciplines to pricing, in conjunction with a clear and meaningful assessment of the risks inherent in each transaction and in the portfolio as a whole, can be important tools in avoiding competitive future excessive practices.

2122.0.4.5 Internal Allocation of Capital

Those institutions that choose to allocate capital may use their internal risk grades as important inputs in identifying appropriate internal capital allocations. Use of appropriately allocated capital in evaluating profitability offers many advantages, including the incentive to consider both risk and return in making lending decisions rather than merely rewarding loan volume and short-term fee revenue. Under appropriate circumstances—that is, where internal capital allocations are sufficiently consistent, rigorous, and well-documented—such allocations may also be considered as a source of input for supervisory evaluations of capital adequacy.[9]

2122.0.5 INSPECTION OBJECTIVES

1. To evaluate whether the internal risk-identification and -monitoring systems are consistent with—
   a. sound practices in the function and design of internal rating systems;
   b. sound practices in assigning and reviewing internal risk ratings; and
   c. the nature, size, and complexity of activities within the banking organization.
2. To determine whether the level and volume of lower-quality pass grades of loans have grown significantly over time and whether any such trends should—
   a. have adverse implications for determining the adequacy of risk management and capital, and
   b. materially alter the institution's asset-quality ratings and valuations, and the examiner's evaluation of the adequacy of the allowance for loan and lease losses.
3. To determine whether improvements are needed in the credit-risk-management process and to discuss them with the board of directors and senior management.
4. To document the extent to which the institution has adopted current and emerging sound

7. See section 2010.2 regarding a bank holding company's supervision of its subsidiaries and loan administration. See also the more general financial analysis sections 4020.2 and 4060.1 with regard to evaluating the asset quality of subsidiary financial institutions and evaluating the asset quality of the holding company on a consolidated basis.

8. See footnote 3. Section 2010.7 emphasizes the bank holding company's responsibility as it supervises its subsidiaries with respect to each entity maintaining an adequate allowance for loan and lease losses.

9. See sections 4060.3 and 4060.4 regarding the evaluation of capital adequacy of bank holding companies.

practices in the use of internal ratings information in internal risk management and analysis.

5. To incorporate the examiner's evaluation of sound credit-risk-rating practices into the assessment of management and capital adequacy.

2122.0.6 INSPECTION PROCEDURES

1. Determine whether the institution is considered "large" for purposes of applying this section's guidance and procedures.
2. Evaluate the adequacy of internal credit-risk-rating systems, including ongoing development efforts, when assessing the quality and overall strength of risk management. Give particular attention to the following practices:
   a. *Function and design of internal rating systems.*
      - Ascertain whether the rating scale meaningfully distinguishes gradations of risk within the institution's portfolio evidencing clear linkage to loan quality and/or loss characteristics.
        — Determine if the design of the rating system has an adequate number of internal ratings to distinguish among levels of risks in its portfolio, and whether the grades used address the range of risks typically encountered in the underlying businesses of the institution.
        — Determine whether loans or exposures are broadly distributed across the internal grades.
        — Establish if there are "watch grades" that are intended to capture loans needing heightened administrative attention, or whether separate or auxiliary indicators are used for such loans.
      - Determine whether credit-risk-rating definitions are linked to one or more measurable outcomes (for example, the probability of a borrower's default or expected loss).
   b. *Sound practices in assigning internal risk ratings.*
      - Determine whether loan policies provide clear and explicit criteria for each risk grade as to the risk factors that are to be considered in assigning a grade with respect to—
        — financial analysis, including whether reference financial ratios or other objective indicators are used to indicate the borrower's financial performance;
        — explicit linkages between the internal grades assigned and credit ratings issued by external parties (for example, senior public debt ratings by major rating agencies);
        — default probability models, bankruptcy scoring, or other analytical tools used;
        — analysis of a borrower's primary industry, considering both the broad characteristics of borrowers within that industry and the borrower's position within that industry; and
        — qualitative factors (for example, the quality of the financial information that is provided, the borrower's access to alternative sources of funding, whether the financial statements were audited or merely compiled, or whether collateral was independently valued).
      - Determine whether loan policies provide clear and explicit guidance as to how these risk factors should be weighed in arriving at a final grade.
      - Determine whether the ratings assignment is well documented, possibly including the use of a risk-rating form to provide formalization and standardization of the quantitative and qualitative criteria elements used in rating borrowers and/or transactions.
      - Establish whether risk ratings are independently reviewed at the inception of a loan and periodically over the life of a loan, and whether risk-rating changes have been timely and appropriate (particularly downgrades).
      - Ascertain whether the performance of rating grades is tracked over time to evaluate migration, consistency, and default/loss characteristics and trends.
   c. *Application of internal risk ratings to internal management and analysis.*
      - Determine whether loan-approval requirements for each grade appear to be supported by the degree of risk and uncertainty associated with the respective loans.
      - Review internal management information system reports and determine

whether such reporting is adequate for the institution.

- Ascertain if the risk-rating-specific loss factors are used to determine risk pricing, minimum profitability requirements, and capital adequacy needs, and document the institution's progress in this regard.

3. Determine whether other risk elements may compensate for any specific weaknesses attributable to an inadequate rating system.
4. Review internal management information system reports to determine whether the portion of loans in lower-quality pass grades has grown significantly over time, and whether any such change might have negative implications for the adequacy of risk management or capital at the institution.
5. Determine whether a significant shift toward higher-risk pass grades, or an overall large proportion of loans in a higher-risk pass grade, should have negative implications for the institution's asset-quality rating, including the adequacy of the loan-loss reserve.
6. Evaluate trends in risk-rating categories associated with problem assets.
7. Discuss the results of the evaluations with management, including whether there are any plans to enhance existing credit-rating systems.
8. Prepare written comments for the inspection report on the adequacy of risk-rating systems and the credit quality of the pass portfolio, noting any deficiencies.

Full-scope inspections under a risk-focused approach must be performed to fulfill the objectives of a full-scope inspection, adjusted depending on the circumstances of the banking organization being evaluated. At a minimum, full-scope inspections should include sufficient procedures to reach an informed judgment on the assigned ratings for the factors addressed by the BOPEC rating system. The business of banking is fundamentally predicated on taking risks, and the components of the supervisory rating system are strongly influenced by risk exposure. Consequently, the procedures of full-scope inspections focus to a large degree on assessing the types and extent of risks to which a bank holding company and its subsidiaries are exposed, evaluating the organization's methods of managing and controlling its risk exposures, and ascertaining whether management and directors fully understand and are actively monitoring the organization's exposure to those risks. Given the Federal Reserve's responsibility for ensuring compliance with banking laws and regulations, inspections also include an appropriate level of compliance testing. (See SR-96-14.)

2124.0.1 TRANSACTION TESTING

Historically, Federal Reserve examinations and inspections have placed significant reliance on transaction-testing procedures. For example, to evaluate the adequacy of the credit-administration process, assess the quality of loans, and ensure the adequacy of the allowance for loan and lease losses (ALLL), a high percentage of large loan amounts have traditionally been individually reviewed. Similarly, the assessment of the accuracy of regulatory reporting often has involved extensive review of reconciliations of a bank holding company's general ledger to the FR Y-9C report and other FR Y-series reports. Other similar procedures typically have been completed to ascertain compliance with applicable laws and regulations, to determine whether the banking and nonbank subsidiaries are following their internal policies and procedures and those of the bank holding company, and to evaluate the adequacy of internal control systems.

Transaction testing remains a reliable and essential inspection technique for assessing a banking organization's condition and verifying its adherence to internal policies, procedures, and controls. In a highly dynamic banking market, however, such testing is not sufficient for ensuring continued safe and sound operations. As evolving financial instruments and markets have enabled banking organizations to rapidly reposition their portfolio risk exposures, periodic assessments of the condition of banking organizations based on transaction testing alone cannot keep pace with the moment-to-moment changes occurring in financial risk profiles.

To ensure that banking organizations have in place the processes necessary to identify, measure, monitor, and control their risk exposures, inspections must focus more on evaluating the appropriateness of a very high degree of transaction testing. Under a risk-focused approach, the degree of transaction testing should be reduced when internal risk-management processes are determined to be adequate or risks are considered minimal. However, when an organization's risk-management processes or internal controls are considered inappropriate (such as when there is an inadequate segregation of duties or when on-site testing determines that such processes or controls are lacking), additional transaction testing sufficient to fully assess the degree of risk exposure in that function or activity must be performed. In addition, if an examiner believes that a banking organization's management is being less than candid, has provided false or misleading information, or has omitted material information, then substantial on-site transaction testing should be undertaken and appropriate follow-up actions should be initiated, including the requirement of additional audit work and appropriate enforcement actions.

In most cases, full-scope inspections are conducted on or around a single date. This is appropriate for the vast majority of banking organizations supervised by the Federal Reserve. However, as the largest banking organizations have undergone considerable geographic expansion and the range of their products has become more diversified, coordinating the efforts of the large number of examiners necessary to conduct inspections at a single point in time has become more difficult. To avoid causing undue burden on these banking organizations, full-scope inspections for many large companies are conducted over the course of a year, rather than over a span of weeks, in a series of targeted reviews focusing on one or two significant aspects of the bank holding company's operations. This approach to conducting full-scope

inspections provides more continuous supervisory contact with the largest bank holding companies and can facilitate improved coordination of inspection efforts with other federal banking agencies. It also provides more flexibility in the allocation of examiner resources, which has been especially important as the complexity of banking markets and products has increased and has led to the development of cadres of examiners with specialized skills.

2124.0.2 RISK-FOCUSED INSPECTIONS

Developments in the business of banking have increased the range of banking activities, heightening demands on examiner resources and making the need for examiners to effectively focus their activities on areas of the greatest risk even more crucial. Improved in-office planning can result in more efficient and effective on-site inspections that are focused on risks particular to specific organizations of the bank holding company. Such improved planning minimizes supervisory burden and provides for the close coordination of the supervisory efforts of the Federal Reserve with those of the other state and federal banking agencies. Improved planning also allows information requests to be better tailored to the specific organizations.

2124.0.2.1 Risk Assessment

To focus procedures on the areas of greatest risk, a risk assessment should be performed before on-site supervisory activities. The risk-assessment process highlights both the strengths and vulnerabilities of a bank holding company and provides a foundation from which to determine the procedures to be conducted during an inspection. Risk assessments indentify the financial activities in which a banking organiation has chosen to engage, determine the types and quantities of risks to which these activities expose the organization, and consider the quality of management and control of these risks. At the conclusion of the risk-assessment process, a preliminary supervisory strategy can be formulated for the bank holding company and its subsidiaries and each of their major activities. Naturally, those activities that are most significant to the organization's risk profile or that have inadequate risk-management processes or rudimentary internal controls represent the highest risks and should undergo the most rigorous scrutiny and testing.

Identifying the significant activities of a bank holding company, including those conducted off-balance-sheet, should be the first step in the risk-assessment process. These activities may be identified through the review of prior bank examination and bank holding company inspection reports and workpapers, surveillance and monitoring reports generated by Board and Reserve Bank staffs, Uniform Bank Performance Reports and Bank Holding Company Performance Reports, regulatory reports (for example, bank call reports and the FR Y-9C and FFIEC 002 reports), and other relevant supervisory materials. Where appropriate, conduct reviews of strategic plans and budgets, internal management reports, board of directors information packages, correspondence and minutes of meetings between the bank holding company and the Reserve Bank, annual reports and quarterly SEC filings, press releases and published news stories, and stock analysts' reports. In addition, examiners should hold periodic discussions with management to gain insight into their latest strategies or plans for changes in activities or management processes.

Once significant activities have been identified, the types and quantities of risks to which these activities expose the bank holding company should be determined. This allows identification of the high-risk areas that should be emphasized in conducting inspections. The types of risk that may be encountered in banking activities individually or in various combinations include, but are not limited to, credit, market, liquidity, operational, legal, and reputational risks.[1] For example, lending activities are a primary source of credit and liquidity risks. They may also present considerable market risk (if the bank holding company or its subsidiaries are originating mortgage loans for later resale), interest-rate risk (if fixed-rate loans are being granted), or legal risk (if loans are poorly documented). Similarly, the asset/liability management function has traditionally been associated with exposures to interest-rate and liquidity risks. There are also operational risks associated with many of the transactions undertaken by this function, and with other market risks associated with the investments and hedging instruments commonly used by the asset/liability management function. The quantity of risks associated with a given activity may be indi-

1. Appendix A defines these primary risk types.

cated by the volume of assets and off-balance-sheet items that the activity represents or by the portion of revenue for which the activity accounts. Activities that are new to an organization or for which exposure is not readily quantified may also represent high risks that should be evaluated at inspections.

A number of analytical techniques may be used to estimate the quantity of risk exposure, depending on the activity or risk type being evaluated. For example, to assess the quantity of credit risk in loans and commitments, the level of past-due loans, internally classified or watch-list loans, nonperforming loans, and concentrations of credit exposure to particular industries or geographic regions should be considered (see section 2010.2). In addition, as part of the assessment of credit risk, the adequacy of the overall ALLL can be evaluated by considering trends in past-due, special-mention, and classified loans; historic charge-off levels; and the coverage of nonperforming loans by the ALLL. Analytical techniques for gauging the exposure of a bank holding company and its subsidiaries to interest-rate risk, as part of the evaluation of asset/liability management practices, can include a review of the historic performance of net interest margins, as well as the results of internal projections of future earnings performance or net economic value under a variety of plausible interest-rate scenarios. The measurement of the quantity of market risk arising from trading in cash and derivative instruments may take into account the historic volatility of trading revenues, the results of internal models calculating the level of capital and earnings at risk under various market scenarios, and the market value of contracts relative to their notional amounts.

Once the types and quantities of risk in each activity have been identified, a preliminary assessment of the banking organization's process to identify, measure, monitor, and control these risks should be completed. This evaluation should be based on findings from previous examination and inspection activities conducted by the Reserve Bank or other banking agencies, supplemented by the review of internal policies and procedures, management reports, and other documents that provide information on the extent and reliability of internal risk-management systems. Sound risk-management processes vary from one banking organization to another, but generally include four basic elements for each individual financial activity or function and for the organization in aggregate. These elements are (1) active board and senior management oversight; (2) adequate policies, procedures, and limits; (3) adequate risk-measurement, monitoring, and management information systems; and (4) comprehensive internal audits and controls. (See section 4070.1 and SR-95-51.)

The preliminary evaluation of the risk-management process for each activity or function also helps determine the extent of transaction testing that should be planned for each area. If the organization's risk-management process appears appropriate and reliable, then a limited amount of transaction testing may well suffice. If, on the other hand, the risk-management process appears inappropriate or inadequate to the types and quantities of risk in an activity or function, examiners should plan a much higher level of transaction testing. They should also plan to conduct the most testing in those areas that comprise the most significant portions of a bank holding company's activities and, thus, typically represent high potential sources of risk.

2124.0.2.2 Preparation of a Scope Memorandum

Once the inspection planning and risk-assessment processes are completed, a scope memorandum should be prepared. A scope memorandum provides a detailed summary of the supervisory strategy for a bank holding company and assigns specific responsibilities to inspection team members. A scope memorandum should be tailored to the size and complexity of the bank holding company that is subject to review, define the objectives of each inspection, and generally include—

- a summary of the results of the prior inspection;
- a summary of the strategy and significant activities of the banking organization, including its new products and activities;
- a description of the bank holding company's organization and management structure;
- a summary of performance since the prior inspection;
- a statement of the objectives of the current inspection;
- an overview of the activities and risks to be addressed by the inspection; and
- a description of the procedures that are to be performed at the inspection.

For large, complex organizations operating in a number of states or internationally, the planning and risk-assessment processes are necessarily more complicated. The traditional scope memorandum may have to be broadened into a more extensive set of planning documents to reflect the unique requirements of complex bank holding companies. Examples of these planning documents include annual consolidated analyses, periodic risk assessments, and supervisory plans.

2124.0.2.3 On-Site Procedures

The amount of review and transaction testing necessary to evaluate particular functions or activities of a bank holding company generally depend on the quality of the process the company uses to identify, measure, monitor, and control the risks of an activity. When the risk-management process is considered sound, further procedures are limited to a relatively small number of tests of the integrity of the management system. Once the integrity of the management system is verified through limited testing, conclusions on the extent of risks within the function or activity are drawn based on internal management assessments of those risks rather than on the results of more extensive transaction testing by examiners. On the other hand, if initial inquiries into the risk-management system—or efforts to verify the integrity of the system—raise material doubts as to the system's effectiveness, no significant reliance should be placed on the system. A more extensive series of tests should be undertaken to ensure that the banking organization's exposure to risk from a given function or activity can be accurately gauged and evaluated. More extensive transaction testing is also generally completed for activities that are much more significant to a bank holding company than for other areas, although the actual level of testing for these significant activities may be reduced commensurate with the quality of internal risk-management processes.

Consider, as an example, the risk exposure associated with commercial lending activities whereby examiners have traditionally reviewed a relatively high number and dollar volume of real estate–associated loans.[2] If, however, credit-administration practices are considered satisfactory, fewer loans may need be reviewed to verify that this is the case (that is, fewer loans than would be reviewed if deficiencies in credit-administration practices were suspected). This review may be achieved through a valid statistical sampling technique, when appropriate. It should be noted that if credit-administration practices are initially considered sound, but loans reviewed to verify this raise doubts about the accuracy of internal assessments or the compliance with internal policies and procedures, the number and volume of loans subject to review should generally be expanded. Examiners should thus review a sufficient number of loans to ensure that the level of risk is clearly understood, an accurate determination of the adequacy of the ALLL can be made, and the deficiencies in the credit risk-management process can be comprehensively detailed.

2. Guidance on the selection of loans for review is provided in SR-94-13, "Loan Review Requirements for On-Site Examinations."

2124.0.2.4 Evaluation of Audit Function as Part of Assessment of Internal Control Structure

A bank holding company's internal control structure is critical to its safe and sound functioning in general and to its risk-management system in particular. When properly structured, internal controls promote effective operations and reliable financial and regulatory reporting; safeguard assets; and help to ensure compliance with laws, regulations, and internal policies and procedures. In many banking organizations, internal controls are tested by an independent internal auditor who reports directly to the board of directors or its audit committee. However, in some smaller banking organizations whose size and complexity of operations do not warrant an internal audit department, reviews of internal controls may be conducted by other personnel independent of the area subject to review.

Because the audit function is an integral part of a bank holding company's assessment of its internal control system, examiners must include a review of the organization's control-assessment activities in every inspection. Such reviews help identify significant risks and facilitate a comprehensive evaluation of the organization's internal control structure and also provide information to determine the inspection procedures that should be completed in assessing internal controls for particular functions and activities and for the bank holding company overall. When conducting this review, examin-

ers should evaluate the independence and competence of the personnel conducting control assessments and the effectiveness of the assessment program in covering the bank holding company's significant activities and risks. In addition, examiners should meet with the internal auditors or other personnel responsible for evaluating internal controls and review internal control risk assessments, work plans, reports, workpapers, and related communications with the audit committee or board of directors.

Depending on the size and complexity of the activities conducted by a bank holding company, the examiner should also consider conducting a similar review of the work performed by the company's external auditors. Such a review often provides added insight into key risk areas by detailing the nature and extent of the external auditors' testing of those areas.

2124.0.2.5 Evaluation of Overall Risk-Management Process

To highlight the importance of a banking organization's risk-management process, bank holding companies are assigned a risk-management rating on a five-point scale as a significant part of the evaluation of the management components of the BOPEC rating systems (see section 4070.1). In addition, U.S. branches and agencies of foreign banking organizations are assigned a similar rating under the ROCA rating system.[3] These risk-management ratings encompass evaluations of the quality of risk-management processes for all significant activities and all types of risks. As such, they should largely summarize conclusions on the adequacy of risk-management processes for each individual function or activity evaluated.

In assigning these risk-management ratings, it is important to consider the quality of the risk-management process for the bank holding company overall, as well as for each individual function. At smaller bank holding companies engaged in traditional banking and nonbanking activities, relatively basic risk-management processes established for each significant activity, such as lending or asset/liability management, may be adequate to allow senior management to effectively manage the organization's overall risk profile. On the other hand, at larger bank holding companies that are typically engaged in more complex and widely diversified activities, effective risk-management systems must evaluate various functional management processes in combination so that aggregate risk exposures can be identified and monitored by senior management. Management information reports should typically be generated for the overall organization, as well as for individual functional areas. Some aggregate or specific company-wide limits may also be needed for the principal types of risks that are relevant to its activities.

A critical aspect of ensuring that a bank holding company's risk-management and control procedures remain adequate is the ongoing testing of the strength and integrity of these procedures and the extent to which they are understood and followed throughout the organization. When assigning a risk-management rating, examiners should assess the adequacy of the company's efforts to ensure that its procedures are being followed. The company's validation efforts must be conducted by those individuals who have proper levels of organizational independence and expertise, such as internal or external auditors, internal risk-management units, or managers or other professionals of the bank holding company who have no direct connection to the activities for which procedures are being assessed.

2124.0.2.6 Evaluation of Compliance with Laws and Regulations

Compliance with relevant laws and regulations should be assessed at every inspection. The steps taken to complete these assessments, however, will vary depending on the circumstances of the bank holding company being reviewed. When an organization has a history of satisfactory compliance with relevant laws and regulations or an effective compliance function, only a relatively limited degree of transaction testing need be conducted to assess compliance. For example, in evaluating compliance with the appraisal requirements of Regulation Y at a bank holding company with a formal compliance function, compliance may be ascertained by reviewing the scope and findings of internal and external audit activities, evaluating internal appraisal ordering and review processes, and sampling a selection of appraisals for compliance as part of the supervisory loan review process. On the other hand, at bank holding companies that have a less satisfactory compli-

3. U.S. branches and agencies of foreign banking organizations are assigned separate ROCA ratings for Risk management, Operational controls, Compliance, and Asset quality under guidance included in SR-95-22.

ance record or that lack a compliance function, more appraisals would naturally need to be tested to assess the overall compliance with the appraisal requirements of Regulation Y.

2124.0.2.7 Documentation of Supervisory Findings

The examiners' workpaper documentation of supervisory findings is necessary for Reserve Bank management to objectively verify the inspection work performed. Such documentation also provides a source of information on the condition and prospects of a bank holding company that is invaluable to the planning of future reviews. Most important, examiners' workpaper documentation provides support for the conclusions and recommendations detailed in the inspection report.

2124.0.2.8 Communication of Supervisory Findings

Effective and open communication between bank supervisory agencies and the board of directors and management of bank holding companies is essential to ensuring that the results of inspections are fully understood; the directorship and management are aware of any identified deficiencies; and, when necessary, they take appropriate corrective actions.

2124.0.3 INSPECTION OBJECTIVES

1. To ensure that the bank holding company has in place the processes necessary to identify, measure, monitor, and control its risk exposures for each of its activities or functions.
2. To improve inspection efficiencies by stressing increased in-office planning of inspections based on a risk- focused emphasis.
3. To identify and assess significant on- and off-balance-sheet activities and the greatest types and quantities of risk exposures and vulnerabilities to the bank holding company, tailoring the extent of transaction testing to the results of this review and other inspections' findings.
4. To review and assess the effectiveness and adequacy of documentation of the bank holding company's control and assessment activities and arrangements, including its internal control structure, and the qualifications of internal and external auditors and other independent personnel involved in the program.
5. To emphasize the preparation of a risk-focused scope memorandum, tailored to the size and complexity of the bank holding company under inspection.
6. To evaluate compliance with laws and regulations.
7. To adequately document and communicate inspection supervisory findings, recommendations, and conclusions.

2124.0.4 INSPECTION PROCEDURES

1. Identify the significant on- and off-balance-sheet activities of the bank holding company.
   a. Review prior inspection reports and workpapers, surveillance and monitoring reports generated by the Board and Reserve Bank staff, Uniform Bank Performance Reports and Bank Holding Company Performance Reports; regulatory reports (for example, bank call reports and FR Y-series and other FFIEC reports), and other relevant supervisory materials.
   b. Review strategic plans and budgets; internal management reports; board of directors information packages; correspondence and minutes, including minutes of meetings held between the bank holding company and the Reserve Bank; annual reports and quarterly SEC filings; press releases and published news stories; and stock analysts' reports.
2. Hold periodic discussions with management to gain insight into recently adopted strategies or plans to change activities or management processes.
3. Once the significant activities have been identified, determine and analyze the types (for example, credit, market, liquidity, operational, legal, and reputational) and quantities of risks to which those activities expose the bank holding company, placing greater inspection emphasis on the high-risk areas.
5. Develop an assessment of the processes that are used to identify, measure, monitor, and control the risks. Focus on the extent of board and senior management oversight; the adequacy of policies, procedures, limits, risk measurement, monitoring, and management information systems; and the existence of adequately documented internal audits and controls.
6. Prepare a scope memorandum tailored to the size and complexity of the bank holding company under inspection.
7. Conduct limited tests of the integrity of the risk-management system. Conduct more extensive transaction testing for those areas of a

bank holding company that are very significant in comparison to other areas, adjusting the level of transaction testing to the quality of internal risk-management processes. If initial inquiries or efforts to verify the system raise material doubts as to its effectiveness, place no reliance on the integrity of the bank holding company's risk-management system and conduct more extensive transaction testing.

8. Review the bank holding company's risk-assessment control activities, including an assessment of internal controls for particular functions and activities and for the bank holding company overall.

a. Evaluate the independence and competence of the personnel conducting control assessments and the effectiveness of the assessment program in covering the bank holding company's significant activities and risks.

b. Meet the independent external and internal auditors and other personnel responsible for evaluating internal controls and review the internal-control risk assessments, work plans, reports, workpapers, and related communications with the audit committee or board of directors.

9. Assess the adequacy of efforts to ensure that the current risk-management and control procedures are being followed.

10. Assess compliance with laws and regulations, adjusting the extent of transaction testing with the organization's history of satisfactory compliance.

11. Document all work performed and the supervisory findings. Include information on the condition and prospects of the bank holding company and its significant subsidiaries as well as the inspection's conclusions and recommendations.

2124.0.5 APPENDIX A—DEFINITIONS OF RISK TYPES EVALUATED AT INSPECTIONS

- *Credit risk* arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- *Market risk* is the risk to a bank holding company's condition resulting from adverse movements in market rates or prices, such as interest rates, foreign-exchange rates, or equity prices.
- *Liquidity risk* is the potential that a bank holding company will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as ''funding liquidity risk'') or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions (''market liquidity risk'').
- *Operational risk* arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.
- *Legal risk* arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a bank holding company.
- *Reputational risk* is the potential that negative publicity on a bank holding company's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions.

2124.01.1 INSPECTION APPROACH FOR RISK-FOCUSED SUPERVISION

The inspection approach for large, complex banking organizations (LCBOs) is a risk-focused process that relies on an understanding of the banking organization[1] (the institution), the performance of risk assessments, the development of a supervisory plan, and inspection procedures that are tailored to the risk profile. The process for a complex institution relies more heavily on a central point of contact (CPC), detailed risk assessments, and a supervisory plan before the on-site inspection. The risk-focused inspection also incorporates the U.S. operations of foreign banking organizations (FBOs), for which the Federal Reserve has overall supervisory authority. See SR-97-24, SR-99-15, and section 2124.04.

2124.01.1.1 Risk-Focused Supervisory Objectives

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

1. *To provide flexible and responsive supervision.* The supervisory process is designed to be dynamic and forward looking so that it responds to technological advances, product innovation, and new risk-management systems and techniques, as well as to changes in the condition of an individual financial institution and developments in the market.
2. *To foster consistency, coordination, and communication among the appropriate supervisors.* Seamless supervision, which reduces regulatory burden and duplication, is promoted. The supervisory process uses examiner resources effectively by using the institution's internal and external risk-assessment and -monitoring systems; making appropriate use of joint and alternating examinations and inspections; and tailoring supervisory activities to an institution's condition, risk profile, and unique characteristics.
3. *To promote safety and soundness.* The supervisory process effectively evaluates the safety and soundness of banking organizations, including the assessment of risk-management systems, financial condition, and compliance with laws and regulations.
4. *To provide a comprehensive assessment of the institution.* The supervisory process integrates specialty areas (for example, information technology systems, trust, capital markets, and consumer compliance) and functional risk assessments and reviews, in cooperation with interested supervisors, into a comprehensive assessment of the institution.

2124.01.1.2 Key Elements of the Risk-Focused Framework

To meet the established objectives and respond to the characteristics of large institutions, the framework for risk-focused supervision of large, complex institutions contains the following key elements:

1. *Designation of a central point of contact.* Large institutions typically have operations in several jurisdictions, multiple charters, and diverse product lines. Consequently, the program requires that a CPC be designated for each institution to facilitate coordination and communication among the principal bank and other regulatory authorities (for example, securities, insurance, and other nonbanking supervisory entities). Further, the program requires that each CPC and LCBO be assigned a dedicated supervisory team and staff with specialized skills, knowledge, and experience tailored to the unique profile of a particular institution.
2. *Review of functional activities.* Large institutions are generally structured along business lines or functions, and some activities are managed on a centralized basis. As a result, a single type of risk may cross several legal entities. Therefore, the supervisory program incorporates assessments along functional lines to evaluate risk exposure and its impact on safety and soundness. These functional reviews will be integrated into the risk assessments for specific legal entities and

1. For this section, the term "banking organization" refers to bank holding companies and their domestic and foreign banking and nonbank subsidiaries. It is used synonomously with the term "institutions." That term, however, has an even broader meaning since it may include other entities (for example, Edge Act corporations and foreign branches of state member banks). See subsection 2124.01.1.3.1

used to support the supervisory ratings for individual legal entities.[2]

3. *Focus on risk-management processes.* Large institutions generally have highly developed risk-management systems such as internal audit, loan review, and compliance. The supervisory program emphasizes each institution's responsibility to be the principal source for detecting and deterring abusive and unsound practices through adequate internal controls and operating procedures. The program incorporates an approach that focuses on and evaluates the institution's risk-management systems, processes, and core proficiencies for identifying, measuring, monitoring, and controlling key risks, including credit, market, and operational risks. Yet, the program retains transaction testing and supervisory rating systems such as CAMELS, BOPEC, and ROCA. This diagnostic perspective provides insight into how effectively an institution is managing its operations and how well it is positioned to meet future business challenges. The program places less emphasis on traditional "point-in-time" balance-sheet assessments.
4. *Tailoring of supervisory activities.* Large institutions are unique, but all possess the ability to quickly change their risk profiles. To deliver effective supervision, the program incorporates an approach that tailors supervisory activities to the risk profile of an institution. By concentrating on an institution's major risk areas, examiners can achieve a more relevant and penetrating understanding of the institution's condition.
5. *Review of internally and externally generated management information.* A review of internal management and board reports, internal and external audit reports, and publicly available information will further supplement existing supervisory processes. Banking organizations are also encouraged to continually review and enhance their public disclosures in order to promote transparency and to foster and support supervisory processes and effective market discipline.
6. *Emphasis on ongoing supervision.* Large institutions face a rapidly changing environment. The supervisory program thus emphasizes ongoing supervision, monitoring, and assessment through increased planning; no less than quarterly reassessment of the organization's profile; and continuous off-site monitoring. Ongoing supervision allows for timely adjustments to the supervisory strategy as conditions change within the institution, enhanced information sharing System-wide and on an interagency basis, and the use of information technology platforms that foster more effective collaboration and communication.
7. *Effective communication with management.* An effective program of regular and meaningful contacts with management is necessary to maintain a current understanding of the institution's risk profile and risk-management processes without imposing undue burden, interfering with legitimate management prerogatives, or compromising the objectivity of the supervisory process.

2. When functions are located entirely in legal entities that are not primarily supervised by the Federal Reserve, the results of supervisory activities conducted by the primary regulator will be used to the extent possible to avoid duplication of activities.

2124.01.1.3 Banking Organizations Covered by the Framework

For purposes of the risk-focused supervision framework, LCBOs generally have a functional management structure, a broad array of products, operations that span multiple supervisory jurisdictions, and consolidated assets of $1 billion or more.[3] These institutions may be state member banks, bank holding companies (including their nonbank and foreign subsidiaries), and branches and agencies of FBOs. The complex-institution process may also be appropriate for some organizations with consolidated assets less than $1 billion.

LBCOs comprise larger institutions that have particularly complex operations and dynamic risk profiles. They demand a heightened level of planning, coordination, and innovative techniques to implement an effective supervisory program. These organizations typically have significant on- and off-balance-sheet risk exposures, offer a broad range of products and services at the domestic and international levels, are subject to multiple supervisors in the United States and abroad, and participate extensively in large-value payment and settlement systems.

An important aspect of the LCBO program is the assessment and evaluation of banking practices across a group of institutions with similar

3. Large institutions are defined differently in other regulatory guidance regarding regulatory reports and examination mandates.

business lines, characteristics, and risk profiles. This "portfolio" approach to supervision will (1) support and enhance timely judgments about individual institutions, including the identification of possible "outliers"; (2) facilitate peer-group assessments; (3) provide an improved framework for discerning industry trends; (4) foster more consistent supervision of institutions with similar businesses and risk profiles; (5) contribute substantially to the maintenance of a highly informed and skilled supervisory staff; and (6) promote the development and sharing of the best supervisory practices within the Federal Reserve and the supervisory community more broadly.

2124.01.1.3.1 Foreign Institutions

U.S. supervisory authorities are host-country rather than home-country supervisors for most of the U.S. operations of FBOs; therefore, the supervisory focus and objectives are somewhat different for U.S. operations of FBOs and are addressed separately in the FBO supervision program. The desired result of a risk-focused examination process, however, should be the same. The framework encompasses the supervision and examination processes and procedures relevant to the U.S. operations of FBOs, to the extent that they are appropriate. Any significant remaining differences are incorporated in the FBO supervision program.

2124.01.1.3.2 Nonbank Subsidiaries of Domestic Institutions

Nonbank subsidiaries of large, complex domestic institutions are covered by the risk-focused supervision program. These include (1) nonbank subsidiaries of the parent bank holding company and those of the subsidiary state member banks; (2) the significant branch operations, primarily foreign branches, of state member banks; and (3) subsidiary foreign banks of the holding company. The level of supervisory activity to be conducted for nonbank subsidiaries and foreign branches and subsidiaries of domestic institutions should be based on their individual risk levels relative to the consolidated organization. The risk associated with significant nonbank subsidiaries or branches should be identified as part of the consolidated risk-assessment planning process, and the appropriate level of supervisory coverage (whether on-site or off-site) should be described in the supervisory plan for the organization. Risk-focused supervisory planning should incorporate the use of the workpaper, "Nonbank Subsidiary of a Bank Holding Company Risk-Assessment Questionnaire" (see appendix B). It should be used as a guide for (1) determining whether a nonbank subsidiary poses significant risk to the entire LCBO (parent bank holding company) and (2) determining whether an on-site supervisory inspection or examination of the entity is needed.[4] The supervisory plan for the organization should also include a review of the institution's processes to ensure compliance with sections 23A and 23B of the Federal Reserve Act and various other regulations and guidelines that govern transactions between the bank and nonbank affiliates.

2124.01.1.3.3 Edge Act Corporations

Under section 25A, paragraph 17, of the Federal Reserve Act, Edge Act corporations are subject to examination once a year and at such other times as deemed necessary by the Federal Reserve. While Reserve Banks must fulfill this legal mandate, there is flexibility in determining the extent of examination coverage. The scope of Edge Act corporation examinations should be determined through the risk-assessment process. Additionally, separate reports of examination are not required for Edge Act corporations, provided that all relevant findings are included in the consolidated report of examination of the parent bank.[5] This reporting procedure also applies to other nonbank subsidiaries of the bank or bank holding company.

2124.01.1.3.4 Specialty Areas Covered by the Framework

The Federal Reserve regularly conducts examinations, inspections, or reviews of several spe-

4. When this workpaper is used, a separate risk assessment of each nonbank subsidiary of the LCBO (for domestic bank holding companies) is not required. The separate risk-assessment requirements of SR-93-19 are thus partially superseded for LCBOs. Nonbank subsidiary risk assessments should be reflected in the entire consolidated organization's risk assessment.

5. A separate memorandum to the file should be prepared and retained that provides the date of examination of the Edge Act corporation, a summary of findings, the rating assigned, and a reference to the consolidated report of examination. This information should also be forwarded to Federal Reserve Board staff.

cialty areas. To achieve more efficient supervision and reduce the regulatory burden on institutions, steps have been taken to coordinate these reviews with the annual full-scope inspection of the consolidated organization. Under the risk-focused approach, the specialty areas should be included in the planning process in relation to the perceived level of risk to the consolidated organization or any state member bank subsidiary. Reviews of any specialty areas can be performed in conjunction with the annual full-scope inspection, or through targeted examinations or inspections, at any time during the supervisory cycle. The findings of all specialty reviews should be included in the inspection report for the consolidated organization.

2124.01.2 COORDINATION OF SUPERVISORY ACTIVITIES

Many large, complex institutions have interstate operations that expand with the continuation of mergers and acquisitions. In this environment, close cooperation with the other federal and state banking agencies is critical. To facilitate coordination between the Federal Reserve and other regulators, district Reserve Banks have been assigned roles and responsibilities that reflect their status as either the responsible Reserve Bank (RRB) with the CPC or the local Reserve Bank (LRB).

2124.01.2.1 Responsible Reserve Bank

The RRB facilitates the increased flexibility, planning, and coordination needed to effectively and efficiently supervise institutions with interstate operations. Considering the overriding objectives of seamless, risk-focused supervision, the RRB is responsible for designating the CPC and for ensuring that all aspects of the supervisory process are fully coordinated with LRBs and home-state supervisors.

To the extent possible, the RRB should rely on LRBs to provide the resources to conduct inspections/examinations of out-of-district subsidiaries of a parent organization, its state member bank subsidiaries, or the out-of-district offices of FBOs. Close coordination among the Reserve Banks and other appropriate regulators for each organization is critical to ensure a consistent, risk-focused approach to supervision. For further guidance, see sections 5000.0.7.5 or SR-93-48, section 5000.0.7.4 or SR-89-25, and SR-78-464.

2124.01.2.2 Local Reserve Banks

In general, LRBs are responsible for the direct supervision of institutions (including state member banks and bank holding companies) that are under Federal Reserve System supervision and are located in their district. The LRB provides the resources to the RRB to conduct the inspections of second-tier, domestic bank holding companies; nonbank subsidiaries; and branches and agencies of FBOs for top-tier holding companies located in the RRB's district. If the functional management of a banking organization is headquartered in its district, the LRB may also be called upon to conduct functional-business-line reviews. However, if a state member bank is owned by an out-of-district domestic holding company or if another Reserve Bank is responsible for the supervision of the overall U.S. operations of the FBO, the supervision of that entity should be coordinated by the RRB.

If the banking organization prefers to have supervisory contact with only one Reserve Bank, every effort should be made to centralize communication and coordination with the RRB for that organization. On the other hand, if the organization prefers more localized contact and communication, the coordination process can be adapted accordingly.

2124.01.2.3 Central Point of Contact

A CPC is critical to fulfilling the objectives of seamless, risk-focused supervision. The RRB should designate a CPC for each large, complex institution it supervises. Generally, all Federal Reserve System contacts, activities, and duties, as well as those with other supervisors, should be coordinated through this contact. The CPC should—

1. be knowledgeable, on an ongoing basis, about the institution's financial condition, management structure, strategic plan and direction, and overall operations;
2. remain up-to-date on the condition of the assigned institution and be knowledgeable regarding all supervisory activities, monitoring and surveillance information, applications issues, capital-markets activities, meetings with management, and enforcement issues, if applicable;

3. ensure that the objectives of seamless, risk-focused supervision are achieved for each institution and that the supervisory products (that is, an institutional overview, a risk matrix, a risk assessment, a supervisory plan, an inspection program, a scope memorandum, inspection modules, and an inspection report) are prepared in a timely manner;
4. ensure appropriate follow-up and tracking of supervisory concerns, corrective actions, or other matters which come to light through ongoing communications or surveillance; and
5. participate in the inspection/examination process, as needed, to (1) ensure consistency with the institution's supervisory plan and effective allocation of resources, including coordination of on-site efforts with specialty examination areas and other supervisors, as appropriate, and (2) to facilitate requests for information from the institution, wherever possible.

2124.01.2.4 Sharing of Information

To further promote seamless, risk-focused supervision, information related to a specific institution should be provided, as appropriate, to other interested supervisors. Sharing of these products with the institution, however, should be carefully evaluated on a case-by-case basis. The institutional overview, risk assessment, and supervisory plan may not be appropriate for release if they contain a hypothesis about an institution's risk rather than assessments verified through the inspection/examination process. On the other hand, it may be appropriate to share the inspection program with the institution in the interest of better coordination of activities.

2124.01.2.5 Coordination with Other Supervisors

Section 305 of the Riegle Community Development and Regulatory Improvement Act of 1994 directed the agencies to coordinate their examinations, to the extent possible, when they are jointly responsible for examination of various entities of a bank holding company.[6] To help achieve the desired degree of coordination, staffs of the agencies are expected, primarily at the regional level, to discuss examination plans and coordination issues. The institution involved is to be kept fully informed of the coordinated activities planned by the agencies, including a general timeframe in which each agency is expecting to conduct its examination activities.

6. In a December 1996 letter to the House Committee on Banking and Financial Services, the agencies outlined their cooperative efforts to meet the objectives of section 305.

2124.01.3 FUNCTIONAL APPROACH AND TARGETED INSPECTIONS

The framework for risk-focused supervision of large, complex institutions relies more heavily on a functional-business-line approach to supervising institutions, while effectively integrating the functional approach into the legal-entity assessment. Bank holding companies are increasingly being managed on a functional basis. Such functional management allows organizations to take advantage of the synergies among their components, to deliver better products to the market, and to provide higher returns to stockholders. Virtually all of the large bank holding companies operate as integrated units and are managed as such. For these companies, the risk-management systems are generally organized along business lines on a centralized basis. A key implication of this shift in management structure is that much of the information and insight gathered on inspections and examinations of individual legal entities can be fully understood only in the context of examination findings of other related legal entities or centralized functions. Developing that understanding means adapting some of the same functional-business-line approaches to supervision, including examination processes. Consequently, this risk-focused supervision framework incorporates risk assessments, that is, inspection and examination procedures that are organized by function.

The functional approach focuses principally on the key business activities (for example, lending, treasury, retail banking) rather than reviewing the legal entity and its balance sheet. This does not mean that the responsibility for a legal-entity assessment is ignored, nor should the Federal Reserve perform examinations of institutions for which other regulators have primary supervisory responsibility.[7] Rather, Fed-

7. With respect to U.S. banks owned by FBOs, it is particularly important to review the U.S. bank on a legal-entity basis and also the risk exposure to the U.S. bank from its parent foreign bank, as U.S. supervisory authorities do not supervise or regulate the parent bank.

eral Reserve examiners should integrate the findings of a functional review into the legal-entity assessment and coordinate closely with the primary regulator to gather sufficient information to form an assessment of the consolidated organization. Nonetheless, in some cases, effective supervision of the consolidated organization may require Federal Reserve examiners to perform process reviews and, possibly, transaction testing at all levels of the organization.

Functional-risk-focused supervision is to be achieved by the following actions:

1. Planning and conducting joint inspections and examinations with the primary regulator in areas of mutual interest, such as nondeposit investment products, interest-rate risk, liquidity, and mergers and acquisitions.
2. Leveraging off, or working from, the work performed by the primary regulator and the work performed by the institution's internal and external auditors by reviewing and using their workpapers and conclusions to avoid duplication of effort and to lessen the burden on the institution.
3. Reviewing inspection and examination reports and other communications to the institution that were issued by other supervisors.
4. Conducting a series of functional reviews or targeted inspections/examinations of business lines, relevant risk areas, or areas of significant supervisory concern during the supervisory cycle.[8] Functional reviews and targeted inspections/examinations are increasingly necessary to evaluate the relevant risk exposure of a large, complex institution and the effectiveness of related risk-management systems.

The relevant findings of functional reviews or targeted inspections and examinations should be handled as outlined below.

1. *Incorporated into the annual full-scope inspection.* In this context, a full-scope inspection involves the analysis of data sufficient to determine the safety and soundness of the institution and to assign supervisory ratings.

   The inspection/examination procedures required to arrive at those determinations do not necessarily have to be performed at the time of the annual inspection, but can be a product of the collective activities performed throughout the supervisory cycle. However, inspection procedures should contain follow-up on deficiencies noted in functional reviews or targeted inspections and examinations.
2. *Conveyed to the institution's management during a close-out or exit meeting with the relevant area's line management.* The need to communicate the findings to senior management or the board of directors is left to the judgment of Reserve Bank management based on the significance of the findings.
3. *Communicated in a formal written report to the institution's management or board of directors when significant weaknesses are detected or when the findings result in a downgrade of any rating component.* Otherwise, the vehicle for communicating the results is left to the judgment of the Reserve Bank's management and may either be a formal report or a supervisory letter.[9]

The functional approach to risk assessments and planning supervisory activities should include a review of the parent company and its significant nonbank subsidiaries. However, it is anticipated that the level of supervisory activities, on-site or off-site, will be appropriate to the risk profile of the parent company or its nonbank subsidiary in relation to the consolidated organization. Intercompany transactions should continue to be reviewed as part of the inspection procedures performed to ensure that they comply with laws and regulations and do not pose safety-and-soundness concerns.

2124.01.4 OVERVIEW OF THE PROCESS AND PRODUCTS

The risk-focused methodology for the supervi-

8. A supervisory cycle is the period of time from the close of one annual examination to the close of the following annual examination.

9. As discussed in SR-92-31, it is currently Federal Reserve System practice to update BOPEC ratings between inspections to keep them current and to ensure that they reflect the latest information on the institution's financial condition. For state member banks, current policy dictates that Reserve Banks refrain from revising CAMELS ratings based on off-site analysis in view of the emphasis being placed on the CAMELS ratings for implementing risk-based insurance assessments and other supervisory initiatives. In accordance with SR-96-26 (see section 5010.4), Reserve Banks should notify the institution's management whenever the rating is changed as a result of off-site analysis.

sion program for large, complex institutions reflects a continuous and dynamic process. As table 1 indicates, the methodology consists of six key steps, each of which uses certain written products to facilitate communication and coordination.

Table 1—Steps and Products Involved in the Risk-Focused Supervision Process

Steps	*Products**
1. Understanding the institution	1. Institutional overview
2. Assessing the institution's risk	2. Risk matrix 3. Risk assessment
3. Planning and scheduling supervisory activities	4. Supervisory plan 5. Inspection/examination program
4. Defining inspection activities	6. Scope memorandum 7. Entry letter
5. Performing inspection procedures	8. Functional-inspection modules
6. Reporting the findings	9. Inspection report(s)

* For examples of products 1 through 8, see the appendixes D through K of the Federal Reserve's handbook, "Framework for Risk-Focused Supervision of Large, Complex Institutions" referred to in SR-97-24. See also appendix B, the bank holding company nonbank subsidiary risk-assessment questionnaire, discussed in section 2124.01.1.3.2.

With the exception of the entry letter, the written products associated with steps one through four are designed to sharpen the supervisory focus on those business activities of an institution that pose the greatest risk, as well as to assess the adequacy of the institution's risk-management systems to identify, measure, monitor, and control risks. The products should be revised as new information is received from such sources as the current inspection, recent targeted inspections and examinations, and periodic reviews of regulatory reports.

The focus of the products should be on fully achieving a risk-focused, seamless, and coordinated supervisory process. The content and format of the products are flexible and should be adapted to correspond to the supervisory practices of the agencies involved and to the structure and complexity of the institution.

2124.01.5 UNDERSTANDING THE INSTITUTION

The starting point for risk-focused supervision is developing an understanding of the institution. This step is critical to tailoring the supervision program to meet the characteristics of the organization and to adjusting that program on an ongoing basis as circumstances change. It is also essential to clearly understand the Federal Reserve's supervisory role in relation to an institution and its affiliates. For example, the Federal Reserve's role pertaining to an FBO will vary depending on whether the Federal Reserve is the home- or host-country supervisor for the particular legal entity. Thus, planning and monitoring are key components.

Through increased emphasis on planning and monitoring, supervisory activities can focus on the significant risks to the institution and related supervisory concerns. Given the technological and market developments within the financial sector and the speed with which an institution's financial condition and risk profile can change, it is critical to keep abreast of events and changes in risk exposure and strategy. The CPC for each large, complex institution should continuously review certain information and prepare an institutional overview that will communicate the contact's understanding of that institution.

2124.01.5.1 Sources of Information

Information generated by the Federal Reserve, other supervisors, the institution, and public organizations may assist the CPC in forming and maintaining an ongoing understanding of the institution's risk profile and current condition. For example, the Federal Reserve maintains a significant amount of financial and structure information in various automated databases. In addition, prior inspection and examination reports are excellent sources of information regarding previously identified problems.

Each Reserve Bank has various surveillance reports that identify outliers when an institution is compared to its peer group. The Bank Holding Company Performance Report and Uniform Bank Performance Report may identify significant deviations in performance relative to the institutions' peer groups, currently and between the inspections and examinations of those institutions. For branches and agencies, state mem-

ber banks, and domestic bank holding companies that are part of FBOs, the strength-of-support assessment (SOSA) rating and relevant credit assessments from major rating agencies provide information that needs to be considered in developing an appropriate supervisory strategy. For FBOs, the Federal Reserve has developed automated systems that provide information on foreign financial systems, foreign accounting standards, and the financial performance of FBOs with U.S. operations.

Leveraging off the work, knowledge, and conclusions of other supervisors is of key importance to understanding a large, complex organization. Ongoing contact and the exchange of information with other supervisors who have responsibilities for a given institution may provide insight into the institution that cannot be obtained from other sources. Additional information can be obtained from examination reports issued by other supervisors and their databases, for example, the OCC's Supervisory Monitoring System (SMS) and the FDIC's Bank Information Tracking System (BITS).

Using information generated by the institution's management information system improves the supervisory process. It provides an efficient way to reduce on-site time, identify emerging trends, and remain informed about the activities of the institution and financial markets. Information that may be periodically reviewed by the contact includes the size and composition of intraday balance sheets, internal risk-ratings of loans, internal limits and current risk measures regarding trading activities, and internal limits and measures covering the institution's interest-rate and market risk. Additionally, functional-organization charts reflecting the major lines of business across legal entities, changes to the organization's strategic plan, and information provided to the board of directors and management committees should be reviewed.

The CPC should also hold periodic discussions with the institution's management to cover, among other topics, credit-market conditions, new products, divestitures, mergers and acquisitions, and the results of any recently completed internal and external audits. When other agencies have supervisory responsibilities for the organization, joint meetings should be considered.

Publicly available information may provide additional insight into an institution's condition. This may be particularly valuable in assessing an organization's ability to raise capital. Public sources of information include SEC reports, press releases, and analyses by private rating agencies and securities dealers and underwriters.

2124.01.5.2 Preparation of the Institutional Overview

The institutional overview should provide an executive summary that communicates, in one concise document, information demonstrating an understanding of the institution's present condition and its current and prospective risk profiles. The overview should also highlight key issues and past supervisory findings. General types of information that may be valuable to present in the overview are listed below.[10]

1. a brief description of the organizational structure (with comments on the legal and business units) and changes through merger, acquisition, divestitures, consolidation, or charter conversion since the prior review
2. a summary of the organization's business strategies, key business lines, product mix, marketing emphasis, growth areas, acquisition or divestiture plans, and new products introduced since the prior review
3. key issues for the organization, either from external or internal factors (for example, difficulties in keeping pace with competition or poorly performing business lines)
4. an overview of management, commenting on the level of board oversight, leadership strengths or weaknesses, policy formulation, and the adequacy of management information systems (Comments should include anticipated changes in key management, unusual turnover in line management, and management-succession plans. Key executives and the extent of their participation in strategic planning, policy formulation, and risk management may also be described.)
5. a brief analysis of the consolidated financial condition and trends, including earnings, invested capital, and return on investment by business line
6. a description of the future prospects of the organization, expectations or strategic forecasts for key performance areas, and budget projections

10. This list is provided in the context of institutions for which the Federal Reserve is the home-country supervisor. In the case of an FBO, the analysis should begin with the SOSA rating and the Summary of Condition of its U.S. operations. See SR-95-22 and also sections 2124.0.2.5 and 2127.0.

7. descriptions of internal and external audit, including the nature of any special work performed by external auditors during the period under review
8. a summary of supervisory activity performed since the last review, including safety-and-soundness inspections, examinations, and targeted or specialty inspections/examinations; supervisory actions and the institution's degree of compliance; and applications approved or in process
9. considerations for conducting future inspections, including the institution's preference for the coordination of specialty inspections/examinations and combined inspection and examination reports, as well as logistical and timing considerations, including conversion activities, space planning, and management availability

2124.01.6 ASSESSING THE INSTITUTION'S RISKS

In order to focus supervisory activities on the areas of greatest risk to an institution, the CPC or designated staff personnel should perform a risk assessment. The risk assessment highlights both the strengths and vulnerabilities of an institution and provides a foundation for determining the supervisory activities to be conducted. Further, the assessment should apply to the entire spectrum of risks facing an institution, including the following risks:

1. *credit risk,* which arises from the potential that a borrower or counterparty will fail to perform on an obligation
2. *market risk,* which is the risk to an institution's financial condition resulting from adverse movements in market rates or prices, such as interest rates, foreign-exchange rates, or equity prices
3. *liquidity risk,* which is the potential that an institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as ''funding-liquidity risk'') or because it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions (referred to as ''market-liquidity risk'')
4. *operational risk,* which arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses
5. *legal risk,* which arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a banking organization
6. *reputational risk,* which is the potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions

An institution's business activities present various combinations and concentrations of the above risks depending on the nature and scope of the particular activity. When conducting the risk assessment, consideration must be given to the institution's overall risk environment, the reliability of its internal risk management, the adequacy of its information technology systems, and the risks associated with each of its significant business activities. The preparation of the risk matrix provides a structured approach to assessing an institution's risks and is the basis for preparing the narrative risk assessment. See section 4070.1 and SR-95-51 for additional guidance on the evaluation of an institution's risk management.

2124.01.6.1 Assessment of the Overall Risk Environment

The starting point in the risk-assessment process is an evaluation of the institution's risk tolerance and of management's perception of the organization's strengths and weaknesses. Such an evaluation should entail discussions with management and a review of supporting documents, strategic plans, and policy statements. Management, in general, is expected to have a clear understanding of the institution's markets; the general banking, business, and economic environment; and how these factors affect the institution (in other words, their effect on the institution's use of technology, products, and delivery channels).

The institution should have a clearly defined risk-management structure. This structure may be formal or informal, centralized or decentralized. However, the greater the risk assumed by the institution, the more sophisticated its risk-management system should be. Regardless of the approach, the types and levels of risk an institution is willing to accept should reflect the

risk appetite determined by its board of directors.

2124.01.6.1.1 Internal-Risk-Management Evaluation

In assessing the overall risk environment, the CPC should make a preliminary evaluation of the institution's internal risk management. That includes an assessment of the adequacy of the institution's internal audit, loan-review, and compliance functions. External audits also provide important information regarding the risk profile and condition of the institution and may be used in the risk assessment. In completing this evaluation, Reserve Banks should consider holding meetings with the external auditor and senior management who are responsible for internal audit, loan review, and compliance, as well as with other key risk managers. As appropriate, the meetings should be held jointly with a representative from other supervisory agencies that have an interest in the institution.

In addition, the CPC or designated staff personnel should consider reviewing risk assessments developed by the internal audit department for significant lines of business, and then compare their results with the supervisory risk assessment. Further, the contact should consider evaluating management's ability to aggregate risks on a global basis. Examiners can use this preliminary evaluation to determine how much they can rely on the institution's internal risk management when developing their scope of inspection and examination activities.

2124.01.6.1.2 Adequacy of Information Technology Systems

Effective risk monitoring requires institutions to identify and measure all material risk exposures. Consequently, risk-monitoring activities must be supported by management information systems (MIS) that provide senior managers and directors with timely and reliable reports on the financial condition, operating performance, and risk exposure of the consolidated organization. Such systems must also provide managers engaged in the day-to-day management of the organization's activities with regular and sufficiently detailed reports for their areas of responsibility. Moreover, in most large, complex institutions, MIS not only provides reporting systems, but also supports a broad range of business decisions through sophisticated risk-management and decision tools, such as credit scoring and asset/liability models and automated trading systems. Accordingly, the institution's risk assessment must consider the adequacy of information technology systems.

Institutions need to determine which business unit or units are responsible for the development and operation of the information technology system. Traditionally, such systems were largely centered on mainframe computers. However, the development of increasingly powerful and inexpensive personal computers and sophisticated network communication capabilities has given institutions more timely access to a greater volume of information that supports a broader range of business decisions—moving some transaction processing out of the mainframe environment. Consequently, many large institutions are transferring responsibility for development and operation of the hardware (generally, a local area or wide area network) and the related operating systems and applications from a centralized, mainframe function to individual business units. Many of these institutions are also integrating the information technology audit function with the general internal-audit function.

Once it has been determined which business units are responsible for information technology, a fuller understanding of the risk profile of specific functions and of the consolidated organization can be gained through close coordination between information systems specialists and safety-and-soundness examiners. Since business managers must have MIS reports that are sufficient and appropriate for identifying risks, examiners must work with specialists to assess the adequacy of the information technology system and the extent to which it can be relied upon. Evaluating the integrity of the information contained in reports for business managers requires an understanding of the information flows and the control environment for the operation. Knowledge of the business application is essential to determine whether the information flows are complete, accurate, and appropriate in a particular MIS. In addition, such a determination requires an assessment of the extent to which the institution's internal audit function has procedures in place for reviewing and testing the effectiveness of the processes and internal controls related to information technology systems.

2124.01.6.2 Preparation of the Risk Matrix

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

2124.01.6.2.1 Identification of Significant Activities

Activities and their significance can be identified by reviewing information from the institution, the Reserve Bank, or other supervisors. Information generated by the institution may include the balance sheet, off-balance-sheet reports, the income statement, management accounting reports, or any other report that is prepared for the institution's board of directors and senior management to monitor performance. A detailed income statement is particularly informative because it reflects significant activities and their relative importance to the institution's revenue and net income. The income statement also yields information regarding the relationship between the return on individual assets and the inherent risk associated with these assets, providing an important indicator of the institution's overall risk appetite.

Off-site surveillance information is another source of information that can be used to identify new or expanding business activities. For example, substantial growth in the loan portfolio may indicate that the institution has introduced a new lending activity.

In addition to financial factors, information on strategic plans, new products, and possible management changes needs to be considered. The competitive climate in which the institution operates is very important and should be assessed in the identification of significant activities. Industry segmentation and the position the institution occupies within its markets should also be considered.

2124.01.6.2.2 Type and Level of Inherent Risk of Significant Activities

After the significant activities are identified, the type and level of risk inherent in those activities should be determined. Types of risk may be categorized according to section 4070.1.2 and SR-95-51, or by using categories defined either by the institution or other supervisory agencies. If the institution uses risk categories that differ from those defined by the supervisory agencies, the examiner should determine if all relevant types of risk are appropriately captured. If risks are appropriately captured by the institution, the examiner should use the categories identified by the institution.

Table 2 illustrates risk types as defined by the Federal Reserve and the OCC.[11] This table is designed to show the relationship between the respective agencies' risk categories.

Table 2—Types of Risk

Federal Reserve	*OCC*
Credit	Credit
Market	Price Interest rate Foreign exchange
Liquidity	Liquidity
Reputational	Reputation
Operational	Transaction
Legal	Compliance
	Strategic*

* Elements of strategic risk are reflected in each of the risk categories as defined by the Federal Reserve.

For the identified functions or activities, the inherent risk involved in that activity should be described as high, moderate, or low for each type of risk associated with it. For example, it may be determined that a portfolio of commercial loans in a particular institution has high credit risk, moderate market risk, moderate liquidity risk, low operational risk, low legal risk, and low reputational risk. The following definitions apply:

1. *High inherent risk* exists when (1) the activity is significant or positions are large in

11. The FDIC is considering its definition of risk types.

relation to the institution's resources or to its peer group, (2) there are a substantial number of transactions, or (3) the nature of the activity is inherently more complex than normal. Thus, the activity could potentially result in a significant and harmful loss to the organization.
2. *Moderate inherent risk* exists when (1) positions are average in relation to the institution's resources or to its peer group, (2) the volume of transactions is average, and (3) the activity is more typical or traditional. Thus, while the activity could potentially result in a loss to the organization, the loss could be absorbed by the organization in the normal course of business.
3. *Low inherent risk* exists when the volume, size, or nature of the activity is such that even if the internal controls have weaknesses, the risk of loss is remote or, if a loss were to occur, it would have little negative impact on the institution's overall financial condition.

It is important to remember that this assessment of risk is made without considering management processes and controls. Those factors are considered in evaluating the adequacy of the institution's risk-management systems.

2124.01.6.2.3 Risk-Management-Adequacy Assessment for Significant Activities

When assessing the adequacy of an institution's risk-management systems for identified functions or activities, the CPC or designated staff personnel should place primary consideration on findings related to the following key elements of a sound risk-management system:

1. active board and senior management oversight
2. adequate policies, procedures, and limits
3. adequate risk-management, -monitoring, and management information systems
4. comprehensive internal controls

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

1. *Strong risk management* indicates that management effectively identifies and controls all major types of risk posed by the relevant activity or function. The board and management participate in managing risk and ensure that appropriate policies and limits exist, which the board understands, reviews, and approves. Policies and limits are supported by risk-monitoring procedures, reports, and management information systems that provide the necessary information and analyses to make timely and appropriate responses to changing conditions. Internal controls and audit procedures are appropriate to the size and activities of the institution. There are few exceptions to established policies and procedures, and none of these exceptions would likely lead to a significant loss to the organization.
2. *Acceptable risk management* indicates that the institution's risk-management systems, although largely effective, may be lacking to some modest degree. It reflects an ability to cope successfully with existing and foreseeable exposure that may arise in carrying out the institution's business plan. While the institution may have some minor risk-management weaknesses, these problems have been recognized and are being addressed. Overall, board and senior management oversight, policies and limits, risk-monitoring procedures, reports, and management information systems are considered effective in maintaining a safe and sound institution. Risks are generally being controlled in a manner that does not require more than normal supervisory attention.
3. *Weak risk management* indicates risk-management systems that are lacking in important ways and, therefore, are a cause for more than normal supervisory attention. The internal control system may be lacking in important respects, particularly as indicated by continued control exceptions or by the failure to adhere to written policies and procedures. The deficiencies associated in these systems could have adverse effects on the safety and soundness of the institution or could lead to a material misstatement of its financial statements if corrective actions are not taken.

The definitions above apply to the risk management of individual functions or activities. They parallel the definitions set forth in section

4070.1.2 (SR-95-51) that examiners are to use to rate an institution's overall risk management. However, unlike the overall risk-management rating, the assessment of the adequacy of risk-management systems incorporated into the risk matrix is to be used primarily for planning supervisory activities. In addition, because the risk matrix is prepared during the planning process, it generally would not be appropriate to make fine gradations in the strength of risk-management systems on a function-by-function basis. In particular, for purposes of rating an institution's overall risk management, section 4070.1.2 (SR-95-51) makes distinctions in degrees of weakness—fair, marginal, and unsatisfactory—that generally cannot be made appropriately on a function-by-function basis, as called for when preparing the risk matrix. After appropriate inspection and examination procedures are performed, the assessment of the institution's risk management that was prepared for the risk matrix may be a starting point for assigning an overall risk-management rating for the institution.

2124.01.6.2.4 *Composite-Risk Assessment of Significant Activities*

The composite risk for each significant activity is determined by balancing the overall level of inherent risk of the activity with the overall strength of risk-management systems for that activity. For example, commercial real estate loans usually will be determined to be inherently high risk. However, the probability and the magnitude of possible loss may be reduced by having very conservative underwriting standards, effective credit administration, strong internal loan review, and a good early warning system. Consequently, after accounting for these mitigating factors, the overall risk profile and level of supervisory concern associated with commercial real estate loans may be moderate. Table 3 provides guidance on assessing the composite risk of an activity by balancing the observed quantity and degree of risk with the perceived strength of related management processes and internal controls.

To facilitate consistency in the preparation of the risk matrix, general definitions of the composite level of risk for significant activities are provided below.

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

Table 3—Composite Risk for Significant Activities

Risk-Management Systems	*Inherent Risk of the Activity*		
	Low	*Moderate*	*High*
	Composite-Risk Assessment		
Weak	Low or Moderate	Moderate or High	High
Acceptable	Low	Moderate	High
Strong	Low	Low or Moderate	Moderate or High

2124.01.6.2.5 Overall-Composite-Risk Assessment

Once the examiner has assessed the composite risk of each identified significant activity or function, an overall-composite-risk assessment should be made for off-site analytical and planning purposes. This assessment is the final step in the development of the risk matrix; the evaluation of the overall composite risk is incorporated into the written risk assessment.

2124.01.6.2.6 Preparation of the Risk Assessment

A written risk assessment should be prepared to serve as an internal supervisory planning tool and to facilitate communication with other supervisors. A sample risk assessment is provided below. The goal is to develop a document that presents a comprehensive, risk-focused view of the institution, which delineates the areas of supervisory concern and is a platform for developing the supervisory plan.

The format and content of the written risk assessment are flexible and should be tailored to the individual institution. The risk assessment reflects the dynamics of the institution and, therefore, should consider the institution's evolving business strategies and be amended as significant changes in the risk profile occur. It should include input from other affected supervisors and specialty units to ensure that all significant risks of the institution are identified. The risk assessment should—

1. include an overall risk assessment of the organization;
2. describe the types of risks (credit, market, liquidity, reputational, operational, legal), their level (high, moderate, low), and the direction (increasing, stable, decreasing) of risks;
3. identify all major functions, business lines, activities, products, and legal entities from which significant risks emanate and the key issues that could affect the risk profile;
4. consider the relationship between the likelihood of an adverse event and the potential impact on an institution (for example, the likelihood of a computer system failure may be remote, but the financial impact could be significant); and
5. describe the institution's risk-management systems. Reviews and risk assessments performed by internal and external auditors should be discussed, as should the ability of the institution to take on and manage risk prospectively.

The CPC should attempt to identify and report the cause of unfavorable trends, as well as their symptoms. Also, it is very important that the risk assessment reflect a thorough, detailed analysis that supports the conclusions made about the institution's risk profile.

2124.01.7 PLANNING AND SCHEDULING SUPERVISORY ACTIVITIES

The supervisory plan represents a bridge between the institution's risk assessment, which identifies significant risks and supervisory concerns, and the supervisory activities to be conducted. In developing the supervisory plan and inspection and examination schedules, the CPC should minimize disruption to the institution and, whenever possible, avoid duplicative inspection and examination efforts and requests for information from other supervisors.[12]

The institution's organizational structure and complexity represent significant considerations in planning the specific supervisory activities to be conducted. Additionally, interstate banking and branching activities have implications for planning on-site and off-site reviews. The scope and location of on-site work for interstate banking operations will depend on the significance and risk profile of local operations, the location of the supervised entity's major functions, and the degree of its centralization. Consistent with the Federal Reserve practice of not examining each branch of an intrastate branching network, the bulk of safety-and-soundness examinations for branches of an interstate bank would likely be conducted at the head office or regional offices, supplemented by periodic reviews of branch operations and internal controls. The supervisory plan should reflect the need to coordinate these reviews of branch operations with other supervisors.

12. See section 5000.0.8.3 and SR-93-30 and its attachments for guidance on examination coordination of holding company inspections with subsidiary bank and thrift examinations, and SR-95-22 regarding coordination with other agencies as part of the FBO supervision program.

2124.01.7.1 Preparation of the Supervisory Plan

A comprehensive supervisory plan[13] should be developed annually and updated as appropriate for the consolidated organization. The plan should demonstrate the supervisory concerns identified through the risk-assessment process and how the deficiencies noted in the previous inspection or examination are being or will be addressed. To the extent that the institution's risk-management systems are adequate, the level of supervisory activity may be adjusted. The plan should generally address the following areas:

1. All supervisory activities to be conducted, the scope of those activities (full or targeted), the objectives of those activities (for example, review of specific business lines, products, support functions, legal entities), and specific concerns regarding those activities, if any. Consideration should be given to—
   a. prioritizing supervisory resources on areas of higher risk,
   b. pooling examiner resources to reduce burden and redundancies,
   c. maximizing the use of examiners located where the activity is being conducted,
   d. coordinating examinations of different disciplines,
   e. determining compliance with, or the potential for, supervisory action, and
   f. balancing mandated requirements with the objectives of the plan.
2. General logistical information (for example, timetable of supervisory activities, participants, and expected resource requirements).
3. The extent to which internal and external audit, internal loan review, compliance, and other risk-management systems will be tested and relied upon.

The planning horizon to be covered by the plan is generally 18 months for domestic institutions.[14] The overall supervisory objectives and basic framework need to be outlined by midyear to facilitate preliminary discussions with other supervisors and to coincide with planning for the Federal Reserve's scheduling conferences. The plan should be finalized by the end of the year, for execution in the following year.

2124.01.7.2 Preparation of the Inspection/Examination Program

The inspection/examination program should provide a comprehensive schedule of inspection/examination activities for the entire organization and aid in the coordination and communication of responsibilities for supervisory activities. An inspection/examination program provides a comprehensive listing of all inspection and examination activities to be conducted at an institution for the given planning horizon. To prepare a complete program and to reflect the current conditions and activities of an institution and the activities of other supervisors, the CPC needs to be the focal point for communications on a particular institution, including any communications with the Federal Reserve and the institution's management and other supervisors. The inspection/examination program should generally incorporate the following logistical elements:

1. a schedule of activities, the duration of time, and resource estimates for planned projects
2. an identification of the agencies conducting and participating in the supervisory activity (when conducted jointly with other agencies, indicate the lead agency and the agency responsible for a particular activity) and the resources committed by all participants to the area(s) under review
3. the planned product for communicating findings (indicate whether it will be a formal report or supervisory memorandum)
4. the need for special examiner skills and the extent of participation by specialty disciplines

2124.01.8 DEFINING INSPECTION/EXAMINATION ACTIVITIES

The scope memorandum is an integral product in the risk-focused methodology. The memorandum identifies the key objectives of the on-site inspection or examination. The focus of on-site inspection or examination activities, as identified in the scope memorandum, should be oriented to a top-down approach that includes a

13. The supervisory plan is a high-level plan of supervisory activities to be conducted in monitoring the consolidated organization. More detailed procedures for a specific on-site inspection are appropriately addressed in a scope memorandum, which is discussed in section 2124.01.8.

14. The examination plans and assessments of condition of U.S. operations that are used for FBO supervision use a 12-month period.

review of the organization's internal risk-management systems and an appropriate level of transaction testing. The risk-focused methodology provides flexibility in the amount of on-site transaction testing. Although the focus of the inspection/examination is on the institution's processes, an appropriate level of transaction testing and asset review will be necessary to verify the integrity of internal systems. If internal systems are considered reliable, then transaction testing should be targeted to a level sufficient to validate that the systems are effective and accurate. Conversely, if internal management systems are deemed unreliable or ineffective, then transaction testing must be adjusted to increase the amount of coverage. The entry letter identifies the information necessary for the successful execution of the on-site inspection and/or examination procedures.

2124.01.8.1 Scope Memorandum

After the areas to be reviewed have been identified in the supervisory plan, a scope memorandum should be prepared that documents specific objectives for the projected inspection or examination. This document is of key importance, as the scope will likely vary from year to year. Thus, it is necessary to identify the specific areas chosen for review and the extent of those reviews. The scope memorandum will help ensure that the supervisory plan for the institution is executed and will define and communicate those specific objectives to the inspection/examination staff.

The scope memorandum should be tailored to the size, complexity, and current rating of the institution subject to review. For large but less complex institutions, the scope memorandum may be combined with the supervisory plan or risk assessment. The scope memorandum should generally include—

1. a statement of the objectives;
2. an overview of the activities and risks to be evaluated;
3. the level of reliance on internal risk-management systems and internal or external audit findings;
4. a description of the procedures that are to be performed, indicating any sampling process to be used and the level of transaction testing, when appropriate;
5. identification of the procedures that are expected to be performed off-site; and
6. a description of how the findings of targeted reviews, if any, will be used on the current inspection/examination.

2124.01.8.2 Entry Letter

Standardized entry inspection and examination letters[15] have been developed that are closely aligned with the risk-focused approach for large, complex institutions. They are designed to reduce the institutions' paperwork burden. The entry letters include a core section of required information that is pertinent to all large institutions, regardless of size or complexity. In addition to the core requests, supplementary questionnaires should be used as needed for the specialized areas such as asset securitization/sales, information systems, private banking, securities clearance/lending, trading activities, and transfer risk. The cover letters must be used (they can be modified), as they provide specific guidance to the inspected or examined institution.

The entry letters direct management to provide written responses to questions and to provide copies of specific documents requested, but only if the requested information is new or has changed since the previous examination or inspection. Examiners should not request management to provide them with copies of the institution's regulatory reports that are available within each Federal Reserve Bank or from other bank regulatory agencies, such as regulatory inspection and examination reports and various financial information (for example, annual reports or call reports). These reports should be gathered from internal sources during the preexamination planning process. Also, entry letters should not request information that is regularly provided to designated CPCs. The examiner-in-charge should always review anticipated information and document needs with the CPC for the inspected or examined institution before the mailing of any entry letter.

The entry letters should be used as a starting point, or template, in preparing for an examination or inspection. They should be tailored during the planning process to fit the specific character and profile of the institution to be inspected or examined and the scope of the

15. Such entry letters should be used for a (1) combined bank holding company inspection and lead state member bank examination, (2) bank holding company inspection (see appendix B), and (3) state member bank examination.

activities to be performed. Thus, the effective use of entry letters is highly dependent on the planning and scoping of a risk-focused inspection or examination.

The entry letters request internal management information reports for each of the key inspection/examination areas. Internal management reports should be used in all instances. If they do not provide sufficient information to inspect or examine the institution, then it would appear that management is not adequately informed—this may well be the first inspection or examination finding. As specific items are selected for inclusion in the entry letter, the following guidelines for items should be considered:

1. *Reflect risk-focused supervision objectives and the inspection/examination scope.* Items that are not needed to support selected inspection/examination procedures should not be requested.
2. *Facilitate efficiency in the inspection/examination process and lessen the burden on financial institutions.* Minimize the number of requested items and avoid, to the extent possible, duplicate requests for information already provided to other agencies.
3. *Limit, to the extent possible, requests for special management reports.*
4. *Eliminate items used for audit-type procedures.* Such procedures (for example, verifications) are generally performed only when there is a reason to suspect that significant problems exist.
5. *Distinguish information to be mailed to the examiner-in-charge for off-site inspection/examination procedures from information to be held at the institution for on-site procedures.* Information that is not easily reproduced should be reviewed on-site (for example, policies, corporate minutes, audit workpapers).
6. *Allow management sufficient lead time to prepare the requested information.*

2124.01.9 PERFORMING INSPECTION OR EXAMINATION PROCEDURES

Inspection or examination procedures should be tailored to the characteristics of each institution, keeping in mind its size, complexity, and risk profile. The procedures should focus on developing appropriate documentation to adequately assess management's ability to identify, measure, monitor, and control risks. Procedures should be completed to the degree necessary to determine whether the institution's management understands and adequately controls the levels and types of risks that are assumed. In terms of transaction testing, the volume of transactions tested should be adjusted according to management's ability to accurately identify problem and potential problem transactions and to measure, monitor, and control the institution's risk exposure. Likewise, the level of transaction testing for compliance with laws, regulations, and supervisory policy statements should take into account the effectiveness of management systems to monitor, evaluate, and ensure compliance.

Most full-scope inspections/examinations are expected to include the examiners' evaluation of 10 functional areas during the supervisory cycle. There may be a need to identify and include additional functional areas. To evaluate these functional areas, examiners must perform procedures tailored to fit (1) the risk assessment prepared for the institution and (2) the scope memorandum. These functional areas represent the primary business activities and functions of large, complex institutions, as well as common sources of significant risk to them. Further, consistent with the risk-focused approach, examiners are expected to evaluate other areas that are significant sources of risk to an institution or central to the assignment of CAMELS, BOPEC, and ROCA ratings. The identified functional areas include the following:

1. loan portfolio analysis (portfolio management, loan review, allowance for loan and lease losses)
2. Treasury activities (asset/liability management, interest-rate risk, parent company liquidity, funding, investments, deposits)
3. trading and capital-markets activities (foreign exchange, commodities, equities, and other interest-rate risk; credit risk; and liquidity risk)
4. audit and internal-control review
5. final assessment of supervisory ratings (CAMELS, BOPEC, ROCA, or other)
6. information systems
7. fiduciary activities
8. private banking
9. retail-banking activities (new products and delivery systems)
10. payments system risk (wire transfers, reserves, settlement)

2124.01.10 REPORTING THE FINDINGS

It is important for examiners to document their overall conclusions after performing the inspection/examination procedures. Conclusions, as they relate to the functional area under review, should clearly communicate the examiner's assessment of the internal risk-management system, the financial condition, and compliance with laws and regulations.

Inspection and examination activities should be coordinated with the respective state and other federal banking authorities, with joint examinations performed and joint inspection and examination reports completed wherever practicable. The inspection and examination activities should be planned over the supervisory cycle, culminating with an annual, full-scope inspection/examination of the organization. As part of the FBO supervision program, individual examination findings are integrated into an assessment of the FBO's entire U.S. operations.

The results of a targeted, subsidiary, or specialty inspection or examination are usually reported to the institution's management in a separate report or supervisory letter. Therefore, the report for the annual full-scope inspection of the consolidated parent organization should include a summary of the relevant results of any preceding supervisory activity. When targeted or specialty inspections or examinations of affiliates are conducted concurrently with the annual full-scope inspection of the consolidated parent organization, the findings from the targeted or specialty examinations should be incorporated into the parent's inspection report in lieu of separate reports, unless the institution's management requests separate reports. For organizations in which the lead bank is a state member bank, the annual full-scope examination report should be combined with the bank holding company inspection report, as appropriate. The bank holding company inspection report, or combined inspection/examination report, may also include other bank and nonbank subsidiary examinations, according to the organization's supervisory plan.

The contents of the report should clearly and concisely communicate to the institution's management or to the directorate any supervisory issues, problems, or concerns related to the institution, as well as disclose the assigned supervisory rating.[16] The report should also include appropriate comments regarding deficiencies noted in the institution's risk-management systems. Accordingly, the descriptions accompanying each component of the CAMELS rating system[17] should emphasize management's ability to identify, measure, monitor, and control risks. The rating assigned should reflect the adequacy of the institution's risk-management systems in light of the amount and types of risks that the institution has taken on.

16. See section 5010.4 and SR-96-26 for additional information.

17. See SR-96-38 for additional information on the revised CAMELS rating system.

2124.01.11 APPENDIX A—RISK-FOCUSED SUPERVISORY LETTERS WITH BHC SUPERVISION MANUAL SECTION NUMBERS

SR-Letter	*SR-Letter Title*	*BHCSM Section No.*
SR-00-15 (SUP)	Risk-Focused Supervision Policy for Small Shell BHCs	5000.0.4.5
SR-00-13 (SUP)	Framework for Financial Holding Company Supervision	3900.0
SR-99-37 (SUP)	Risk Management and Valuation of Retained Interests Arising from Securitization Activities	2128.06
SR-99-23 (SUP)	Recent Trends in Bank Lending Standards for Commercial Loans	2010.2.2 2010.10
SR-99-18 (SUP)	Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles	4070.3

SR-Letter	*SR-Letter Title*	*BHCSM Section No.*
SR-99-15 (SUP)	Risk-Focused Supervision of Large Complex Banking Organizations	2124.04
SR-99-6 (SUP)	Subprime Lending	2128.08
SR-99-3 (SUP)	Supervisory Guidance Regarding Counterparty Credit Risk Management	2126.3
SR-98-18 (SUP)	Lending Standards for Commercial Loans	2122.0
SR-98-12 (SUP)	FFIEC Policy Statement on Investment Securities and End-User Derivatives Activities	2126.1
SR-98-9 (SUP)	Assessment of Information Technology in the Risk-Focused Frameworks for the Supervision of Community Banks and Large Complex Banking Organizations	2124.1
SR-97-35 (SUP)	Interagency Guidance on the Internal-Audit Function and Its Outsourcing	2060.05
SR-97-24 (SUP)	Risk-Focused Framework for Supervision of Large Complex Institutions	2124.01
SR-97-21 (SUP)	Risk Management and Capital Adequacy of Exposures Arising from Secondary-Market Credit Activities	2129.05
SR-96-38 (SUP)	Uniform Financial Institution Rating System (CAMELS—adding the "S" for risk management)	4020.9 4070.0.4 4080.0
SR-96-33 (SUP)	State/Federal Protocol and Nationwide Supervisory Agreement	
SR-96-29 (SUP)	Supervisory Program for Risk-Based Inspection of Top 50 Bank Holding Companies	
SR-96-27 (SUP)	Guidance on Addressing Internal-Control Weaknesses in U.S. Branches and Agencies of Foreign Banking Organizations Through Special Audit Procedures	
SR-96-26 (SUP)	Provisions of Individual Components of the Rating System	5010.4
SR-96-17 (GEN)	Supervisory Guidance for Credit Derivatives	2129.0
SR-96-14 (SUP)	Risk-Focused Safety-and-Soundness Examination and Inspection	2124.0
SR-96-13 (SUP)	Joint Policy Statement on Interest-Rate Risk	2127.0
SR-96-10 (SPE)	Risk-Focused Fiduciary Examinations	
SR-95-51 (SUP)	Rating the Adequacy of Risk Management and Internal Controls at State Member Banks and Bank Holding Companies	4070.1
SR-95-17 (SUP)	Evaluating the Risk Management and Internal Controls of Securities and Derivative Contracts Used in Nontrading Activities	2126.0
SR-93-69 (FIS)	Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations	2125.0
SR-93-19 (FIS)	Supplemental Guidance for Inspection of Nonbank Subsidiaries of Bank Holding Companies	5000.0.4.4
SR-92-31 (FIS)	Administrative Procedures for Reporting Revised BOPEC Ratings	
SR-89-25 (FIS)	Multi-Tier Bank Holding Company Inspections	5000.0.7.5

2124.01.12 APPENDIX B—NONBANK SUBSIDIARY RISK-ASSESSMENT QUESTIONNAIRE

NONBANK SUBSIDIARY OF A BANK HOLDING COMPANY RISK-ASSESSMENT QUESTIONNAIRE

Name of subsidiary ________________________________

Name of bank holding company ________________________________

BHC Consolidated:
Tier 1 capital: $_____________ Total operating revenue*: $_____________

*Defined as the sum of total interest income and total non-interest income, before extraordinary items.

Subsidiary total assets: $________ Subsidiary total operating revenue: $________

Questions: *(Circle answer.)*

1. Are the subsidiary's total assets 10 percent or more of BHC consolidated tier 1 capital? Yes No

2. Is the subsidiary's total operating revenue 10 percent or more of BHC consolidated operating revenue? Yes No

3. Does the subsidiary issue debt to unaffiliated parties? Yes No

4. Does the subsidiary rely on affiliated banks for funding debt that is either greater than $10 million or 5 percent of BHC consolidated tier 1 capital? (See SR-93-19.) Yes No

5. Is the subsidiary involved in asset securitization? Yes No

6. Does the subsidiary generate assets and sell assets to affiliates? Yes No

7. Is the subsidiary a broker-dealer affiliate engaged in underwriting, dealing, or market making? Yes No

8. Does the subsidiary provide derivative instruments for sale or as a service to unaffiliated parties? Yes No

9. Has the subsidiary had a significant impact on the BHC's condition or performance? Yes No

If any question is answered yes, then this subsidiary should be considered for on-site review. If an on-site review is not being conducted, state the reason below.

Prepared by: ________________________________ Date: _____________

2124.01.13 APPENDIX C—FEDERAL RESERVE BANK COVER LETTER AND BHC INSPECTION QUESTIONNAIRE

Federal Reserve Bank
of San Francisco

Division of Banking Supervision and Regulation
San Francisco, California 94120

D.F. Roe
Senior Vice President
DEF BanCorp
Greentree Boulevard
Anytown, U.S.A. 11111

Dear Mr. Roe:

In order to facilitate an inspection of DEF BanCorp on a fully consolidated basis, you are requested to instruct the appropriate staff to provide the information described in this questionnaire. Unless indicated otherwise, information is requested as of the financial statement date December 31, 20X2. You are asked to provide written responses to questions and copies of specific documents requested in this questionnaire only if the requested information is new or has changed since the previous inspection, which was conducted as of December 31, 20X1 (indicate no change where applicable). For each area covered by this questionnaire, please provide the most recent reports used by management to identify, measure, monitor, and control risk in the respective areas. Please note that examiners may make additional requests during the inspection.

Single copies of all submissions in response to the requests will be satisfactory unless otherwise indicated and should be delivered to the examiner-in-charge or designee. Any requests for clarification or definition of terms should also be directed to the examiner-in-charge.

In order to expedite the inspection, each completed schedule and other requested information should be submitted as soon as prepared and should not be accumulated for submission as a package. Please respond to every item in the questionnaire, indicating N/A if a question is not applicable.

Most of the requested data will not be needed until the commencement of the inspection, which is March 15, 20X3. However, certain information may be needed earlier. Such information and the date due will be discussed with you.

______________________________	______________________________
Federal Reserve examiner-in-charge	Examiner's telephone number

FEDERAL RESERVE BANK
BANK HOLDING COMPANY INSPECTION QUESTIONNAIRE

Please provide the following:

Structure

1. The most recent organization chart—
   (a) for the holding company and its subsidiaries by legal entity, showing percentage of ownership if less than 100 percent; and
   (b) of management by legal entity and functional business lines, if different, indicating lines of authority and allocation of duties for all key business lines and support areas of the organization.
2. List new activities that the bank holding company or nonbank subsidiaries have engaged in since the previous inspection, either on- or off-balance-sheet, and identify the group responsible for the management of these activities. How has management identified and evaluated risk in relation to these new activities? Provide copies of any management reports regarding these products/activities. Please provide a copy of the company's risk policy statement regarding new activities.
3. The following on each new subsidiary formed or acquired since the prior inspection and changes, where applicable, on existing subsidiaries.
   (a) name
   (b) location
   (c) date acquired or formed
   (d) percentage of ownership
   (e) nature of business or business purpose
   (f) list of branch locations by city and state
   (g) balance sheet and income statement
   (h) off-balance-sheet, asset securitization, and derivatives activities and description of such
   (i) list of principal officers
   (j) management contact person
4. Since (date), has there been any change in or transfer of functions or responsibilities between the corporation and its subsidiaries and between subsidiaries and/or their affiliates? If so, describe fully.
5. Since (date), have there been any sales or other transfers of any assets among the corporation and its subsidiary banks, affiliates of the banks, and/or other subsidiaries? If so, describe fully and include details on loan participations purchased and sold.
6. Since (date), have any subsidiaries been deactivated, sold, liquidated, transferred, or disposed of in some other way? If so, identify the subsidiary, the reason for disposition, and the effective date of disposition.
7. Has the corporation planned or entered into any new agreements, written or oral, to acquire any additional entities? If so, give pertinent details, including name, location, type of business, and purchase terms.

Corporate Planning and Policy Information

8. The latest financial projections or business plan(s) for revenues, expenses, assets, liabilities, capital, and contingent liabilities for the current and next fiscal years. Please include details on the assumptions used in the preparation of the projections.
9. A copy of the strategic business plan with updates or revisions, if any.
10. If new or amended since the prior inspection, copies of policies for the following:
    (a) the level of supervision exercised over subsidiaries
    (b) loans and investments of subsidiaries
    (c) loan participations by and between subsidiaries
    (d) dividends and fees from subsidiaries
    (e) dividends paid to stockholders
    (f) budgeting and tax planning for subsidiaries
    (g) insider transactions
    (h) funds, asset-liability, and interest-rate risk management at the parent company and subsidiaries
    (i) risk identification, evaluation, and control (for example, any credit risks, market risks, liquidity risks, reputational risks, operational risks, and legal risks)
    (j) internal loan-review and -grading system
    (k) internal audit
    (*l*) any authorized outstanding commitments to the Federal Reserve
    (m) description of any routine tie-in arrangements that are used in providing or contracting for services

Corporate Financial Information

11. For the consolidated company, provide consolidating balance sheet and income statement, including schedules of eliminating entries.
12. Full details on unaffiliated borrowings of the consolidated organization. For debt issued since the prior inspection, please provide the prospectus for public-debt offerings and a summary of terms for private-debt placements.
13. A copy of the most current periodic financial package prepared for senior management and/or directors.

Subsidiary Information

14. Consolidating and consolidated balance sheets, including off-balance-sheet items, and income statements for each nonbank first-tier subsidiary.
15. Details of all capital injections made to subsidiaries or returns of capital from subsidiaries (excluding normal operating dividends) since the prior inspection. Also provide details on any advance to a subsidiary which has been reclassified as equity.
16. If subsidiary banks have made any extensions of credit to the bank holding company and/or other affiliates, give details.

17. Describe any services performed by the parent for any subsidiaries or any company in which it has a 5 percent or greater interest.

Parent Company

18. Details on intercompany payments either (1) from the parent company to affiliates or subsidiaries or (2) from subsidiaries or affiliates to the parent company. Segregate into dividends, interest, management or service fees, expense payments, or other transfers made since the prior inspection. If a payment is governed by an intercompany agreement, please provide a copy of the agreement. If not, please provide the basis of the payment made.
19. Internally generated cash-flow statement and liquidity schedule for the latest quarter ending. Make available supporting documentation. Provide access to the workpapers supporting the preparation of the Cash-Flow Schedule (schedule PI-A) from the Y-9LP report
20. Full details on new parent company's investments in or advances to subsidiaries, and extensions of credit to and borrowings from subsidiaries (including unused lines of credit) since the previous inspection.
21. Full details on the terms of any third-party borrowing and credit lines made available since the previous inspection.
22. If any entities (parent company and/or subsidiaries) maintain compensating balances with third parties, indicate restrictions, if any.
23. A copy of the contingency funding plan. If such a plan does not exist, please provide a description of what actions would be taken to meet disruptions in the corporation's short-term liability market.
24. Details on security and other investments held by type; par; book and market values; number of shares owned; interest rates; maturity dates; and convertibility features, where applicable. Include a copy of all investment authorization policies and delegations of authority pertaining thereto.
25. For equity investments or any lending activity, please provide a listing with comments on any significant items that may not be fully collectible and any other relevant factors.
26. A copy of the capital funding plan or planned changes in equity funding, a financial analysis of any changes in equity (including any stock redemptions), and any internal financial analysis used to evaluate capital adequacy.
27. Since the previous inspection, if the corporation has purchased or sold securities or other assets under an agreement to resell or repurchase, give details.
28. If the corporation has, for its own account, any incomplete purchases or sales of securities pending, give details.
29. If the parent corporation and/or any nonbank subsidiaries have loans outstanding that are secured by stock or any obligations of the corporation or any of its subsidiaries, give details.
30. Since the prior inspection, if the corporation, either for its own account or for others, has guaranteed the payment of any loan or other debt obligation or guaranteed the performance of any other undertaking, provide details.

Corporate-Debt-Markets Activities

31. The following information on commercial paper:
    (a) direct placements outstanding

  (b) dealer placements outstanding
  (c) monthly maturity schedules showing breakdown for direct and dealer placements
  (d) a copy of a "no action" letter, if the SEC has issued one

32. Identify any subsidiary which sells commercial paper for its own use or for its parent.
33. If any commercial paper, stock, and/or convertible debt of the corporation or its subsidiaries is held by trust departments of subsidiary banks, provide details.
34. If there are any concentrations of commercial paper holdings in excess of 10 percent of the outstanding commercial paper by any individual or organization, provide details.

Corporate Tax Information

35. If the corporation files a consolidated tax return, on what basis does it determine the amount of taxes to be paid by subsidiaries? Provide a copy of the tax-sharing agreement with subsidiaries.
36. A schedule detailing the following information for (specify dates)—
    (a) payments (estimated or otherwise) made by the corporate-tax-paying entity to the taxing authorities and the dates of such payments; and
    (b) payments received by the tax-paying entity from other holding company subsidiaries (or the tax benefits paid to those subsidiaries) and transaction dates.
37. Provide details of any ongoing IRS audit.

Officers, Directors, and Shareholders

38. For senior officers of the corporation, indicate their title, responsibility, and position(s) held at subsidiary and/or other organizations.
39. List of directors of the corporation, including—
    (a) number of shares owned directly and/or indirectly, and
    (b) occupation or principal business affiliation.
40. A brief biography of each senior officer appointed and director elected since the prior inspection. Please include the person's date of birth, business background, education, and affiliations with any outside organizations. For senior officers, indicate date of hire. For directors, indicate date of election to board.
41. List of board committees, their memberships, and frequency of meetings.
42. Make available board and committee minutes.
43. Details on fees paid to directors.
44. If the corporation has entered into any contracts or agreements to pay or provide additional sums or fringe benefits to any director, officer, or employee, provide cost and details.
45. Details on any stock option, incentive, bonus, or performance plans for officers and employees.
46. List of loans made by the parent company and/or nonbank subsidiaries to directors and executive officers (and their interests) of the parent company and/or subsidiaries. For the purpose of this request, a director's or executive officer's interest refers to a beneficial ownership, directly or indirectly, amounting to 25 percent or more and also to companies otherwise controlled by a director or officer.
47. List of investments of the parent and/or subsidiaries in stocks, bonds, or other obligations of

corporations in which directors and executive officers have a beneficial interest.

48. List of loans to any borrower that are secured by stocks, bonds, or other obligations of corporations in which directors and executive officers have a beneficial interest.
49. List of shareholders who own 5 percent or more of any class of voting stock and the percentage held.
50. List of loans made by the parent company and/or nonbank subsidiaries to shareholders who own 5 percent or more of the parent company's outstanding shares.

Asset Quality

51. A copy of the latest internal consolidated asset-quality tracking report with aggregate totals of internally criticized assets and off-balance-sheet items. Identify aggregate exposures by type, risk rating, and entity where the exposure is booked. Distinguish between direct and indirect extensions of credit.
52. Details on consolidated loans past due as to principal and/or interest, nonperforming loans and other real estate owned, and totals of such for each subsidiary.
53. A breakdown of the corporation's consolidated and major subsidiaries' loan-loss reserves (for example, the allowance for loan and lease losses), including portions earmarked for the commercial, consumer, and other segments, with a description of and supporting data for the methodology used in determining its adequacy.

Audit

(The following information should be requested only if the function resides within the parent company. If the function is performed at a nonmember lead bank subsidiary, then assess the audit function through discussions with the bank's primary regulator.)

54. A copy of the most recent engagement letters or equivalent information which describes the scope of external audit activities performed for the corporation and any of its nonbank subsidiaries. Make available a copy of the audit program.
55. An organization chart which shows the structure and staffing of the audit function.
56. The following information about the auditor and key assistants (if not provided at prior inspections):
    (a) present position and date assumed
    (b) date of employment
    (c) brief summary of education, experience at this institution, and prior work experience
57. Make available the audit timetable and audit program, workpapers, and procedures used in conducting audits of the parent company and all subsidiaries.

Miscellaneous

58. A summary schedule of fidelity bond and general liability insurance, listing all areas covered for loss/liability, and date of board approval.
59. Make available the corporation's latest pending litigation report describing any significant pending or potential litigation or investigations against the organization or any director, officer, or policy-making employee in their official capacity, with the following information:

(a) name(s) of plaintiff

(b) nature of claim and damages requested

(c) current status

(d) an opinion of the probable outcome, including an estimation of the organization's liability

The Federal Reserve's ongoing large, complex banking organization (LCBO) supervisory program is designed to recognize dramatic changes in the financial, technological, legal, and regulatory environment that necessitate a flexible supervisory framework. This includes the ongoing review and assessment of LCBO risk profiles and the continual adjustment of supervisory plans and programs for individual banking organizations (BOs). Environmental factors that have a significant impact on the nature of LCBO operations and the financial system include the following:

1. *Financial innovation and deregulation.* The range, volume, and complexity of traditional banking businesses have increased, and BOs have moved into nontraditional and potentially more complex financial activities and services, such as securitizations, securities underwriting and dealing, trading, derivatives, and other capital-markets activities.[1]
2. *Increasing competitive pressures.* The distinctions between financial products have blurred, and the competition in national and global markets between BOs, nonbank financial firms, and diversified financial-services conglomerates has intensified.
3. *Geographic expansion and globalization.* The continued expansion by BOs, both nationally and globally, and the integration of financial markets have increased the challenges associated with assessing and supervising the worldwide activities of U.S. BOs and the U.S. operations of foreign banking organizations.
4. *Revolution in information technology.* The dramatic changes in information and telecommunications technology have increased the speed, complexity, geographic scope, and volume of financial transactions, and have made possible new techniques for BOs to take on and manage risks.

These environmental factors have the potential for swift and dramatic changes in the risk profiles of LCBOs and can provide avenues for the more rapid transmission of financial shocks. Such developments in turn require supervisors to employ more continuous and risk-focused supervision processes. See SR-99-15, SR-97-24, and section 2124.01.

1. The term "banking organizations" refers to bank holding companies and their bank and nonbank subsidiaries.

2124.04.1 CONTINUED UNDERSTANDING OF AN LCBO AND ITS MAJOR RISKS

The process of maintaining a *current* understanding of an LCBO and its major risks relies heavily on gathering information from a wide variety of public and confidential sources, including supervisory reviews and evaluations and discussions with management and other supervisors. One of the primary objectives of this enhanced supervisory method is to generate a flow of meaningful information that continuously promotes a comprehensive understanding of the LCBO. This understanding should include its major business lines and strategies, the risks inherent in its business activities, and the quality and effectiveness of its risk-management systems. Maintaining an up-to-date understanding of an LCBO's risk profile reduces the time-consuming and burdensome discovery process associated with conducting on-site examinations. Similarly, this understanding can also facilitate timely and efficient processing of major regulatory applications, including acquisitions and mergers, and other requests from BOs. Publicly available information, internal management reports, discussions with management, regulatory reports, information from internal and external auditors, and information from other supervisors are examples of the sources that are used to develop and maintain a current understanding of the organization. It may be less burdensome for the BO if supervisors can access management reports electronically, so electronic access should be employed when and where feasible and appropriate.

It is important that the principal risk-focused supervisory tools and documents, including the overview, risk matrix, and risk assessment for the LCBO, remain current. Accordingly, the central point of contact (CPC) should regularly distill and incorporate significant new information into these documents *at least quarterly.* Factors such as emerging risks; new products; and significant changes in business strategy, management, condition, or ownership may warrant more frequent updates. In general, the more dynamic the LCBO's operations and risks, the more frequently the CPC should update the risk assessment, strategies, and plans.

2124.04.2 DESIGN AND EXECUTION OF A CURRENT SUPERVISORY PLAN

Effective risk-focused supervision requires the development and maintenance of a supervisory plan that is current and relevant to the organization's changing risk profile. In addition to addressing all key supervisory objectives, the supervisory plan should be individually tailored for each BO to reflect its particular organizational and operational structure, and, where appropriate, the activities of other principal or functional supervisors. The supervisory plan and attendant supervisory activities, including on-site examinations, inspections, and supervisory reviews, should be sufficiently robust to maintain an up-to-date and thorough understanding of the BO's operations and risks, as well as the quality of its risk-management systems.

Ongoing assessments of the LCBO's major risks (for example, credit, market, liquidity, operational, legal, and reputational risks) should be used to formulate, revise, and update the supervisory plan. The Federal Reserve's supervisory plan should endeavor to take into account (1) the nature and scope of major activities conducted by other regulators involved in the LCBO and (2) any actions necessary to address existing or emerging supervisory concerns, including follow-up on past supervisory issues. For BOs supervised by the Federal Reserve, a combination of full- and limited-scope examinations, inspections, targeted reviews, meetings with management, and analyses of public and supervisory information should be used to maintain an up-to-date risk assessment and to reduce unnecessary regulatory burden. The necessary level of transaction testing and the degree of reliance on sampling should be fully explained in the scope documents of the supervisory plan and should adequately address the types and level of risks in the organization's business lines. Instances in which efficiencies can be gained by relying on the work of other regulators, internal and external auditors, and the internal risk-management function should, where appropriate, be specified in the plan and incorporated in the supervisory program.

The CPC should review and revise the supervisory plan whenever necessary *(but in no case less frequently than quarterly)* to reflect any significant new information or emerging trends or risks. The supervisory plan and any revisions should be periodically discussed with representatives of the principal regulators of major affiliates to reconfirm agreement on the overall plan and to coordinate its implementation, when warranted.

2124.04.3 COMMUNICATION AND COORDINATION OF SUPERVISION IN DEVELOPING AND ADMINISTERING A SUPERVISORY PLAN

The communication process as described herein can serve as the basis for executing a comprehensive supervisory approach that capitalizes on the mandates and resources of the various supervisory authorities (for example, banking, securities, and insurance authorities), while minimizing possible duplication and burden on the BO. The objective is for supervisors to work cooperatively in developing supervisory plans and scope documents and, when possible and appropriate, to carry out important supervisory activities on a joint or coordinated basis. Coordination and communication among supervisors can reduce the burden on BOs and result in a more efficient deployment of supervisory resources.

An important element of the LCBO program is effective communication between the Federal Reserve and the BO's management throughout the supervision cycle. Communication with the LCBO can take various forms, including formal and informal meetings with management and the board of directors, and the issuance of periodic and annual supervisory reports, including examination/inspection reports, to the organization's management and board. The objective of these reports is to identify significant risks and summarize the Federal Reserve's view of the financial condition and effectiveness of the LCBO's risk-management processes.

As part of the LCBO program, the management of the BO should be encouraged to continue and, if warranted, strengthen communications with Reserve Bank management, CPCs, and the supervisory teams, particularly with respect to providing information to supervisors on a timely basis regarding material financial or operational issues or problems. BOs should also be encouraged to continuously review and enhance their public disclosures to promote transparency and foster effective market discipline. Also, if BOs promptly notify supervisors of emerging problems, they often can be resolved in a way that minimizes disruptions. Strong two-way communications and information flows between supervisors and the LCBO's senior management, including key business-line

and risk managers, are essential to the success of the LCBO program. In carrying out this program, the Federal Reserve will continue to attach the highest priority to information security and to protecting the integrity of sensitive, confidential supervisory and examination/inspection information.

The LCBO supervisory framework also requires that results and findings of supervisory activities conducted throughout the supervisory cycle be continually evaluated and reflected in the Federal Reserve's current understanding and assessment of the organization's risk profile. Reports of examination/inspection or letters to the LCBO's management and board of directors should routinely be prepared when examinations, inspections, and targeted reviews are completed. If necessary, the organization's supervisory ratings should be revised in a timely manner based on those findings.[2] Management and composite supervisory ratings should be adjusted appropriately if material weaknesses in risk-management systems or controls exist, even if these weaknesses have not yet affected the organization's reported financial results.

At least annually, a comprehensive summary supervisory report should be prepared that supports the organization's assigned ratings and encompasses the results of the entire supervisory cycle. This report should convey the Federal Reserve's view of the condition of the LCBO and its key risk-management processes, communicate the composite supervisory rating(s), discuss each of the major business risks, summarize the supervisory activities conducted during the supervisory cycle and the resulting findings, and assess the effectiveness of any corrective actions taken by the LCBO. This report will satisfy supervisory and legal requirements for a full-scope examination/inspection. Reserve Bank management, as well as Board officials, when warranted, will meet with the LCBO's board of directors to present and discuss the contents of the report and the Federal Reserve's assessment of the condition of the BO.

2124.04.3.1 Information Sharing and Coordination with Supervisory Authorities and External and Internal Auditors

Information sharing and coordination within the Federal Reserve and with supervisors of major affiliates are critical elements of the LCBO program and are essential to successful supervision of LCBOs. Most LCBOs, regardless of their business lines and functional management structure, operate through a variety of legal entities that may be under the jurisdiction of different licensing and supervisory authorities in the United States and abroad.

To maximize efficiency and reduce regulatory burden, the risk-assessment and supervisory-planning processes should use and leverage off, or benefit from, the efforts of other principal supervisors to the extent possible, consistent with achieving the Federal Reserve's key supervisory objectives. The Reserve Bank responsible for the supervision of the LCBO should have regular contacts with supervisors of important affiliates of the organization to discuss and coordinate matters of common interest, to develop supervisory plans, and, when and where appropriate, to coordinate the scheduling and conduct of examinations, inspections, and targeted reviews. Consistent with the supervisory needs and responsibilities of the Federal Reserve and the other supervisors, information may be exchanged as permitted by law, and in accordance with applicable rules and policies of the Board. In addition, meetings should be held at reasonable intervals with internal and external auditors to review audit plans, evaluate significant audit findings and other control assessments, and foster opportunities to leverage off the auditors' work. Building on the work of auditors, when and where appropriate, can enhance supervisory efficiency and reduce the regulatory burden on the LCBO.

2124.04.3.2 Enhanced Use of Information Technology

The Federal Reserve's supervisory approach for LCBOs continues to use enhanced information technology. Timely and user-friendly access to a full range of internal and third-party information, and mechanisms to foster collaboration among Federal Reserve staff and other supervisors are essential to effective risk-focused supervision for LCBOs. Effective and timely information flows, facilitated by the use of enhanced information technology, can provide a way for supervisors to "harvest" and share the core knowledge and experience gained through the conduct of supervisory activities and through ongoing contacts with BOs. Ready access to the

2. The supervisory ratings include the BOPEC, CAMELS, and an FBO's combined U.S. operations rating.

collective knowledge, insights, and current assessments of fellow supervisors, bank management, financial markets, and other relevant third parties can enhance the ability of supervisors to identify problems in a timely manner and formulate effective supervisory responses. To this end, the Federal Reserve System's information-sharing and information-technology strategies will continue to be aimed at broadening and strengthening the role of the CPCs, supervisory teams, and other System staff that are responsible for conducting and overseeing its supervisory programs, including the LCBO program.

2124.04.4 ORGANIZATION OF FEDERAL RESERVE SUPERVISORY TEAMS

A principal component of the supervisory framework is the assignment to each LCBO of a dedicated supervisory team, made up of individuals with specialized skills based on the organization's particular business lines and risk profile. This full-time, dedicated cadre will be supplemented, as necessary, by other specialized System staff, who will participate in examinations and targeted reviews.

In addition to designing and executing the supervisory strategy for an LCBO, the CPC has responsibility for managing the supervisory team. Important objectives in managing the supervision resources for a particular LCBO are to maximize institutional knowledge and minimize burden to the BO, while maintaining an objective, ongoing understanding of the BO's risk profile. The CPC serves as the Federal Reserve's primary day-to-day contact for a particular LCBO and has, together with other members of the Reserve Bank management team, primary responsibility for communicating with senior officials of the LCBO.

The supervisory team's major responsibilities are to maintain a high level of knowledge of the BO and to ensure that supervisory strategies and priorities are consistent with the identified risks and the LCBO's profile. The team should include supervisors with broad-based knowledge and experience in banking, as well as specialists whose technical skills and market knowledge bring depth and perspective to highly focused reviews of selected LCBO activities.

The Federal Reserve had adopted risk-focused supervision frameworks for community banks and large complex banking organizations, including foreign banking organizations. These frameworks incorporate a methodology to assess an organization's risks and business activities and to tailor supervisory activities to its risk profile. These frameworks aim to sharpen the focus of supervisory activities on areas that pose the greatest risk to the safety and soundness of banking organizations and on management processes to identify, measure, monitor, and control risks.[1]

The Federal Reserve recognizes that the use of information technology can greatly affect a banking organization's financial condition and operating performance.[2] With the increasing dependency of banking organizations on the use of information technology, the Federal Reserve expects an organization's management and board of directors to effectively manage the risks associated with information technology. Accordingly, examiners must consider the risks associated with information technology in their evaluations of an organization's significant business activities and assess the effectiveness of the risk-management process that the organization applies to information technology. See SR-98-09.

This section supplements further the guidance on the evaluation of banking organizations' risk-management processes. The primary objectives are to—

1. highlight the critical dependence of the financial services industry on information technology and its potential effect on safety and soundness,
2. reinforce the concept that the risk-focused supervisory process and related products (risk assessments, supervisory plans, and scope memoranda) for an organization must address the risks associated with its use of information technology,[3] and
3. provide a basic framework and a common vocabulary to evaluate the effectiveness of processes used to manage the risks associated with information technology.

2124.1.1 CHANGING ROLE OF INFORMATION TECHNOLOGY

As the automated processing of information has moved beyond centralized mainframe operations to encompass end-user computer and distributed processing systems, the use of information technology in general has expanded greatly. In the banking industry, information technology was once limited to automation of routine transactions and preparation of financial reports but is now used to automate all levels of a banking organization's operations and information processing. Some decision-making processes such as credit scoring and securities trading have been fully automated. New, complex financial products are possible largely because of valuation models that depend on technology. Moreover, technological advances in communications and connectivity have minimized geographic constraints within the industry.

While information technology enables banking organizations to carry out their activities more efficiently and effectively, information technology also can be a source of risk to the industry. The operational concerns associated with information processing, traditionally the domain of the "back office," have assumed critical importance during banking mergers and consolidations.

Banking organizations, recognizing the dependency of their operations and decision-making processes on information technology, have placed increased emphasis on the management of this important resource. In large banking organizations, the positions of the chief information officer and chief technology officer have become more visible in the top executive ranks of banking organizations. In addition, managers of activities that rely on end-user computing and distributed processing systems

1. The types of risk may be categorized according to those presented in the guidelines for rating risk management (that is, credit, market, liquidity, operational, legal, and reputational) or by categories defined by the institution or other supervisory agencies. If the institution uses risk categories that differ from those defined by the supervisory agencies, those categories may be used if all relevant types of risks are captured. See SR-95-51, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies."

2. Information technology refers to a business resource that is the combination of computers (hardware and software), telecommunications, and information.

3. The supervisory products are described in SR-97-24 for large complex institutions and SR-97-25 for community banks.

have been assigned more direct responsibility for the information technology used in conducting their business. As a result, the management of the risks associated with information technology must be evaluated for each significant business activity as well as for the overall organization.

Notwithstanding the move towards decentralized management of information technology, large centralized mainframe computer systems are still an integral part of the information technology on which many large banking organizations rely. This includes systems critical to the global payments system and to the transfer and custody of securities. Similarly, with the continued growth of outsourcing, many third-party information technology service centers also perform a vital role in the banking industry. Therefore, the review of the effectiveness and reliability of the critical mainframe systems and third-party processors will continue to be an important part of the Federal Reserve's supervisory activities.

2124.1.2 IMPLICATIONS FOR RISK-FOCUSED SUPERVISION

The risk-focused supervisory process is evolving and adapting to the changing role of information technology, with a greater emphasis being placed on an evaluation of information technology and an assessment of its effect on an organization's safety and soundness. Accordingly, examiners should explicitly consider information technology when developing their risk assessments and supervisory plans. It is expected that examiners will exercise appropriate judgment in determining the level of review, given the characteristics, size, and business activities of the organization. Moreover, to determine the scope of supervisory activities close coordination is needed between general safety-and-soundness examiners and information technology specialists during the risk assessment and planning, as well as during the on-site phase of the examination or inspection. In general, examiners should take the following actions:

1. Develop a broad understanding of the organization's approach, strategy, and structure with regard to information technology. This requires a determination of the role and importance of information technology to the organization and any unique characteristics or issues.
2. Incorporate an analysis of information technology systems into risk assessments, supervisory plans, and scope memoranda. The analysis should include identification of critical information technology systems, related management responsibility, and the major technology components.[4] An organization's information technology systems should be considered in relation to the size, activities, and complexity of the organization, as well as the degree of reliance on these systems.
3. Assess the organization's critical systems, that is, those that support its major business activities, and the degree of reliance those activities have on information technology systems. The level of review should be sufficient to determine that the systems are delivering the services necessary for the organization to conduct its business safely and soundly.
4. Determine whether the board of directors and senior management are adequately identifying, measuring, monitoring, and controlling the significant risks associated with information technology for the overall organization and its major business activities.

2124.1.3 FRAMEWORK FOR EVALUATING INFORMATION TECHNOLOGY

In order to provide a common terminology and consistent approach for evaluating the adequacy of an organization's information technology, five information technology elements are introduced and defined below. These elements may be used to evaluate the information technology processes at the functional business level or for the organization as a whole. They may also be applied to a variety of information technology management structures: centralized, decentralized, or outsourced.[5]

Although deficiencies in information technology appear to be most directly related to operational risk, information technology also can affect the other business risks (credit, market, liquidity, legal, and reputational) depending on

4. These components include mainframe, local area network, and personal computers, as well as software applications.

5. When banking organizations outsource operations, they delegate a certain level of responsibility and authority to an outside party (depending on the contractual arrangements). However, ultimate accountability remains with the banking organization.

the specific circumstances. Examiners should view the information technology elements in an integrated manner with the overall business risks of the organization or business activity; a deficiency in any one of the elements could have a substantive adverse effect on the organization's or activity's business risks. Moreover, the elements below do not replace or independently add to the business risks described in SR-95-51. Rather, these elements should be assessed in relation to all business risks.

The elements are to be used as a flexible tool to facilitate consideration and discussion of the risks associated with information technology. Where an organization uses different terminology to describe information technology elements, examiners may use that terminology provided the organization adequately addresses all elements. Regardless of the terminology employed, examiners should focus on those systems and issues that are considered critical to the organization.

The five information technology elements are described below:

1. *Management processes.* Management processes[6] encompass planning, investment, development, execution, and staffing of information technology from a corporate-wide and business-specific perspective. Management processes over information technology are effective when they are adequately and appropriately aligned with, and supportive of, the organization's mission and business objectives. Management processes include strategic planning, management and reporting hierarchy, management succession, and a regular independent review function. Examiners should determine if the information technology strategy for the business activity or organization is consistent with the organization's mission and business objectives and whether the information technology function has effective management processes to execute that strategy.
2. *Architecture.* Architecture[7] refers to the underlying design of an automated information system and its individual components. The underlying design encompasses both physical and logical architecture, including operating environments, as well as the organization of data. The individual components refer to network communications, hardware, and software, which includes operating systems, communications software, database management systems, programming languages, and desktop software. Effective architecture meets current and long-term organizational objectives, addresses capacity requirements to ensure that systems allow users to easily enter data at both normal and peak processing times, and provides satisfactory solutions to problems that arise when information is stored and processed in two or more systems that cannot be connected electronically. In assessing the adequacy of information technology architecture, examiners should consider the hardware's capability to run the software, the compatibility and integration with other systems and sources of data, the ability to upgrade to higher levels of performance and capacity, and the adequacy of controls.
3. *Integrity.* Integrity refers to the reliability, accuracy, and completeness of information delivered to the end-user. An information technology system has an effective level of integrity when the resulting information flows are accurate and complete. Insufficient integrity in an organization's systems could adversely affect day-to-day reliability, processing performance, input and output accuracy, and the ease of use of critical information. Examiners should review and consider whether the organization relies upon information system audits or independent application reviews to ensure the integrity of its systems. To assess the integrity of an organization's systems, examiners should review the reliability, accuracy, and completeness of information delivered.
4. *Security.* Security refers to the safety afforded to information assets and their data processing environments, using both physical and logical controls to achieve a level of protection commensurate with the value of the assets. Information technology has effective security when controls prevent unauthorized access; modification; destruction; or disclosure of information assets during their creation, transmission, processing, maintenance, or storage. Examiners should ensure that operating procedures and controls are commensurate with the potential for and risks associated with security breaches, which may be either physical or electronic, inadvertent or intentional, or internal or external.
5. *Availability.* Availability refers to the delivery of information to end-users. Information technology has effective availability when

6. Also referred to as "organization" or "strategic."
7. Sometimes referred to as "infrastructure."

information is consistently delivered on a timely basis in support of business and decision-making processes. In assessing the adequacy of availability, examiners should consider the capability of information technology to provide information from either primary or secondary sources to the end-users, as well as the ability of back-up systems, presented in contingency plans, to mitigate business disruption. Contingency plans should set out a process for an organization to restore or replace its information-processing resources, reconstruct its information assets, and resume its business activity from disruption caused by human error or intervention, natural disaster, or infrastructure failure (including the loss of utilities and communication lines and operational failure of hardware, software, and network communications).

Appendix A provides a table with examples of situations where deficiencies in information technology elements potentially have a negative effect on the business risks of an organization. The table also provides possible actions that an organization could take in these situations to mitigate its risks. The examples in this table are representative and should not be viewed as an exhaustive list of the risks associated with information technology.

2124.1.4 ALIGNING EXAMINER STAFFING WITH THE TECHNOLOGY ENVIRONMENT

While mainframe computer systems are still an integral part of the information technology for large organizations, information technology processes have become embedded in the various business activities of a banking organization—particularly with the increased use of local area network and personal computers. In contrast, many community and regional banks continue to rely on third-party information technology service centers. Given this variability of information technology environments, the level of technical expertise needed for a particular examination or inspection will vary and should be identified during its planning phase. For example, a specialist in information technology or the particular business activity may be the most appropriate person to review information technology integrity, while general safety-and-soundness examiners may be better suited to review management processes related to information technology. Development of the overall supervisory approach for an organization requires continuous collaboration between general safety-and-soundness examiners and information technology specialists. Accordingly, a discussion of information technology should be integrated into the supervisory process and products. That is, examiners should consider and comment on the risks associated with information technology when developing an understanding of an organization, assessing an organization's risks, and preparing a scope memorandum.

2124.1.5 INSPECTION OBJECTIVES

1. To assess the risks associated with information technology when developing the scope of supervisory plans and activities.
2. To consider the various risks associated with information technology along with the risk evaluation of the banking organization's business activities.
3. To assess the effectiveness of the risk-management process that the banking organization applies to information technology.
4. To view the banking organization's information technology elements in an integrated manner along with the overall business risks of the banking organization or its business activity, and ascertain if there are any deficiencies therein.

2124.1.6 INSPECTION PROCEDURES

1. Develop a broad understanding of the organization's approach, strategy, and structure with regard to information technology.
2. Incorporate an analysis of information technology systems into risk assessments, supervisory plans, and scope memoranda.
3. Assess the banking organization's critical systems and the degree of reliance those activities have on information technology systems.
4. Determine that the information systems are delivering the services necessary for the organization to conduct its business safely and soundly.
5. Determine if the board of directors or senior management has conducted an independent review, either by independent qualified staff or by an independent third-party consultant, of the current architecture, assessing the risks

associated with the institution's information technology. Did the review establish whether the organization's architecture had provided for—

a. current and long-term organizational objectives,
b. capacity requirements during normal and peak processing periods,
c. solutions when information is stored and processed in two or more separate systems,
d. the hardware's capability to run the software and its compatibility and integration with other systems and sources of data,
e. the ability to upgrade to higher levels of performance and capacity, and
f. the adequacy of controls.

6. Determine if the institution relies on information system audits or independent application reviews to determine whether information flows are accurate and complete.
7. Review, on a sample basis, the reliability, accuracy, and completeness of processed delivered information.
8. Determine whether the operating procedures and controls are commensurate with the potential for, and risks associated with, security breaches, which may be either physical or electronic, inadvertent or intentional, or internal or external.
9. Determine whether the board of directors and senior management are adequately identifying, measuring, monitoring, and controlling the significant risks associated with information technology for the overall banking organization and its major business activities.
10. After developing an understanding of the banking organization, assess and comment on the information technology risks and management in a scope memorandum.

2124.1.7 Appendix A—Examples of Information Technology Elements that Should Be Considered in Assessing Business Risks of Particular Situations

Situation	*IT elements to be considered*	*Potential effect on business risks*	*Risk mitigants*
A bank holding company expands very rapidly via acquisition into new product lines and geographic areas.	*Management processes.* Lack of clear, cohesive strategies could result in dependence on different systems that are incompatible and fragmented. *Integrity.* Unreliable information could be produced due to incompatible systems. *Availability.* Critical information may not be available to management when needed.	*Credit risk.* Exposure to less creditworthy borrowers may increase. *Liquidity risk.* Depositors may withdraw funds or close accounts due to unreliable account information. *Operational risk.* Controls may be inadequate to address the increase in manual interventions to correct incompatibility problems between affiliates' systems, leading to a greater potential for fraudulent transactions.	Develop a well-thought-out plan for integrating acquired systems, mapping data flows and sources, and ensuring reliability of systems.
A bank's consumer loan division inputs erroneous entries into the general-ledger system.	*Integrity.* Billing errors and unwarranted late-payment fees could occur due to the inaccurate loan information maintained by the system.	*Reputational risk.* Knowledge of errors could become widespread resulting in adverse public opinion. *Operational risk.* Increased expenditures may be required to resolve accounting operations problems. *Legal risk.* Litigation could arise because of errors in customer accounts due to processing deficiencies.	Improve policies and procedures related to input of accounting entries. Ensure internal audit considers system aspects of accounting operations.
Substantial turnover occurs in bank's wire-transfer department.	*Security.* Security procedures could be compromised due to inadequate training and lack of qualified personnel. *Integrity.* System may not be able to provide "real-time" funds availability.	*Operational risk.* Financial losses could occur due to fraud or incorrectly sent wire transfers. *Legal risk.* Litigation could arise as a result of errors in customer accounts and fraudulent wire transfers. *Reputational risk.* Knowledge of fraudulent or erroneous wire operations could result in adverse public opinion.	Increase and strengthen procedural and access controls for wire operations. Implement security measures such as passwords and firewalls. Develop and monitor appropriate audit trails. Provide for adequate training program and staffing levels.

Trading Activities of Banking Organizations (Risk Management and Internal Controls)[1] Section 2125.0

The review of risk management and internal controls is an essential element of the inspection or examination of trading activities. In view of the increasing importance of these activities to the overall risk profile and profitability of certain banking organizations,[2] this guidance highlights key considerations when inspecting or examining the risk management and internal controls of trading activities in both cash and derivative instruments.[3]

The principles set forth in this guidance apply to the risk management practices of bank holding companies, which should manage and control aggregate risk exposures on a consolidated basis while recognizing legal distinctions among subsidiaries. This guidance is specifically designed to target trading, market making, and customer accommodation activities in cash and derivative instruments at state member banks, branches and agencies of foreign banks, and Edge corporations. Many of the principles advanced can also be applied to banking organizations' use of derivatives as end-users. Examiners should assess management's application of this guidance to the holding company and to a banking organization's end-user derivative activities where appropriate, given the nature of the organization's activities and current accounting standards.

This examiner guidance is specifically provided for evaluating the following elements of an organization's risk management process for trading and derivatives activities:

- Board of directors and management oversight
- The measurement procedures, limit systems, and monitoring and review functions of the risk management process
- Internal controls and audit procedures

In assessing the adequacy of these elements at individual institutions, examiners should consider the nature and volume of a banking organization's activities and its overall approach toward managing the various types of risks involved. As with the inspection of other activities, examiner judgment plays a key role in assessing the adequacy and necessary sophistication of a banking organization's risk management system for cash and derivative instrument trading and hedging activities.

Many of the managerial practices and examiner procedures contained in this guidance are fundamental and are generally accepted as sound banking practices for both trading and nontrading activities. However, other elements may be subject to change, as both supervisory and bank operating standards evolve in response to new technologies, financial innovations, and developments in market and business practices.

2125.0.1 OVERSIGHT OF THE RISK MANAGEMENT PROCESS

As is standard practice for most banking activities, banking organizations should maintain written policies and procedures that clearly outline the organization's risk management guidance for trading and derivative activities. At a minimum these policies should identify the risk tolerances of the board of directors and should clearly delineate lines of authority and responsibility for managing the risk of these activities. Individuals throughout the trading and derivatives areas should be fully aware of all policies and procedures that relate to their specific duties.

The board of directors, senior-level management, and members of independent risk management functions are all important participants in the risk management process. Examiners should ensure that these participants are aware of their responsibilities and that they adequately perform their appropriate role in managing the risk of trading and derivative activities.

2125.0.1.1 Board of Directors' Approval of Risk Management Policies

The board of directors should approve all significant policies relating to the management of risks throughout the organization. These policies, which should include those related to trading activities, should be consistent with the organization's broader business strategies, capital adequacy, expertise, and overall willingness

1. The following is the text of SR-93-69, adapted for this manual. Section numbers have been added for reference.

2. The term ''banking organizations'' refers to institutions or entities that are directly supervised by the Board of Governors of the Federal Reserve System, such as state member banks and bank holding companies, including the nonbank subsidiaries of the holding company.

3. In general terms, derivative instruments are bilateral contracts or agreements whose value derives from the value of one or more underlying assets, interest rates, exchange rates, commodities, or financial or commodity indexes.

to take risk. Accordingly, the board should be informed regularly of risk exposure and should regularly reevaluate significant risk management policies and procedures with special emphasis placed on those defining the institution's risk tolerance regarding these activities. The board of directors should also conduct and encourage discussions between its members and senior management, as well as between senior management and others in the organization, regarding its risk management process and risk exposure.

2125.0.1.2 Senior Management's Risk Management Responsibilities

Senior management is responsible for ensuring that there are adequate policies and procedures for conducting trading operations on both a long-range and day-to-day basis. This responsibility includes ensuring that there are clear delineations of lines of responsibility for managing risk, adequate systems for measuring risk, appropriately structured limits on risk taking, effective internal controls, and a comprehensive risk-reporting process.

Senior management should regularly evaluate the procedures in place to manage risk to ensure that those procedures are appropriate and sound. Senior management should also foster and participate in active discussions with the board, with staff of risk management functions, and with traders regarding procedures for measuring and managing risk. Management must also ensure that trading and derivative activities are allocated sufficient resources and staff to manage and control risks.

2125.0.1.3 Independent Risk Management Functions

The process of measuring, monitoring, and controlling risk consistent with the established policies and procedures should be managed independently of individuals conducting trading activities, up through senior levels of the institution. An independent system for reporting exposures to both senior-level management and to the board of directors is an important element of this process.

Banking organizations should have highly qualified personnel throughout their trading and derivatives areas, including their risk management and internal control functions. The personnel staffing independent risk management functions should have a complete understanding of the risks associated with all traded on- and off-balance-sheet instruments. Accordingly, compensation policies for these individuals should be adequate to attract and retain personnel qualified to judge these risks. As a matter of general policy, compensation policies, especially in the risk management, control, and senior management functions, should be structured in a way that avoids the potential incentives for excessive risk taking that can occur if, for example, salaries are tied too closely to the profitability of trading or derivatives activities.

2125.0.2 THE RISK MANAGEMENT PROCESS

The primary components of a sound risk management process are a comprehensive risk measurement approach; a detailed structure of limits, guidelines, and other parameters used to govern risk taking; and a strong management information system for monitoring and reporting risks. These components are fundamental to both trading and nontrading activities alike. Moreover, the underlying risks associated with these activities, such as credit, market, liquidity, and operating risk, are not new to banking organizations, although their measurement and management can be somewhat more complex. Accordingly, the process of risk management for trading activities should be integrated into the organization's overall risk management system to the fullest extent possible using a conceptual framework common to its other activities. Such a common framework enables the organization to manage its consolidated risk exposure more effectively, especially since the various individual risks involved in trading activities can, at times, be interconnected and can often transcend specific markets.

As is the case with all risk-bearing activities, the risk exposures a banking organization assumes in its trading and derivatives activities should be fully supported by an adequate capital position. Banking organizations should ensure that their capital positions are sufficiently strong to support all trading and derivatives risks on a fully consolidated basis and that adequate capital is maintained in all affiliated entities engaged in these activities.

2125.0.2.1 Risk Measurement Systems

A banking organization's system for measuring

the various risks of trading and derivatives activities should be both comprehensive and accurate. Risks should be measured and aggregated across trading and nontrading activities on an organizationwide basis to the fullest extent possible.

While examiners should not require the use of a single prescribed risk measurement approach for management purposes, they should evaluate the extent to which the organization's procedures enable management to assess exposures on a consolidated basis. Examiners should also evaluate whether the risk measures and the risk measurement process are sufficiently robust to accurately reflect the multiple types of risks facing the banking organization. Risk measurement standards should be understood by relevant personnel at all levels—from individual traders to the board of directors—and should provide a common framework for limiting and monitoring risk-taking activities.

The process of marking trading and derivatives positions to market is fundamental to measuring and reporting exposures accurately and on a timely basis. Banking organizations active in dealing in foreign exchange, derivatives, and other traded instruments should have the ability to monitor credit exposures, trading positions, and market movements at least daily. Some organizations should also have the capacity, or at least the goal, of monitoring their more actively traded products on a real-time basis.

Analyzing stress situations, including combinations of market events that could affect the banking organization, is also an important aspect of risk measurement. Sound risk measurement practices include identifying possible events or changes in market behavior that could have unfavorable effects on the organization and assessing its ability to withstand them. These analyses should consider not only the likelihood of adverse events, reflecting their probability, but also plausible "worst-case" scenarios. Ideally, such worst-case analysis should be conducted on an organizationwide basis by taking into account the effect of unusual price changes or the default of a large counterparty across both the derivatives and cash-trading portfolios and the loan and funding portfolios.

Such stress tests should not be limited to quantitative exercises that compute potential losses or gains. They should also include more qualitative analyses of the actions management might take under particular scenarios. Contingency plans outlining operating procedures and lines of communication, both formal and informal, are important products of such qualitative analyses.

2125.0.2.2 Limiting Risks

A sound system of integrated organizationwide limits and risk-taking guidelines is an essential component of the risk management process. Such a system should set boundaries for organizational risk-taking and should also ensure that positions that exceed certain predetermined levels receive prompt management attention, so that they can be either reduced or prudently addressed. The limit system should be consistent with the effectiveness of the organization's overall risk management process and with the adequacy of its capital position. An appropriate limit system should permit management to control exposures, to initiate discussion about opportunities and risks, and to monitor actual risk-taking against predetermined tolerances, as determined by the board of directors and senior management.

Global limits should be set for each major type of risk involved. These limits should be consistent with the banking organization's overall risk measurement approach and should be integrated to the fullest extent possible with organizationwide limits on those risks as they arise in all other activities of the firm. The limit system should provide the capability to allocate limits down to individual business units.

At times, especially when markets are volatile, traders may exceed their limits. While such exceptions may occur, they should be made known to senior management and approved only by authorized personnel. These positions should also prompt discussions between traders and management about the consolidated risk-taking activities of the firm or the trading unit. The seriousness of individual or continued limit exceptions depends in large part upon management's approach toward setting limits and on the actual size of individual and organizational limits relative to the organization's capacity to take risk. Banking organizations with relatively conservative limits may encounter more exceptions to those limits than do organizations where limits may be less restrictive. Ultimately, examiners should ensure that stated policies are enforced and that the level of exposure is managed prudently.

2125.0.2.3 Reporting

An accurate, informative, and timely management information system is essential to the pru-

dent operation of a trading or derivatives activity. Accordingly, the examiner's assessment of the quality of the management information system is an important factor in the overall evaluation of the risk management process. Examiners should determine the extent to which the risk management function monitors and reports its measures of trading risks to appropriate levels of senior management and to the board of directors. Exposures and profit and loss statements should be reported at least daily to managers who supervise but do not, themselves, conduct trading activities. More frequent reports should be made as market conditions dictate. Reports to other levels of senior management and the board may occur less frequently, but examiners should determine whether the frequency of reporting provides these individuals with adequate information to judge the changing nature of the organization's risk profile.

Examiners should ensure that the management information systems translate the measured risk from a technical and quantitative format to one that can be easily read and understood by senior managers and directors, who may not have specialized and technical knowledge of trading activities and derivative products. Risk exposures arising from various products within the trading function should be reported to senior managers and directors using a common conceptual framework for measuring and limiting risks.

2125.0.2.4 Management Evaluation and Review of the Risk Management Process

Management should ensure that the various components of an organization's risk management process are regularly reviewed and evaluated. This review should take into account changes in the activities of the organization and in the market environment, since the changes may have created exposures that require additional management and examiner attention. Any material changes to the risk management system should also be reviewed.

The independent risk management functions should regularly assess the methodologies, models, and assumptions used to measure risk and to limit exposures. Proper documentation of these elements of the risk measurement system is essential for conducting meaningful reviews. The review of limit structures should compare limits to actual exposures and should also consider whether existing measures of exposure and limits are appropriate in view of the banking organization's past performance and current capital position.

The frequency and extent to which banking organizations should reevaluate their risk measurement methodologies and models depends, in part, on the specific risk exposures created by their trading activities, on the pace and nature of market changes, and on the pace of innovation with respect to measuring and managing risks. At a minimum, banking organizations with significant trading and derivative activities should review the underlying methodologies of their models at least annually—and more often as market conditions dictate—to ensure they are appropriate and consistent. Such internal evaluations may, in many cases, be supplemented by reviews by external auditors or other qualified outside parties, such as consultants who have expertise with highly technical models and risk management techniques. Assumptions should be evaluated on a continual basis.

Banking organizations should also have an effective process to evaluate and review the risks involved in products that are either new to the firm or new to the marketplace and of potential interest to the firm. In general, a banking organization should not trade a product until senior management and all relevant personnel (including those in risk management, internal control, legal, accounting, and auditing) understand the product and are able to integrate the product into the banking organization's risk measurement and control systems. Examiners should determine whether the banking organization has a formal process for reviewing new products and whether it introduces new products in a manner that adequately limits potential losses.

2125.0.2.5 Managing Specific Risks

The following discussions present examiner guidance for evaluating the specific components of a firm's risk management process in the context of each of the risks involved in trading cash and derivatives instruments.

2125.0.2.5.1 Credit Risk

Broadly defined, credit risk is the risk that a counterparty will fail to perform on an obligation to the banking organization. Banking organizations should evaluate both settlement and

presettlement credit risk at the customer level across all traded derivative and nonderivative products. On settlement day, the exposure to counterparty default may equal the full value of any cash flows or securities the banking organization is to receive. Prior to settlement, credit risk is measured as the sum of the replacement cost of the position, plus an estimate of the banking organization's potential future exposure from the instrument as a result of market changes. Replacement cost should be determined using current market prices or generally accepted approaches for estimating the present value of future payments required under each contract, given current market conditions.

Potential credit-risk exposure is measured more subjectively than current exposure and is primarily a function of the time remaining to maturity and the expected volatility of the price, rate, or index underlying the contract. It is often assessed through simulation analysis and option-valuation models, but can also be addressed by using "add-ons," such as those included in the risk-based capital standard. In either case, examiners should evaluate the reasonableness of the assumptions underlying the banking organization's risk measure and should also ensure that banking organizations that measure exposures using a portfolio approach do so in a prudent manner.

Master netting agreements and various credit enhancements, such as collateral or third-party guarantees, can be used by banking organizations to reduce their counterparty credit risk. In such cases, a banking organization's credit exposures should reflect these risk-reducing features only to the extent that the agreements and recourse provisions are legally enforceable in all relevant jurisdictions. This legal enforceability should extend to any insolvency proceedings of the counterparty. Banking organizations should be able to demonstrate that they have exercised due diligence in evaluating the enforceability of these contracts and that individual transactions have been executed in a manner that provides adequate protection.

Credit limits that consider both settlement and presettlement exposures should be established for all counterparties with whom the banking organization trades. As a matter of general policy, trading with a counterparty should not commence until a credit line has been approved. The structure of the credit-approval process may differ among organizations, reflecting the organizational and geographic structure of the organization and the specific needs of its trading activities. Nevertheless, in all cases, it is important that credit limits be determined by personnel who are independent of the trading function, that these personnel use standards that are consistent with those used for nontrading activities, and that counterparty credit lines are consistent with the organization's policies and consolidated exposures.

Examiners should consider the extent to which credit limits are exceeded and whether exceptions were resolved according to the banking organization's adopted policies and procedures. Examiners should also evaluate whether the organization's reports adequately provide traders and credit officers with relevant, accurate, and timely information about the credit exposures and approved credit lines.

Trading activities that involve cash instruments often involve short-term exposures that are eliminated at settlement. However, in the case of derivative products traded in over-the-counter markets, the exposure can often exist for a period similar to that commonly associated with a loan from a banking organization. Given this potentially longer-term exposure and the complexity associated with some derivative instruments, banking organizations should consider not only the overall financial strength of the counterparty and its ability to perform on its obligation, but should also consider the counterparty's ability to understand and manage the risks inherent in the derivative product.

2125.0.2.5.2 Market Risk

Market risk is the risk to a banking organization's financial condition resulting from adverse movements in market prices. Accurately measuring a banking organization's market risk requires timely information about the current market values of its assets, liabilities, and off-balance-sheet positions. Although there are many types of market risks that can affect a portfolio's value, they can generally be described as those involving forward risk and those involving options. Forward risks arise from factors such as changing interest rates and currency exchange rates, the liquidity of markets for specific commodities or financial instruments, and local or world political and economic events. Market risks related to options include these factors as well as evolving perceptions of the volatility of price changes, the passage of time, and the interactive effect of other market risks. All of these sources of potential market risk can affect the value of the organiza-

tion and should be considered in the risk measurement process.

Market risk is increasingly measured by market participants using a value-at-risk approach, which measures the potential gain or loss in a position, portfolio, or organization that is associated with a price movement of a given probability over a specified time horizon. Banking organizations should revalue all trading portfolios and calculate their exposures at least daily. Although banking organizations may use risk measures other than value at risk, examiners should consider whether the measure used is sufficiently accurate and rigorous and whether it is adequately incorporated into the banking organization's risk management process.

Examiners should also ensure that the organization compares its estimated market-risk exposures with actual market-price behavior. In particular, the output of any market-risk models that require simulations or forecasts of future prices should be compared with actual prices. If the projected and actual results differ materially, the models should be modified, as appropriate.

Banking organizations should establish limits for market risk that relate to their risk measures and that are consistent with maximum exposures authorized by their senior management and board of directors. These limits should be allocated to business units and individual traders and be clearly understood by all relevant parties. Examiners should ensure that exceptions to limits are detected and adequately addressed by management. In practice, some limit systems may include additional elements such as stop-loss limits and trading guidelines that may play an important role in controlling risk at the trader and business-unit level; examiners should include them in their review of the limit system.

2125.0.2.5.3 Liquidity Risk

Banking organizations face two types of liquidity risk in their trading activities: those related to specific products or markets and those related to the general funding of the banking organization's trading activities. The former is the risk that a banking organization cannot easily unwind or offset a particular position at or near the previous market price because of inadequate market depth or because of disruptions in the marketplace. Funding-liquidity risk is the risk that the banking organization will be unable to meet its payment obligations on settlement dates. Since neither type of liquidity risk is unique to trading activities, management should evaluate these risks in the broader context of the organization's overall liquidity. When establishing limits, organizations should be aware of the size, depth, and liquidity of the particular market and establish trading guidelines accordingly. Management should also give consideration to the potential problems associated with replacing contracts that terminate early in volatile or illiquid markets.

In developing guidelines for controlling the liquidity risks in trading activities, banking organizations should consider the possibility that they could lose access to one or more markets, either because of concerns about the banking organization's own creditworthiness, the creditworthiness of a major counterparty, or because of generally stressful market conditions. At such times, the banking organization may have less flexibility in managing its market-, credit-, and liquidity-risk exposures. Banking organizations that make markets in over-the-counter derivatives or that dynamically hedge their positions require constant access to financial markets, and that need may increase in times of market stress. The banking organization's liquidity plan should reflect the organization's ability to turn to alternative markets, such as futures or cash markets, or to provide sufficient collateral or other credit enhancements in order to continue trading under a broad range of scenarios.

Examiners should ensure that banking organizations that participate in over-the-counter derivative markets adequately consider the potential liquidity risks associated with the early termination of derivative contracts. Many forms of standardized contracts for derivative transactions allow counterparties to request collateral or to terminate their contracts early if the banking organization experiences an adverse credit event or a deterioration in its financial condition. In addition, under conditions of market stress, customers may ask for the early termination of some contracts within the context of the dealer's market-making activities. In such situations, a banking organization that owes money on derivative transactions may be required to deliver collateral or settle a contract early and possibly at a time when the banking organization may face other funding and liquidity pressures. Early terminations may also open up additional, unintended, market positions. Management and directors should be aware of these potential liquidity risks and should address them in the banking organization's liquidity plan and in the broader context of the

banking organization's liquidity management process. In their reviews, examiners should consider the extent to which such potential obligations could present liquidity risks to the banking organization.

2125.0.2.5.4 Operational Risk, Legal Risk, and Business Practices

Operating risk is the risk that deficiencies in information systems or internal controls will result in unexpected loss. Legal risk is the risk that contracts are not legally enforceable or documented correctly. Although operating and legal risks are difficult to quantify, they can often be evaluated by examining a series of plausible "worst-case" or "what-if" scenarios, such as a power loss, a doubling of transaction volume, a mistake found in the pricing software for collateral management, or an unenforceable contract. They can also be assessed through periodic reviews of procedures, documentation requirements, data processing systems, contingency plans, and other operating practices. Such reviews may help to reduce the likelihood of errors and breakdowns in controls, improve the control of risk and the effectiveness of the limit system, and prevent unsound marketing practices and the premature adoption of new products or lines of business. Considering the heavy reliance of trading activities on computerized systems, banking organizations should have plans that take into account potential problems with their normal processing procedures.

Banking organizations should also ensure that trades that are consummated orally are confirmed as soon as possible. Oral transactions conducted via telephone should be recorded on tape and subsequently supported by written documents. Examiners should ensure that the organization monitors the consistency between the terms of a transaction as they were orally agreed upon and the terms as they were subsequently confirmed.

Examiners should also consider the extent to which banking organizations evaluate and control operating risks through the use of internal audits, stress testing, contingency planning, and other managerial and analytical techniques. Banking organizations should also have approved policies that specify documentation requirements for trading activities and formal procedures for saving and safeguarding important documents that are consistent with legal requirements and internal policies. Relevant personnel should fully understand the requirements.

Legal risks should be limited and managed through policies developed by the organization's legal counsel (typically in consultation with officers in the risk management process) that have been approved by the banking organization's senior management and board of directors. At a minimum, there should be guidelines and processes in place to ensure the enforceability of counterparty agreements. Examiners should determine whether a banking organization is adequately evaluating the enforceability of its agreements before individual transactions are consummated. Banking organizations should also ensure that the counterparty has sufficient authority to enter into the transaction and that the terms of the agreement are legally sound. Banking organizations should further ascertain that their netting agreements are adequately documented, that they have been executed properly, and that they are enforceable in all relevant jurisdictions. Banking organizations should have knowledge of relevant tax laws and interpretations governing the use of these instruments. Knowledge of these laws is necessary not only for the banking organization's marketing activities, but also for its own use of derivative products.

Sound business practices provide that banking organizations take steps to ascertain the character and financial sophistication of counterparties. This includes efforts to ensure that the counterparties understand the nature of and the risks inherent in the agreed transactions. Where the counterparties are unsophisticated, either generally or with respect to a particular type of transaction, banking organizations should take additional steps to ensure that counterparties are made aware of the risks attendant in the specific type of transaction. While counterparties are ultimately responsible for the transactions into which they choose to enter, where a banking organization recommends specific transactions for an unsophisticated counterparty, the banking organization should ensure that it has adequate information regarding its counterparty on which to base its recommendation.

2125.0.3 INTERNAL CONTROLS AND AUDITS

A review of internal controls has long been central to the Federal Reserve's examination and inspection of trading and derivatives activities. Policies and related procedures for the operation of these activities should be an exten-

sion of the organization's overall structure of internal controls and should be fully integrated into routine work-flows. Properly structured, a system of internal controls should promote effective and efficient operations, reliable financial and regulatory reporting, and compliance with relevant laws, regulations, and banking organization policies. In determining whether internal controls meet those objectives, examiners should consider the overall control environment of the organization; the process for identifying, analyzing, and managing risk; the adequacy of management information systems; and adherence to control activities such as approvals, confirmations, and reconciliations.

Assessing the adequacy of internal controls involves a process of understanding, documenting, evaluating, and testing an organization's internal control system. This assessment should include product- or business-line reviews which, in turn, should start with an assessment of the line's organizational structure. Examiners should check for adequate separation of duties, especially between trading desk personnel and internal control and risk management functions, adequate oversight by a knowledgeable manager without day-to-day trading responsibilities, and the presence of separate reporting lines for risk management and internal control personnel on one side and for trading personnel on the other. Product-by-product reviews of management structure should supplement the overall assessment of the organizational structure of the trading and derivatives areas.

Examiners are expected to conduct in-depth reviews of the internal controls of key activities. For example, for transaction recording and processing, examiners should evaluate written policies and procedures for recording trades, assess the trading area's adherence to policy, and analyze the transaction processing cycle, including settlement, to ensure the integrity and accuracy of the banking organization's records and management reports. Examiners should review the revaluation process in order to assess the adequacy of written policies and procedures for revaluing positions and for creating any associated revaluation reserves. Examiners should review compliance with revaluation policies and procedures, the frequency of revaluation, and the independence and quality of the sources of revaluation prices, especially for instruments traded in illiquid markets. All significant internal controls associated with the management of market risk, such as position versus limit reports and limit overage approval policies and procedures, should also be reviewed. Examiners should also review the credit approval process to ensure that the risks of specific products are adequately captured and that credit approval procedures are followed for all transactions.

An important step in the process of reviewing internal controls is the examiner's appraisal of the frequency, scope, and findings of independent internal and external auditors and the ability of those auditors to review the banking organization's trading and derivatives activities. Internal auditors should audit and test the risk management process and internal controls on a periodic basis, with the frequency based on a careful risk assessment. The depth and frequency of internal audits should be increased if weaknesses and significant issues are discovered or if significant changes have been made to product lines, modeling methodologies, the risk oversight process, internal controls, or the overall risk profile of the organization.

In reviewing the risk management functions in particular, internal auditors should thoroughly evaluate the effectiveness of internal controls relevant to measuring, reporting, and limiting risks. Internal auditors should also evaluate compliance with risk limits and the reliability and timeliness of information reported to the banking organization's senior management and board of directors. Internal auditors are also expected to evaluate the independence and overall effectiveness of the banking organization's risk management functions.

The level of confidence that examiners place in the banking organization's audit programs, the nature of the audit findings, and management's response to those findings will influence the scope of the current examination of trading and derivatives activities. Even when the audit process and findings are satisfactory, examiners should document, evaluate, and test critical internal controls.

Similar to the focus of internal auditors, examiners should pay special attention to significant changes in product lines, risk measurement methodologies, limits, and internal controls that have occurred since the last examination. Meaningful changes in earnings from trading or derivatives activities, or in the size of positions or the value at risk associated with these activities, should also receive emphasis during the inspection or examination.

The following is the text of SR-95-17, adapted for this manual. Section numbers have been added for reference.

Section 2125.0, "Trading Activities of Banking Organizations (Risk Management and Internal Controls)," derived from SR-93-69, highlights the key elements of a sound risk-management process and emphasizes the importance of applying them to the trading and derivatives activities of banking institutions. It also provides examiners with guidance on evaluating the risk-management process and internal controls of trading activities. This section provides similar guidance on evaluating the risk-management practices used by banking institutions in acquiring and managing securities and off-balance-sheet (OBS) derivative contracts for "nontrading" purposes. Traditionally, these nontrading activities have been termed investment activities in the case of securities and end-user activities for OBS derivative contracts. Institutions should ensure that they employ sound risk-management practices consistently across these varying product categories regardless of legal characteristics or nomenclature.

2126.0.1 SCOPE OF NONTRADING ACTIVITIES AND GUIDANCE

This guidance specifically targets the risk-management practices of state member banks and Edge Act corporations engaged in banking. The basic principles also apply to bank holding companies, which should manage and control aggregate risk exposures on a consolidated basis, while recognizing legal distinctions and possible obstacles to cash movements among subsidiaries.[1] More generally, the principles advanced here set forth fundamental risk-management practices that are relevant to most portfolio-management endeavors. Institutions should review the applicability of these principles in providing trust and investment-management services.

For the purpose of this guidance, an institution's nontrading activities involve the use of securities (both available-for-sale and held-to-maturity) and OBS derivative contracts to achieve earnings and risk-management objectives that involve longer time horizons than typically associated with trading activities. Nontrading activities involve the full array of cash securities, money market instruments, and OBS derivative contracts.[2] Cash securities include fixed- and floating-rate notes and bonds, structured notes, mortgage pass-through and other asset-backed securities, and mortgage-derivative products. OBS derivative contracts include swaps, futures, and options.

2126.0.2 OVERVIEW OF GUIDANCE

This guidance reiterates and supplements existing guidance and directives on the use of these instruments for nontrading purposes as provided in various supervisory letters and examination manuals.[3] It identifies basic factors that examiners should consider in evaluating the four key elements of a sound risk-management process:

1. active board and senior management oversight
2. adequate risk-management policies and limits
3. appropriate risk-measurement and -reporting systems
4. comprehensive internal controls

1. The basic principles set forth in this guidance should also be incorporated into the policies of U.S. branches and agencies of foreign banks with appropriate adaptations to reflect the facts that (1) those offices are an integral part of a foreign bank, which should be managing its risks on a consolidated basis and recognizing possible obstacles to cash movements among branches, and (2) the foreign bank is subject to overall supervision by its home authorities.

2. In general terms, derivatives are financial contracts whose value derives from the value of one or more underlying assets, interest rates, exchange rates, commodities, or financial or commodity indexes.

3. Existing policies and examiner guidance on various supervisory topics applicable to securities and off-balance-sheet instruments can be found in various chapters of the *Commercial Bank Examination Manual*, the *Bank Holding Company Supervision Manual*, the *Trust Activities Examination Manual*, the *Merchant and Investment Bank Examination Manual*, and the *Trading and Capital-Markets Activities Manual*, as well as in various supervision and regulation (SR) letters, including SR-90-16, "Implementation of Examination Guidelines for the Review of Asset Securitization Activities"; SR-90-41, "Interest Rate Risk"; SR-91-4, "Inspections of Investment Adviser Subsidiaries of Bank Holding Companies" (see section 3130.1); SR-98-12, announcement of the FFIEC *Statement on Investment Securities and End-User Derivatives Activities* (effective May 25, 1998); and SR-93-69, "Risk Management and Internal Controls for Trading Activities" (see section 2125.0). Examiners of U.S. branches and agencies of foreign banks should take the principles included in these guidelines into consideration in accordance with the procedures set forth in the *Examination Manual for Branches and Agencies of Foreign Banking Organizations*.

Section 2126.0.8 identifies important policy considerations related to specific risks and should receive special attention. It contains specific guidance for evaluating an institution's management of each of the risks involved in these activities, including credit, market, liquidity, operating, and legal risks.

In evaluating an institution's risk-management process, examiners should consider the nature and size of its holdings. Examiner judgment plays a key role in assessing the adequacy of an institution's risk-management process for securities and derivative contracts. Examiners should focus particular attention on evaluating an institution's understanding of the risks involved in the instruments it holds. Regardless of any responsibility, legal or otherwise, assumed by a dealer or counterparty regarding a transaction, the acquiring institution is ultimately responsible for understanding and managing the risks of the transactions into which it enters. *Failure of an institution to understand adequately the risks involved in its securities or derivative positions, either through the lack of internal expertise or inadequate outside advice, constitutes an unsafe and unsound banking practice.*

As with all risk-bearing activities, institutions should fully support the risk exposures of nontrading activities with adequate capital. Banking organizations should ensure that their capital positions are sufficiently strong to support all the risks associated with these activities on a fully consolidated basis and should maintain adequate capital in all affiliated entities engaged in these activities. In evaluating the adequacy of an institution's capital, examiners should consider any unrecognized net depreciation or appreciation in an institution's securities and derivative holdings.[4]

2126.0.3 BOARD OF DIRECTORS AND SENIOR MANAGEMENT OVERSIGHT

Active oversight by the institution's board of directors and relevant senior management is critical to a sound risk-management process. Examiners should ensure that these individuals are aware of their responsibilities and that they adequately perform their appropriate roles in overseeing and managing the risks associated with nontrading activities involving securities and derivative instruments.

2126.0.3.1 Board of Directors

The board of directors has the ultimate responsibility for the level of risk taken by the institution. Accordingly, the board should approve overall business strategies and significant policies that govern risk taking, including those involving securities and derivative contracts. In particular, policies identifying managerial oversight and articulating risk tolerances and exposure limits of these activities should be approved by the board of directors. The board should also actively monitor the performance and risk profile of the institution and its various securities and derivative portfolios. Directors should periodically review information that is sufficient in detail and timeliness to allow them to understand and assess the credit, market, and liquidity risks facing the institution as a whole and its securities and derivative positions in particular. Such reviews should be conducted at least quarterly and more frequently if the institution holds significant positions in complex instruments. In addition, the board should periodically reevaluate the institution's business strategies and significant risk-management policies and procedures, placing special emphasis on the institution's financial objectives and risk tolerances. The minutes of board meetings and accompanying reports and presentation materials should clearly demonstrate the board's fulfillment of these basic responsibilities. Section 2126.0.8 provides guidance on the types of objectives, risk tolerances, limits, and reports that directors should consider.

The board of directors should also conduct and encourage discussions between its members and senior management, as well as between senior management and others in the institution, regarding the institution's risk-management process and risk exposures. Although it is not essential for board members to have detailed technical knowledge of these activities, if they do not, it is incumbent upon them to ensure that they have adequate access to independent legal and professional advice regarding the institution's securities and derivative holdings and strategies. The familiarity, technical knowledge, and awareness of directors and senior management should be commensurate with the level and nature of an institution's securities and derivative positions.

4. For further guidance, see SR-93-72, "Guidance on the Capital Treatment and Other Issues Relating to the Financial Accounting Standards Board Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities."

2126.0.3.2 Senior Management

Senior management is responsible for ensuring that there are adequate policies and procedures for conducting nontrading securities and derivative activities on both a long-range and day-to-day basis. Management should maintain clear lines of authority and responsibility for acquiring instruments and managing risk, appropriate limits on risk taking, adequate systems for measuring risk, acceptable standards for valuing positions and measuring performance, effective internal controls, and a comprehensive risk-reporting and risk-management review process. In order to provide adequate oversight, management should fully understand the institution's risk profile, including that of its securities and derivative activities. Examiners should review the reports to senior management and evaluate whether they provide both good summary information and sufficient detail to enable management to assess the sensitivity of securities and derivative holdings to changes in credit quality, market prices and rates, liquidity conditions, and other important risk factors. As part of its oversight responsibilities, senior management should periodically review the organization's risk-management procedures to ensure that they remain appropriate and sound. Senior management also should encourage and participate in active discussions with members of the board and with risk-management staff regarding risk measurement, reporting, and management procedures.

Management should ensure that nontrading securities and derivative activities are conducted by competent staff with technical knowledge and experience consistent with the nature and scope of the institution's activities. There should be sufficient depth in staff resources to manage these activities if key personnel are not available. Management should also ensure that there are sufficient back-office and financial control resources to effectively manage and control risks.

2126.0.3.3 Independence in Managing Risks

To avoid possible conflicts of interest, the process of measuring, monitoring, and controlling risks should be managed as independently as practicable from those individuals who have the authority to initiate transactions. The nature and extent of this independence should be commensurate with the size and complexity of an institution's securities and derivative activities. Institutions with large and complex balance sheets, or with significant holdings of complex instruments, would be expected to have risk managers or risk-management functions fully independent of the individuals who have the authority to conduct transactions. Institutions with less complex holdings should ensure that there is some mechanism for independently reviewing both the level of risk exposures created by securities and derivative holdings and the adequacy of the process used in managing those exposures. Depending on the size and nature of the institution, such a mechanism may reside either in the management structure or in a board committee. Regardless of size and sophistication, institutions should ensure that back- office, settlement, and transaction-reconciliation responsibilities are conducted and managed by personnel who are independent of those initiating risk-taking positions.

2126.0.4 POLICIES AND PROCEDURES FOR ACQUIRING AND MANAGING SECURITIES AND DERIVATIVE INSTRUMENTS

Institutions should maintain written policies and procedures that clearly outline their approach for managing securities and derivative instruments. Such policies should be consistent with the organization's broader business strategies, capital adequacy, technical expertise, and general willingness to take risk. They should identify relevant objectives, constraints, and guidelines for both acquiring instruments and managing portfolios. In doing so, policies should establish a logical framework for limiting the various risks involved in an institution's securities and derivative holdings. Policies should clearly delineate lines of responsibility and authority over securities and derivative activities. They should also provide for the systematic review of products new to the firm. Examiners should evaluate the adequacy of an institution's risk-management policies and procedures in relation to its size, sophistication, and the scope of its activities.

2126.0.4.1 Specifying Objectives

Institutions can use securities and derivative instruments for several primary and complemen-

tary purposes.[5] Banking organizations should clearly articulate these objectives and identify the types of securities and derivative contracts to be used for achieving them. Objectives also should be identified at the appropriate portfolio and institutional levels. These objectives should guide the acquisition of individual instruments and should provide benchmarks for periodically evaluating the performance and effectiveness of an institution's holdings, strategies, and programs. Wherever multiple objectives are involved, management should identify the hierarchy of potentially conflicting objectives.

2126.0.4.2 Identifying Constraints, Guidelines, and Limits

An institution's policies should clearly articulate the organization's risk tolerance by identifying its willingness to take the credit, market, and liquidity risks involved in holding securities and derivative contracts. A statement of authorized instruments and activities is an important vehicle for communicating these risk tolerances. This statement should clearly identify permissible instruments or instrument types and the purposes or objectives for which the institution may use them. The statement also should identify permissible credit quality, market-risk sensitivity, and liquidity characteristics of the instruments and portfolios used in nontrading activities. For example, in the case of market risk, policies should address the permissible degree of price sensitivity and/or effective maturity volatility, taking into account an instrument's or portfolio's option and leverage characteristics. Specifications of permissible risk characteristics should be consistent with the institution's overall credit, market, and liquidity risk limits and constraints and should help delineate a clear set of institutional limits for use in acquiring specific instruments and managing portfolios. Such limits can be specified either as guidelines within the overall policies or in management operating procedures. Section 2126.0.8 provides further guidance on the types of constraints and limits an institution might use in managing the credit, market, and liquidity risk of securities and derivative contracts.

5. These purposes include, but are not limited to, generating earnings, creating funding opportunities, providing liquidity, hedging risk exposures, taking risk positions, modifying and managing risk profiles, managing tax liabilities, and meeting pledging requirements.

Limits should be set to guide acquisition and ongoing management decisions, control exposures, and initiate discussion within the organization about apparent opportunities and risks. Although procedures for establishing limits and for operating within them may vary among institutions, examiners should determine whether the organization enforces its policies and procedures through a clearly identified system of risk limits. Positions that exceed established limits should receive the prompt attention of appropriate management and should be resolved according to approved policies.

Limits should implement the overall risk tolerances and constraints articulated in general policy statements. Depending on the nature of an institution's holdings and its general sophistication, limits can be identified with individual business units, portfolios, instrument types, or specific instruments. The level of detail of risk limits should reflect the characteristics of the institution's holdings including the types of risk to which the institution is exposed. Regardless of their specific form or level of aggregation, limits should be consistent with the institution's overall approach to managing various types of risks. They should also be integrated to the fullest extent possible with institution-wide limits on the same risks as they arise in other activities of the firm. Section 2126.0.8 presents specific examiner considerations in evaluating the policies and limits used in managing each of the various types of risks involved in nontrading securities and derivative activities.

2126.0.4.3 New-Product Review

An institution's policies should also provide for effective review of products being considered that would be new to the firm. An institution should not acquire a meaningful position in a new instrument until senior management and all relevant personnel (including those in internal control, legal, accounting, and auditing functions) understand the product and can integrate it into the institution's risk-measurement and control systems. An institution's policies should define the terms "new product" and "meaningful position" consistent with its size, complexity, and sophistication. Institutions should not be hesitant to define an instrument as a new product. Small changes in payment formulas or other terms of relatively simple and standard products can greatly alter their risk profiles and justify the designation of an instrument as a new product. New-product reviews should analyze all of the relevant risks involved in an instru-

ment and should assess the reasonableness of the product or activity in achieving specified objectives. New-product reviews also should include a description of the relevant accounting guidelines and identify the procedures for measuring, monitoring, and controlling the risks involved.

2126.0.4.4 Accounting

The accounting systems and procedures used for public and regulatory reporting purposes are critically important to enhancing the transparency of an institution's risk profile. Accordingly, an institution's policies should provide clear guidelines regarding the accounting for all securities and derivative holdings. This treatment should be consistent with specified objectives and with the institution's regulatory requirements. Institutions should ensure that they categorize each cash or derivative contract for accounting purposes consistent with appropriate accounting policies and requirements. Furthermore, the accounting for nontrading securities and OBS derivative contracts should reflect the economic substance of the transactions.[6] Where instruments are used for hedging purposes, the hedging rationale and performance criteria should be well documented. Management should reassess these classifications periodically to ensure that they remain appropriate.[7]

2126.0.5 RISK MEASUREMENT, MONITORING SYSTEMS, AND MANAGEMENT REVIEW

Clear procedures for measuring and monitoring risks are the foundation of a sound risk-management process. Examiners should ensure that an institution sufficiently integrates these functions into its ongoing management process and that relevant personnel recognize their role and understand the instruments held.

2126.0.5.1 Risk Measurement

An institution's system for measuring the credit, market, liquidity, and other risks involved in cash and derivative contracts should be as comprehensive and accurate as practicable. The degree of comprehensiveness should be commensurate with the nature of the institution's holdings and risk exposures. Exposures to each type of risk (that is, credit, market, liquidity) should be aggregated across securities and derivative contracts and integrated with similar exposures arising from lending and other business activities to obtain the institution's overall risk profile.

Examiners should evaluate whether the risk measures and the risk-measurement process are sufficiently robust to accurately reflect the different types of risks facing the institution. Institutions should establish clear risk-measurement standards for both the acquisition and ongoing management of securities and derivative positions. Risk-measurement standards should provide a common framework for limiting and monitoring risks and should be understood by relevant personnel at all levels of the institution—from individual managers to the board of directors.

2126.0.5.1.1 Acquisition Standards

Institutions conducting securities and derivative activities should have the capacity to evaluate the risks of instruments before acquisition. Before executing any transaction, an institution should evaluate the instrument to ensure that it meets the various objectives, risk tolerances, and guidelines identified by the institution's policies. Evaluations of the credit-, market-, and liquidity-risk exposures should be clearly and adequately documented for each acquisition. Such documentation should be appropriate for the nature and type of instrument. Relatively simple instruments would be expected to require less documentation than instruments with significant leverage or option characteristics.

Institutions with significant securities and derivative activities are expected to either conduct their own in-house preacquisition analyses or make use of specific third-party analyses that are independent of the seller or counterparty. Analyses provided by the originating dealer or counterparty should be used only when there is a clearly defined investment advisory relationship. Less active institutions with relatively uncomplicated holdings may use risk analyses provided by the dealer only to the extent that the analyses are derived using standard industry

6. Adjusted trading involves the sale of an instrument at a price above the prevailing market value and the simultaneous purchase and booking of an instrument at a price greater than its market value.

7. Reporting requirements for bank and bank holding company regulatory reports are set forth in the Reports of Condition and Income (call report) for banks and the FR Y-9C for bank holding companies.

calculators and market conventions. Such analyses must comprehensively depict the potential risks involved in the acquisition, and they should be accompanied by documentation that sufficiently demonstrates that the acquirer understands fully both the analyses and the nature of the institution's relationship with the provider of those analyses. Notwithstanding information and analyses obtained from outside sources, management is ultimately responsible for understanding the nature and risk profiles of the institution's securities and derivative holdings.

It is a prudent practice to obtain and compare price quotes and risk analyses from more than one dealer before acquisition. In doing so, institutions should ensure that they clearly understand the responsibilities of any outside parties that provide analyses and price quotes. With regard to analyses and price quotes provided by dealers, institutions should assume that each party deals at arm's length for its own account unless there is a written agreement stating the contrary. Institutions should exercise caution in situations in which dealers limit the institution's ability to show securities or derivative contract proposals to other dealers in order to receive comparative price quotes or risk analyses. As a general sound practice, unless the dealer or counterparty is also acting under a specific investment advisory relationship, an investor or end-user should not acquire an instrument or enter into a transaction if its fair value or the analyses required to assess its risk cannot be determined through a means that is independent of the originating dealer or counterparty.

2126.0.5.1.2 Portfolio-Management Standards

Institutions should periodically review the performance and effectiveness of instruments, portfolios, and institutional programs and strategies. This review should be conducted no less frequently than quarterly and should evaluate the extent to which the institution's securities and derivative holdings meet the various objectives, risk tolerances, and guidelines established by the institution's policies.[8] Institutions with large or highly complex holdings should conduct such reviews more frequently.

For internal measurement purposes, effective measurement of the credit, market, and liquidity risks of many securities and derivative contracts requires mark-to-market valuations.[9] Accordingly, the periodic revaluation of securities and derivative holdings is an integral part of an effective risk-measurement system. These periodic revaluations should be fully documented. Where available, actual market prices should be used. For less liquid or complex instruments, institutions with only limited holdings may use properly documented periodic prices and analyses provided by dealers or counterparties. More active institutions should conduct periodic revaluations and portfolio analyses using either their own in-house capabilities or outside party analytical systems that are independent of sellers or counterparties. Institutions should recognize that indicative price quotes and model revaluations may differ from the values at which transactions can be executed.

2126.0.5.1.3 Stress Testing

Analyzing the credit, market, and liquidity risk of individual instruments, portfolios, and the entire institution under a variety of unusual and stressful conditions is an important aspect of the risk-measurement process. Management should seek to identify the types of situations, or the combinations of credit and market events, that could produce substantial losses or liquidity problems. Since institutions typically manage nontrading securities and derivative contracts with consideration to the institution's consolidated exposures, management should review the effect of stress situations on an institution-wide basis. Stress tests should evaluate changes in market conditions, including alternatives in the underlying assumptions used to value instruments.

Stress tests should not be limited to quantitative exercises that compute potential losses or gains, but should also include qualitative analyses of the tools available to management to deal with various scenarios. Contingency plans outlining operating procedures and lines of communication, both formal and informal, are important products of such qualitative analyses.

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8. For example, the performance of instruments and portfolios used to meet tax-advantaged earnings objectives should be evaluated to ensure that they meet the necessary credit rating, market sensitivity, and liquidity characteristics established for this objective.

9. The Reports of Condition and Income (call report) require quarterly reporting of the fair value of all securities holdings.

The appropriate extent and sophistication of an institution's stress testing depends heavily on the scope and nature of its securities and derivative holdings and on its ability to limit the effect of adverse events. Institutions holding securities or derivative contracts with complex credit-, market-, or liquidity-risk profiles should have an established regime of stress testing. Examiners should consider the circumstances at each institution when evaluating the adequacy or need for stress-testing procedures.

2126.0.5.2 Risk Reporting

An accurate, informative, and timely management information system is essential. Examiners should evaluate the adequacy of an institution's monitoring and reporting of the risks, returns, and overall performance of security and derivative activities to senior management and the board of directors. The frequency of reporting should provide the responsible individuals with adequate information to judge the changing nature of the institution's risk profile and to evaluate compliance with stated policy objectives and constraints.

Management reports should translate measured risks from technical and quantitative formats to those that can be easily read and understood by senior managers and directors, who may not have specialized and technical knowledge of all financial instruments used by the institution. Institutions should ensure that they use a common conceptual framework for measuring and limiting risks in reports to senior managers and directors. Such reports should include the periodic assessment of the performance of appropriate instruments or portfolios in meeting their stated objective(s) subject to the relevant constraints and risk tolerances.

2125.0.5.3 Management Evaluation and Review

Management should regularly review the institution's approach and process for managing risks. This includes regularly assessing the methodologies, models, and assumptions used to measure risks and to limit exposures. Proper documentation of the elements used in measuring risks is essential for conducting meaningful reviews. Limits should be compared to actual exposures. Such reviews should also consider whether existing measures of exposure and limits are appropriate in view of the institution's holdings, past performance, and current capital position.

The frequency of the reviews should reflect the nature of an institution's holdings and the pace of market innovations in measuring and managing risks. At a minimum, institutions with significant activities involving complex cash or derivative contracts should review the underlying methodologies of the models they use at least annually—and more often as market conditions dictate—to ensure that they are appropriate and consistent. Reviews by external auditors or other qualified outside parties, such as consultants with expertise in highly technical models and risk-management techniques, may often supplement these internal evaluations. Institutions depending on outside parties to provide various risk-measurement capabilities should ensure that the institution has personnel with the necessary expertise to identify and evaluate the important assumptions incorporated in the risk-measurement methodologies it uses.

2126.0.6 COMPREHENSIVE INTERNAL CONTROLS AND AUDIT PROCEDURES

An institution's risk-management process should be an extension of its overall structure of internal controls. Properly structured, a system of internal controls should promote effective and efficient operations, reliable financial and regulatory reporting, and compliance with relevant laws, regulations, and institutional policies. In determining whether internal controls meet those objectives, examiners should consider the general control environment of the organization; the process for identifying, analyzing, and managing risk; the adequacy of management information systems; and adherence to control activities such as approvals, confirmations, and reconciliations.

Assessing the adequacy of internal controls involves a process of understanding, documenting, evaluating, and testing an institution's internal control system. This assessment should include product reviews that start with an analysis of the organizational structure of securities and derivative activities. Duties should be separated between personnel initiating transactions and personnel overseeing back-office operations, internal controls, and the management of risk exposures.

Examiners should conduct in-depth reviews of the internal controls of all key activities involving securities and derivative contracts. For example, for transaction recording and processing, examiners should evaluate and assess adherence to the written policies and procedures for recording transactions. They should also analyze the transaction-processing cycle to ensure the integrity and accuracy of the institution's records and management reports. Examiners should review all significant internal controls associated with the management of the credit, market, liquidity, operational, and legal risks involved in securities and derivative holdings.

The examiner should appraise the frequency, scope, and findings of any independent internal and external auditors. This appraisal should include an evaluation of the ability of those auditors to review the institution's securities and derivative activities. Where applicable, internal auditors should audit and test the risk-management process and internal controls periodically. The depth and frequency of internal audits should increase if weaknesses and significant issues exist or if portfolio structures, modeling methodologies, or the overall risk profile of the institution has changed.

In reviewing the management of the risks of nontrading securities and derivative activities, internal auditors should thoroughly evaluate the effectiveness of internal controls used for measuring, reporting, and limiting risks. Internal auditors should also evaluate compliance with risk limits and the reliability and timeliness of information reported to the institution's senior management and board of directors. Internal auditors should also evaluate the independence and overall effectiveness of the institution's risk-management process. The level of confidence that examiners place in an institution's audit programs, the nature of the audit findings, and management's response to those findings will influence the scope of the current examination of securities and derivative activities.

Examiners should pay special attention to significant changes in the nature of instruments acquired, risk-measurement methodologies, limits, and internal controls that have occurred since the last examination. Significant changes in earnings from securities and derivative contracts, in the size of positions, or in the value at risk associated with these activities should also receive attention during the examination.

2126.0.7 SOUND RISK MANAGEMENT FOR MANAGING SECURITIES AND DERIVATIVE CONTRACTS—CONCLUSION

The foregoing discussion identified, in broad terms, the key elements of a sound risk-management system for acquiring and managing securities and derivative contracts. Section 2126.0.8 presents important guidance for evaluating specific risks—credit, market, liquidity, operating, and legal—that institutions encounter in conducting nontrading securities and derivative activities.

These guidelines, including those in section 2126.0.8, are intended to help examiners, and the management and boards of directors of institutions, evaluate the adequacy of the risk-management process as it applies to the use of securities and derivative contracts in a nontrading environment. However, the nature of these activities and the broad range of circumstances in which these instruments are used by banking organizations requires examiners to apply substantial judgment in their evaluation of management procedures. In the final analysis, *examiners must determine whether the institution's use of securities and derivatives represents a prudent activity in light of the purposes for which they are used, management's ability to evaluate and control risks, and the capital position of the institution.* They should also ensure that depository institutions adopt adequate policies related to securities and derivative transactions and that all levels of management provide sufficient oversight of the risk-management process.

2126.0.8 EVALUATING THE MANAGEMENT OF THE CREDIT, MARKET, LIQUIDITY, OPERATING, AND LEGAL RISKS OF NONTRADING SECURITIES AND DERIVATIVE ACTIVITIES

This section highlights specific considerations in evaluating the key elements of sound risk-management systems as they relate to the management of the various risks involved in an institution's use of securities and derivative contracts for nontrading activities. These risks include credit, market, liquidity, operating, and legal risks.

2126.0.8.1 Credit Risk

Broadly defined, credit risk is the risk that an issuer or counterparty will fail to perform on an obligation to the institution. The policies of an institution should recognize credit risk as a significant risk faced by the institution's securities and derivative activities. Accordingly, policies should identify credit-risk constraints, risk tolerances, and limits at the appropriate instrument, portfolio, and institutional level. In doing so, institutions should ensure that credit-risk constraints are clearly associated with specified objectives. For example, credit-risk constraints and guidelines should be defined for instruments used to meet pledging requirements, to generate tax-advantaged income, to hedge positions, and to generate temporary income or any other specifically defined objective.

As a matter of general policy, an institution should not acquire securities or derivative contracts until it has assessed the creditworthiness of the issuer or counterparty and determined that the risk exposure conforms with its policies. The credit risk arising from these positions should be incorporated into the overall credit-risk profile of the institution to the fullest extent possible. As a matter of policy, the board of directors and responsible senior management should be informed of the institution's total credit-risk exposures regularly, and no less frequently than quarterly.

In managing their credit risk, institutions also should consider settlement and presettlement credit risk. The selection of dealers, investment bankers, and brokers is particularly important in effectively managing these risks. An institution's policies should identify criteria for selecting these organizations and should list all approved firms. The approval process should include a review of each firm's financial statements and an evaluation of its ability to honor its commitments. An inquiry into the general reputation of the dealer is also appropriate. The board of directors, or a committee thereof, should set limits on the amounts and types of transactions authorized for each firm. They should also periodically review and reconfirm the list of authorized dealers, investment bankers, and brokers. See section 2190.0.5 for a discussion of SR-98-12 regarding the FFIEC *Statement on Investment Securities and End-User Derivatives Activities* (effective May 25, 1998).

An institution's credit policies should also include guidelines on the quality and quantity of each type of security that may be held. Policies should also provide credit-risk diversification and concentration limits. Such limits may define concentrations as those to a single or related issuer or counterparty, in a geographical area, or in obligations with similar characteristics.

Sound credit-risk management requires that credit limits be developed by personnel who are independent of the acquisition function. In authorizing issuer and counterparty credit lines, these personnel should use standards that are consistent with those used for other activities conducted within the institution, and with the organization's overall policies and consolidated exposures. In assessing the creditworthiness of other organizations, institutions should not rely solely on outside sources, such as standardized ratings provided by independent rating agencies, but should also perform their own analysis of a counterparty's or issuer's financial strength. In addition, examiners should review the credit-approval process to ensure that the credit risks of specific products are adequately identified and that credit-approval procedures are followed for all transactions.

For most cash instruments, credit exposure is measured as the current carrying value. In the case of many derivative contracts, especially those traded in OTC markets, credit exposure is measured as the replacement cost of the position, plus an estimate of the institution's potential future exposure to changes in the replacement value of that position in response to market-price changes. Replacement costs of derivative contracts should be determined using current market prices or generally accepted approaches for estimating the present value of future payments required under each contract, at current market rates.

The measurement of potential future credit-risk exposure for derivative contracts is more subjective than the measurement of current exposure and is primarily a function of the time remaining to maturity, the number of exchanges of principal, and the expected volatility of the price, rate, or index underlying the contract. Potential future exposure can be measured using an institution's own simulations or, more simply, through the use of "add-ons" such as those included in the Federal Reserve's risk-based capital guidelines. Regardless of method, examiners should evaluate the reasonableness of the assumptions underlying the institution's risk measure.

For derivative contracts and certain types of cash transactions, master agreements (including netting agreements) and various credit enhance-

ments (such as collateral or third-party guarantees) can reduce settlement, issuer, and counterparty credit risk. In such cases, an institution's credit exposures should reflect these risk-reducing features only to the extent that the agreements and recourse provisions are legally enforceable in all relevant jurisdictions. This legal enforceability should extend to any insolvency proceedings of the counterparty. Institutions should be prepared to demonstrate sufficient due diligence in evaluating the enforceability of these contracts.

In reviewing credit exposures, examiners should consider the extent to which positions exceed credit limits and whether exceptions are resolved according to the institution's adopted policies and procedures. Examiners should also evaluate whether the institution's reports adequately provide all personnel involved in the acquisition and management of financial instruments with relevant, accurate, and timely information about the credit exposures and approved credit lines.

2126.0.8.2 Market Risk

Market risk is the exposure of an institution's financial condition to adverse movements in the market rates or prices of its holdings before such holdings can be liquidated or expeditiously offset. It is measured by assessing the effect of changing rates and/or prices on either the earnings or economic value of an individual instrument, a portfolio, or the entire institution. Although many banking institutions focus on carrying values and reported earnings when assessing market risk at the institutional level, other measures focusing on total returns and changes in economic or fair values better reflect the potential market-risk exposure of institutions, portfolios, and individual instruments. Changes in fair values and total returns directly measure the effect of market movements on the economic value of an institution's capital and provide significant insights as to their ultimate effects on the institution's long-term earnings. Institutions should manage and control their market risks using both an earnings and an economic-value approach and at least on an economic- or fair-value basis.

When evaluating capital adequacy, examiners should consider the effect of changes in market rates and prices on the economic value of the institution by evaluating any unrealized losses in an institution's securities or derivative positions. This evaluation should assess the ability of the institution to hold its positions and function as a going concern if recognition of unrealized losses would significantly affect the institution's capital ratios. Examiners also should consider the impact that liquidating positions with unrealized losses may have on the institution's prompt-corrective-action capital category.

Market-risk limits should be established for both the acquisition and ongoing management of an institution's securities and derivative holdings and, as appropriate, should address exposures for individual instruments, instrument types, and portfolios. These limits should be integrated fully with limits established for the entire institution. At the institutional level, the board of directors should approve market-risk exposure limits in terms of specific percentage changes in the economic value of capital and in the projected earnings of the institution under various market scenarios. Similar and complementary limits on the volatility of prices or fair value should be established at the appropriate instrument, product type, and portfolio levels based on the institution's willingness to accept market risk. Limits on the variability of effective maturities may also be desirable for certain types of instruments or portfolios.

The federal bank regulatory agencies have established price and effective maturity standards for mortgage-derivative products based on specified scenarios. Institutions should ensure that they meet these regulatory requirements and should employ similar techniques in controlling the exposures of other cash securities and to all derivative contracts—especially for instruments involving explicit or embedded options. The scenarios specified for assessing the market risk of these products should be sufficiently rigorous to capture all meaningful effects of any options. For example, in assessing interest-rate risk, scenarios such as 100, 200, and 300 basis point parallel shifts in yield curves should be considered as well as appropriate nonparallel shifts in structure to evaluate potential basis, volatility, and yield curve risks.

Accurately measuring an institution's market risk requires timely information about the current carrying and market values of its securities and derivative holdings. Accordingly, institutions should have market-risk-measurement systems commensurate with the size and nature of these holdings. Institutions with significant holdings of highly complex instruments should ensure that they have independent means to value their positions. Institutions employing

internal models should have adequate procedures to validate the models and to periodically review all elements of the modeling process, including its assumptions and risk-measurement techniques. Institutions relying on third parties for market-risk-measurement systems and analyses should ensure that they fully understand the assumptions and techniques used.

Institutions should evaluate and report to their boards of directors the market-risk exposures of their securities and derivative positions on a regular basis and not less frequently than each quarter. These evaluations should assess trends in aggregate market-risk exposure and the performance of portfolios in terms of established objectives and risk constraints. They also should identify compliance with board-approved limits and identify any exceptions to established standards. Examiners should ensure that institutions have mechanisms to detect and adequately address exceptions to limits and guidelines. Examiners should also determine if management reports on market risk appropriately address potential exposures to basis risk, yield curve changes, and other factors pertinent to the institution's holdings. In this connection, examiners should assess an institution's compliance with broader guidance for managing interest-rate risk in a consolidated organization, including that detailed in the *Commercial Bank Examination Manual*.

Complex and illiquid instruments can often involve greater market risk than broadly traded, more liquid securities. Oftentimes, this higher potential market risk arising from illiquidity is not captured by standardized financial modeling techniques. Such risk is particularly acute for instruments that are highly leveraged or that are designed to benefit from specific, narrowly defined market shifts. If market prices or rates do not move as expected, the demand for such instruments can evaporate. Where examiners encounter such instruments, they should review the adequacy with which the institution has assessed its potential market risks. If the risks from these instruments are material, the institution should have a well-documented process of stress testing their value and liquidity assumptions under a variety of market scenarios.

2126.0.8.3 Liquidity Risk

Banks face two types of liquidity risk in their securities and derivative activities: those related to specific products or markets and those related to the general funding of the bank's activities. The former, market liquidity risk, is the risk that an institution cannot easily unwind or offset a particular position at or near the previous market price because of inadequate market depth or because of disruptions in the marketplace. Funding liquidity risk is the risk that the bank will be unable to meet its payment obligations on settlement dates. Since neither type of liquidity risk is unique to securities and derivative activities, management should evaluate these risks in the broader context of the institution's overall liquidity.

In specifying permissible securities and derivative instruments for accomplishing established objectives, institutions should ensure that they take into account the size, depth, and liquidity of the market for those instruments and the effect that such characteristics may have on achieving the objective. The market liquidity of certain types of instruments may make them entirely inappropriate for achieving certain objectives. Moreover, institutions should ensure that they consider the effects that market risk can have on the liquidity of different types of instruments. For example, some government-agency securities may have embedded options that make them highly illiquid during periods of market volatility and stress, despite their high credit rating. Accordingly, institutions should clearly articulate the market liquidity characteristics of instruments to be used in accomplishing institutional objectives.

The funding risk of an institution becomes a more important consideration when its unrealized losses are material and, therefore, should be a factor in evaluating capital adequacy. Institutions with weak liquidity positions are more likely to be forced to recognize these losses and to suffer declines in their accounting and regulatory capital. In extreme cases, these effects could force supervisors to take prompt corrective actions.

Examiners should assess whether the institution adequately considers the potential liquidity risks associated with the liquidation of securities or the early termination of derivative contracts. Many forms of standardized contracts for derivative transactions allow counterparties to request collateral or to terminate their contracts early if the institution experiences an adverse credit event or a deterioration in its financial condition. In addition, under situations of market stress, customers may ask for the early termination of some contracts within the context of

the dealer's market-making activities. In such circumstances, an institution that owes money on derivative transactions may be required to deliver collateral or settle a contract early and possibly at a time when the institution may face other funding and liquidity pressures. Early terminations may also open additional, unintended market positions. Management and directors should be aware of these potential liquidity risks and should address them in the institution's liquidity plan and in the broader context of the institution's liquidity-management process. In their reviews, examiners should consider the extent to which such potential obligations could present liquidity risks to the institution.

2126.0.8.4 Operating Risk and Legal Risk

Operating risk is the risk that deficiencies in information systems or internal controls will result in unexpected loss. Some specific sources of operating risk that can result in unexpected losses include inadequate procedures, human error, system failure, or fraud. Inaccurately assessing or controlling operating risks is one of the more likely sources of problems facing institutions involved in securities and derivative activities.

Adequate internal controls are the first line of defense in controlling the operating risks involved in an institution's securities and derivatives activities. Of particular importance are internal controls that ensure the separation of duties and supervision of persons executing transactions from those responsible for processing contracts, confirming transactions, controlling various clearing accounts, approving the accounting methodology or entries, and performing revaluations.

Institutions should have approved policies that specify documentation requirements for transactions and formal procedures for saving and safeguarding important documents that are consistent with legal requirements and internal policies. Relevant personnel should fully understand the requirements. Examiners should also consider the extent to which institutions evaluate and control operating risks through the use of internal audits, stress testing, contingency planning, and other managerial and analytical techniques.

An institution's operating policies should establish appropriate procedures to obtain and maintain possession or control of instruments purchased. Institutions should also ensure that transactions consummated orally are confirmed as soon as possible. Banking organizations should, to the extent possible, seek diversification with regard to the firms used for safekeeping arrangements in order to avoid concentrations of assets or other types of risk.[10]

Legal risk is the risk that contracts are not legally enforceable or documented correctly. Legal risks should be limited and managed through policies developed by the institution's legal counsel. At a minimum, there should be guidelines and processes in place to ensure the enforceability of counterparty agreements. Examiners should determine whether an institution is adequately evaluating the enforceability of its agreements before individual transactions are consummated. Institutions should also ensure that the counterparty has sufficient authority to enter into the transaction and that the terms of the agreement are legally sound. Institutions should further ascertain that their netting agreements are adequately documented, that they have been executed properly, and that they are enforceable in all relevant jurisdictions. Institutions should have knowledge of relevant tax laws and interpretations governing the use of these instruments.

An institution's policies should also provide guidelines for conflicts of interest for employees who are directly involved in purchasing and selling securities for the institution from securities dealers. These guidelines should ensure that all directors, officers, and employees act in the best interest of the institution. The board of directors may wish to adopt policies prohibiting these employees from engaging in personal securities transactions with these same securities firms without specific prior board approval. The board of directors may also wish to adopt a policy applicable to directors, officers, and employees restricting or prohibiting the receipt of gifts, gratuities, or travel expenses from approved securities dealer firms and their personnel.

10. See SR-95-3 for further guidance on safekeeping.

On April 23, 1998, the Federal Financial Institutions Examination Council (FFIEC) issued a Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities that became effective on May 25, 1998. The statement was adopted by the Board of Governors and provides guidance on sound practices for managing the risks of investment activities. This statement replaced the 1992 Supervisory Policy Statement on Securities Activities, including the constraints on bank investments in "high-risk" mortgage investment products (the FFIEC "high-risk test"). The guidance focuses on risk-management practices of state member banks and Edge corporations. The basic principles also apply to bank holding companies, which should manage and control risk exposures on a consolidated basis, recognizing the legal distinctions and potential obstacles to cash movements among subsidiaries. The statement's risk-management principles should also be incorporated into the policies of U.S. branches and agencies of foreign banks.[1]

The statement's principles set forth sound risk-management practices that are relevant to most portfolio-management endeavors. The statement places greater emphasis on a risk-focused approach to supervision. Instruments held for end-user reasons are considered, taking into consideration a variety of factors such as management's ability to manage and measure risk within the institution's holdings and the impact of those holdings on aggregate portfolio risk.

The statement focuses on managing the market, credit, liquidity, operational, and legal risks of investment and end-user activities. When managing the interest-rate-risk component of market risk, institutions are informed of the merits of developing internal policies that specify the type of pre-acquisition analysis (stress testing) that is consistent with the scope, sophistication, and complexity of their investment securities and end-user derivative holdings. Such analyses should be conducted for certain types of instruments, including those that have complex or potentially volatile risk profiles. Institutions are advised to periodically monitor the price sensitivity of their portfolios, ensuring that they meet the established limits of the board of directors. Institutions are further advised to fully assess the creditworthiness of their counterparties, including brokers and issuers. Institutions are to ensure that they take proper account of the liquidity of the instruments held. (See SR-98-12.)

The principles set forth within this interagency policy statement are derived generally from those set forth in SR-95-17. See section 2126.0 and the appropriate sections of the *Trading and Capital-Markets Activities Manual.* The policy statement, as written, follows. The section numbers have been added for reference.

1. Appropriate adaptations should be made to reflect the fact that (1) those offices are an integral part of a foreign bank that must also manage its consolidated risks and recognize possible obstacles to cash movement among branches; and (2) the foreign bank is subject to overall supervision by its home-country supervisory authority.

2126.1.1 SUPERVISORY POLICY STATEMENT ON INVESTMENT SECURITIES AND END-USER DERIVATIVES ACTIVITIES

2126.1.1.1 Purpose

This policy statement (statement) provides guidance to financial institutions (institutions) on sound practices for managing the risks of investment securities and end-user derivatives activities.[2] The FFIEC agencies—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—believe that effective management of the risks associated with securities and derivative instruments represents an essential component of safe and sound practices. This guidance describes the practices that a prudent manager normally would follow and is not intended to be a checklist. Management should establish practices and maintain documentation appropriate to the institution's individual circumstances, consistent with this statement.

2126.1.1.2 Scope

This guidance applies to all securities in *held-to-maturity* and *available-for-sale* accounts as defined in the Statement of Financial Accounting Standards No.115 (FAS 115), certificates of

2. The 1998 statement does not supersede any other requirements of the respective agencies' statutory rules, regulations, policies, or supervisory guidance.

deposit held for investment purposes, and end-user derivative contracts not held in trading accounts. This guidance covers all securities used for investment purposes, including money market instruments, fixed-rate and floating-rate notes and bonds, structured notes, mortgage pass-through and other asset-backed securities, and mortgage-derivative products. Similarly, this guidance covers all end-user derivative instruments used for nontrading purposes, such as swaps, futures, and options.[3] This statement applies to all federally insured commercial banks, savings banks, savings associations, and federally chartered credit unions.

As a matter of sound practice, institutions should have programs to manage the market, credit, liquidity, legal, operational, and other risks of investment securities and end-user derivatives activities (investment activities). While risk-management programs will differ among institutions, there are certain elements that are fundamental to all sound risk-management programs. These elements include board and senior management oversight and a comprehensive risk-management process that effectively identifies, measures, monitors, and controls risk. This statement describes sound principles and practices for managing and controlling the risks associated with investment activities.

Institutions should fully understand and effectively manage the risks inherent in their investment activities. *Failure to understand and adequately manage the risks in these areas constitutes an unsafe and unsound practice.*

2126.1.1.3 Board and Senior Management Oversight

Board of director and senior management oversight is an integral part of an effective risk-management program. The board of directors is responsible for approving major policies for conducting investment activities, including the establishment of risk limits. The board should ensure that management has the requisite skills to manage the risks associated with such activities. To properly discharge its oversight responsibilities, the board should review portfolio activity and risk levels, and require management to demonstrate compliance with approved risk limits. Boards should have an adequate understanding of investment activities. Boards that do not should obtain professional advice to enhance its understanding of investment-activity oversight, so as to enable it to meet its responsibilities under this statement.

Senior management is responsible for the daily management of an institution's investments. Management should establish and enforce policies and procedures for conducting investment activities. Senior management should have an understanding of the nature and level of various risks involved in the institution's investments and how such risks fit within the institution's overall business strategies. Management should ensure that the risk-management process is commensurate with the size, scope, and complexity of the institution's holdings. Management should also ensure that the responsibilities for managing investment activities are properly segregated to maintain operational integrity. Institutions with significant investment activities should ensure that back-office, settlement, and transaction-reconciliation responsibilities are conducted and managed by personnel who are independent of those initiating risk-taking positions.

2126.1.1.4 Risk-Management Process

An effective risk-management process for investment activities includes (1) policies, procedures, and limits; (2) the identification, measurement, and reporting of risk exposures; and (3) a system of internal controls.

2126.1.1.4.1 Policies, Procedures, and Limits

Investment policies, procedures, and limits provide the structure to effectively manage investment activities. Policies should be consistent with the organization's broader business strategies, capital adequacy, technical expertise, and risk tolerance. Policies should identify relevant investment objectives, constraints, and guidelines for the acquisition and ongoing management of securities and derivative instruments. Potential investment objectives include generating earnings; providing liquidity; hedging risk exposures; taking risk positions; modifying and managing risk profiles; managing tax liabilities; and meeting pledging requirements, if applicable. Policies should also identify the risk charac-

3. Natural-person federal credit unions are not permitted to purchase non-residential mortgage asset-backed securities and may participate in derivative programs only if authorized by the NCUA.

teristics of permissible investments and should delineate clear lines of responsibility and authority for investment activities.

An institution's management should understand the risks and cash-flow characteristics of its investments. This is particularly important for products that have unusual, leveraged, or highly variable cash flows. An institution should not acquire a material position in an instrument until senior management and all relevant personnel understand and can manage the risks associated with the product.

An institution's investment activities should be fully integrated into any institution-wide risk limits. In so doing, some institutions rely only on the institution-wide limits, while others may apply limits at the investment portfolio, subportfolio, or individual instrument level.

The board and senior management should review, at least annually, the appropriateness of its investment strategies, policies, procedures, and limits.

2126.1.1.4.2 Risk Identification, Measurement, and Reporting

Institutions should ensure that they identify and measure the risks associated with individual transactions prior to acquisition and periodically after purchase. This can be done at the institutional, portfolio, or individual-instrument level. Prudent management of investment activities entails examination of the risk profile of a particular investment in light of its impact on the risk profile of the institution. To the extent practicable, institutions should measure exposures to each type of risk, and these measurements should be aggregated and integrated with similar exposures arising from other business activities to obtain the institution's overall risk profile.

In measuring risks, institutions should conduct their own in-house pre-acquisition analyses, or to the extent possible, make use of specific third-party analyses that are independent of the seller or counterparty. Irrespective of any responsibility, legal or otherwise, assumed by a dealer, counterparty, or financial advisor regarding a transaction, the acquiring institution is ultimately responsible for the appropriate personnel understanding and managing the risks of the transaction.

Reports to the board of directors and senior management should summarize the risks related to the institution's investment activities and should address compliance with the investment policy's objectives, constraints, and legal requirements, including any exceptions to established policies, procedures, and limits. Reports to management should generally reflect more detail than reports to the board of the institution. Reporting should be frequent enough to provide timely and adequate information to judge the changing nature of the institution's risk profile and to evaluate compliance with stated policy objectives and constraints.

2126.1.1.4.3 Internal Controls

An institution's internal control structure is critical to the safe and sound functioning of the organization generally and the management of investment activities in particular. A system of internal controls promotes efficient operations; reliable financial and regulatory reporting; and compliance with relevant laws, regulations, and institutional policies. An effective system of internal controls includes enforcing official lines of authority, maintaining appropriate separation of duties, and conducting independent reviews of investment activities.

For institutions with significant investment activities, internal and external audits are integral to the implementation of a risk-management process to control risks in investment activities. An institution should conduct periodic independent reviews of its risk-management program to ensure its integrity, accuracy, and reasonableness. Items that should be reviewed include—

1. compliance with and the appropriateness of investment policies, procedures, and limits;
2. the appropriateness of the institution's risk-measurement system given the nature, scope, and complexity of its activities; and
3. the timeliness, integrity, and usefulness of reports to the board of directors and senior management.

The review should note exceptions to policies, procedures, and limits and suggest corrective actions. The findings of such reviews should be reported to the board and corrective actions taken on a timely basis.

The accounting systems and procedures used for public and regulatory reporting purposes are critically important to the evaluation of an organization's risk profile and the assessment of its financial condition and capital adequacy. Accordingly, an institution's policies should provide clear guidelines regarding the reporting

treatment for all securities and derivatives holdings. This treatment should be consistent with the organization's business objectives, generally accepted accounting principles (GAAP), and regulatory reporting standards.

2126.1.1.5 Risks of Investment Activities

The following discussion identifies particular sound practices for managing the specific risks involved in investment activities. In addition to these sound practices, institutions should follow any specific guidance or requirements from their primary supervisor related to these activities.

2126.1.1.5.1 Market Risk

Market risk is the risk to an institution's financial condition resulting from adverse changes in the value of its holdings arising from movements in interest rates, foreign-exchange rates, equity prices, or commodity prices. An institution's exposure to market risk can be measured by assessing the effect of changing rates and prices on either the earnings or economic value of an individual instrument, a portfolio, or the entire institution. For most institutions, the most significant market risk of investment activities is interest-rate risk.

Investment activities may represent a significant component of an institution's overall interest-rate-risk profile. It is a sound practice for institutions to manage interest-rate risk on an institution-wide basis. This sound practice includes monitoring the price sensitivity of the institution's investment portfolio (changes in the investment portfolio's value over different interest-rate/yield curve scenarios). Consistent with agency guidance, institutions should specify institution-wide interest-rate-risk limits that appropriately account for these activities and the strength of the institution's capital position. These limits are generally established for economic value or earnings exposures. Institutions may find it useful to establish price-sensitivity limits on their investment portfolio or on individual securities. These sub-institution limits, if established, should also be consistent with agency guidance.

It is a sound practice for an institution's management to fully understand the market risks associated with investment securities and derivative instruments prior to acquisition and on an ongoing basis. Accordingly, institutions should have appropriate policies to ensure such understanding. In particular, institutions should have policies that specify the types of market-risk analyses that should be conducted for various types or classes of instruments, including that conducted prior to their acquisition (pre-purchase analysis) and on an ongoing basis. Policies should also specify any required documentation needed to verify the analysis.

It is expected that the substance and form of such analyses will vary with the type of instrument. Not all investment instruments may need to be subjected to a pre-purchase analysis. Relatively simple or standardized instruments, the risks of which are well known to the institution, would likely require no or significantly less analysis than would more volatile, complex instruments.[4]

For relatively more complex instruments, less familiar instruments, and potentially volatile instruments, institutions should fully address pre-purchase analyses in their policies. Price-sensitivity analysis is an effective way to perform the pre-purchase analysis of individual instruments. For example, a pre-purchase analysis should show the impact of an immediate parallel shift in the yield curve of plus and minus 100, 200, and 300 basis points. Where appropriate, such analysis should encompass a wider range of scenarios, including nonparallel changes in the yield curve. A comprehensive analysis may also take into account other relevant factors, such as changes in interest-rate volatility and changes in credit spreads.

When the incremental effect of an investment position is likely to have a significant effect on the risk profile of the institution, it is a sound practice to analyze the effect of such a position on the overall financial condition of the institution.

Accurately measuring an institution's market risk requires timely information about the current carrying and market values of its investments. Accordingly, institutions should have market-risk-measurement systems commensurate with the size and nature of these investments. Institutions with significant holdings of highly complex instruments should ensure that they have the means to value their positions. Institutions employing internal models should have adequate procedures to validate the models and to periodically review all elements of the modeling process, including its assumptions and

4. Federal credit unions must comply with the investment-monitoring requirements of 12 C.F.R. 703.90. See 62 FR 32989 (June 18, 1997).

risk-measurement techniques. Managements relying on third parties for market-risk-measurement systems and analyses should ensure that they fully understand the assumptions and techniques used.

Institutions should provide reports to their boards on the market-risk exposures of their investments on a regular basis. To do so, the institution may report the market-risk exposure of the whole institution. Alternatively, reports should contain evaluations that assess trends in aggregate market-risk exposure and the performance of portfolios in terms of established objectives and risk constraints. They also should identify compliance with board-approved limits and identify any exceptions to established standards. Institutions should have mechanisms to detect and adequately address exceptions to limits and guidelines. Management reports on market risk should appropriately address potential exposures to yield curve changes and other factors pertinent to the institution's holdings.

2126.1.1.5.2 Credit Risk

Broadly defined, credit risk is the risk that an issuer or counterparty will fail to perform on an obligation to the institution. For many financial institutions, credit risk in the investment portfolio may be low relative to other areas, such as lending. However, this risk, as with any other risk, should be effectively identified, measured, monitored, and controlled.

An institution should not acquire investments or enter into derivative contracts without assessing the creditworthiness of the issuer or counterparty. The credit risk arising from these positions should be incorporated into the overall credit-risk profile of the institution as comprehensively as practicable. Institutions are legally required to meet certain quality standards (i.e., investment grade) for security purchases. Many institutions maintain and update ratings reports from one of the major rating services. For nonrated securities, institutions should establish guidelines to ensure that the securities meet legal requirements and that the institution fully understands the risk involved. Institutions should establish limits on individual counterparty exposures. Policies should also provide credit-risk and concentration limits. Such limits may define concentrations relating to a single or related issuer or counterparty, a geographical area, or obligations with similar characteristics.

In managing credit risk, institutions should consider settlement and presettlement credit risk. These risks are the possibility that a counterparty will fail to honor its obligation at or before the time of settlement. The selection of dealers, investment bankers, and brokers is particularly important in effectively managing these risks. The approval process should include a review of each firm's financial statements and an evaluation of its ability to honor its commitments. An inquiry into the general reputation of the dealer is also appropriate. This includes review of information from state or federal securities regulators and industry self-regulatory organizations such as the National Association of Securities Dealers concerning any formal enforcement actions against the dealer, its affiliates, or associated personnel.

The board of directors is responsible for supervision and oversight of investment portfolio and end-user derivatives activities, including the approval and periodic review of policies that govern relationships with securities dealers.

Sound credit-risk management requires that credit limits be developed by personnel who are as independent as practicable of the acquisition function. In authorizing issuer and counterparty credit lines, these personnel should use standards that are consistent with those used for other activities conducted within the institution and with the organization's overall policies and consolidated exposures.

2126.1.1.5.3 Liquidity Risk

Liquidity risk is the risk that an institution cannot easily sell, unwind, or offset a particular position at a fair price because of inadequate market depth. In specifying permissible instruments for accomplishing established objectives, institutions should ensure that they take into account the liquidity of the market for those instruments and the effect that such characteristics have on achieving their objectives. The liquidity of certain types of instruments may make them inappropriate for certain objectives. Institutions should ensure that they consider the effects that market risk can have on the liquidity of different types of instruments under various scenarios. Accordingly, institutions should articulate clearly the liquidity characteristics of instruments to be used in accomplishing institutional objectives.

Complex and illiquid instruments can often involve greater risk than actively traded, more liquid securities. Oftentimes, this higher potential risk arising from illiquidity is not captured

by standardized financial modeling techniques. Such risk is particularly acute for instruments that are highly leveraged or that are designed to benefit from specific, narrowly defined market shifts. If market prices or rates do not move as expected, the demand for such instruments can evaporate, decreasing the market value of the instrument below the modeled value.

2126.1.1.5.4 Operational (Transaction) Risk

Operational (transaction) risk is the risk that deficiencies in information systems or internal controls will result in unexpected loss. Sources of operating risk include inadequate procedures, human error, system failure, or fraud. Inaccurately assessing or controlling operating risks is one of the more likely sources of problems facing institutions involved in investment activities.

Effective internal controls are the first line of defense in controlling the operating risks involved in an institution's investment activities. Of particular importance are internal controls that ensure the separation of duties and supervision of persons executing transactions from those responsible for processing contracts, confirming transactions, controlling various clearing accounts, preparing or posting the accounting entries, approving the accounting methodology or entries, and performing revaluations.

Consistent with the operational support of other activities within the financial institution, securities operations should be as independent as practicable from business units. Adequate resources should be devoted, such that systems and capacity are commensurate with the size and complexity of the institution's investment activities. Effective risk management should also include, at least, the following:

1. *Valuation.* Procedures should ensure independent portfolio pricing. For thinly traded or illiquid securities, completely independent pricing may be difficult to obtain. In such cases, operational units may need to use prices provided by the portfolio manager. For unique instruments where the pricing isbeing provided by a single source (e.g., the dealer providing the instrument), the institution should review and understand the assumptions used to price the instrument.
2. *Personnel.* The increasingly complex nature of securities available in the marketplace makes it important that operational personnel have strong technical skills. This will enable them to better understand the complex financial structures of some investment instruments.
3. *Documentation.* Institutions should clearly define documentation requirements for securities transactions, saving and safeguarding important documents, as well as maintaining possession and control of instruments purchased.

An institution's policies should also provide guidelines for conflicts of interest for employees who are directly involved in purchasing and selling securities for the institution from securities dealers. These guidelines should ensure that all directors, officers, and employees act in the best interest of the institution. The board may wish to adopt policies prohibiting these employees from engaging in personal securities transactions with these same securities firms without specific prior board approval. The board may also wish to adopt a policy applicable to directors, officers, and employees restricting or prohibiting the receipt of gifts, gratuities, or travel expenses from approved securities dealer firms and their representatives.

2126.1.1.5.5 Legal Risk

Legal risk is the risk that contracts are not legally enforceable or documented correctly. Institutions should adequately evaluate the enforceability of its agreements before individual transactions are consummated. Institutions should also ensure that the counterparty has authority to enter into the transaction and that the terms of the agreement are legally enforceable. Institutions should further ascertain that netting agreements are adequately documented, executed properly, and are enforceable in all relevant jurisdictions. Institutions should have knowledge of relevant tax laws and interpretations governing the use of these instruments.

Bank holding companies should directly manage and control their aggregate risk exposures on a consolidated basis and, if appropriate, for individual subsidiaries, in view of the distinct legal existence of various subsidiaries and possible obstacles to moving cash, other assets, and contractual agreements among subsidiaries.[1] See SR-99-3.

2126.3.1 FUNDAMENTAL ELEMENTS OF COUNTERPARTY CREDIT RISK MANAGEMENT

When conducting bank holding company inspections and supervisory contacts, and when monitoring trading and derivatives activities, supervisors and examiners should fully evaluate the integrity of certain key elements of a banking organization's (BO) counterparty credit risk management process, such as the following:

1. The BO's assessment of counterparty creditworthiness, both initially and on an ongoing basis. A counterparty's creditworthiness can be evidenced by its capital strength, leverage, any on- and off-balance-sheet risk factors, and contingencies. Creditworthiness can also be evidenced by the counterparty's liquidity, operating results, reputation, and ability to understand and manage the risks inherent in its line of business, as well as the risks involved in the particular products and transactions that define a particular customer relationship.
2. The standards, methodologies, and techniques used in measuring counterparty-credit-risk exposures on an individual instrument, counterparty, and portfolio basis.
3. The use and management of credit enhancements to mitigate counterparty credit risks, including collateral arrangements and collateral-management systems, contractual downgrades or material-change triggers, and contractual "option-to-terminate" or close-out provisions.
4. The risk-limit and -monitoring systems that involve (1) setting meaningful limits on counterparty credit risk, (2) monitoring exposures against those limits, and (3) initiating meaningful risk assessments and risk-controlling actions in the event that exposures exceed limits.

The confluence of competitive pressures, pursuit of earnings, and overreliance on customer reputation can lead to substantive lapses in fundamental risk-management principles regarding counterparty risk assessment, exposure monitoring, and the management of credit-risk limits. Policies governing these activities may be unduly general so as to compromise their usefulness in managing the risks involved with particular types of counterparties. Practices may not conform to the stated policies or their intent. Situations may also exist where internal controls, including documentation and independent review, may be inadequate or lack rigor. For some larger BOs, regimes for measuring and monitoring counterparty-credit-risk exposure may be effective in more traditional areas of credit extension, but may need enhancements when used in trading and derivatives activities.

2126.3.2 TARGETING SUPERVISORY RESOURCES

When risk focusing their supervisory initiatives, examiners should continue to target those activities and areas with significant growth and above-normal profitability profiles—especially in trading and derivatives activities where the press of business and competitive pressures may invite a BO to offer new product lines before the approval of counterparties and the necessary risk-management infrastructure or procedures are fully in place. Supervisors and examiners should encourage a BO to adopt growth, profitability, and size criteria for their audit and independent risk-management functions to use in targeting their reviews.

2126.3.3 ASSESSMENT OF COUNTERPARTY CREDITWORTHINESS

Supervisors and examiners should increase their

1. These basic principles are also to be employed in the supervision of U.S. branches and agencies of foreign banks, with appropriate adaptations to reflect that (1) those offices are an integral part of a foreign bank that should be managing its risks on a consolidated basis and recognizing possible obstacles to cash movements among branches, and (2) the foreign bank is subject to overall supervision by its home-country authorities.

focus on the appropriateness, specificity, and rigor of the policies, procedures, and internal controls that a BO currently uses to assess the counterparty credit risks arising from its trading and derivatives activities. BOs should have extensive written policies covering their assessment of counterparty creditworthiness for both the initial due-diligence process (that is, before conducting business with a customer) and for ongoing monitoring. Examiners should focus particular attention on how such policies are structured and implemented. Broadly structured, general policies that apply to all types of counterparties may prove inadequate for directing staff in the proper review of the risks posed by particular types of counterparties. For example, although most policies call for the assessment and monitoring of the capital strength and leverage of customers, the assessment of hedge-fund counterparties should not rely exclusively on simple balance-sheet measures and traditional assessments of financial condition. This information may be insufficient for those counterparties whose off-balance-sheet positions are a source of significant leverage and whose risk profiles are narrowly based on concentrated business lines (such as with hedge funds and similar institutional investors). General policies calling for periodic counterparty credit reviews over significant intervals (such as annually) are another example of broad policies that may compromise the integrity of the assessment of individual counterparties or types of counterparties—a counterparty's risk profile can change significantly over much shorter time horizons.

Credit-risk-assessment policies should also properly define the types of analyses to be conducted for particular types of counterparties based on the nature of their risk profiles. Stress testing and scenario analysis may be needed, in addition to customizing fundamental analyses based on industry and business-line characteristics. Customized analyses are particularly important when a counterparty's creditworthiness may be adversely affected by short-term fluctuations in financial markets, especially when potential credit exposure to a counterparty increases at the same time the counterparty's credit quality deteriorates.

Examiners should continue to pay special attention to areas where banking organization practices may not conform to stated policies. Such supervisory efforts may be especially difficult when the BO's policies are not specificic enough for it to properly focus its counterparty risk assessments. Therefore, examiners must ensure that the banking organization's policies sufficiently address the risk profiles of particular types of counterparties and instruments. The policies should specify (1) the types of counterparties that may require special consideration; (2) the types and frequency of information to be obtained from such counterparties; (3) the types and frequency of analyses to be conducted, including the need for and type of any stress-testing analysis; and (4) how such information and analyses appropriately address the risk profile of the particular type of counterparty. This specificity in credit-assessment policies is particularly important when limited transparency may hinder market discipline on the risk-taking activities of counterparties—as may be the case with hedge funds.

Examiners should also place increasing emphasis on ensuring that a BO's existing practice conforms both with its stated objectives and the intent of its established policies. For example, some BOs may not obtain and evaluate all the information on the financial strength, condition, and liquidity of some types of counterparties that may be required by their own policies. In highly competitive and fast-moving transaction areas, organizations should be sufficiently rigorous in conducting the analyses specified in their policies, such as the review of a counterparty's ability to manage the risks of its business.

Necessary internal controls for ensuring that practices conform with stated policies include actively enforced documentation standards and periodic independent reviews by internal auditors or other risk-control units, particularly for business lines, products, and exposures to particular groups of counterparties and individual customers that exhibit significant growth or above-normal profitability. Using targeted inspections and reviews, examiners should evaluate the integrity of a BO's internal controls. Examiners should thus conduct their own transaction testing of such situations. This testing should include robust sampling of transactions with major counterparties in the targeted area, as well as sufficient stratification to ensure that practices involving smaller relationships also adhere to stated policies.

2126.3.4 CREDIT-RISK-EXPOSURE MEASUREMENT

Financial market turbulence emphasizes the important interrelationships between market

movements and the credit-risk exposures involved in derivatives activities. Accordingly, supervisors and examiners should be alert to situations where a BO may need to be more diligent in conducting current computations of the loan equivalents and potential future exposures (PFE) that are used to measure, monitor, and control its derivatives counterparty credit exposure.

Most BOs fully recognize that the credit risk of derivatives positions includes both the current replacement cost of a contract as well as the contract's PFE. PFEs are generally calculated using statistical techniques to estimate the worst potential loss over a specified time horizon at some specified confidence interval (for example, 95 percent, 97.5 percent, and 99 percent), which is generally derived in some manner from historically observed market fluctuations. Together with the current replacement cost, such PFEs are used to convert derivatives contracts to "loan equivalents" for aggregating credit exposures across products and instruments.

The time horizon used to calculate PFEs can vary depending on the banking organization's risk tolerance, collateral protection, and ability to terminate its credit exposure. Some BOs may use a time horizon equal to the life of the respective instrument. While such a time horizon may be appropriate for unsecured positions, for collateralized exposures, the use of lifetime, worst-case-estimate PFEs may be ineffective to measure the true nature of counterparty risk exposure. While life-of-contract PFE measures provide an objective and conservative long-term exposure estimate, they bear little relationship to the actual credit exposures typically incurred in the case of collateralized relationships. In such cases, a banking organization's actual credit exposure is the PFE from the time a counterparty fails to meet a collateral call until the time the bank liquidates its collateral and closes out the derivative contract—a period which is typically much shorter than the contract's life. The lack of realism in conservative measurement can cause managers and traders to discount them and may result in inappropriate limits being set, thereby compromising the entire risk-management process.

More realistic measures of collateralized credit-risk exposures should also take into account the shorter time horizons over which action can be taken to mitigate losses in times of market stress. These measures should incorporate estimates of collateral-recovery rates given the potential market liquidity impacts of stress events on collateral values. Some BOs already do stress tests, calculating measures that assess the worst-case value of positions over a time horizon of one or two weeks—their estimate of a reasonable liquidation period in times of stress. They also perform scenario analyses of counterparty credit exposures. Stress testing and scenario analyses should evaluate the impact of large market moves on the credit exposure to individual counterparties, and they should assess the implications inherent in liquidating positions under such conditions. Analyses should consider the effects of market liquidity on the value of positions and any related collateral. The use of meaningful scenario analyses is particularly important since stress tests derived from simple applications of higher confidence intervals or longer time horizons to PFE, value-at-risk, and other measures may not adequately capture the market and exposure dynamics under turbulent market conditions, particularly as they relate to the interaction between market, credit, and liquidity risk.

The results of stress testing and scenario analyses should be incorporated into senior management reports. Such reports should provide sufficient information to ensure an adequate understanding of the nature of the exposure and the analyses conducted. Information should also be sufficient to trigger risk-controlling actions where necessary.

Other BOs are moving to build the capability of estimating portfolio-based PFEs by any one of several different time horizons or buckets, depending on the liquidity and breadth of the underlying instrument or risk factor. Based on management's opinion of the appropriate workout timeframe, different time horizons can be used for different counterparties, transactions, or collateral types to more precisely define exposures. Supervisors and examiners should be alert to situations where collateralized exposures may be inaccurately estimated, and should encourage management at these BOs to enhance their exposure-measurement systems accordingly.

Supervisors should also be cognizant of the manner in which the credit exposures are aggregated for individual counterparties. Some BOs may take a purely transactional approach to aggregation and *not incorporate the netting of long and short derivatives contracts*, even when legally enforceable bilateral netting agreements are available. In such cases, *simple sum estimates of positive exposures may seriously overestimate true credit exposure*, and examiners should monitor and encourage a BO's movement toward more realistic measures of counter-

party exposure. Other BOs may take a portfolio approach, in which information systems allow and incorporate netting (both within and across products, business lines, or risk factors) and portfolio correlation effects to construct more comprehensive counterparty exposure measures. In such cases, supervisors should ensure that a BO has adequate internal controls governing exposure estimation, including robust model-review processes and data-integrity checks.

When stratifying samples and selecting the counterparties and transactions to use for their targeted testing of practices and internal controls, supervisors and examiners should incorporate measures of potential future exposure regardless of the collateralization of current market-value exposures. As recent events have shown, meaningful counterparty credit risks that surface during periods of stress can go undetected when too much emphasis is placed on collateralization of current market values and only unsecured current market exposures are used for targeting transaction testing.

2126.3.5 CREDIT ENHANCEMENTS

BOs continue to rely increasingly on different types of credit enhancements to mitigate counterparty credit risks. These enhancements include the use of collateral arrangements, contractual downgrades or material-change triggers that enable the alteration of collateral or margining arrangements, or the activation of contractual "option to terminate" or closeout provisions.

Collateralization of exposures has become an industry standard for many types of counterparties. Collateralization mitigates but does not eliminate credit risks. BOs therefore should ensure that overreliance on collateral does not compromise other elements of sound counterparty credit-risk management, such as the due-diligence process. Clear policies should govern the determination of loss thresholds and margining requirements for derivatives counterparties of BOs. Such policies should not be so broad that they compromise the risk-reducing nature of collateral agreements with specific types of counterparties. Policies governing collateral arrangements should specifically define those cases in which initial and variation margin is required, and they should explicitly identify situations in which the lack of transparency, business-line risk profiles, and other counterparty characteristics merit special treatment—as may be the case with some highly leveraged counterparties such as hedge funds. Where consistent with the risk profile of the counterparty and instruments involved, policies should specify when margining requirements based on estimates of potential future exposures might be warranted.

Adequate policies should also govern the use of material-change triggers and closeout provisions, which should take into account counterparty-specific situations and risk profiles. For example, closeout provisions based on annual events or material-change triggers based on long-term performance may prove ineffective for counterparties whose risk profiles can change rapidly. Also, such material-change triggers, closeout provisions, and related covenants should be designed to adequately protect against deterioration in a counterparty's creditworthiness. They should ensure that a BO is made aware of adverse financial developments on a timely basis and should facilitate action as counterparty risk increases—well in advance of the time when termination of a relationship is appropriate.

Internal assessments of potential risk exposures sometimes dictate loss thresholds, margining requirements, and closeout provisions with some counterparties. Insufficient internal controls may unduly expose certain BOs to these as well as other types of trading and derivatives counterparties. When evaluating the management of collateral arrangements and other credit enhancements, examiners should not only assess the adequacy of a banking organization's policies but should also determine whether internal controls are sufficient to ensure that practices comply with these policies. Examiners should identify the types of credit enhancements and contractual covenants that are being used when reviewing areas of counterparty risk management, and then determine whether the banking organization has sufficiently assessed the adequacy of these enhancements and covenants relative to the risk profile of the counterparty.

2126.3.6 CREDIT-RISK-EXPOSURE LIMIT-SETTING AND MONITORING SYSTEMS

Exposure-monitoring and limit systems are critical to the effective management of counterparty credit risk. Examiners should focus special attention on the policies, practices, and internal controls employed within such systems at large, complex BOs. An effective exposure-

monitoring system consists of (1) establishing meaningful limits on the risk exposures a BO is willing to take, (2) independent, ongoing monitoring of exposures against such limits, and (3) adequate controls to ensure that meaningful risk-controlling action takes place when limits are exceeded. An effective exposure-monitoring and limit process depends on meaningful exposure-measurement methodologies, so supervisors should closely evaluate measurement methodologies, especially for the estimation of PFEs. Inaccurate measurement can easily compromise well-structured policies and procedures. Such situations can lead to limits driven primarily by customer demand and used only to define and monitor customer facilities, rather than limits that serve as strict levels defined by credit management and that initiate risk-controlling actions.

Supervisors and examiners should also assess the procedures used for controlling credit-risk exposures when they become large, when a counterparty's credit standing weakens, or when the market comes under stress. Management should demonstrate its clear ability to reduce large positions. Such actions can include ''capping'' current exposures, curtailing new business, assigning transactions to another counterparty (where feasible), and restructuring the transaction to limit potential exposure or make it less sensitive to market volatility. BOs can also use various credit-enhancement tools to manage exposures that have become unduly large or highly sensitive to market volatility.

2126.3.7 INSPECTION OBJECTIVES

1. To determine if sufficient resources are devoted and adequate attention is given to the management of the risks involved in growing, highly profitable, or potentially high-risk activities and product lines.
2. To ascertain if the banking organization's internal audit and independent risk-management functions adequately focus on growth, profitability, and risk criteria when targeting their reviews.
3. To determine if there is an appropriate balance among all elements of credit-risk management. This balance includes both qualitative and quantitative assessments of counterparty creditworthiness; measurement and evaluation of on- and off-balance sheet exposures, including potential future exposure; adequate stress testing; reliance on collateral and other credit enhancements; and the monitoring of exposures against meaningful limits.
4. To ascertain whether the banking organization employs policies that are sufficiently calibrated to the risk profiles of particular types of counterparties and instruments, which ensures adequate credit-risk assessment, exposure measurement, limit setting, and use of credit enhancements.
5. To ensure that the banking organization's actual business practices conform with their stated policies and the intent of these policies.
6. To establish if the banking organization is moving in a timely fashion to enhance its measurement of counterparty credit-risk exposures, including refining potential future exposure measures and establishing stress-testing methodologies to better incorporate the interaction of market and credit risks.
7. To accomplish the above inspection objectives by using sufficient, targeted transaction testing on those activities, business lines, and products experiencing significant growth, above-normal profitability, or large potential future exposures.

2126.3.8 INSPECTION PROCEDURES

1. Give increased focus to the adequacy, appropriateness, specificity, and rigor of the policies, procedures, and internal controls that a BO currently uses to assess the counterparty credit risks arising from its trading and derivatives activities.
   a. Determine if sufficient written policies cover the assessment of counterparty creditworthiness for the initial due-diligence process (that is, before conducting business with a customer) and for ongoing monitoring.
   b. Give particular attention to how such policies are structured, their adequacy, and how they are implemented.
2. Focus special attention on areas where a BO's practices may not conform to its stated policies.
   a. Determine if the banking organization's policies sufficiently address the risk profiles of its particular types of counterparties and instruments.
   b. Ascertain whether existing practices conform to the stated objectives and the intent of the organization's established policies.

3. Evaluate the banking organization's documentation standards.
4. Determine whether the internal reviews are adequately conducted for business lines, products, and exposures to particular groups of counterparties and individual customers that exhibit significant growth or above-normal profitability.
5. Evaluate the integrity of the internal controls that the banking organization uses to assess its own transaction testing during internal reviews.
6. Conduct independent targeted reviews of the internal controls.
   a. Use robust sampling when testing transactions of major counterparties within a targeted area.
   b. Employ sufficient stratification to ensure that practices involving smaller relationships also adhere to stated policies.
   c. Be alert to situations whereby the current computations of loan equivalents and potential exposures—that are used to measure, monitor, and control derivatives counterparty credit exposures—could be deliberately enhanced.
7. Determine if the banking organization needs to develop more meaningful measures of credit-risk exposures, such as using stress testing and scenario analyses, under volatile market conditions.

Interest-Rate Risk (Risk Management and Internal Controls) Section 2127.0

Interest-rate risk (IRR) is the exposure of a banking organization's financial condition to adverse movements in interest rates. Accepting this risk can be an important source of profitability and shareholder value. However, excessive levels of IRR can pose a significant threat to a bank's or bank holding company's earnings and capital base. Accordingly, effective risk management that maintains IRR at prudent levels is essential to the organization's safety and soundness.

Evaluating a bank holding company's exposure to changes in interest rates is an important element of any full-scope inspection and may be the sole topic for specialized or targeted inspections. This evaluation includes assessing both the adequacy of the management process used to control IRR and the organization's quantitative level of exposure. When assessing the IRR management process, examiners should ensure that appropriate policies, procedures, management information systems, and internal controls are in place to maintain IRR at prudent levels with consistency and continuity. Evaluating the quantitative level of IRR exposure requires examiners to assess the existing and potential future effects of changes in interest rates on a bank holding company's consolidated financial condition, including its capital adequacy; earnings; liquidity; and, where appropriate, asset quality. To ensure that these assessments are both effective and efficient, examiner resources must be appropriately targeted at those elements of an organization's IRR that pose the greatest threat to its financial condition. This targeting requires an inspection process built on a well-focused assessment of IRR exposure before the on-site engagement, a clearly defined inspection scope, and a comprehensive program for following up on inspection findings and ongoing monitoring.

The Board, together with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, adopted a Joint Agency Policy Statement on Interest-Rate Risk, effective June 26, 1996. (See SR-96-17.) It provides guidance to examiners and bankers on sound practices for managing interest-rate risk, which will form the basis for ongoing evaluation of the adequacy of interest-rate risk management at supervised institutions.

The policy statement outlines fundamental elements of sound management that have been identified in prior Federal Reserve guidance and discusses the importance of these elements in the context of managing interest-rate risk.[1] Specifically, the guidance emphasizes the need for active board and senior management oversight and a comprehensive risk-management process that effectively identifies, measures, and controls interest-rate risk.

Although the guidance targets interest-rate risk management at commercial banks and Edge Act corporations, the basic principles presented in the policy statement are to be applied to bank holding companies. Bank holding companies should manage and control aggregate risk exposure on a consolidated basis by recognizing legal distinctions and possible obstacles to cash movements among subsidiaries. The assessment of interest-rate risk management made by examiners in accordance with the 1996 Joint Policy Statement will be incorporated into a bank holding company's overall risk-management rating. Bank holding company examiners should refer to section 4090.1 of the *Commercial Bank Examination Manual* for more detailed inspection guidance on the joint policy statement on interest-rate risk.

1. Guidance to examiners identifying fundamental elements of sound risk management includes SR-96-14 (see section 2124.0), "Risk-Focused Examinations and Inspections"; SR-96-13, "Joint Policy Statement on Interest-Rate Risk"; SR-96-10, "Risk-Focused Fiduciary Examinations"; SR-95-51 (see section 4070.1), "Rating the Adequacy of Risk-Management Processes and Internal Controls at State Member Banks and Bank Holding Companies"; SR-95-22, "Enhanced Framework for Supervising the U.S. Operations of Foreign Banking Organizations"; SR-95-17 (see section 2126.0), "Evaluating the Risk Management and Internal Controls of Securities and Derivatives Contracts Used in Nontrading Activities"; and SR-93-69 (see section 2125.0), "Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations."

Structured Notes (Risk Management and Internal Controls) Section 2128.0

This section discusses supervisory policy with regard to structured notes and their increased use by banking organizations. Examiners should be mindful of these instruments, whether they are used in the banking organization's trading, investment, or trust activities. Some of these instruments can expose investors to significant losses as interest rates, foreign-exchange rates, and other market indices change. Consequently, during examinations or inspections, examiners need to ensure that banks and bank holding companies that hold structured notes do so according to their own investment policies and procedures and with a full understanding of the risks and price sensitivity of these instruments under a broad range of market conditions.

Structured notes, many of which are issued by U.S. government agencies, government-sponsored entities, and other organizations with high credit ratings, are debt securities whose cash flows are dependent on one or more indices in ways that create risk characteristics of forwards or options. They tend to have medium-term maturities and reflect a wide variety of cash-flow characteristics that can be tailored to the needs of individual investors.

As such, these notes may offer certain advantages over other financial instruments used to manage market risk. In particular, they may reduce counterparty credit risk, offer operating efficiencies and lower transaction costs, require fewer transactions, and more specifically address an institution's risk exposures. Risk to principal is typically small. Accordingly, when structured notes are analyzed and managed properly, they can be acceptable investments and trading products for banks.

However, structured notes can also have characteristics that cause them to be inappropriate holdings for many banking organizations, including depository institutions. They can have substantial price sensitivity; they can be complex and difficult to evaluate; and they may also reflect high amounts of leverage relative to fixed-income instruments with comparable face values. Their customized features and embedded options may also make them difficult to price and can reduce their liquidity. Consequently, banking organizations considering the purchase of structured notes should determine whether these factors are compatible with their investment horizons and with their overall portfolio strategies.

There are a wide variety of structured notes, with names such as single- or multi-index floaters, inverse floaters, index-amortizing notes, step-up bonds, and range bonds. These simple, though sometimes cryptic, labels can belie the potential complexity of these notes and their possibly volatile and unpredictable cash flows, which can involve both principal and interest payments. Some notes employ "trigger levels" at which cash flows can change significantly, or caps or floors, which can also substantially affect their price behavior.

The critical factor for examiners to consider is the ability of management to understand the risks inherent in these instruments and to satisfactorily manage the market risks of their institution. Therefore, examiners should evaluate the appropriateness of these securities institution by institution, with a knowledge of management's expertise in evaluating such instruments, the quality of the relevant information systems, and the nature of its overall exposure to market risk. This evaluation may include a review of the stress-test capabilities. Failure of management to adequately understand the dimensions of the risks in these and similar financial products can constitute an unsafe and unsound practice for banking organizations.

When making investment decisions, some banking organizations may focus only on the low credit risk and favorable yields of structured notes and either overlook or underestimate their market and liquidity risks. Consequently, where these notes are material, examiners should discuss their role in the organization's risk-management process and assess management's recognition of their potential volatility.

The risks inherent in such complex instruments and relevant risk-management standards have been addressed in a variety of previously issued supervisory guidance, including SR-letters and supervisory manuals. This guidance includes SR-90-16, standards for investing in asset-backed securities (see section 2128.02); SR-93-69 (see section 2125.0) and SR-95-17 (see section 2126.0), examination guidance for reviewing trading and nontrading activities (SR-95-17 deals with securities and derivative contracts used in nontrading activities); and the *Trading and Capital-Markets Activities Manual.* Although these documents may not specifically cite structured notes, they all help to highlight the following important supervisory and risk-management practices that are relevant to these instruments:

1. the importance of policies, approved by the board of directors, that address the goals and objectives expected to be achieved with such products and that set limits on the amount of funds that may be committed to them
2. the need for management to fully understand the risks these instruments can present, including their potentially reduced liquidity in secondary markets and the price volatility that any embedded options, leveraging, or other characteristics can create
3. the need for adequate information systems and internal controls for managing the risks under changing market conditions
4. the importance of clear lines of authority for making investment decisions and for evaluating and managing the institution's securities activities that involve such instruments

For additional information, see SR-97-21 and SR-91-4. See also sections 3010.3 and 4040.1 of the *Trading and Capital-Markets Activities Manual* for more detailed guidance.

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

While the objectives of securitization may vary from one depository institution to another, there are essentially five benefits that can be derived from those transactions. First, the sale of assets may reduce regulatory costs. The removal of an asset from an institution's books reduces capital requirements and reserve requirements on deposits funding the asset. Second, securitization provides originators with an additional source of funding and liquidity. The process of securitization is basically taking an illiquid asset and converting it into a security with greater marketability. Securitized issues often carry a higher credit rating than that which the institution itself could normally obtain and consequently may provide a cheaper form of funding. Third, securitization may be used to reduce interest-rate risk by improving the depository institution's asset-liability mix. This is especially true if the institution has a large investment in fixed-rate, low-yield assets. Fourth, by removing assets, the institution enhances its return on equity and assets. Finally, the ability to sell these securities worldwide diversifies the institution's funding base, thereby reducing dependence on local economies.

It is appropriate for banking organizations to engage in securitization activities and to invest in ABS, if they do so prudently. Nonetheless, these activities can significantly affect their overall risk exposure. It is therefore of great importance, particularly given the growth and expansion of such activities, for examiners to be fully informed about the fundamentals of the securitization process, the various risks that securitization and investing in ABS can create for banking organizations, and procedures that should be followed in examining banks and inspecting bank holding companies in order to effectively assess their exposure to risk and management of that exposure.

To provide examiners with the information and guidance they need on asset securitization, the following instructions were developed for System use. The mechanics of securitization and related accounting issues are discussed, and inspection guidelines, objectives, and procedures are provided.[1]

2128.02.1 OVERVIEW OF ASSET SECURITIZATION

In recent years, the number of banks and bank holding companies (hereafter referred to as banking organizations) that have issued securities backed by their assets and that have acquired asset-backed securities as investments has increased markedly. The reason for this increase is that securitization activities can yield significant financial and operational benefits for banking organizations.

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

The federal government encouraged the securitization of residential mortgages. In 1970, the Government National Mortgage Association (Ginnie Mae or GNMA) created the first publicly traded mortgage-backed security. Soon, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), both government-sponsored agencies, also developed mortgage-backed securities. The guarantees that these government or government-sponsored entities provide, which assure investors of the payment of principal and interest, have greatly facilitated the securitization of mortgage assets.

1. The Federal Reserve System has developed the following three-volume set that contains educational material on the process of asset securitization and provides examination guidelines (see SR-90-16):
- An Introduction to Asset Securitization
- Accounting Issues Relating to Asset Securitization
- Examination Guidelines for Asset Securitization

2128.02.2 SECURITIZATION PROCESS

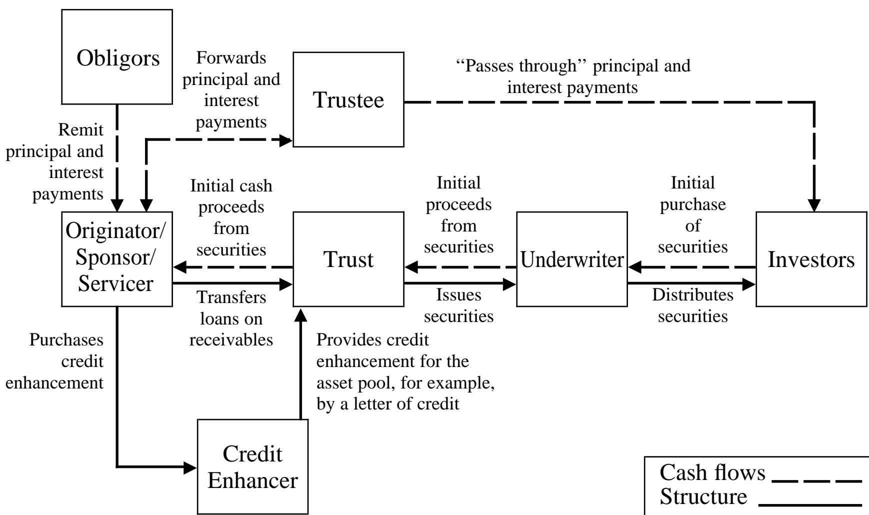
The asset-securitization process, as depicted in figure 1, begins with the segregation of loans or leases into pools that are relatively homogeneous with respect to credit, maturity, and interest-rate risks. These pools of assets are then transferred to a trust or other entity known as an issuer because it issues the securities or ownership interests that are acquired by investors. These asset-backed securities may take the form of debt, certificates of beneficial ownership, or other instruments. The issuer is typically protected from bankruptcy by various structural and legal arrangements. A sponsor that provides the assets to be securitized owns or otherwise establishes the issuer.

Each issue of asset-backed securities has a servicer responsible for collecting interest and principal payments on the loans or leases in the underlying pool of assets and for transmitting these funds to investors (or a trustee representing them). A trustee monitors the activities of servicers to ensure that they properly fulfill their role.

A guarantor may also be involved to see that investors receive principal and interest payments on a timely basis, even if the servicer does not collect these payments from the obligors. Many issues of mortgage-backed securities are either directly guaranteed by GNMA, a government agency backed by the full faith and credit of the U.S. government, or are guaranteed by Fannie Mae or FHLMC, which are government-sponsored agencies that are perceived by the credit markets to have the implicit support of the federal government. Privately issued, mortgage-backed securities and other types of asset-backed securities generally depend on some form of credit enhancement provided by the originator or third party to insulate the investor from some or all of any credit losses. Usually, credit enhancement is provided for several multiples of the historical losses experienced on the particular asset backing the security.

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

Figure 1
Pass-through, asset-backed securities: structure and cash flows



of historical losses on the particular asset collateralizing the securities.

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

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

Traditional lending activities are generally funded by deposits or other liabilities, and both the assets and related liabilities are reflected on the balance sheet. Deposit liabilities must generally increase in order to fund additional loans.

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

2128.02.3 STRUCTURE OF ASSET-BACKED SECURITIES

Asset securitization involves different kinds of capital-market instruments. These instruments may be structured as "pass-throughs" or "pay-throughs." Under a pass-through structure, the cash flows from the underlying pool of assets are passed through to investors on a pro rata basis. This type of security is typically a single-class instrument such as a GNMA pass-through. The pay-through structure, with multiple classes, combines the cash flows from the underlying pool of assets and reallocates them to two or more issues of securities that have different cash-flow characteristics and maturities. An example is the collateralized mortgage obligation (CMO), which has a series of bond classes, each with its own specified coupon and stated maturity. In most cases, the assets that make up the CMO collateral pools are pass-through securities. Scheduled principal payments, and any prepayments, from the underlying collateral go first to the earliest maturing class of bonds. This first class of bonds must be retired before the principal cash flows are used to retire the later bond classes. The development of the pay-through structure resulted from the desire to broaden the marketability of these securities to investors who were interested in maturities other than those generally associated with pass-through securities.

Multiple-class asset-backed securities may also be issued as derivative instruments such as "stripped" securities. Investors in each class of a stripped security will receive a different portion of the principal and interest cash flows from the underlying pool of assets. In their purest form, stripped securities may be issued as *interest-only (IO) strips*, for which the investor receives 100 percent of the interest from the underlying pool of assets, and as *principal-only (PO) strips*, for which the investor receives all of the principal.

In addition to these securities, other types of financial instruments may arise as a result of asset securitization. One such instrument is loan-servicing rights that are created when organizations purchase the right to act as servicers for pools of loans. The cost of these purchased servicing rights may be recorded as an intangible asset when certain criteria are met. Another financial instrument, excess-servicing-fee receivables, generally arise when the present value of any additional cash flows from the underlying

assets that a servicer expects to receive exceeds standard normal servicing fees. Another instrument, asset-backed securities residuals (sometimes referred to as "residuals" or "residual interests"), represents claims on any cash flows that remain after all obligations to investors and any related expenses have been met. Such excess cash flows may arise as a result of overcollateralization or from reinvestment income. Residuals can be retained by sponsors or purchased by investors in the form of securities.

2128.02.4 SUPERVISORY CONSIDERATIONS REGARDING ASSET SECURITIZATION

Although banking organizations clearly benefit from engaging in securitization activities and investing in asset-backed securities, these activities, if not conducted prudently, can increase a banking organization's overall risk profile. For the most part, the risks that financial institutions encounter in the securitization process are identical to those that they face in traditional lending transactions. These involve credit risk, concentration risk, and interest-rate risk—including prepayment risk, operational risk, liquidity risk, and funding risk. However, since the securitization process separates the traditional lending function into several limited roles such as originator, servicer, credit enhancer, trustee, and investor, the types of risks that a bank will encounter will differ depending on the role it assumes.

Investors who invest in asset-backed securities, like investors who invest directly in the underlying assets, will be exposed to credit risk, that is, the risk that obligors will default on principal and interest payments. Investors are also subject to the risk that the various parties in the securitization structure, for example, the servicer or trustee, will be unable to fulfill their contractual obligations. Moreover, investors may be susceptible to concentrations of risks across various asset-backed security issues through overexposure to an organization performing various roles in the securitization process or as a result of geographic concentrations within the pool of assets providing the cash flows for an individual issue. Also, because the secondary markets for certain asset-backed securities are thin, investors may encounter greater than anticipated difficulties when seeking to sell their securities. Furthermore, certain derivative instruments, such as stripped asset-backed securities and residuals, may be extremely sensitive to interest rates and exhibit a high degree of price volatility, and, therefore, may dramatically affect the risk exposure of investors unless used in a properly structured hedging strategy.

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

Banking organizations that service securitization issues must ensure that their policies, operations, and systems will not permit breakdowns that may lead to defaults. Issuers and servicers may face pressures to provide "moral recourse" by repurchasing securities backed by loans or leases that they have originated that have deteriorated and become nonperforming. Funding risk may also be a problem for issuers when market aberrations do not permit the issuance of asset-backed securities that are in the securitization pipeline.

Asset-securitization transactions are frequently structured to obtain certain accounting treatments, which, in turn, affect reported measures of profitability and capital adequacy. In transferring assets into a pool to serve as collateral for asset-backed securities, a key question is whether the transfer should be treated as a sale of the assets or as a collateralized borrowing, that is, a financing transaction secured by assets. Sales treatment results in the assets being removed from the banking organization's balance sheet, thus reducing total assets relative to earnings and capital, thereby producing higher performance and capital ratios. Treatment of these transactions as financings, however, means that the assets in the pool remain on the balance sheet and are subject to capital requirements and the related liabilities to reserve requirements.[2]

2128.02.5 POLICY STATEMENT ON INVESTMENT SECURITIES AND END-USER DERIVATIVES ACTIVITIES

On April 23, 1998, the FFIEC issued a State-

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

ment on Investment Securities and End-User Derivatives Activities, effective May 25, 1998. The statement was adopted by the Board of Governors and the other federal financial institutions regulatory agencies. It provides guidance on sound practices for managing the risks of investment activities, focusing on sound risk-management practices that should be used by state member banks and Edge corporations. The basic principles also apply to bank holding companies, which should manage and control risk exposures on a consolidated basis, giving recognition to the legal distinctions and potential obstacles to cash movements among subsidiaries.

The statement's principles set forth risk-management practices that are relevant to most portfolio-management endeavors. The statement places greater emphasis on a risk-focused approach to supervision. Instruments held for end-user reasons are considered, taking into consideration a variety of factors such as management's ability to manage and measure risk within the institution's holdings and the impact of those holdings on aggregate portfolio risk. See section 2126.1 and SR-98-12.[3]

2128.02.5.1 Mortgage-Derivative Products

Mortgage-derivative products include instruments such as collateralized mortgage obligations (CMOs), real estate mortgage investment conduits (REMICs), stripped mortgage-backed securities (SMBS), and CMO and REMIC residuals. Supervisory concerns about these instruments arise from their extreme sensitivity to interest rates and the resulting price volatility. This price volatility is caused in part by the uncertain cash flows that result from changes in the prepayment rates of the underlying mortgages. Institutions that purchase such high-risk mortgage-derivative securities need to understand and effectively manage the associated risks. The levels of activity in such products should reasonably be related to the institution's capital, capacity to absorb losses, and level of in-house management sophistication and expertise. Appropriate managerial and financial controls need to be in place, and the institution must analyze, monitor, and prudently adjust its holdings of high-risk mortgage securities in an environment of changing price and maturity expectations.

Before an institution takes a position in any high-risk mortgage security, management should conduct an analysis to ensure that the position will reduce the institution's overall interest-rate risk. It should also consider the liquidity and price volatility of these products before their purchase.

CMOs and REMICs were developed in response to investors' concerns about the uncertainty of cash flows associated with the prepayment option of the underlying mortgagor. These securities can be collateralized directly by mortgages, but more often they are collateralized by mortgage-backed securities issued or guaranteed by GNMA, Fannie Mae, or FHLMC and held in trust for investors. The cash flow from the underlying mortgages is segmented and paid in accordance with a predetermined priority to investors holding various tranches. By allocating the principal and interest cash flows from the underlying collateral among the separate CMO tranches, different classes of bonds are created, each with its own stated maturity, estimated average life, coupon rate, and prepayment characteristics. It is essential to understand the coupon rates of the underlying mortgages of the CMO or REMIC in order to assess the prepayment sensitivity of the CMO tranches.

SMBS consist of two classes of securities, with each class receiving a different portion of the monthly interest and principal cash flows from the underlying mortgage-backed securities (MBS). A stripped mortgage-backed security, in its purest form, is converted into an interest-only (IO) strip, in which the investor receives all of the interest cash flows and none of the principal. An investor owning a principal-only (PO) strip receives all of the principal cash flows and none of the interest. IOs and POs have highly volatile price characteristics based, in part, on the prepayment variability of the underlying mortgages. Generally, POs increase in value when interest rates decline, in part because prepayments shorten the maturity of mortgages. In contrast, IOs and residuals tend to increase in value when interest rates rise because prepayments decline, maturities lengthen, and more interest is collected on the underlying mortgages.

When purchasing an IO, PO, or residual, without offsetting hedges, the investor may be speculating on future interest-rate movements and how these movements will affect the prepayment of the underlying collateral. Furthermore, stripped mortgage-backed securities

3. The supervisory policy statement on Investment Securities and End-User Derivatives Activities is in the *Federal Reserve Regulatory Service* at 3–1562.

that do not have a government agency's or a government-sponsored agency's guarantee of principal and interest have an added element of credit risk. The policy statement discusses the appropriateness of these instruments for depository institutions and the prudential measures that a depository institution should take to protect itself from undue risk when investing in them.

Residuals represent claims on any cash flows from a CMO issue or other asset-backed security remaining after the payments to the holders of the other classes have been made and after trust-administration expenses are met. The economic value of a residual is a function of the present value of the anticipated cash flows.

2128.02.6 RISK-BASED CAPITAL PROVISIONS AFFECTING ASSET SECURITIZATION

The risk-based capital framework has three main features that will affect the asset-securitization activities of banking organizations. First, the framework assigns risk weights to loans, asset-backed securities, and other assets related to securitization. Second, bank holding companies that transfer assets with recourse to the seller as part of the securitization process will now explicitly be required to hold capital against their off-balance-sheet credit exposures. Third, banking organizations that provide credit enhancement to asset-securitization issues through standby letters of credit or by other means will have to hold capital against the related off-balance-sheet credit exposure.

The risk weights assigned to an asset-backed security depend on the issuer and whether the assets that make up the collateral pool are mortgage-related assets. Asset-backed securities issued by a trust or by a single-purpose corporation and backed by nonmortgage assets are to be assigned a risk weight of 100 percent.

Securities guaranteed by U.S. government agencies and those issued by U.S. government–sponsored agencies are assigned risk weights of 0 and 20 percent, respectively, because of the low degree of credit risk. Accordingly, mortgage pass-through securities guaranteed by GNMA are placed in the risk category of 0 percent. In addition, securities such as participation certificates and CMOs issued by Fannie Mae or FHLMC are assigned a 20 percent risk weight.

However, several types of securities issued by Fannie Mae and FHLMC are excluded from the lower risk weight and slotted in the 100 percent risk category. Residual interests (for example, CMO residuals) and subordinated classes of pass-through securities or CMOs that absorb more than their pro rata share of loss are assigned to the 100 percent risk-weight category. Furthermore, all stripped mortgage-backed securities, including IOs, POs, and similar instruments, are assigned to the 100 percent risk-weight category because of their extreme price volatility and market risk. The treatment of stripped mortgage-backed securities will be reconsidered when a method to measure interest-rate risk is incorporated into the risk-based capital guidelines.

A privately issued, mortgage-backed security that meets the criteria listed below is considered as a direct or indirect holding of the underlying mortgage-related assets and is assigned to the same risk category as those assets (for example, U.S. government agency securities, U.S. government–sponsored agency securities, FHA- and VA-guaranteed mortgages, and conventional mortgages). However, under no circumstances will a privately issued mortgage-backed security be assigned to the 0 percent risk category. Therefore, private issues that are backed by GNMA securities will be assigned to the 20 percent risk category as opposed to the 0 percent category appropriate to the underlying GNMA securities. Following are the criteria that a privately issued mortgage-backed security must meet to be assigned the same risk weight as the underlying assets:

1. The underlying assets are held by an independent trustee, and the trustee has a first-priority, perfected security interest in the underlying assets on behalf of the holders of the security.
2. The holder of the security has an undivided pro rata ownership interest in the underlying mortgage assets, or the trust or single-purpose entity (or conduit) that issues the security has no liabilities unrelated to the issued securities.
3. The cash flow from the underlying assets of the security in all cases fully meets the cash-flow requirements of the security without undue reliance on any reinvestment income.
4. No material reinvestment risk is associated with any funds awaiting distribution to the holders of the security.

Those privately issued mortgage-backed securities that do not meet the above criteria are

to be assigned to the 100 percent risk category.

If the underlying pool of mortgage-related assets is composed of more than one type of asset, then the entire class of mortgage-backed securities is assigned to the category appropriate to the highest risk-weighted asset in the asset pool. For example, if the security is backed by a pool consisting of U.S. government–sponsored agency securities (for example, FHLMC participation certificates) that qualify for a 20 percent risk weight and conventional mortgage loans that qualify for the 50 percent risk category, then it would receive the 50 percent risk weight.

As previously mentioned, bank holding companies report their activities in accordance with generally accepted accounting principles (GAAP), which permits asset-securitization transactions to be treated as sales when certain criteria are met, even when there is recourse to the seller. With the advent of risk-based capital, bank holding companies will be explicitly required to hold capital against the off-balance-sheet credit exposure arising from the contingent liability associated with the recourse provisions. This exposure is considered a direct credit substitute that would be converted at 100 percent to an on-balance-sheet credit-equivalent amount for appropriate risk weighting.

Banking organizations that issue standby letters of credit for asset-backed security issues, as credit enhancements, must hold capital against these contingent liabilities under the risk-based capital guidelines. According to the guidelines, financial standby letters of credit are direct credit substitutes, which are converted in their entirety to credit-equivalent amounts. The credit-equivalent amounts are then risk weighted according to the type of counterparty or, if relevant, to any guarantee or collateral.

2128.02.7 UNDERWRITING AND DEALING IN SECURITIES

Member banks may underwrite and deal in obligations of the United States, general obligations of states and political subdivisions, and certain securities issued or guaranteed by government agencies (12 U.S.C. 335 and 12 U.S.C. 24 (Seventh)). Bank holding companies may underwrite and deal in U.S. government and agency and state and municipal securities and other obligations that state member banks are authorized to underwrite and deal in under section 16 of the Glass-Steagall Act (referred to as “eligible-securities”), as authorized by section 225.28(b)(8) of Regulation Y. By Board order, beginning in 1987, certain bank holding company nonbanking subsidiaries were given the authority to underwrite and deal in “ineligible securities” that member banks may not underwrite and deal in, specifically—

1. municipal revenue bonds, including “public ownership” industrial development bonds (tax-exempt bonds in which the governmental issuer, or the government unit on behalf of which the bonds are issued, is the owner, for federal income tax purposes, of the financed facility—such as airports, mass transportation facilities, and water pollution control facilities);
2. mortgage-related securities (obligations secured by or representing an interest in one-to four-family residential real estate);
3. consumer-receivable-related securities; and
4. “prime quality” commercial paper.

In January 1989, certain bank holding companies having section 20 nonbanking subsidiaries were also approved to underwrite and deal in debt or equity securities (excluding open-end investment companies). The Board, however, required that each applicant establish the necessary managerial and operational infrastructure before receiving Board authorization to commence the expanded underwriting and dealing activity. All bank holding companies having section 20 Board orders are subject to specific conditions (“firewalls”) as stated within their respective Board orders.

On September 21, 1989, the Board approved by order (1989 FRB 751) the ability of bank holding company subsidiaries to underwrite and deal in securities of affiliates, consistent with the former section 20 of the Glass-Steagall Act, if the securities—

1. are rated by an unaffiliated, nationally recognized statistical rating organization or
2. are issued or guaranteed by Fannie Mae, FHLMC, or GNMA, or represent interests in such obligations.

The securitization power of national banks was reaffirmed on February 20, 1990, when the Supreme Court let stand a court of appeals ruling that permits national banks to package and sell mortgage loans as securities. The ruling confirms that they can not only sell but underwrite mortgage-backed securities from mortgage loans that they originate (*Securities Indus-*

try Association v. *Clarke*, 885 F.2d 1034 (2d Cir. 1989), *cert. denied*, 110 S.Ct. 1113).

2128.02.8 INSPECTION OBJECTIVES

1. To determine that securitization activities are integrated into the overall strategic objectives of the organization.
2. To determine that sources of credit risk are understood, properly analyzed, and managed, without excessive reliance on credit ratings by outside agencies.
3. To determine that credit, operational, and other risks are recognized and addressed through appropriate policies, procedures, management reports, and other controls.
4. To determine that liquidity and market risks are recognized and that the organization is not excessively dependent on securitization as a substitute for funding or as a source of income.
5. To determine that steps have been taken to minimize the potential for conflicts of interest due to securitization.
6. To determine that possible sources of structural failure in securitization transactions are recognized and that the organization has adopted measures to minimize the impact of such failures if they occur.
7. To determine that the organization is aware of the legal risks and uncertainty regarding various aspects of securitization.
8. To determine that concentrations of exposure in the underlying asset pools, in the asset-backed securities portfolio, or in the structural elements of securitization transactions are avoided.
9. To determine that all sources of risk are evaluated at the inception of each securitization activity and are monitored on an ongoing basis.

2128.02.9 INSPECTION PROCEDURES

1. Review the parent company's policies and procedures to ensure that its banking and nonbanking subsidiaries follow prudent standards of credit assessment and approval for all securitization exposure. Procedures should include thorough and independent credit assessment of each loan or pool for which it has assumed credit risk, followed by periodic credit reviews to monitor performance throughout the life of the exposure. If a banking organization invests in asset-backed securities, determine whether there is sole reliance on conclusions of external rating services when evaluating the securities.
2. Determine that rigorous credit standards are applied regardless of the role the organization plays in the securitization process, for example, servicer, credit enhancer, or investor.
3. Determine that major policies and procedures, including internal credit-review and -approval procedures and "in-house" exposure limits, are reviewed periodically and approved by the bank holding company's board of directors.
4. Determine whether adequate procedures for evaluating the organization's internal-control procedures and the financial strength of the other institutions involved in the securitization process are in place.
5. Obtain the documentation outlining the remedies available to provide credit enhancement in the event of a default. Both originators and purchasers of securitized assets should have prospectuses on the issue. Obtaining a copy of the prospectus can be an invaluable source of information. Prospectuses generally contain information on credit enhancement, default provisions, subordination agreements, etc.
6. Ensure that, regardless of the role an institution plays in securitization, the documentation for an asset-backed security clearly specifies the limitations of the institution's legal responsibility to assume losses.
7. Verify whether the banking organization, acting as originator, packager, or underwriter, has written policies addressing the repurchase of assets and other reimbursement to investors in the event that a defaulted package results in losses exceeding any contractual credit enhancement. The repurchase of defaulted assets or pools in contradiction of the underlying agreement in effect sets a standard by which a banking organization could be found legally liable for all "sold" assets. Review and report any situations in which the organization has repurchased or otherwise reimbursed investors for poor-quality assets.
8. Classify adverse credit risk associated with securitization of assets when analyzing the adequacy of an organization's capital or reserve levels. Adverse credit risk should be classified accordingly.
9. Aggregate securitization exposures with all loans, extensions of credit, debt and equity

securities, legally binding financial guarantees and commitments, and any other investments involving the same obligor when determining compliance with internal credit-exposure limits.

10. Review securitized assets for industrial or geographic concentrations. Excessive exposures to an industry or region among the underlying assets should be noted in the review of the loan portfolio.
11. Ensure that, in addition to policies limiting direct credit exposure, an institution has developed exposure limits with respect to particular originators, credit enhancers, trustees, and servicers.
12. Review the policies of the banking organization engaged in underwriting with regard to situations in which it cannot sell underwritten asset-backed securities. Credit review, funding capabilities, and approval limits should allow the institution to purchase and hold unsold securities. All potential credit exposure should be within legal lending limits.
13. Ensure that internal systems and controls adequately track the performance and condition of internal exposures and adequately monitor the organization's compliance with internal procedures and limits. In addition, adequate audit trails and internal-audit coverage should be provided.
14. Determine that management information systems provide—
    a. a listing of all securitizations in which the organization is involved;
    b. a listing of industry and geographic concentration;
    c. information on total exposure to specific originators, servicers, credit enhancers, trustees, or underwriters;
    d. information regarding portfolio aging and performance relative to expectations; and
    e. periodic and timely information to senior management and directors on the organization's involvement in and credit exposure arising from securitization.
15. Ensure that internal auditors examine all facets of securitization regularly.
16. Review policies and procedures for compliance with applicable state lending limits and federal law such as section 5136 of the Revised Code. These requirements must be analyzed to determine whether a particular asset-backed security issue is considered a single investment or a loan to each of the creditors underlying the pool. Collateralized mortgage obligations may be exempt from this limitation if they are issued or guaranteed by an agency or instrumentality of the U.S. government.
17. Determine whether the underwriting of asset-backed securities of affiliates are—
    a. rated by an unaffiliated, nationally recognized statistical rating organization or
    b. issued or guaranteed by Fannie Mae, FHLMC, or GNMA, or represent interests in such obligations.
18. If the parent organization or any of its banking and nonbanking subsidiaries invests in high-risk mortgage-derivative securities, determine whether management effectively manages the associated risks commensurate with the level of activity.
    a. Determine whether the level of activity is reasonably related to the level of capital, the organization's ability to absorb losses, and the level of in-house management sophistication and expertise.
    b. Ascertain whether the appropriate managerial and financial controls are required to be in place, and whether the parent organization analyzes, monitors, and prudently adjusts holdings of such high-risk securities when an environment of changing price and maturity expectations exists. In that regard, determine to what extent the organization considers the liquidity and price volatility of the high-risk mortgage-derivative products before their acquistion.

2128.03.1 INTRODUCTION TO CREDIT- SUPPORTED AND ASSET-BACKED COMMERCIAL PAPER

The issuance of commercial paper provides an alternative to bank borrowing for large corporations (nonfinancial and financial) and municipalities. Generally, commercial paper issuers are those with high credit ratings. In recent years, however, some corporations with lower credit ratings have been able to issue commercial paper by obtaining credit enhancements (credit support from a firm with a high credit rating[1]) or other high-quality asset collateral (asset-backed commercial paper) to allow them to enter the market as issuers. An example of credit-supported commercial paper is one supported by a letter of credit (LOC), the terms of which specify that the bank issuing the LOC guarantees that the bank will pay off the commercial paper if the issuer fails to pay off the commercial paper upon maturity.[2] A credit enhancement could also consist of a surety bond from an insurance company.

2128.03.2 COMMERCIAL BANK INVOLVEMENT IN CREDIT-ENHANCED AND ASSET-BACKED COMMERCIAL PAPER

A number of commercial banks have become involved in credit-enhanced and asset-backed commercial paper programs. These securitization programs enable banks to help arrange short-term financing support for their customers without having to extend credit directly. This provides borrowers with an alternative source of funding and allows banks to earn fee income for managing the programs. Fees are earned for providing credit and liquidity enhancements to these programs.

It is important to emphasize that involvement in such programs can have potentially significant implications for the organizations' credit and liquidity risk exposure. Therefore, examiners need to be fully informed on the fundamentals of these programs, on the risks associated with these programs, and on the examination and inspection procedures for banking organizations engaged in this activity.

Asset-backed commercial paper programs have been in existence since the early 1980s and have grown substantially over the last few years. These programs use a special-purpose entity (SPE) to acquire receivables generally originated either by corporations or sometimes by the advising bank itself.[3] The SPEs, which are owned by third parties,[4] fund their acquisitions of receivables by issuing commercial paper that is to be repaid from the cash flow of the receivables.

Bank involvement in an asset-backed commercial paper program can range from advising the program to advising and providing all of the required credit and liquidity enhancements in support of the SPE's commercial paper. Typically, the advising bank, or an affiliate, performs a review to determine if the receivables of potential program participants (that is, corporate sellers) are eligible for purchase by the SPE. The scope of the review is similar to that used in structuring credit card or automobile-loan-backed transactions.

Once the bank (or its affiliate) determines that a receivables portfolio has an acceptable credit-risk profile, it approves the purchase of the portfolio at a discounted price by the SPE. The bank or its affiliate may also act as the operating agent for the SPE. This entails structuring the sale of receivable pools to the SPE and then overseeing the performance of the pools on an ongoing basis.

The SPE pays for the receivables by issuing commercial paper in an amount equal to the discounted price paid for the receivables. The difference between the face value of the receivables and the discounted price paid provides, as discussed below, the first level of credit protection for the commercial paper. The individual companies selling their receivables traditionally act as the servicer for receivables sold to an SPE; that is, they are responsible for collecting principal and interest payments from the obli-

1. Such paper is usually called "credit-supported commercial paper."

2. Usually referred to as "LOC paper."

3. To date, the type of receivables that have been included in such programs are trade receivables, installment sales contracts, financing leases, and noncancelable portions of operating leases and credit card receivables.

4. Employees of an investment banking firm or some other third party generally own the equity of the SPE. The advising bank can specifically avoid owning the stock if it does not want to raise the issue of whether it must consolidate the SPE for accounting purposes.

gors and passing these funds on to the SPE on a periodic basis. The SPE then distributes the proceeds to the holders of the commercial paper.

Asset-backed commercial paper programs typically have several levels of credit enhancement cushioning the commercial paper purchaser from potential loss. As noted above, the first level of loss protection is provided by the difference between the face value of the receivables purchased and the discounted price paid for them, known as a "holdback" or "overcollateralization." In some cases, the terms of the sale also give the SPE recourse back to the seller if there are defaults on the receivables. The amount of overcollateralization and recourse varies from pool to pool and depends, in part, upon the quality of the receivables in the pool and the desired credit rating for the paper to be issued. Usually, the level of credit protection provided by overcollateralization is specified in terms of some multiple of historical loss experience for similar assets.

In addition to overcollateralization and recourse, secondary credit enhancements are also customarily provided. Secondary credit enhancements include letters of credit, surety bonds, or other backup facilities that obligate a third party to purchase pools of receivables from the SPE at a specified price. In addition to credit enhancements, the programs generally have liquidity enhancements to ensure that the SPE can meet maturing paper obligations.

The rating agencies typically require an SPE's commercial paper to have secondary enhancements aggregating 100 percent of the amount outstanding in order to receive the highest credit rating. These enhancements are generally structured in one of two ways. In the first, a commercial bank enters into a single agreement under which it is unconditionally obligated to provide funding for all or any portion of maturing commercial paper that an SPE cannot pay from other sources. The obligation to fund may be triggered by credit losses, a liquidity shortfall, or both. In the second, two separate agreements that jointly cover 100 percent of an SPE's outstanding commercial paper are established.

The first, typically an irrevocable letter of credit, is primarily intended to absorb credit losses that exceed the first tier of credit enhancement for the commercial paper. The second arrangement is a "liquidity" facility that may or may not provide credit support. This second structure will often have a letter of credit equalling 10 to 15 percent of outstandings, with the liquidity facility covering the remaining 85 to 90 percent.

2128.03.3 RISK-BASED CAPITAL TREATMENT FOR CREDIT-SUPPORTED AND ASSET-BACKED COMMERCIAL PAPER PROGRAMS

Generally, a single funding agreement that has no escape clause, such as a material-adverse-change clause that requires a bank to unconditionally provide funding to repay maturing commercial paper when the need arises because of either credit or liquidity problems should be treated as a direct credit substitute, or guarantee. The risk-based capital guidelines specify that the full amount of such obligations are to be converted to an on-balance-sheet credit-equivalent amount using a 100 percent conversion factor. No part of these arrangements should be considered commitments (either short-term or long-term) for risk-based capital purposes and assigned the conversion factor of a commitment. In the case of enhancements provided by separate facilities, a 100 percent conversion factor should be assigned to a letter of credit or any other form of credit guarantee provided by the bank. The accompanying liquidity facility, on the other hand, should be treated as a commitment and assigned a 50 percent conversion factor if over one year in maturity and a zero percent conversion factor if one year or less in maturity. One of the characteristics of liquidity facilities is that such arrangements generally have some reasonable asset-quality test that must be met before funds are extended to the SPE, to ensure that the bank is not providing credit protection.

2128.03.4 BOARD OF DIRECTORS' POLICIES PERTAINING TO CREDIT-ENHANCED OR ASSET-BACKED COMMERCIAL PAPER

A banking organization (that is, a bank or bank holding company) participating in an asset-backed commercial paper program should ensure that such participation is clearly and logically integrated into its overall strategic objectives. Furthermore, the management should ensure that the risks associated with the various roles that the institution may play in such programs are fully understood and that safeguards are in place to manage these risks properly.

Appropriate policies, procedures, and controls should be established by a banking organi-

zation before it participates in asset-backed commercial paper programs. Significant policies and procedures should be approved and reviewed periodically by the organization's board of directors. These policies and procedures should ensure that the organization follows prudent standards of credit assessment and approval regardless of the role an institution plays in an asset-backed commercial paper program. Such policies and procedures would be applicable to all pools of receivables to be purchased by the SPE as well as the extension of any credit enhancements and liquidity facilities. Procedures should include an initial, thorough credit assessment of each pool for which it had assumed credit risk, followed by periodic credit reviews to monitor performance throughout the life of the exposure. Furthermore, the policies and procedures should outline the credit-approval process and establish "in-house" exposure limits, on a consolidated basis, with respect to particular industries or organizations, that is, companies from which the SPE purchased the receivables as well as the receivable obligors themselves. Controls should include well-developed management information systems and monitoring procedures.

Institutions should analyze the receivables pools underlying the commercial paper as well as the structure of the arrangement. This analysis should include a review of—

1. the characteristics, credit quality, and expected performance of the underlying receivables;
2. the banking organization's ability to meet its obligations under the securitization arrangement; and
3. the ability of the other participants in the arrangement to meet their obligations.

Banking organizations providing credit enhancements and liquidity facilities should conduct a careful analysis of their funding capabilities to ensure that they will be able to meet their obligations under all foreseeable circumstances. The analysis should include a determination of the impact that fulfillment of these obligations would have on their interest-rate risk exposure, asset quality, liquidity position, and capital adequacy.

Examiners should review carefully the asset-backed commercial paper facilities provided by banking organizations to ensure that they are applying, for risk-based capital purposes, the proper conversion factors to their obligations supporting asset-backed commercial paper programs. In addition, examiners should determine whether the previously discussed policies are operative and that institutions are adequately managing their risk exposure. A discussion of the size, effectiveness, and risks associated with these programs should be included in the confidential section of the examination or inspection report if not appropriate for the open section. See SR-92-11.

2128.03.5 INSPECTION OBJECTIVES

1. To determine whether the banking organization (that is, a bank or bank holding company) participating in an asset-backed commercial paper program has included such participation in its overall strategic objectives.
2. To determine whether management fully understands the risks associated with the involvement in such credit enhancement and asset-backed commercial paper programs and whether appropriate safeguards are in place to properly manage those risks.
3. To ascertain that the appropriate policies, procedures, and controls have been established by the banking organization before participating in asset-backed commercial paper programs.
4. To verify whether existing managerial and internal controls include well-developed management information systems and monitoring procedures.
5. To determine whether the banking organization has conducted a careful analysis of its funding capabilities to ensure that it will be able to meet its obligations under all foreseeable circumstances.

2128.03.6 INSPECTION PROCEDURES

1. Review the board of directors or executive committee minutes and establish whether the significant policies and procedures for credit-enhanced or asset-backed commercial paper have been approved and reviewed periodically by the organization's board of directors.
   a. Determine whether the policies are operative and that institutions are adequately managing their risk exposure.
   b. Determine whether the policies and procedures are applicable to all pools of receivables to be purchased by the SPE as well

as to the extension of any credit enhancements and liquidity facilities.

2. Determine if the organization follows prudent standards of credit assessment and approval.
   a. Ascertain whether the procedures include an initial, thorough credit assessment of each pool for which it had assumed credit risk, followed by periodic credit reviews to monitor performance throughout the life of the exposure.
   b. Determine if the policies and procedures outline the credit-approval process and establish "in-house" exposure limits, on a consolidated basis, with respect to particular industries or organizations, that is, companies from which the SPE purchased the receivables as well as the receivable obligors themselves.
   c. Determine whether the organization analyzes the receivables pools underlying the commercial paper as well as the structure of the arrangement. Does the analysis include a review of—
      - the characteristics, credit quality, and expected performance of the underlying receivables;
      - the ability of the banking organization to meet its obligations under the securitization arrangement; and
      - the ability of the other participants in the arrangement to meet their obligations?
3. Review the organization's funding obligations and commitments, and determine whether there is sufficient liquidity to satisfy those funding requirements. Include a determination of the impact that fulfillment of these obligations would have on their interest-rate risk exposure, asset quality, liquidity position, and capital adequacy.
4. Review carefully the asset-backed commercial paper facilities to ensure that they are applying, for risk-based capital purposes, the proper conversion factors to their obligations supporting asset-backed commercial paper programs.
5. Include in the inspection report a discussion of the size, effectiveness, and risks associated with these programs (include in the confidential section of the inspection report if not appropriate for the open section).

Securitization activities present unique and sometimes complex risks that require the attention of senior management and the board of directors. Retained interests from securitization activities, including interest-only strips receivable, arise when a banking organization (BO) keeps an interest in the assets sold to a securitization vehicle that, in turn, issues bonds to investors.[1]

The methods and models BOs use to value retained interests and the difficulties in managing exposure to these volatile assets can raise supervisory concerns. Under generally accepted accounting principles (GAAP), a BO recognizes an immediate gain (or loss) on the sale of assets by recording its retained interest at fair value. The valuation of the retained interest is based on the present value of future cash flows in excess of the amounts needed to service the bonds and cover credit losses and other fees of the securitization vehicle.[2]

Determinations of fair value should be based on reasonable, conservative assumptions about factors such as discount rates, projected credit losses, and prepayment rates. Bank supervisors expect retained interests to be supported by verifiable documentation of fair value in accordance with GAAP. In the absence of such support, the retained interests should not be carried as assets on a BO's books, but should be charged off. Other supervisory concerns include failure to recognize and hold sufficient capital against recourse obligations generated by securitizations, and the absence of an adequate independent audit function.

The supervisory guidance focuses on and incorporates important fundamental concepts of risk-management and risk-focused supervision: active oversight by senior management and the board of directors, the use of effective policies and limits, accurate and independent procedures to measure and assess risk, and the maintenance of strong internal controls.[3] The guidance stresses sound risk-management, modeling, valuation, and disclosure practices for asset securitization; complements previous supervisory guidance issued on this subject; and supplements existing policy statements and examination-inspection procedures.[4] Emphasis is placed on the expectation that a BO's securitization-related retained interest must be supported by documentation of the interest's fair value, using reasonable, conservative valuation assumptions that can be objectively verified. Retained interests that lack such objectively verifiable support or that fail to meet these supervisory standards will be classified as loss and disallowed for inclusion as assets of the BO for regulatory capital purposes. See SR-99-37 and the more complete text of its referenced interagency guidance on the risk mangement and valuation of retained interests arising from asset securitization activities.

Examiners will review a BO's valuation of retained interests and the concentration of these assets relative to capital. Consistent with existing supervisory authority, BOs may be required, on a case-by-case basis, to hold additional capital commensurate with their risk exposures.[5] An excessive dependence on securitizations for day-to-day core funding can present significant liquidity problems during times of market turbulence or if there are difficulties specific to the BO.

2128.06.1 ASSET SECURITIZATION

Asset securitization typically involves the transfer of on-balance-sheet assets to a third party or trust. In turn, the third party or trust issues certificates or notes to investors. The cash flow from the transferred assets supports repayment of the certificates or notes. BOs use asset securi-

1. The term "banking organization" (BO) refers to any federally supervised banking organization. This includes federally insured, federally chartered financial institutions that are supervised by a federal bank or savings association supervisory authority, as well as bank holding companies and their nonbank subsidiaries.

2. See Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard No. 125 (FAS 125), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities."

3. See SR-96-14, "Risk-Focused Safety-and-Soundness Examinations and Inspections" (section 2124.0 of this manual), and SR-95-51, "Rating the Adequacy of Risk-Management Processes and Internal Controls at State Member Banks and Bank Holding Companies" (section 4070.1 of this manual).

4. See SR-97-21, "Risk Management and Capital Adequacy of Exposures Arising from Secondary-Market Credit Activities"; SR-96-40, "Interim Guidance for Purposes of Applying FAS 125 for Regulatory Reporting in 1997 and for the Treatment of Servicing Assets for Regulatory Capital"; and SR-96-30, "Risk-Based Capital Treatment for Spread Accounts That Provide Credit Enhancement for Securitized Receivables."

5. For instance, a BO has high concentrations of retained interests relative to its capital or is otherwise at risk from impairment of these assets.

tization to access alternative funding sources, manage concentrations, improve financial-performance ratios, and more efficiently meet customer needs. Assets typically securitized include credit card receivables, automobile receivable paper, commercial and residential first mortgages, commercial loans, home equity loans, and student loans.

Senior management and directors must have the requisite knowledge of the effect of securitization on the BO's risk profile and must be fully aware of the accounting, legal, and risk-based capital nuances of this activity. BOs must fully and accurately distinguish and measure the risks that are transferred versus those retained, and must adequately manage the retained portion. It is essential that BOs engaging in securitization activities have appropriate front- and back-office staffing, internal and external accounting and legal support, audit or independent review coverage, information systems capacity, and oversight mechanisms to execute, record, and administer these transactions correctly.

Appropriate valuation and modeling methodologies must be used. They must be able to determine the initial and ongoing value of retained interests. Accounting rules provide a method to recognize an immediate gain (or loss) on the sale through booking a "retained interest." The carrying value, however, of that interest must be fully documented, based on reasonable assumptions, and regularly analyzed for any subsequent impairment in value. The best evidence of fair value is a quoted market price in an active market. When quoted market prices are not available, accounting rules allow fair value to be estimated. This estimate must be based on the "best information available in the circumstances."[6] An estimate of fair value must be supported by reasonable and current assumptions. If a best estimate of fair value is not practicable, the asset is to be recorded at zero in financial and regulatory reports.

Unforeseen market events that affect the discount rate or performance of receivables supporting a retained interest can swiftly and dramatically alter its value. Without appropriate internal controls and independent oversight, a BO that securitizes assets may inappropriately generate "paper profits" or mask actual losses through flawed loss assumptions, inaccurate prepayment rates, and inappropriate discount rates. Liberal and unsubstantiated assumptions can result in material inaccuracies in financial statements; substantial write-downs of retained interests; and, if retained interests represent an excessive concentration of the sponsoring BO's capital, the BO's demise. BO managers and directors need to ensure the following:

1. Independent risk-management processes are in place to monitor securitization-pool performance on an aggregate and individual transaction level. An effective risk-management function includes appropriate information systems to monitor securitization activities.
2. Conservative valuation assumptions and modeling methodologies are used to establish, evaluate, and adjust the carrying value of retained interests on a regular and timely basis.
3. Audit or internal review staffs periodically review data integrity, model algorithms, key underlying assumptions, and the appropriateness of the valuation and modeling process for the securitized assets the BO retains. The findings of such reviews should be reported directly to the board or an appropriate board committee.
4. Accurate and timely risk-based capital calculations are maintained, including recognition and reporting of any recourse obligation resulting from securitization activity.
5. Internal limits are in place to govern the maximum amount of retained interests as a percentage of total equity capital.
6. A realistic liquidity plan is in place for the BO in case of market disruptions.

2128.06.2 INDEPENDENT RISK-MANAGEMENT FUNCTION

BOs engaged in securitizations should have an independent risk-management function commensurate with the complexity and volume of their securitizations and their overall risk exposures. The risk-management function should ensure that securitization policies and operating procedures, including clearly articulated risk limits, are in place and appropriate for the BO's circumstances. A sound asset securitization policy should include or address, at a minimum—

1. a writtten and consistently applied accounting methodology;
2. regulatory reporting requirements;
3. valuation methods, including FAS 125 residual value assumptions, and procedures

6. See FAS 125, at para. 43.

to formally approve changes to those assumptions;
4. a management reporting process; and
5. exposure limits and requirements for both aggregate and individual transaction monitoring.

It is essential that the risk-management function monitor origination, collection, and default-management practices. This includes regular evaluations of the quality of underwriting, soundness of the appraisal process, effectiveness of collections activities, ability of the default-management staff to resolve severely delinquent loans in a timely and efficient manner, and the appropriateness of loss-recognition practices. Because the securitization of assets can result in the current recognition of *anticipated income*, the risk-management function should pay particular attention to the types, volumes, and risks of assets being originated, transferred, and serviced. Senior management and the risk-management staff must be alert to any pressures on line managers to originate abnormally large volumes or higher-risk assets to sustain ongoing income needs. Such pressures can lead to a compromise of credit-underwriting standards. This may accelerate credit losses in future periods, impair the value of retained interests, and potentially lead to funding problems.

The risk-management function should also ensure that appropriate management information systems (MIS) exist to monitor securitization activities. Reporting and documentation methods must support the initial valuation of retained interests and ongoing impairment analyses of these assets. Pool-performance information will help well-managed BOs ensure, on a qualitative basis, that a sufficient amount of economic capital is being held to cover the various risks inherent in securitization transactions. The absence of quality MIS will hinder management's ability to monitor specific pool performance and securitization activities.

At a minimum, MIS reports should address the following:

1. *Securitization summaries for each transaction.* The summary should include relevant transaction terms such as collateral type, facility amount, maturity, credit-enhancement and subordination features, financial covenants (termination events and spread-account capture "triggers"), right of repurchase, and counterparty exposures. Management should ensure that the summaries for each transaction are distributed to all personnel associated with securitization activities.
2. *Performance reports by portfolio and specific product type.* Performance factors include gross portfolio yield, default rates and loss severity, delinquencies, prepayments or payments, and excess spread amounts. The reports should reflect the performance of assets, both on an individual-pool basis and total managed assets. These reports should segregate specific products and different marketing campaigns.
3. *Vintage analysis for each pool using monthly data.* Vintage analysis will help management understand historical performance trends and their implications for future default rates, prepayments, and delinquencies, and therefore retained interest values. Management can use these reports to compare historical performance trends with underwriting standards, including the use of a validated credit-scoring model, to ensure loan pricing is consistent with risk levels. Vintage analysis also helps in the comparison of deal performance at periodic intervals and validates retained-interest valuation assumptions.
4. *Static-pool cash-collection analysis.* A static-pool cash-collection analysis involves reviewing monthly cash receipts relative to the principal balance of the pool to determine the cash yield on the portfolio, comparing the cash yield to the accrual yield, and tracking monthly changes. Management should compare monthly the timing and amount of cash flows received from the trust with those projected as part of the FAS 125 retained-interest valuation analysis. Some master-trust structures allow excess cash flow to be shared between series or pools. For revolving-asset trusts with this master-trust structure, management should perform a cash-collection analysis for each master-trust structure. These analyses are essential in assessing the actual performance of the portfolio in terms of default and prepayment rates. If cash receipts are less than those assumed in the original valuation of the retained interest, this analysis will provide management and the board with an early warning of possible problems with collections or extension practices, and impairment of the retained interest.
5. *Sensitivity analysis.* A sensitivity analysis measures the effect of changes in default rates, prepayment or payment rates, and dis-

count rates to assist management in establishing and validating the carrying value of the retained interest. Stress tests should be performed at least quarterly. Analyses should consider potential adverse trends and determine "best," "probable," and "worst case" scenarios for each event. Other factors that need to be considered are the impact of increased defaults on collections staffing, the timing of cash flows, spread-account capture triggers, overcollateralization triggers, and early-amortization triggers. An increase in defaults can result in higher than expected costs and a delay in cash flows, thus decreasing the value of the retained interests. Management should periodically quantify and document the potential impact to both earnings and capital, and report the results to the board of directors. Management should incorporate this analysis into their overall interest-rate risk measurement system.[7] Examiners will review the BO-conducted analysis and the volatility associated with retained interests when assessing the Sensitivity to Market Risk component rating (the "S" in the CAMELS rating system for banks or the "M" for the BHC rating system[8]).

6. *Statement of covenant compliance.* Ongoing compliance with deal-performance triggers as defined by the pooling and servicing agreements should be affirmed at least monthly. Performance triggers include early amortization, spread capture, changes to overcollateralization requirements, and events that would result in servicer removal.

2128.06.3 VALUATION AND MODELING PROCESSES

The method and key assumptions used to value the retained interests and servicing assets or liabilities must be reasonable and fully documented. The key assumptions in all valuation analyses include prepayment or payment rates, default rates, loss-severity factors, and discount rates. BOs are expected to take a logical and conservative approach when developing securitization assumptions and capitalizing future income flows. It is important that management quantifies the assumptions at least quarterly on a pool-by-pool basis and maintains supporting documentation for all changes to the assumptions as part of the valuation. Policies should define the acceptable reasons for changing assumptions and require appropriate management approval.

An exception to this pool-by-pool valuation analysis may be applied to revolving-asset trusts if the master-trust structure allows excess cash flows to be shared between series. In a master trust, each certificate of each series represents an undivided interest in all of the receivables in the trust. Therefore, valuations are appropriate at the master-trust level.

To determine the value of the retained interest at inception, and make appropriate adjustments going forward, the BO must implement a reasonable modeling process to comply with FAS 125. Management is expected to employ reasonable and conservative valuation assumptions and projections, and to maintain verifiable objective documentation of the fair value of the retained interest. Senior management is responsible for ensuring that the valuation model accurately reflects the cash flows according to the terms of the securitization's structure. For example, the model should account for any cash collateral or overcollateralization triggers, trust fees, and insurance payments if appropriate. The board and management are accountable for the model builders' possessing the necessary expertise and technical proficiency to perform the modeling process. Senior management should ensure that internal controls are in place to provide for the ongoing integrity of MIS associated with securitization activities.

As part of the modeling process, the risk-management function should ensure that periodic validations are performed to reduce vulnerability to model risk. Validation of the model includes testing the internal logic, ensuring empirical support for the model assumptions, and back-testing the models using actual cash flows on a pool-by-pool basis. The validation process should be documented to support conclusions. Senior management should ensure the validation process is independent from line management and from the modeling process. The audit scope should include procedures to ensure that the modeling process and validation mechanisms are both appropriate for the BO's circumstances and executed consistent with its asset securitization policy.

7. The Joint Agency Policy Statement on Interest-Rate Risk (see SR-96-13 and section 2127.0) advises institutions with a high level of exposure to interest-rate risk relative to capital that they will be directed to take corrective action.

8. See sections 4070.0 and 4070.1.

2128.06.4 USE OF OUTSIDE PARTIES

Third parties are often engaged to provide professional guidance and support regarding a BO's securitization activities, transactions, and valuing of retained interests. The use of outside resources does not relieve directors of their oversight responsibility, or relieve senior management of its responsibilities to provide supervision, monitoring, and oversight of securitization activities, particularly the management of the risks associated with retained interests. Management is expected to have the experience, knowledge, and abilities to discharge its duties and understand the nature and extent of the risks retained interests present, and to have the policies and procedures necessary to implement an effective risk-management system to control such risks. Management must have a full understanding of the valuation techniques employed, including the basis and reasonableness of underlying assumptions and projections.

2128.06.5 INTERNAL CONTROLS

Effective internal controls are essential to a BO's management of the risks associated with securitization. When properly designed and consistently enforced, a sound system of internal controls will help management safeguard the BO's resources; ensure that financial information and reports are reliable; and comply with contractual obligations, including securitization covenants. It will also reduce the possibility of significant errors and irregularities, and assist in their timely detection. Internal controls typically (1) limit authorities; (2) safeguard access to and use of records; (3) separate and rotate duties; and (4) ensure both regular and unscheduled reviews, including testing.

Operational and managerial standards have been established for internal control and information systems.[9] A system of internal controls should be maintained that is appropriate to the BO's size and the nature, scope, and risk of its activities.[10]

9. See the safety-and-soundness standards for national banks at 12 CFR 30 (OCC), and for savings associations at 12 CFR 570 (OTS).

10. BOs that are subject to the requirements of FDIC regulation 12 CFR 363 should include an assessment of the effectiveness of internal controls over their asset securitization activities as part of management's report on the overall effectiveness of the system of internal controls over financial reporting. This assessment implicitly includes the internal controls over financial information that is included in regulatory reports.

2128.06.6 AUDIT FUNCTION OR INTERNAL REVIEW

A BO's board of directors is responsible for ensuring that its audit staff or independent review function is competent regarding securitization activities. The audit function should perform periodic reviews of securitization activities, including transaction testing and verification, and report all findings to the board or appropriate board committee. The audit function also may be useful to senior management in identifying and measuring risk related to securitization activities. Principal audit targets should include compliance with securitization policies, operating and accounting procedures (FAS 125), deal covenants, and the accuracy of MIS and regulatory reports. The audit function also should confirm that the BO's regulatory reporting process is designed and managed to facilitate timely and accurate report filing. Furthermore, when a third party services loans, the auditors should perform an independent verification of the existence of the loans to ensure that balances reconcile to internal records.

2128.06.7 REGULATORY REPORTING OF RETAINED INTERESTS

The securitization and subsequent removal of assets from a BO's balance sheet requires additional reporting as part of the regulatoryreporting process. Common regulatory reporting errors stemming from securitization activities may include—

1. failure to include off-balance-sheet assets subject to recourse treatment when calculating risk-based capital ratios;
2. failure to recognize retained interests and retained subordinate security interests as a form of credit enhancement;
3. failure to report loans sold with recourse in the appropriate section of the regulatory report; and
4. overvaluing retained interests.

A BO's directors and senior management are responsible for the accuracy of its regulatory

reports. Because of the complexities associated with securitization accounting and risk-based capital treatment, attention should be directed to ensuring that personnel who prepare these reports maintain current knowledge of reporting rules and associated interpretations. This often will require ongoing support by qualified accounting and legal personnel.

2128.06.8 MARKET DISCIPLINE AND DISCLOSURES

Transparency through public disclosure is crucial to effective market discipline and can reinforce supervisory efforts to promote high standards in risk management. Timely and adequate information on the BO's asset securitization activities should be disclosed. The information in the disclosures should be comprehensive; however, the amount of disclosure that is appropriate will depend on the volume of securitizations and complexity of the BO. Well-informed investors, depositors, creditors, and other counterparties can provide a BO with strong incentives for maintaining sound risk-management systems and internal controls. Adequate disclosure allows market participants to better understand the BO's financial condition and apply market discipline, creating incentives to reduce inappropriate risk taking or inadequate risk-management practices. Examples of sound disclosures include—

1. accounting policies for measuring retained interests, including a discussion of the impact of key assumptions on the recorded value;
2. the process and methodology used to adjust the value of retained interests for changes in key assumptions;
3. risk characteristics, both quantitative and qualitative, of the underlying securitized assets;
4. the role of retained interests as credit enhancements to special-purpose entities and other securitization vehicles, including a discussion of techniques used for measuring credit risk; and
5. sensitivity analyses or stress testing conducted by the BO, showing the effect of changes in key assumptions on the fair value of retained interests.

2128.06.9 RISK-BASED CAPITAL FOR RECOURSE AND LOW-LEVEL-RECOURSE TRANSACTIONS

For regulatory purposes, recourse is generally defined as an arrangement in which an institution retains the risk of credit loss in connection with an asset transfer, if the risk of credit loss exceeds a pro rata share of its claim on the assets.[11] In addition to broad contractual language that may require the seller to support a securitization, recourse can arise from retained interests, retained subordinated security interests, the funding of cash-collateral accounts, or other forms of credit enhancements that place a BO's earnings and capital at risk. These enhancements should generally be *aggregated* to determine the extent of a BO's support of securitized assets. Although an asset securitization qualifies for sales treatment under GAAP, the underlying assets may still be subject to regulatory risk-based capital requirements. Assets sold with recourse should generally be risk-weighted as if they had not been sold.

Securitization transactions involving recourse may be eligible for "low-level-recourse" treatment.[12] Risk-based capital standards provide that the dollar amount of risk-based capital required for assets transferred with recourse should not exceed the maximum dollar amount for which a BO is contractually liable. The low-level-recourse treatment applies to transactions accounted for as sales under GAAP in which a BO contractually limits its recourse exposure to less than the full risk-based capital requirements for the assets transferred. Under the low-level-recourse principle, the BO holds capital on approximately a dollar-for-dollar basis up to the amount of the aggregate credit enhancements.

If a BO does not contractually limit the maximum amount of its recourse obligation, or if the amount of credit enhancement is greater than the risk-based capital requirement that would exist if the assets were not sold, the low-level-recourse treatment does not apply. Instead, the

11. See the risk-based capital treatment for sales with recourse at 12 CFR 3, appendix A, section (3)(b)(1)(iii) (OCC), and 12 CFR 567.6(a)(2)(i)(c) (OTS). For a further explanation of recourse, see the glossary of the call report instructions, "Sales of Assets for Risk-Based Capital Purposes."

12. See 60 *Fed. Reg.* 17986, April 10, 1995 (OCC); 60 *Fed. Reg.* 8177, February 13, 1995 (FRB); and 60 *Fed. Reg.* 15858, March 28,1995 (FDIC). The OTS low-level-recourse rule is found at 12 CFR 567.6(a)(2)(i)(c).

BO must hold risk-based capital against the securitized assets as if those assets had not been sold. Retained interests that lack objectively verifiable support or that fail to meet the supervisory standards set forth in this section will be classified as loss and disallowed as assets of the BO for regulatory capital purposes.

2128.06.10 CONCENTRATION LIMITS IMPOSED ON RETAINED INTERESTS

The creation of a retained interest (the debit) typically also results in an offsetting "gain on sale" (the credit), and thus generation of an asset. BOs that securitize high-yielding assets with long durations may create a retained-interest asset value that exceeds the risk-based capital charge that would be in place if it had not sold the assets (under the existing risk-based capital guidelines, capital is not required for the amount over 8 percent of the securitized assets). Serious problems can arise for those BOs that distribute contrived earnings only later to be faced with a downward valuation and charge-off of part or all of the retained interests.

As an example, a BO could sell $100 in subprime home equity loans and book a retained interest of $20 using liberal "gain on sale" assumptions. Under the current capital rules, the BO is required to hold approximately $8 in capital. This $8 is the current capital requirement if the loans were never removed from the balance sheet (8 percent of $100 = $8). However, the institution is still exposed to substantially all the credit risk, plus the additional risk to earnings and capital from the volatility of the retained interest. If the value of the retained interest decreases to $10 due to inaccurate assumptions or changes in market conditions, the $8 in capital is insufficient to cover the entire loss.

Normally, the sponsor will eventually receive any excess cash flow remaining from securitizations after investor interests have been met. However, recent experience has shown that retained interests are vulnerable to sudden and sizeable write-downs that can hinder a BO's access to the capital markets; damage its reputation in the marketplace; and, in some cases, threaten its solvency. A BO's board of directors and management is expected to develop and implement policies that limit the amount of retained interests that may be carried as a percentage of total equity capital, based on the results of their valuation and modeling processes. Well-constructed internal limits also lessen the incentives for a BO's personnel to engage in activities designed to generate near-term "paper profits" that may be at the expense of its long-term financial position and reputation.

2128.06.11 INSPECTION OBJECTIVES

1. To determine whether the BO's retained interests from asset securitization are properly documented, valued, and accounted for.
2. To verify that the amount of those retained interests not supported by adequate documentation has been charged off and that the involved assets are not used for risk-based calculation purposes.
3. To ascertain the existence of sound risk modeling, management information systems (MIS), and disclosure practices for asset securitization.
4. To obtain assurances that the board of directors and management oversee sound policies and internal controls concerning the recording and valuation of retained interests derived from asset securitization activities.
5. To determine if liquidity problems may arise as the result of an overdependence on asset securitization activities for day-to-day core funding.
6. To determine that sufficient capital is held commensurate with the risk exposures arising from recourse obligations generated by asset securitizations.
7. To determine whether there is an independent audit function that is capable of evaluating retained interests involving asset securitization activities.

2128.06.12 INSPECTION PROCEDURES

1. Determine the existence of independent risk-management processes and MIS, and whether they are being used to monitor securitization-pool performance on an aggregate and individual transaction level.
2. Review the MIS reports and determine whether the reports provide—
   a. securitization summaries for each transaction;
   b. performance reports by portfolio and specific product type;
   c. vintage analysis for each pool using monthly data;

   d. static-pool cash-collection analysis;
   e. sensitivity analysis; and
   f. a statement of covenant compliance.
3. Review the BO's valuation assumptions and modeling methodologies, and determine if they are conservative and being used to establish, evaluate, and adjust the carrying value of retained interests on a regular and timely basis.
4. Determine if audit or internal review staffs periodically review data integrity, model algorithms, key underlying assumptions, and the appropriateness of the valuation and modeling process for the securitized assets that the BO retains.
5. Review the risk-based capital calculations, and determine if they include recognition and reporting of any recourse obligation resulting from securitization activities.
6. Ascertain that internal limits govern the amount of retained interests held as a percentage of total equity capital.
7. Establish that an adequate liquidity contingency plan is in place and that it will be used in the event of market disruptions. Determine further whether liquidity problems may arise as the result of an overdependence on asset securitization activities for day-to-day core funding.
8. Determine whether consistent, conservative accounting practices are in place that satisfy the reporting requirements of regulatory supervisors, GAAP reporting requirements, and valuation assumptions and methods. Ascertain that adequate disclosures of asset securitization activities are made commensurate with the volume of securitizations and the complexities of the BO.
9. Establish that risk-exposure limits and requirements exist and are adhered to on an aggregate and individual transaction basis.

Subprime lending presents unique and significantly greater risk to banking organizations (BOs) associated with the activity,[1] raising issues about how well they are prepared to manage and control those risks. Subprime-lending institutions need strong risk-management practices and internal controls, as well as board-approved policies and procedures that appropriately identify, measure, monitor, and control all associated risks. BOs considering or engaging in this type of lending should recognize the additional risks inherent in this activity and determine if these risks are acceptable and controllable, given their organization's financial condition, asset size, level of capital support, and staff size.

In response to concerns about subprime lending, the statement "Interagency Guidance on Subprime Lending," was issued on March 1, 1999.[2] The statement's objective is to increase awareness among examiners and financial institutions of some of the pitfalls and hazards of this type of lending and to provide general supervisory guidance on the topic. See SR-99-06. The statement is directed to insured depository institutions and their subsidiaries, which includes state member banks. As such, the guidance applies only indirectly to bank holding companies with regard to their supervision of insured depository institutions. Bank holding companies should also consider the statement's guidance as they supervise the lending activities of their nonbanking subsidiaries. Bank holding company examiners should consider this guidance in conjunction with the loan-administration and lending-standards inspection guidance in section 2010.2, and the guidance for asset securitization in section 2128.02. The text of the statement follows. (Section numbers have been added for reference, and the footnotes have been renumbered. Some wording has been slightly altered to make the policy appropriate for this manual, as indicated by ellipses or brackets.)

2128.08.1 INTERAGENCY GUIDANCE ON SUBPRIME LENDING

Insured depository institutions have traditionally avoided lending to customers with poor credit histories because of the higher risk of default and resulting loan losses. However, in recent years a number of lenders[3] have extended their risk-selection standards to attract lower-credit-quality accounts, often referred to as subprime loans. Moreover, recent turmoil in the equity and asset-backed securities market has caused some nonbank subprime specialists to exit the market, thus creating increased opportunities for financial institutions to enter, or expand their participation in, the subprime-lending business

The term "subprime lending" is defined for this statement as extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers.[4] Risk of default may be measured by traditional credit-risk measures (credit/repayment history, debt-to-income levels, etc.) or by alternative measures such as credit scores. Subprime borrowers represent a broad spectrum of debtors ranging from those who have exhibited repayment problems due to an adverse event, such as job loss or medical emergency, to those who persistently mismanage their finances and debt obligations. Subprime lending does not include loans to borrowers who have had minor, temporary credit difficulties but are now current. This guidance applies to direct extensions of credit; the purchase of subprime loans from other lenders, including delinquent or credit-impaired loans purchased at a discount; the purchase of subprime automobile or other financing "paper" from lenders or dealers; and the purchase of loan companies that originate subprime loans.

Due to their higher risk, subprime loans command higher interest rates and loan fees than those offered to standard-risk borrowers. These loans can be profitable, provided the price charged by the lender is sufficient to cover higher loan-loss rates and overhead costs related to underwriting, servicing, and collecting the loans. Moreover, the ability to securitize and sell subprime portfolios at a profit while retaining the servicing rights has made subprime lending attractive to a larger number of institutions, further increasing the number of subprime lend-

1. The term "banking organizations" refers to bank holding companies and their banking and nonbanking subsidiaries.
2. The statement was adopted and issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.
3. The terms "lenders," "financial institutions," and "institutions," . . . refer to insured depository institutions and their subsidiaries.
4. For purposes of this statement, loans to customers who are not subprime borrowers are referred to as "prime."

ers and loans. . . . [A] number of financial institutions have experienced losses attributable to ill-advised or poorly structured subprime-lending programs. This has brought greater supervisory attention to subprime lending and the ability of insured depository institutions to manage the unique risks associated with this activity.

Institutions should recognize the additional risks inherent in subprime lending and determine if these risks are acceptable and controllable given the institution's staff, financial condition, size, and level of capital support. Institutions that engage in subprime lending in any significant way should have board-approved policies and procedures, as well as internal controls that identify, measure, monitor, and control these additional risks. Institutions that engage in a small volume of subprime lending should have systems in place commensurate with their level of risk. Institutions that began a subprime-lending program prior to the issuance of this guidance should carefully consider whether their program meets the following guidelines and should implement corrective measures for any area that falls short of these minimum standards. If the risks associated with this activity are not properly controlled, the agencies consider subprime lending a high-risk activity that is unsafe and unsound.

2128.08.2 CAPITALIZATION

[S]ubprime-lending activities can present a greater-than-normal risk for financial institutions and the deposit insurance funds; therefore, the level of capital institutions need to support this activity should be commensurate with the additional risks incurred. The amount of additional capital necessary will vary according to the volume and type of subprime activities pursued and the adequacy of the institution's risk-management program. Institutions should determine how much additional capital they need to offset the additional risk taken in their subprime-lending activities and document the methodology used to determine this amount. The agencies will evaluate an institution's overall capital adequacy on a case-by-case basis through on-site examinations and off-site monitoring procedures considering, among other factors, the institution's own analysis of the capital needed to support subprime lending. Institutions determined to have insufficient capital must correct the deficiency within a reasonable time frame or be subject to supervisory action. In light of the higher risks associated with this type of lending, . . . higher minimum-capital requirements [may be imposed] on institutions engaging in subprime lending.

2128.08.3 RISK MANAGEMENT

The following items are essential components of a well-structured risk-management program for subprime lenders:

1. *Planning and strategy.* Prior to engaging in subprime lending, the board and management should ensure that proposed activities are consistent with the institution's overall business strategy and risk tolerances, and that all involved parties have properly acknowledged and addressed critical business risk issues. These issues include the costs associated with attracting and retaining qualified personnel, investments in the technology necessary to manage a more complex portfolio, a clear solicitation and origination strategy that allows for after-the-fact assessment of underwriting performance, and the establishment of appropriate feedback and control systems. The risk-assessment process should extend beyond credit risk and appropriately incorporate operating, compliance, and legal risks. Finally, the planning process should set clear objectives for performance, including the identification and segmentation of target markets and/or customers, and performance expectations and benchmarks for each segment and the portfolio as a whole. Institutions establishing a subprime-lending program should proceed slowly and cautiously into this activity to minimize the impact of unforeseen personnel, technology, or internal-control problems and to determine if favorable initial profitability estimates are realistic and sustainable.
2. *Staff expertise.* Subprime lending requires specialized knowledge and skills that many financial institutions may not possess. Marketing, account-origination, and collections strategies and techniques often differ from those employed for prime credit; thus it may not be sufficient to have the same lending staff responsible for both subprime loans and other loans. Additionally, servicing and collecting subprime loans can be very labor intensive. If necessary, the institution should implement programs to train staff. The board should ensure that staff possesses sufficient

expertise to appropriately manage the risks in subprime lending and that staffing levels are adequate for the planned volume of subprime activity. Seasoning of staff and loans should be taken into account as performance is assessed over time.

3. *Lending policy*. A subprime-lending policy should be appropriate to the size and complexity of the institution's operations and should clearly state the goals of the subprime-lending program. While not exhaustive, the following lending standards should be addressed in any subprime-lending policy:
   a. types of products offered as well as those that are not authorized
   b. portfolio targets and limits for each credit grade or class
   c. lending and investment authority clearly stated for individual officers, supervisors, and loan committees
   d. a framework for pricing decisions and profitability analysis that considers all costs associated with the loan, including origination costs, administrative/servicing costs, expected charge-offs, and capital
   e. collateral evaluation and appraisal standards
   f. well-defined and specific underwriting parameters (i.e., acceptable loan term, debt-to-income ratios, loan-to-collateral-value ratios for each credit grade, and minimum acceptable credit score) that are consistent with any applicable supervisory guidelines[5]
   g. procedures for separate tracking and monitoring of loans approved as exceptions to stated policy guidelines
   h. credit-file documentation requirements such as applications, offering sheets, loan and collateral documents, financial statements, credit reports, and credit memoranda to support the loan decision
   i. correspondent/broker/dealer approval process, including measures to ensure that loans originated through this process meet the institution's lending standards

   If the institution elects to use credit scoring (including applications scoring) for approvals or pricing, the scoring model should be based on a development population that captures the behavioral and credit characteristics of the subprime population targeted for the products offered. Because of the significant variance in characteristics between the subprime and prime populations, institutions should not rely on models developed solely for products offered to prime borrowers. Further, the model should be reviewed frequently and updated as necessary to ensure that assumptions remain valid.

4. *Purchase evaluation*. Institutions that purchase subprime loans from other lenders or dealers must give due consideration to the cost of servicing these assets and the loan losses that may be experienced as they evaluate expected profits. For instance, some lenders who sell subprime loans charge borrowers high up-front fees, which are usually financed into the loan. This provides incentive for originators to produce a high volume of loans with little emphasis on quality, to the detriment of a potential purchaser. Further, subprime loans, especially those purchased from outside the institution's lending area, are at special risk for fraud or misrepresentation (i.e., the quality of the loan may be less than the loan documents indicate).

   Institutions should perform a thorough due-diligence review prior to committing to purchase subprime loans. Institutions should not accept loans from originators that do not meet their underwriting criteria, and should regularly review loans offered to ensure that loans purchased continue to meet those criteria. Deterioration in the quality of purchased loans or in the portfolio's actual performance versus expectations requires a thorough reevaluation of the lenders or dealers who originated or sold the loans, as well as a reevaluation of the institution's criteria for underwriting loans and selecting dealers and lenders. Any such deterioration may also highlight the need to modify or terminate the correspondent relationship or make adjustments to underwriting and dealer/lender selection criteria.

5. *Loan-administration procedures*. After the loan is made or purchased, loan-administration procedures should provide for the diligent monitoring of loan performance and establish sound collection efforts. To minimize loan losses, successful subprime lenders have historically employed stronger

5. Extensions of credit secured by real estate, whether subprime or otherwise, are subject to the Interagency Guidelines for Real Estate Lending Policies, which establish supervisory loan-to-value (LTV) limits on various types of real estate loans and impose limits on an institution's aggregate investment in loans that exceed the supervisory LTV limits. See 12 C.F.R. 34, subpart D (OCC); 12 C.F.R. 208, appendix C (FRB); 12 C.F.R. 365 (FDIC); and 12 C.F.R. 560.100–101 (OTS) for further information.

collection efforts such as calling delinquent borrowers frequently, investing in technology (e.g., using automatic dialing for follow-up telephone calls on delinquent accounts), assigning more experienced collection personnel to seriously delinquent accounts, moving quickly to foreclose or repossess collateral, and allowing few loan extensions. This aspect of subprime lending is very labor intensive but critical to the program's success. To a large extent, the cost of such efforts can represent a tradeoff relative to future loss expectations when an institution analyzes the profitability of subprime lending and assesses its appetite to expand or continue this line of business.

Subprime loan-administration procedures should be in writing and at a minimum should detail—

a. billing and statement procedures;
b. collection procedures;
c. content, format, and frequency of management reports;
d. asset-classification criteria;
e. methodology to evaluate the adequacy of the allowance for loan and lease losses (ALLL);
f. criteria for allowing loan extensions, deferrals, and re-agings;
g. foreclosure and repossession policies and procedures; and
h. loss-recognition policies and procedures.

6. *Loan review and monitoring*. Once loans are booked, institutions must perform an ongoing analysis of subprime loans, not only on an aggregate basis but also for subportfolios. Institutions should have information systems in place to segment and stratify their portfolio (e.g., by originator, loan-to-value, debt-to-income ratios, credit scores) and produce reports for management to evaluate the performance of subprime loans. The review process should focus on whether performance meets expectations. Institutions then need to consider the source and characteristics of loans that do not meet expectations and make changes in their underwriting policies and loan-administration procedures to restore performance to acceptable levels.

   When evaluating actual performance against expectations, it is particularly important that management review credit scoring, pricing, and ALLL adequacy models. Models driven by the volume and severity of historical losses experienced during an economic expansion may have little relevance in an economic slowdown, particularly in the subprime market. Management should ensure that models used to estimate credit losses or to set pricing allow for fluctuations in the economic cycle and are adjusted to account for other unexpected events.

7. *Consumer protection*. Institutions that originate or purchase subprime loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Higher fees and interest rates combined with compensation incentives can foster predatory pricing or discriminatory "steering" of borrowers to subprime products for reasons other than the borrower's underlying creditworthiness. An adequate compliance-management program must identify, monitor, and control the consumer protection hazards associated with subprime lending.

   Subprime mortgage lending may trigger the special protections of the Home Ownership and Equity Protection Act of 1994, subtitle B of title I of the Riegle Community Development and Regulatory Improvement Act of 1994. This act amended the Truth in Lending Act to provide certain consumer protections in transactions involving a class of nonpurchase, closed-end home mortgage loans. Institutions engaging in this type of lending must also be thoroughly familiar with the obligations set forth in Regulation Z (12 C.F.R. 226.32), Regulation X, and the Real Estate Settlement Procedures Act (RESPA) (12 U.S.C. 2601) and adopt policies and implement practices that ensure compliance.

   The Equal Credit Opportunity Act makes it unlawful for a creditor to discriminate against an applicant on a prohibited basis regarding any aspect of a credit transaction. Similarly, the Fair Housing Act prohibits discrimination in connection with residential real estate related transactions. Loan officers and brokers must treat all similarly situated applicants equally and without regard to any prohibited basis characteristic (e.g., race, sex, age, etc.). This is especially important with respect to how loan officers or brokers assist customers in preparing their applications or otherwise help them to qualify for loan approval.

8. *Securitization and sale*. Some subprime lenders have increased their loan-production and -servicing income by securitizing and selling the loans they originate in the asset-backed securities market. Strong demand from

investors and favorable accounting rules often allow securitization pools to be sold at a gain, providing further incentive for lenders to expand their subprime-lending program. However, the securitization of subprime loans carries inherent risks, including interim credit risk and liquidity risk, that are potentially greater than those for securitizing prime loans. Accounting for the sale of subprime pools requires assumptions that can be difficult to quantify, and erroneous assumptions could lead to the significant overstatement of an institution's assets. Moreover, the practice of providing support and substituting performing loans for nonperforming loans to maintain the desired level of performance on securitized pools has the effect of masking credit-quality problems.

[T]urmoil in the financial markets [can illustrate] the volatility of the secondary market for subprime loans and the significant liquidity risk incurred when originating a large volume of loans intended for securitization and sale. Investors can quickly lose their appetite for risk in an economic downturn or when financial markets become volatile. As a result, institutions that have originated, but have not yet sold, pools of subprime loans may be forced to sell the pools at deep discounts. If an institution lacks adequate personnel, risk-management procedures, or capital support to hold subprime loans originally intended for sale, these loans may strain an institution's liquidity, asset quality, earnings, and capital. Consequently, institutions actively involved in the securitization and sale of subprime loans should develop a contingency plan that addresses back-up purchasers of the securities or the attendant servicing functions, alternate funding sources, and measures for raising additional capital.

Institutions should refer to Statement of Financial Accounting Standards No. 125 (FAS 125), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," for guidance on accounting for these transactions. If a securitization transaction meets FAS 125 sale or servicing criteria, the seller must recognize any gain or loss on the sale of the pool immediately and carry any retained interests in the assets sold (including servicing rights/obligations and interest-only strips) at fair value. Management should ensure that the key assumptions used to value these retained interests are reasonable and well supported, both for the initial valuation and for subsequent quarterly revaluations. In particular, management should consider the appropriate discount rates, credit-loss rates, and prepayment rates associated with subprime pools when valuing these assets. Since the relative importance of each assumption varies with the underlying characteristics of the product types, management should segment securitized assets by specific pool, as well as predominant risk and cash-flow characteristics, when making the underlying valuation assumptions. In all cases, however, institutions should take a conservative approach when developing securitization assumptions and capitalizing expected future income from subprime lending pools. Institutions should also consult with their auditors as necessary to ensure their accounting for securitizations is accurate.

9. *Reevaluation*. Institutions should periodically evaluate whether the subprime-lending program has met profitability, risk, and performance goals. Whenever the program falls short of original objectives, an analysis should be performed to determine the cause and the program should be modified appropriately. If the program falls far short of the institution's expectations, management should consider terminating it. Questions that management and the board need to ask may include:
   a. Have cost and profit projections been met?
   b. Have projected loss estimates been accurate?
   c. Has the institution been called upon to provide support to enhance the quality and performance of loan pools it has securitized?
   d. Were the risks inherent in subprime lending properly identified, measured, monitored, and controlled?
   e. Has the program met the credit needs of the community that it was designed to address?

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(Issued jointly by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision March 1, 1999.)

2128.08.4 INSPECTION OBJECTIVES

1. To assess and evaluate the extent of subprime-lending activities and whether management has adequately planned for this activity.
2. To determine whether the BO has the financial capacity, including capital adequacy, to conduct the high-risk activity of subprime lending.
3. To establish whether management has committed the necessary resources with regard to technology and skilled personnel to manage the subprime-lending program.
4. To ascertain whether management has established adequate subprime-lending standards and is maintaining proper controls over the subprime-lending program.
5. To determine if the BO has contingency plans for subprime lending and if they are adequate for volatile financial markets and during economic downturns.
6. To review and evaluate the performance of the subprime-lending program, including its profitability, delinquency, and loss experience.

2128.08.5 INSPECTION PROCEDURES

1. Determine whether the subprime-lending activities are consistent with the banking organization's overall business strategy and risk tolerances, and that all critical business risks have been identified and considered.
2. Assess whether the BO has the financial capacity, including capital adequacy, to conduct the high-risk activity of subprime lending safely without any undue concentrations of credit.
3. Ascertain if management has committed the necessary resources in terms of technology and skilled personnel to manage and control the risks associated with the volume and complexity of the subprime-lending program.
4. Determine if management has established adequate lending standards that are appropriate for the size and complexity of the BO's operations and is maintaining proper controls over the program. See subsection 2128.08.3 for the lending standards that should be included in the subprime-loan program. See also section 2010.2 with regard to loan administration and lending standards.
5. Determine whether the BO's contingency plans are adequate to address the issues of (1) alternative funding sources, (2) back-up purchasers of the securities or the attendant servicing functions, and (3) methods of raising additional capital during an economic downturn or when financial markets become volatile.
6. Review and evaluate loan-administration and loan-monitoring procedures for subprime loans originated or purchased, including—
   a. collection, repossession, and disclosure procedures;
   b. management of the level and effective use of skilled staffing and advanced technology;
   c. the adequacy of the allowance for loan and lease losses; and
   d. the adequacy and accuracy of models used to estimate credit losses or to set pricing, making certain that the models account for economic cycles and other unexpected events.
7. Review securitization transactions for compliance with FAS 125 and this guidance, including whether the BO has provided any support to maintain the credit quality of loans pools it has securitized.
8. Analyze the performance of the program, including profitability, delinquency, and loss experience.
9. Consider management's response to adverse performance trends, such as higher-than-expected prepayments, delinquencies, charge-offs, customer complaints, and expenses.
10. Determine if the BO's subprime-lending program effectively manages the credit, market, liquidity, reputational, operational, and legal risks associated with subprime-lending operations.

Credit Derivatives (Risk Management and Internal Controls) Section 2129.0

Banking organizations must establish and maintain sound risk-management policies and procedures and effective internal controls over their use of credit derivatives. Credit derivatives are off-balance-sheet financial instruments that are used to assume or lay off credit risk on loans and other assets, some only to a limited extent. They allow one party (the beneficiary) to transfer the credit risk of a "reference asset," which it often actually owns, to another party (the guarantor).[1] This arrangement allows the guarantor party to assume the credit risk associated with the reference asset without directly purchasing it. Unlike traditional guarantee arrangements, credit-derivative transactions often are documented using master agreements developed by the International Swaps and Derivatives Association (ISDA) that are similar to those governing swaps or options. Since credit derivatives are privately negotiated financial contracts, they expose the user to credit risk as well as liquidity risk (thin secondary market for credit derivatives), operational risk (instruments used for speculation rather than hedging), counterparty risk (default), and legal risk (the contracts may be deemed illegal).

Banking organizations use credit-derivative instruments either as end-users, purchasing credit protection from or providing credit protection to third parties, or as dealers intermediating such protection. Credit derivatives are used to manage overall credit-risk exposure. A banking organization may use credit derivatives to mitigate its concentration to a particular borrower or industry without severing the customer relationship. In addition, organizations that are approaching established in-house limits on counterparty credit exposure could continue to originate loans to a particular industry, using credit derivatives to transfer the credit risk to a third party.

Banking organizations may also use credit derivatives to diversify their portfolios by assuming the associated credit exposures and revenue returns to different borrowers or industries without actually purchasing the underlying assets. Nonbank companies may serve as counterparties to credit-derivative transactions with banks to gain access to the commercial bank loan market. Such entities may not lend or may not have the facilities or staff to adequately administer a loan portfolio.

Under some credit-derivative arrangements, a beneficiary may pay a fee to the guarantor in exchange for a guarantee against any loss that may occur, usually in excess of a prespecified amount, if the reference asset defaults (a "credit-default swap"). Alternatively, the beneficiary may pay the total return on a reference asset, including any appreciation in the asset's price, to a guarantor in exchange for a spread over funding costs plus any depreciation in the value of the reference asset (a "total-rate-of-return swap").

Credit derivatives and their market are likely to take on various forms, such as the market for put options on specific corporate bonds or loans. While the payoffs of these puts are expressed in terms of a strike price, rather than a default event, if the strike price is sufficiently high, credit risk effectively could be transferred from the buyer of the put to the writer of the put. See SR-96-17.

2129.0.1 SUPERVISORY AND EXAMINER GUIDANCE

In reviewing credit derivatives, examiners should consider the credit risk associated with the reference asset as the primary risk, as they do for loan participations or guarantees. A banking organization providing credit protection through a credit derivative may be as exposed to the credit risk of the reference asset as it would be if the asset were on its own balance sheet. Thus, for supervisory purposes, the exposure generally should be treated as if it were a letter of credit or other off-balance-sheet guarantee.[2] This treatment would apply, for example, in determining a banking organization's overall credit exposure to a borrower for purposes of evaluating concentrations of credit. The overall exposure should include exposure it assumes

1. For purposes of this supervisory guidance, when the beneficiary owns the reference asset, it will be referred to as the "underlying" asset. However, in some cases, the reference asset and the underlying asset are not the same. For example, the credit-derivative contract may reference the performance of an ABC Company bond, while the beneficiary banking organization may actually own an ABC Company loan. The use of the term "guarantor" does not necessarily refer to a guarantor involving a suretyship contract. The transferred risk can be in a primary liability of the acquiring party that assumes the credit risk.

2. Credit derivatives that are based on a broad-based index, such as the Lehman Brothers Bond Index or the S&P 500 stock index, could be treated for capital and other supervisory purposes as a derivative contract. This determination should be made on a case-by-case basis.

by acting as a guarantor in a credit-derivative transaction where the borrower is the obligor of the reference asset.

Banking organizations providing credit protection through a credit derivative should hold capital and reserves against their exposure to the reference asset.[3] This broad principle holds for all credit derivatives, except for credit-derivative contracts that incorporate periodic payments for depreciation or appreciation, including most total-rate-of-return swaps. For these transactions, the guarantor can deduct the amount of depreciation paid to the beneficiary from the notional amount of the contract in determining the amount of reference exposure subject to a capital charge.

In some cases (for example, total-rate-of-return swaps), the guarantor also is exposed to the credit risk of the counterparty, which for derivative contracts generally is measured as the replacement cost of the credit-derivative transaction plus an add-on for the potential future exposure of the derivative to market price changes. For banking organizations acting as dealers that have matching offsetting positions, the counterparty risk stemming from credit-derivative transactions could be the principal risk to which the dealer banks are exposed.

In reviewing a credit derivative entered into by a beneficiary banking organization, the examiner should review the organization's credit exposure to the guarantor, as well as to the reference asset—if the asset is actually owned by the beneficiary. The degree to which a credit derivative, unlike most other credit-guarantee arrangements, transfers the credit risk of an underlying asset from the beneficiary to the guarantor may be uncertain or limited. The degree of risk transference depends on the terms of the transaction. For example, some credit derivatives are structured so that a payout only occurs when a predefined event of default or a downgrade below a prespecified credit rating occurs.[4] Others may require a payment only when a defined default event occurs *and* a predetermined materiality (or loss) threshold is exceeded. Default payments themselves may be based on an average of dealer prices for the reference asset during some period of time after default using a prespecified sampling procedure or may be specified in advance as a set percentage of the notional amount of the reference asset. Finally, the term of many credit-derivative transactions is shorter than the maturity of the underlying asset and, thus, provides only temporary credit protection to the beneficiary.

Examiners must ascertain whether the amount of credit protection a beneficiary receives by entering into a credit derivative is sufficient to warrant treatment of the derivative as a guarantee for regulatory capital and other supervisory purposes. Those arrangements that provide virtually complete credit protection to the underlying asset will be considered effective guarantees for purposes of asset classification and risk-based capital calculations. On the other hand, if the amount of credit risk transferred by the beneficiary is severely limited or uncertain, then the limited credit protection provided by the derivative should not be taken into account for these purposes.

In this regard, examiners should carefully review credit-derivative transactions in which the reference asset is not identical to the asset actually owned by the beneficiary banking organization. For the derivative contract to be considered as providing effective credit protection, the examiner must review the arrangement and be satisfied that the reference asset is an appropriate proxy for the loan or other asset, whose credit exposure the banking organization intends to offset. To determine this, examiners should consider, among other factors, whether the reference asset and owned asset have the same obligor and seniority in bankruptcy and whether both contain mutual cross-default provisions.

A banking organization's management should not enter into credit-derivative transactions unless it has the ability to understand and manage the credit and other risks associated with these instruments in a safe and sound manner. Accordingly, examiners should determine the appropriateness of these instruments on an entity-by-entity basis, taking into account management's expertise in evaluating the instruments used; the adequacy of relevant policies, including position limits; and the quality of the banking organization's relevant information systems and internal controls.[5]

3. For guidance on risk-based capital treatment of credit derivatives, see section 4060.3.5.3.9.

4. It may also be necessary to review the credit documentation of the primary obligor to determine the degree of transferred risk.

5. For further guidance on examining the risk-management practices of banking organizations, including guidance on derivatives, that examiners may find helpful in reviewing an organization's management of its credit-derivative activity, see sections 2125.0, 2126.0, 2128.0, and 4070.1. See also the *Commercial Bank Examination Manual* and the *Trading and Capital-Markets Activities Manual*.

2129.0.2 TYPES OF CREDIT DERIVATIVES

The most widely used types of credit derivatives are credit-default swaps and total-rate-of-return (TROR) swaps.[6] While the timing and structure of the cash flows associated with credit default and TROR swaps differ, the economic substance of both arrangements is that they seek to transfer the credit risk on the asset(s) referenced in the transaction.

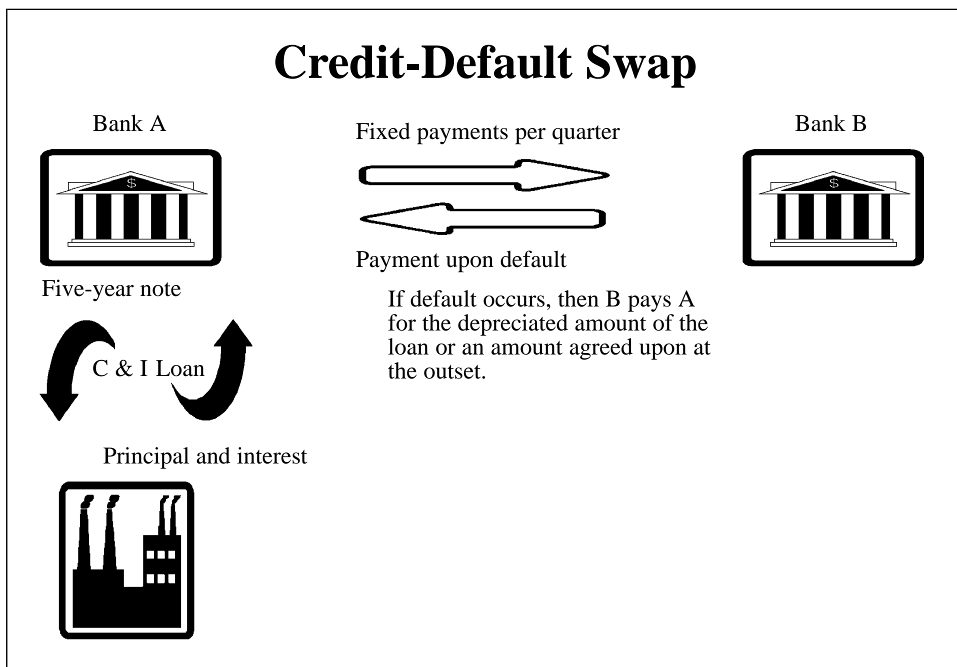
6. Another less common form of credit derivative is the *credit-linked note*, which is an obligation that is based on a reference asset. Credit-linked notes are similar to structured notes with embedded credit derivatives. If there is a credit event, the repayment of the bond's principal is based on the price of the reference asset. A credit-linked note may be a combination of a regular bond and a credit option. The note can promise to make periodic interest payments and a large lump-sum payment when the bond matures. The credit option on the note may allow the issuer to reduce the note's payments if a primary financial indicator or variable deteriorates. When reviewing these transactions, examiners should consider the purchasing banking organization's exposure to the underlying reference asset as well as the exposure to the issuing entity.

2129.0.2.1 Credit-Default Swaps

The purpose of a credit-default swap is to provide protection against credit losses associated with a default on a specified reference asset. The swap purchaser (the beneficiary) "swaps" the credit risk with the provider of the swap (the guarantor). The transaction is very similar to a guarantee or financial standby letter of credit.

In a credit-default swap, illustrated in figure 1, the beneficiary (Bank A) agrees to pay to the guarantor (Bank B) a quarterly or annual fee, typically amounting to a certain number of basis points on the par value of the reference asset. In return, the guarantor agrees to pay the beneficiary an agreed-upon, market-based, post-default amount or a predetermined fixed percentage of the value of the reference asset if there is a default. The guarantor makes no payment until there is a default. A default is strictly defined in the contract to include, for example, bankruptcy, insolvency, or payment default, and the event of default itself must be publicly verifiable. The guarantor may not be obliged to

Figure 1
Credit-Default Swap Cash-Flow Diagram



make any payments to the beneficiary until a preestablished amount of loss has been exceeded in conjunction with a default event (called a materiality threshold).

The swap is terminated if the reference asset defaults before the maturity of the swap. The amount owed by the guarantor is the difference between the reference asset's initial principal (or notional) amount and the actual market value of the defaulted, reference asset. The methodology for establishing the post-default market value of the reference asset should be set out in the contract. Often, the market value of the defaulted reference asset may be determined by sampling dealer quotes. The guarantor may have the option to purchase the defaulted, underlying asset and pursue a workout with the borrower directly, an action it may take if it believes that the "true" value of the reference asset is higher than that determined by the swap-pricing mechanism. Alternatively, the swap may call for a fixed payment in the event of default, such as a percentage of the notional value of the reference asset.

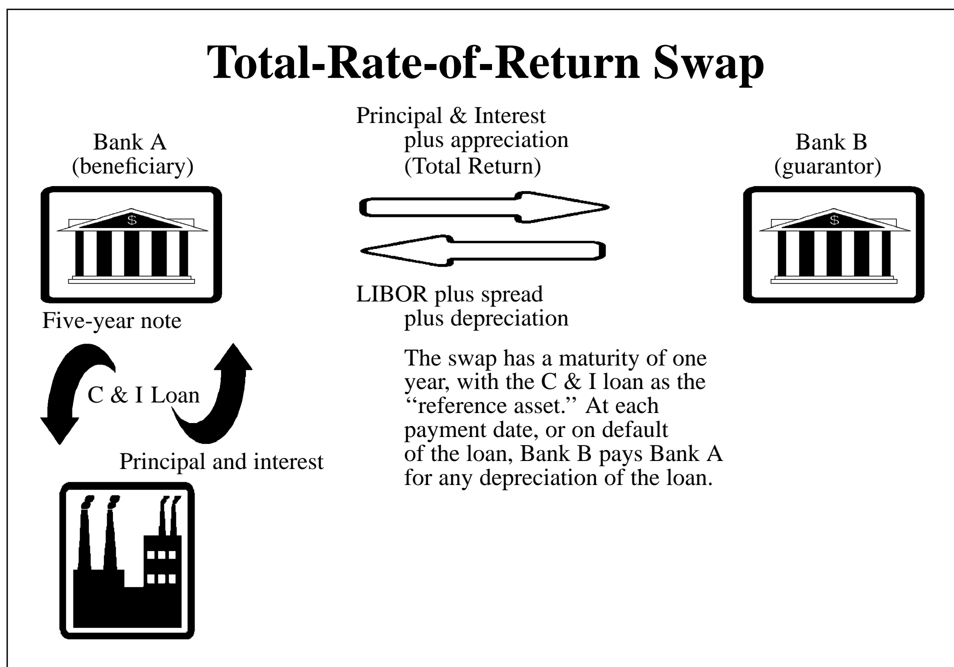
2129.0.2.2 Total-Rate-of-Return Swaps

In a total-rate-of-return (TROR) swap, illustrated in figure 2, the beneficiary (Bank A) agrees to pay the guarantor (Bank B) the "total return" on the reference asset, which consists of all contractual payments, as well as any appreciation in the market value of the reference asset. To complete the swap arrangement, the guarantor agrees to pay LIBOR plus a spread and any depreciation to the beneficiary.[7] Since it bears the risks and rewards of ownership over the term of the swap, the guarantor in a TROR swap could be viewed as having synthetic ownership of the reference asset.

At each payment-exchange date (including when the swap matures) or on default, at which-point the swap may terminate, any depreciation

7. The reference asset is often a floating-rate instrument, for example, a prime-based loan. Thus, if both sides of a TROR swap are based on floating rates, interest-rate risk is effectively eliminated with the exception of some basis risk.

Figure 2
Total-Rate-of-Return Swap Cash-Flow Diagram



or appreciation in the amortized value of the reference asset is calculated as the difference between the notional principal balance of the reference asset and the "dealer price."[8] The dealer price is generally determined either by referring to a market quotation source or by polling a group of dealers, and the price reflects changes in the credit profile of the reference obligor and reference asset.

If the dealer price is less than the notional amount of the contract (the hypothetical original price of the reference asset), then the guarantor must pay the difference to the beneficiary, absorbing any loss caused by a decline in the credit quality of the reference asset.[9] Thus, a TROR swap differs from a standard direct credit substitute in that the guarantor is guaranteeing not only against default of the reference obligor, but also against a deterioration in that obligor's credit quality, which can occur even if there is no default.

TROR swaps allow banking organizations to diversify credit risk and at the same time maintain confidentiality of their client's financial records since the borrowing entity's financial records are held by the originating lender. When the loans are sold, the records are transferred to the new acquiring lender. TROR swaps generally involve fewer administrative costs than those involved in a loan-sales transaction. Risk diversification can thus be achieved at a reduced cost.

2129.0.3 OTHER SUPERVISORY ISSUES

The decision to treat credit derivatives as guarantees could have significant supervisory implications for the way examiners treat concentration risk, classified assets, the adequacy of the allowance for loan and lease losses (ALLL),[10] and transactions involving affiliates. Examples of how credit derivatives that effectively transfer credit risk could affect supervisory procedures are discussed below.

8. Depending on contract terms, a TROR swap may not terminate on default of the reference asset. Instead, payments would continue to be made on subsequent payment dates based on the reference asset's post-default prices until the swap's contractual maturity.

9. As in a credit-default swap, the guarantor may have the option of purchasing the underlying asset from the beneficiary at the dealer price and trying to collect from the borrower directly.

10. See sections 2010.7 and 2065.2.

2129.0.3.1 Credit Exposure

For internal purposes of managing credit risk, banking organizations are encouraged to develop policies to determine how credit-derivative activity will be used to manage credit exposures. For example, a banking organization's internal credit policies may set forth situations in which it is appropriate to reduce credit exposure to an underlying obligor through credit-derivative transactions. Such policies need to address when credit exposure is effectively reduced and how all credit exposures will be monitored, including those resulting from credit-derivative activities.

2129.0.3.2 Concentrations of Credit

Concentrations of credit may be defined as—

- loans collateralized by a common security;
- loans to one borrower or related group of borrowers;
- loans that depend on a particular agricultural commodity;
- aggregate loans to major employers, their employees, and their major suppliers;
- loans within industry groups;
- out-of-territory loans;
- the 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, depend on common key factors, and when weaknesses develop, they have an adverse impact on each individual loan making up the concentration.[11] Generally, examiners should not consider a banking organization's asset concentration to a particular borrower reduced because of the existence of a nongovernment guarantee on one of the borrower's loans since the underlying concentration to the borrower still exists. However, examiners should consider how the banking organization manages the concentration, which could include the use of nongovernmental guarantees. Asset concentrations are to be listed in the confidential "Administrative and Other Matters" page D of the inspection report to highlight that the ultimate risk to the banking organization stems from these concentrations,

11. See sections 2010.2, 2010.7, and 2065.2.

although the associated credit risk may be mitigated by the existence of nongovernmental guarantees.

Any nongovernment guarantee will be included with other exposures to the guarantor to determine if there is an asset concentration with respect to the guarantor. Thus, the use of credit derivatives will increase the beneficiary's concentration exposure to the guarantor without reducing the concentration risk of the underlying borrower. Similarly, a guarantor banking organization's exposure to all reference assets will be included in its overall credit exposure to the reference obligor.

2129.0.3.3 Classification of Assets

The criteria used to classify assets are primarily based on their degree of risk and the likelihood of repayment, as well as on the potential effect of the assets on the bank's safety and soundness.[12] When evaluating the quality of a loan, examiners should review the overall financial condition of the borrower; the borrower's credit history; any secondary sources of repayment, such as guarantees; and other factors. The primary focus in the review of a loan's quality is the original source of payment. The assessment of the credit quality of a troubled loan, however, should take into account support provided by a "financially responsible guarantor."[13]

The protection that a credit derivative from a financially responsible guarantor provides on an underlying asset may be sufficient to preclude classification of the underlying asset or reduce the severity of classification. Sufficiency *depends on the extent of credit protection that is provided*. To be considered a guarantee for purposes of determining the classification of assets, a credit derivative must transfer the credit risk from the beneficiary to the financially responsible guarantor; the financially responsible guarantor must have *both* the financial capacity and willingness to provide support for the credit; the guarantee (the credit-derivative contract) must be legally enforceable; and the guarantee must provide support for repayment of the indebtedness, in whole or in part, during the remaining term of the underlying asset.

However, credit derivatives tend to have a shorter maturity than the underlying asset being protected. Furthermore, it is uncertain whether the credit derivative will be renewed once it matures. Thus, when determining whether to classify an underlying asset protected by a credit derivative, examiners need to consider the *term* of the credit derivative in relation to the maturity of the protected underlying asset, the probability that the protected underlying asset will default while the guarantee is in force, and whether the credit risk has actually been transferred. In general, the beneficiary banking organization continues to be exposed to the credit risk of the classified underlying asset when the maturity of the credit derivative is shorter than the underlying asset. Thus, in these situations of maturity mismatch, the examiner's presumption may be against a diminution of the severity of the underlying asset's classification.

For guarantor banking organizations, examiners should review the credit quality of individual reference assets in derivative contracts in the same manner as other credit instruments, such as standby letters of credit. Thus, examiners should evaluate a credit derivative in which a banking organization provides credit protection based on the overall financial condition and resources of the reference obligor; the obligor's credit history; and any secondary sources of repayment, such as collateral. As a rule, exposure from providing credit protection through a credit derivative should be classified if the reference asset is classified.[14]

2129.0.3.4 Transactions Involving Affiliates

Credit-derivative transactions can involve two or more legal entities (affiliates) within the same banking organization. Thus, transactions between or involving affiliates raise important supervisory issues, especially whether such arrangements are effective guarantees of affiliate obligations or transfers of assets and their related credit exposure between affiliates. Banking organizations should carefully consider existing supervisory guidance on interaffiliate

12. Loans that exhibit potential weaknesses are categorized as "substandard," while those with well-defined weaknesses and a distinct possibility of loss are either "doubtful" or "loss."

13. See section 5010.10 of this manual and section 2060.1 of the *Commercial Bank Examination Manual*.

14. A guarantor banking organization providing credit protection through the use of a credit derivative on a classified asset of a beneficiary bank may preclude classification of *its derivative contract* by laying off the risk exposure to another financially responsible guarantor. This could be accomplished through the use of a second offsetting credit-derivative transaction.

transactions before entering into credit-derivative arrangements involving affiliates, particularly when substantially the same objectives could be met using traditional guarantee instruments.

2129.0.4 INSPECTION OBJECTIVES

1. To determine if the banking organization is providing credit protection through a credit derivative.
2. To ascertain whether the banking organization has and maintains sound risk-management policies and procedures and effective internal controls over the use of credit derivatives.
3. To review and evaluate existing risk involving credit-derivative arrangements.
4. To ascertain whether adequate capital and reserves are held against exposures to reference assets, including whether risk-based capital computations have accounted for any additional risk resulting from derivative arrangements.

2129.0.5 INSPECTION PROCEDURES

1. Consider credit risk associated with reference assets as primary risks. Determine whether the credit-risk exposure is treated as if it was a letter of credit or other off-balance-sheet guarantee.
2. Review the organization's credit exposure to the guarantor, as well as to the reference asset. Determine if the asset is actually owned by the beneficiary.
3. Ascertain whether the amount of credit protection a beneficiary receives when entering into a credit derivative is sufficient to warrant treatment of the derivative as a guarantee for regulatory capital and other supervisory purposes.
4. Review credit-derivative transactions in which the reference asset is not identical to the asset actually owned by the beneficiary banking organization.
   a. Ascertain if the reference asset is an appropriate proxy for loans or other assets whose credit exposure the banking organization intends to offset.
   b. Consider whether the reference asset and owned asset have the same obligor and seniority in bankruptcy and whether both contain mutual cross-default provisions.
5. Determine whether management has the ability to understand and manage the credit and other risks associated with credit derivatives in a safe and sound manner. Consider management's expertise in evaluating the instruments; the adequacy of relevant policies, including position limits; and the quality of the banking organization's relevant management information systems and internal controls.
6. Evaluate the management of a banking organization's asset concentration to a particular borrower, which could include the use of non-governmental guarantees on one or more of the borrower's loans. List the asset concentrations in the confidential "Administrative and Other Matters" page D of the inspection report.
7. Review the quality of loans and the overall financial condition of the borrower; the borrower's credit history; any secondary sources of repayment, such as financially responsible guarantors; and other factors.
8. When determining whether to classify an underlying asset protected by a credit derivative, compare the *term* of the credit derivative in relation to the maturity of the protected underlying asset, the probability that the protected underlying asset will default while the guarantee is in force, and whether the credit risk has actually been transferred.
9. For guarantor banking organizations, review the credit quality of individual reference assets in derivative contracts in the same manner as other credit instruments, such as standby letters of credit.
   a. Evaluate a credit derivative in which a banking organization provides credit protection based on the overall financial condition and resources of the reference obligor; the obligor's credit history; and any secondary sources of repayment, such as collateral.
   b. If the reference asset is classified, classify the exposure from providing credit protection through a credit derivative.

Banking organizations have substantially increased their secondary-market credit activities such as loan syndications, loan sales and participations, credit derivatives, and asset securitizations, as well as the provision of credit enhancements and liquidity facilities to such transactions. These activities can enhance both credit availability and bank profitability, but managing the risks of these activities poses increasing challenges. This is because the risks involved, while not new to banking, may be less obvious and more complex than the risks of traditional lending activities. Some secondary-market credit activities involve credit, liquidity, operational, legal, and reputational risks in concentrations and forms that may not be fully recognized by bank management or adequately incorporated in an institution's risk-management systems. In reviewing these activities, supervisors[1] and examiners should assess whether banking organizations fully understand and adequately manage the full range of the risks involved in secondary-market credit activities.

The heightened need for management attention to these risks is underscored by reports from examiners, surveys of senior lending officers, and discussions with trade and advisory groups. They have indicated that competitive conditions over the past few years have encouraged an easing of credit terms and conditions in both commercial and consumer lending. In addition, indications are that some potential participants in loan syndications have found it necessary to make complex credit decisions within a much shorter time frame than has been customary. Although the recent easing may not be imprudent, the incentives and pressures to lower credit standards have increased as competition has intensified and borrowers have experienced generally favorable business and economic conditions. Supervisors and bank management alike should remain alert to the possibility that loan performance could deteriorate if certain sectors of the economy experience problems. The recent rise in consumer bankruptcies, credit card delinquencies, and credit charge-offs illustrates this concern. These types of developments could have significant implications for the risks associated with secondary-market credit activities.

This section identifies some of the important risks involved in several of the more common types of secondary-market credit activities. Guidance is provided on sound practices along with special considerations supervisors should take into account in assessing the risk-management systems for these activities. A banking institution's failure to understand adequately the risks inherent in secondary-market credit activities and the failure to incorporate for such risk within its risk-management systems and internal capital allocations may constitute an unsafe and unsound banking practice.

A fundamental principle is advanced in this guidance: Banking institutions should explicitly incorporate the full range of risks of their secondary-market credit activities into their overall risk-management systems.[2] In particular, supervisors and examiners should determine whether institutions are recognizing the risks of secondary-market credit activities by (1) adequately identifying, quantifying, and monitoring these risks; (2) clearly communicating the extent and depth of these risks in reports to senior management and the board of directors and in regulatory reports; (3) conducting ongoing stress testing to identify potential losses and liquidity needs under adverse circumstances; and (4) setting adequate minimum internal standards for allowances or liabilities for losses, capital, and contingency funding. Incorporating secondary-market credit activities into banking organizations' risk-management systems and internal capital adequacy allocations is particularly important. This guidance builds on, supports, and is fully consistent with existing guidance on risk management issued by the Federal Reserve.[3]

1. The term "supervisors" is intended to refer to Federal Reserve System staff.

2. This guidance applies to the secondary-market credit activities conducted by state member banks, bank holding companies, Edge corporations, and U.S. branches and agencies of foreign banks. For this guidance, secondary-market credit activities include, but are not limited to, loan syndications; loan participations; loan sales and purchases; credit derivatives; asset securitization; and both implied and direct credit enhancements that may support these or the related activities of the institution, its affiliates, or third parties. Asset securitization activities refer to the issuance, underwriting, and servicing of asset-backed securities; the provision of credit or liquidity enhancements to securitized transactions; and investment in asset-backed securities.

3. For a more detailed discussion of risk management, see SR-95-51, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies"; SR-95-17, "Evaluating the Risk Management and Internal Controls of Securities and Derivative Contracts Used in Nontrading Activities"; SR-93-69, "Risk Management and Internal Controls for Trading Activities of Banking Organizations"; and SR-90-16, "Implementation of

Improvements in technology, greater standardization of lending products, and the use of credit enhancements have helped to increase dramatically the volume of loan syndications, loan sales, loan participations, asset securitizations, and credit guarantees undertaken by commercial banks, affiliates of bank holding companies, and some U.S. branches and agencies of foreign banks. In addition, the advent of credit derivatives permits banking organizations to trade credit risk, manage it in isolation from other types of risk, and maintain credit relationships while transferring the associated credit risk. Such developments have improved the availability of credit to businesses and consumers, allowed management to better tailor the mix of credit risk within loan and securities portfolios, and helped to improve overall bank profitability.

Certain credit and liquidity enhancements that banking organizations provide to facilitate various secondary-market credit activities can make the evaluation of their risks less straightforward than the risks involved in traditional on-balance-sheet banking activities. These enhancements, or guarantees, generally manifest themselves as recourse provisions, securitization structures that entail credit-linked early-amortization and collateral-replacement events, and direct credit substitutes such as letters of credit and subordinated interests that, in effect, provide credit support to secondary-market instruments and transactions.[4]

The transactions involving such enhancements tend to be complex and may expose the institutions extending them to hidden obligations that may not become evident until the transactions have deteriorated. In substance, such activities move the credit risk off the balance sheet by shifting risks associated with traditional on-balance-sheet assets into off-balance-sheet contingent liabilities. Given the potential complexity and, in some cases, the indirect nature of these enhancements, the actual credit-risk exposure can be difficult to assess, especially in the context of traditional credit-risk limit, measurement, and reporting systems.

Moreover, many secondary-market credit activities involve new and compounded dimensions of reputational, liquidity, operational, and legal risks that are not readily identifiable and may be difficult to control. For example, recourse provisions and certain asset-backed security structures can give rise to significant reputational- and liquidity-risk exposures, and ongoing management of underlying collateral in securitization transactions can expose an institution to unique operating and legal risks.

For those institutions involved in providing credit enhancements in connection with loan sales and securitizations, and those involved in credit derivatives and loan syndications, supervisors and examiners should assess whether the institutions' systems and processes adequately identify, measure, monitor, and control *all* of the risks involved in the secondary-market credit activities. In particular, the risk-management systems employed should include the identification, measurement, and monitoring of these risks as well as an appropriate methodology for the internal allocation of capital and reserves. The stress testing conducted within the risk-measurement element of the management system should fully incorporate the risk exposures of these activities under various scenarios to identify their potential effect on an institution's liquidity, earnings, and capital adequacy. Moreover, management reports should adequately communicate to senior management and the board of directors the risks associated with these activities and the contingency plans that are in place to deal with adverse conditions. See SR-97-21.

2129.05.1 CREDIT RISKS IN SECONDARY-MARKET CREDIT ACTIVITIES

Institutions should be aware that the credit risk involved in many secondary-market credit activities may not always be obvious. For certain types of loan sales and securitization transactions, a banking organization may actually be exposed to essentially the same credit risk as in traditional lending activities, even though a particular transaction may, superficially, appear to have isolated the institution from any risk exposure. In such cases, removal of an asset from the balance sheet may not result in a commensurate

Examination Guidelines for the Review of Asset Securitization Activities."

4. Examiners should also review SR-96-30, "Risk-Based Capital Treatment for Spread Accounts that Provide Credit Enhancement for Securitized Receivables." In addition, banking organizations have retained the risk of loss, that is, recourse, on sales and securitizations of assets when, in accordance with generally accepted accounting principles, they record on their balance sheets interest-only strip receivables or other assets that serve as credit enhancements. For more information, see Statement of Financial Accounting Standards No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities," and the instructions to the Reports of Income and Condition.

reduction in credit risk. Transactions that can give rise to such instances include loan sales with recourse; credit derivatives; direct credit substitutes, such as letters of credit; and liquidity facilities extended to securitization programs, as well as certain asset securitization structures, such as the structure typically used to securitize credit card receivables.

2129.05.1.1 Loan Syndications

Recently, the underwriting standards of some syndications have been relaxed through the easing or elimination of certain covenants or the use of interest-only arrangements. Bank management should continually review syndication underwriting standards and pricing practices to ensure that they remain consistent over time with (1) the degree of risk associated with the activity and (2) the potential for unexpected economic developments to adversely affect borrower creditworthiness.

In some cases, potential participants in loan syndications have felt it necessary to make decisions to commit to the syndication within a shorter period of time than is customary. Supervisors and examiners should determine whether syndicate participants are performing their own independent credit analysis of the syndicated credit and make sure they are not placing undue reliance on the analysis of the lead underwriter or on commercial-loan credit ratings. Banking organizations should not feel pressured to make an irrevocable commitment to participate in a syndication until such an analysis is complete.

2129.05.1.2 Credit Derivatives

Credit derivatives are generally off-balance-sheet financial instruments[5] that are used by banking organizations to assume or mitigate the credit risk of loans and other assets.[6] Banking organizations are increasingly employing these instruments either as end-users, purchasing credit protection from—or providing credit protection to—third parties, or as dealers intermediating such protection. In reviewing credit derivatives, supervisors should consider the credit risk associated with the reference asset, as well as general market risk and the risk of the counterparty to the contract.

With respect to credit-derivative transactions in which banking organizations are mitigating the credit risk of their assets, supervisors and examiners should carefully review those situations in which the reference assets are not identical to the assets actually owned by the institutions. Supervisors should consider whether the reference asset is an appropriate proxy for the loan or other asset whose credit exposure the banking organization intends to offset.

2129.05.1.3 Recourse Obligations, Direct Credit Substitutes, and Liquidity Facilities

2129.05.1.3.1 Recourse Obligations

Partial, first-loss recourse obligations retained when selling assets, and the extension of partial credit enhancements (for example, 10 percent letters of credit), can be a source of concentrated credit risk by exposing institutions to the full amount of expected losses on the protected assets. For instance, the credit risk associated with whole loans or pools of assets that are sold to secondary-market investors can often be concentrated within the partial, first-loss recourse obligations retained by banking organizations selling and securitizing the assets. In these situations, even though institutions may have reduced their exposure to catastrophic loss on the assets sold, they generally retain the same credit-risk exposure as if they continued to hold the assets on their balance sheets.

2129.05.1.3.2 Direct Credit Substitutes

Institutions also assume concentrated credit risk through the extension of partial direct credit substitutes, such as the purchase of subordinated interests and the extension of letters of credit. For example, banking organizations that sponsor certain asset-backed commercial paper programs, or so-called "remote origination" conduits, can be exposed to high degrees of credit risk even though it may seem that their notional exposure is minimal. Such a remote origination conduit lends directly to corporate customers referred to it by the sponsoring banking organization that used to lend directly to these same borrowers. The conduit funds this lending activity by issuing commercial paper that, in turn, is

5. Credit-linked notes are on-balance-sheet instruments.

6. See SR-96-17, "Supervisory Guidance for Credit Derivatives," for a discussion of supervisory issues regarding credit derivatives, including the risk-based capital treatment of credit derivatives held in the banking book. SR-97-18, "Application of Market Risk Capital Requirements to Credit Derivatives," provides guidance on the risk-based capital treatment of credit derivatives held in the trading book.

guaranteed by the sponsoring banking organization. The net result is that the sponsoring institution has much the same credit-risk exposure through this guarantee as if it had made the loans directly and held them on its books. However, this credit extension is an off-balance-sheet transaction, and the associated risks may not be fully reflected in the institution's risk-management system.

2129.05.1.3.3 Liquidity Facilities

Banking organizations that extend liquidity facilities to securitized transactions, particularly asset-backed commercial paper programs, may be exposed to high degrees of credit risk which may be subtly embedded within the facilities' provisions. Liquidity facilities are commitments to extend short-term credit to cover temporary shortfalls in cash flow. While all commitments embody some degree of credit risk, certain commitments extended to asset-backed commercial paper programs to provide liquidity may subject the extending institution to the credit risk of the underlying asset pool, often trade receivables, or of a specific company using the program for funding. Often the stated purpose of such liquidity facilities is to provide funds to the program to retire maturing commercial paper when a mismatch occurs in the maturities of the underlying receivables and the commercial paper, or when a disruption occurs in the commercial paper market. However, depending on the provisions of the facility—such as whether the facility covers dilution of the underlying receivable pool—credit risk can be shifted from the program's explicit credit enhancements to the liquidity facility.[7] Such provisions may enable certain programs to fund riskier assets and yet maintain the credit rating on the program's commercial paper without increasing the program's credit enhancement levels.

2129.05.1.4 Asset Securitization Structures

The structure of various securitization transactions can result in an institution's retaining the underlying credit risk in a sold pool of assets. An example of this contingent credit-risk retention is credit card securitizations in which the securitizing organization explicitly sells the credit card receivables to a master trust but, in substance, retains the majority of the economic risk of loss associated with the assets. This is because of the credit protection provided to investors by the excess yield, spread accounts, and structural provisions of the securitization. Excess yield provides the first level of credit protection that can be drawn upon to cover cash shortfalls between the principal and coupon owed to investors and the investors' pro rata share of the master trust's net cash flows. The excess yield is equal to the difference between the overall yield on the underlying credit card portfolio and the master trust's operating expenses.[8] The second level of credit protection is provided by the spread account, which is essentially a reserve funded initially from the excess yield.

The structural provisions of credit card securitizations generally provide credit protection to investors through the triggering of early amortization events. Such an event usually is triggered when the underlying pool of credit card receivables deteriorates beyond a certain point and requires that the outstanding credit card securities begin amortizing early in order to pay off investors before the prior credit enhancements are exhausted. As the early amortization accelerates the redemption of principal (pay down) on the security, the credit card accounts that were assigned to the master credit card trust return to the securitizing institution more quickly than had originally been anticipated, thus exposing the institution to liquidity pressures and any further credit losses on the returned accounts.

2129.05.2 REPUTATIONAL RISKS

The secondary-market credit activities of many institutions may expose them to significant reputational risks. Loan-syndication underwriting may present significant reputational-risk exposure to lead underwriters because syndicate participants may seek to hold the lead underwriter responsible for actual or perceived inadequacies in the loan's underwriting, even though partici-

7. Dilution essentially occurs when the receivables in the underlying asset pool—before collection—are no longer viable financial obligations of the customer. For example, dilution can arise from returns of consumer goods or unsold merchandise by retailers to manufacturers or distributors.

8. The monthly excess yield is the difference between the overall yield on the underlying credit card portfolio and the master trust's operating expenses. It is calculated by subtracting from the gross portfolio yield the (1) coupon paid to investors; (2) charge-offs for that month; and (3) servicing fee, usually 200 basis points paid to the banking organization sponsoring the securitization.

pants are responsible for conducting an independent due-diligence evaluation of each credit. Such risk may be compounded by the rapid growth of new investors in this market, usually nonbanks that may not have previously endured a downturn in the loan market.

There is the possibility that pressure may be brought to bear on the lead participant to repurchase portions of the syndication if the credit deteriorates in order to protect its reputation in the market, even though the syndication was sold without recourse. In addition, the deterioration of the syndicated credit exposes the lead organization to possible litigation, as well as increased operational and credit risk. One way to mitigate reputational risk in syndications is for banking organizations to know their customers[9] and to determine whether syndication customers are in a position to conduct their own evaluation of the credit risks involved in the transaction.

Asset securitization programs also can be a source of increasing reputational risk. Often, banking organizations sponsoring the issuance of asset-backed securities act as servicer, administrator, or liquidity provider in the securitization transaction. It is imperative that these institutions are aware of the potential losses and risk exposure associated with reputational risk. The securitization of assets whose performance has deteriorated may result in a negative market reaction that could increase the spreads on an institution's subsequent issuances. In order to avoid a possible increase in their funding costs, institutions have supported their securitization transactions by improving the performance of the securitized asset pool. This has been accomplished, for example, by selling discounted receivables or adding higher-quality assets to the securitized asset pool. Thus, an institution's voluntary support of its securitization in order to protect its reputation can adversely affect the sponsoring/issuing organization's earnings and capital.

Such methods of improving the credit quality of securitized asset pools have been used by banking organizations in providing voluntary support to their securitizations, especially for credit card master trusts. These actions generally are taken to avoid either a rating downgrade or an early amortization of the outstanding asset-backed securities.

9. See the know-your-customer rules in Regulation H (12 C.F.R. 208), Regulation K (12 C.F.R. 211), and Regulation Y (12 C.F.R. 225).

2129.05.3 LIQUIDITY RISKS

The existence of recourse provisions in asset sales, the extension of liquidity facilities to securitization programs, and the early amortization triggers of certain asset securitization transactions can involve significant liquidity risk to institutions engaged in these secondary-market credit activities. Institutions should ensure that their liquidity contingency plans fully incorporate the potential risk posed by their secondary-market credit activities. With the issuance of new asset-backed securities, the issuing banking organization should determine the potential effect on its liquidity at the inception of each transaction and throughout the life of the securities to better ascertain its future funding needs.

An institution's contingency plans should consider the need to obtain replacement funding, and specify the possible alternative funding sources, in the event of the amortization of outstanding asset-backed securities. This is particularly important for securitizations with revolving receivables, such as credit cards, where an early amortization of the asset-backed securities could unexpectedly return the outstanding balances of the securitized accounts to the issuing institution's balance sheet. An early amortization of a banking organization's asset-backed securities could impede its ability to fund itself—either through re-issuance or other borrowings—since the institution's reputation with investors and lenders may be adversely affected.

2129.05.4 INCORPORATING THE RISKS OF SECONDARY-MARKET CREDIT ACTIVITIES INTO RISK MANAGEMENT

Supervisors should verify that an institution incorporates the risks involved in its secondary-market credit activities in its overall risk-management system. The system should entail (1) inclusion of risk exposures in reports to the institution's senior management and board to ensure proper management oversight; (2) adoption of appropriate policies, procedures, and guidelines to manage the risks involved; (3) appropriate measurement and monitoring of risks; and (4) assurance of appropriate internal controls to verify the integrity of the management process with respect to these activities. The formality and sophistication with which the

risks of these activities are incorporated into an institution's risk-management system should be commensurate with the nature and volume of its secondary-market credit activities. Institutions with significant activities in this area are expected to have more elaborate and formal approaches to manage the risk of their secondary-market credit activities.

2129.05.4.1 Board of Directors and Senior Management Responsibilities

Both the board of directors and senior management are responsible for ensuring that they fully understand the degree to which the organization is exposed to the credit, market, liquidity, operational, legal, and reputational risks involved in the institution's secondary-market credit activities. They are also responsible for ensuring that the formality and sophistication of the techniques used to manage these risks are commensurate with the level of the organization's activities. The board should approve all significant policies relating to the management of risk arising from secondary-market credit activities and should ensure that the risk exposures are fully incorporated in board reports and risk-management reviews.

Senior management is responsible for ensuring that the risks arising from secondary-market credit activities are adequately managed on both a short-term and long-run basis. Management should ensure that there are adequate policies and procedures in place for incorporating the risk of these activities into the overall risk-management process of the institution. Such policies should ensure that the economic substance of the risk exposures generated by these activities is fully recognized and appropriately managed. In addition, banking organizations involved in securitization activities should have appropriate policies, procedures, and controls with respect to underwriting asset-backed securities; funding the possible return of revolving receivables (for example, credit card receivables and home equity lines); and establishing limits on exposures to individual institutions, types of collateral, and geographic and industrial concentrations. Lead banking organizations in loan syndications should have policies and procedures in place that address whether or in what situations portions of syndications may be repurchased. Furthermore, banking organizations participating in a loan syndication should not place undue reliance on the credit analysis performed by the lead organization. Rather, the participant should have clearly defined policies and procedures to ensure that it performs its own due diligence in analyzing the risks inherent in the transaction.

2129.05.4.2 Management Information and Risk-Measurement Systems

An institution's management information and risk-measurement systems should fully incorporate the risks involved in its secondary-market credit activities. Banking organizations must be able to identify credit exposures from all secondary-market credit activities and be able to measure, quantify, and control those exposures on a fully consolidated basis. The economic substance of the credit exposures of secondary-market credit activities should be fully incorporated into the institution's efforts to quantify its credit risk, including efforts to establish more formal grading of credits to allow for statistical estimation of loss probability distributions. Secondary-market credit activities should also be included in any aggregations of credit risk by borrower, industry, or economic sector.

It is particularly important that an institution's information systems can identify and segregate those credit exposures arising from the institution's loan-sale and securitization activities. Such exposures include the sold portions of participations and syndications, exposures arising from the extension of credit enhancement and liquidity facilities, the effects of an early amortization event, and the investment in asset-backed securities. The management reports should provide the board and senior management with timely and sufficient information to monitor the institution's exposure limits and overall risk profile.

2129.05.4.3 System of Internal Controls

One of management's most important responsibilities is establishing and maintaining an effective system of internal controls that, among other things, enforces the official lines of authority and the appropriate separation of duties in managing the risks of the institution. These internal controls must be suitable for the type and level of risks given the nature and scope of the institution's activities. Moreover, these internal controls should provide reasonable assurance of reliable financial reporting (in published financial reports and regulatory reports), includ-

ing adequate allowances or liabilities for expected losses.

2129.05.5 STRESS TESTING

The use of stress testing, including combinations of market events that could affect a banking organization's credit exposures and securitization activities, is another important element of risk management. Stress testing involves identifying possible events or changes in market behavior that could have unfavorable effects on the institution and assessing the organization's ability to withstand them. Stress testing should not only consider the probability of adverse events, but also likely "worst-case" scenarios. Such an analysis should be done on a consolidated basis and consider, for instance, the effect of higher-than-expected levels of delinquencies and defaults as well as the consequences of early amortization events with respect to credit card securities that could raise concerns regarding the institution's capital adequacy and its liquidity and funding capabilities. Stress test analyses should also include contingency plans regarding the actions management might take given certain situations.

2129.05.6 CAPITAL ADEQUACY

As with all risk-bearing activities, institutions should fully support the risk exposures of their secondary-market credit activities with adequate capital. Banking organizations should ensure that their capital positions are sufficiently strong to support *all* of the risks associated with these activities on a fully consolidated basis and should maintain adequate capital in all affiliated entities engaged in these activities. The Federal Reserve's risk-based capital guidelines establish *minimum* capital ratios, and those banking organizations exposed to high or above-average degrees of risk are, therefore, expected to operate significantly above the minimum capital standards.

The current regulatory capital rules do not fully incorporate the economic substance of the risk exposures involved in many secondary-market credit activities. Therefore, when evaluating capital adequacy, supervisors should ensure that banking organizations that sell assets with recourse, assume or mitigate credit risk through the use of credit derivatives, and provide direct credit substitutes and liquidity facilities to securitization programs are accurately identifying and measuring these exposures and maintaining capital at aggregate levels sufficient to support the associated credit, market, liquidity, reputational, operational, and legal risks.

Supervisors and examiners should review the substance of secondary-market transactions when assessing underlying risk exposures. For example, partial, first-loss direct credit substitutes providing credit protection to a securitization transaction can, in substance, involve much the same credit risk as that involved in holding the entire asset pool on the institution's balance sheet. However, under current rules, regulatory capital is explicitly required only against the amount of the direct credit substitute, which can be significantly different from the amount of capital that the institution should maintain against the concentrated credit risk in the guarantee. Supervisors and examiners should ensure that banking organizations have implemented reasonable methods for allocating capital against the economic substance of credit exposures arising from early amortization events and liquidity facilities associated with securitized transactions since such facilities are usually structured as short-term commitments to avoid a risk-based capital requirement, even though the inherent credit risk may be approaching that of a guarantee.[10]

If, in the supervisor's judgment, an institution's capital level is not sufficient to provide protection against potential losses from such credit exposures, this deficiency should be reflected in the banking organization's CAMELS or BOPEC ratings. Furthermore, supervisors and examiners should discuss the capital deficiency with the institution's management and, if necessary, its board of directors. Such an institution will be expected to develop and implement a plan for strengthening the organization's overall capital adequacy to levels deemed appropriate given all the risks to which it is exposed.

2129.05.7 INSPECTION OBJECTIVES

1. To determine whether there are risk-management systems and whether they accu-

10. For further guidance on distinguishing, for risk-based capital purposes, whether a facility is a short-term commitment or a direct credit substitute, see SR-92-11, "Asset-Backed Commercial Paper Programs." Essentially, facilities that provide liquidity, but which also provide credit protection to secondary-market investors, are to be treated as direct credit substitutes for purposes of risk-based capital.

rately identify all the risk exposures stemming from secondary-market activities.

2. To evaluate secondary-market credit activities and to determine if there has been a lowering of credit standards that could deteriorate the institution's financial condition during less favorable business and economic conditions.
3. To establish whether the institution's management system performs stress testing to evaluate the risk exposures of secondary-market credit activities under various scenarios and their potential effect on the institution's liquidity, earnings, and capital adequacy.
4. To review the substance of the institution's secondary-market transactions when assessing underlying risk exposures.
5. To ascertain whether liquidity contingency plans exist and to determine whether they fully incorporate the potential risk posed by secondary-market credit activities, including the need to obtain replacement funding.
6. To determine whether the board of directors is fully informed of the risks involved in secondary-market activities and whether they approve policies, controls, and procedures to control exposures arising from credit, liquidity, operational, legal, reputational, and other risks.
7. To determine whether the institution has a sufficiently strong capital position to support *all* the risk associated with secondary-market credit activities and that it has a capital plan for strenghtening its overall capital adequacy position.
8. To ascertain whether there is an effective system of internal controls—focused on lines of authority and the separation of duties—to monitor and contain the risks associated with secondary-market activities.

2129.05.8 INSPECTION PROCEDURES

1. Determine whether the institution's senior management is recognizing the risk involved in secondary-market credit activities by—
   a. determining if there is adequate identifying, quantifying, and monitoring of risk;
   b. clearly communicating the extent and depth of those risks in discussions, presentations, and inspection reports that are delivered to the board of directors and senior officials of the institution;
   c. presenting to the board of directors, for their approval, all significant policies relating to the risk management of secondary-market activities and the conditions under which a loan syndication can be purchased;
   d. determining whether management is conducting ongoing stress testing to identify potential losses and liquidity needs under adverse and "worst-case" scenarios; and
   e. making certain that senior management is setting adequate minimum internal standards for allowances or liabilities for losses, capital, and contingency funding.
2. Assess whether the institution's systems and processes adequately identify, measure, monitor, and control all of the risks involved in the institution's secondary-market credit activities.
3. Determine whether the various risks associated with secondary-market activities are incorporated into contingency plans, including replacement funding plans and identified alternative funding sources, to lessen the impact of those risks.
4. Establish whether there is an adequate and effective system of internal controls that enforces official lines of authority and the appropriate separation of duties in managing the risks associated with secondary-market activities.
5. Review loan-syndication contract agreements, underwriting documentation, and relevant correspondence with loan syndication contractual parties to establish whether—
   a. the bank holding company's management has performed adequate credit investigations and evaluations of the syndicate loans, the syndicate participants, and the extent of the BHC's credit-risk exposures, and has complied with the Federal Reserve's know-your-customer rules (see footnote 9);
   b. the syndication customers are in a position to conduct their own investigations and evaluation of the credit risks involved in the transaction; and
   c. undue reliance is placed on the lead underwriter, the participants, or on their commercial-loan credit ratings.
6. For credit derivatives—
   a. analyze the credit risk associated with the reference asset, the general market risk, and the counterparty risk; and
   b. determine, for those reference assets that are not identical assets actually owned, whether the reference asset is an appropriate proxy for the loan or other assets

whose credit exposure is to be offset.

7. Review the substance of secondary-market transactions when evaluating and analyzing underlying risk exposures.
8. Evaluate and determine that there are reasonable methods for internally allocating capital against the economic substance of credit exposures that arise from amortization events and liquidity facilities associated with securitized transactions.
9. Incorporate the evaluation of potential risks and losses from credit exposures, including management deficiencies, into the institution's supervisory ratings.

2130.0.1 INTRODUCTION

Effective March 1, 1983, the Board issued an amended bank holding company policy statement entitled "Futures, Forward and Options on U.S. Government and Agency Securities and Money Market Instruments." Bank holding companies are now required to furnish written notification to their District Federal Reserve Banks within 10 days after financial contract activities are begun by the parent or a nonbank subsidiary. The policy is consistent with the joint policy statement previously issued by the three federal bank regulators with regard to banks participating in financial contracts, and reflects the Board's judgment that bank holding companies, as sources of strength for their subsidiary banks, should not take speculative positions in such activities.

If a bank holding company or nonbank subsidiary is taking or intends to take positions in financial contracts, that company's board of directors should approve written policies and establish appropriate limitations to ensure that the activity is conducted in a safe and sound manner. Also, appropriate internal control and audit procedures should be in place to monitor the activity. The following discussion and inspection procedures apply to futures contract activity generally, but are intended to focus specifically on financial futures contracts. For a discussion of currency futures and options and the examination procedures for those instruments, see sections F and G in the Merchant and Investment Bank Examination Manual.

Information, instructions, and inspection procedures have been provided for verifying compliance with the Board's policy statement. It is intended that the policy statement will ensure that contract activities are conducted in accordance with safe and sound banking practices. The task of evaluating BHC contract activities is the responsibility of System examiners. The following information and inspection procedures are intended to serve as a guide for Federal Reserve Bank staff in that effort.

2130.0.2 DEFINITIONS

Basis—Basis is defined as the difference between the futures contract price and the cash market price of the same underlying security, money market instrument, or commodity.

Call Option—A contract that gives the buyer (holder) the right, but not the obligation to buy (call), a specified quantity of an underlying security, money market instrument or commodity at or before the stated expiration of the contract. At expiration, if the value of the option increases, the holder will exercise the option or close it at a profit. If the value of the option does not increase, the holder would probably let the option expire (or close it out at a profit) and, consequently, will lose the cost (premium paid) of (for) the option. Alternatively, the option may be sold prior to expiration.

Clearing Corporation—A corporation organized to function as the clearing house for an exchange. The clearing house registers, monitors, matches and guarantees trades on a futures market, and carries out financial settlement of futures transactions. The clearing house acts as the central counterparty to all trades executed on the exchange. It substitutes as a seller to all buyers and as a buyer to all sellers. In addition, the clearing corporation serves to insure that all contracts will be honored in the event of a counterparty default.

Clearing Member—A member firm of the clearing house or corporation. Membership in clearing associations or corporations is restricted to members of the respective commodity exchanges, but not all exchange members are clearing house members. All trades of a non-clearing member must be registered with, and eventually settled through, a clearing member.

Commodities Futures Trading Commission—The CFTC is a federal regulatory agency charged with regulation of futures trading in all commodities. It has broad regulatory authority over futures trading. It must approve all future contracts traded on U.S. commodity exchanges, ensure that the exchanges enforce their own rules (which it must review and approve), and direct an exchange to take any action needed to maintain orderly markets whenever it believes that an "emergency" exists.

Contract Activities—This term is used in this manual to refer to banking organization participation in the futures, forward, standby contract, or options markets to purchase and sell U.S. government and agency securities or money market instruments, foreign currencies and other financial instruments.

Convergence—The process by which the futures market price and the cash market price of a financial instrument or commodity converge as the futures contract approaches expiration.

Covered Call Options—This term refers to the issuance or sale of a call option where the option seller owns the underlying deliverable security or financial instrument.

Cross Hedging—The process of hedging a "cash" or derivative instrument position with another cash or derivative instrument that has significantly different characteristics. For example, an investor who wants to hedge the sales price of long-term corporate bonds might hedge by establishing a short position in a treasury bond or treasury bond futures contract, but since the corporate bonds cannot be delivered to satisfy the contract, the hedge would be a cross hedge. To be successful, the price movements of the hedged instrument must be highly correlated to that of the position being hedged.

Difference Check—A difference check is sent by the party which recognizes a loss when a forward contract is closed out by the execution of an offsetting forward contract pursuant to a pair-off clause. In essence, the difference check represents a net cash settlement on offsetting transactions between the same two parties and replaces a physical delivery and redelivery of the underlying securities pursuant to offsetting contracts.

Financial Contract—This term is used in the manual to refer to financial futures, forward, standby contracts, and options to purchase and sell U.S. government and agency securities, money market instruments, foreign currency futures and other financial instruments.

Firm Forward Contract—This term is used to describe a forward contract under which delivery of a security is mandatory. See "Standby Contract" for a discussion of optional delivery forward contracts.

Forward Contracts—Over-the-counter contracts for forward placement or delayed delivery of securities in which one party agrees to purchase and another to sell a specified security at a specified price for future delivery. Contracts specifying settlement in excess of 30 days following trade date shall be deemed to be forward contracts. Forward contracts are usually non-standardized and are not traded on organized exchanges, generally have no required margin payments, and can only be terminated by agreement of both parties to the transaction. The term also applies to derivative contracts such as swaps, caps, and collars.

Futures Contracts—Standardized contracts traded on organized commodity exchanges to purchase or sell a specified financial instrument or commodity on a future date at a specified price. While futures contracts traditionally specified a deliverable instrument, newer contracts have been developed that are based on various indexes. Futures contracts based on indexes settle in cash and never result in delivery of an underlying instrument; some traditional contracts that formerly specified delivery of an underlying instrument have been redesigned to specify cash settlement. New financial futures contracts are continually being proposed and adopted for trading on various exchanges.

Futures Commission Merchant (FCM)—An FCM functions like a broker in securities. An FCM must register with the Commodities Futures Trading Commission (CFTC) in order to be eligible to solicit or accept orders to buy or sell futures contracts. The services provided by an FCM include a communications system for transmittal of orders, and may include research services, trading strategy suggestions, trade execution, and recordkeeping services.

Financial Futures Contracts—Standardized contracts traded on organized exchanges to purchase or sell a specified security, money market instrument, or foreign currency on a future date at a specified price on a specified date. Futures contracts on GNMA mortgage-backed securities and Treasury bills were the first interest rate futures contracts. Other financial futures contracts have been developed, including contracts on Eurodollars, currencies, and Euro-Rate differentials. It is anticipated that new and similar financial futures contracts will continue to be proposed and adopted for trading on various exchanges.

Futures Exchange—Under the Commodities Exchange Act (CEA), a "board of trade" designated by the Commodity Futures Trading Commission as a contract market. Trading occurs on the floor of the exchange and is conducted by open auction in designated trading areas.

GNMA or GINNIE MAE—Either term is used to refer to the Government National Mortgage Association. Ginnie Mae is a government corporation within the U.S. Department of Housing and Urban Development. In creating GNMA, Congress authorized it to grant a full faith and credit guaranty of the U.S. government to mortgage-backed securities issued by private sector organizations.

Hedge—The process of entering transactions that will protect against loss through compensatory price movement. A hedge transaction is one which reduces the organization's overall level of risk.

Initial Futures Margin—In the futures market, a deposit held by an FCM on behalf of a

client against which daily gains and losses on futures positions are added or subtracted. A futures margin represents a good-faith deposit or performance bond to guarantee a participant's performance of contractual obligations.

Interest Rate Cap—A multi-period interest rate option for which the buyer pays the seller a fee to receive, at predetermined future times, the excess, if any, of a specified floating interest rate index above a specified fixed per annum rate (cap or strike rate). Caps can be sold separately or may be packaged with an interest rate swap.

Interest Rate Collar—the combination, in single contract, of a simultaneous sale of a cap and the purchase of a floor, or, a purchase of a cap and sale of a floor. The buyer of the collar is a buyer of a cap and the seller of a floor. By selling the floor, the collar buyer gives up the possibility of benefiting from a decline in interest rates below the strike rate in the floor component. On the other hand, the fee earned in selling the floor lowers the cost of protection against interest rate reversal.

Interest Rate Floor—is the reverse of an interest rate cap. The buyer pays a premium to obtain protection against a decline in interest rates below a specified level.

Long Contract—A financial contract to buy securities or money market instruments at a specified price on a specific future date.

Long Hedge—The long hedge, also called the *anticipatory hedge* is the process by which a market participant protects a cash or risk position by buying a futures or forward contract, i.e. taking a long financial contract position.

Maintenance Margin—Maintenance margin is the minimum level to which an equity position can decline as a result of a price decline before additional margin is required. In other words, it is the minimum margin which a customer must keep on deposit with a member at all times. Each futures contract has specified maintenance margin levels. A margin call is issued when a customer's initial margin balance falls below the maintenance margin level specified by the exchange. Maintenance margin must be satisfied by the deposit of cash or agreed upon cash equivalents. The amount of cash required is that amount which is sufficient to restore the account balance to the initial margin level.

Mandatory Delivery—See "Firm Forward Contract."

Mark-to-market—The process by which the carrying value (market value or fair value) of a financial instrument is revalued, and which is recognized as the generally accepted accounting principle for determining profit or loss on securities positions in proprietary trading and investment accounts. Futures positions are typically marked-to-market at the end of each trading session.

Naked Call Option—Refers to the issuance or sale of a call option where the option seller does not own the underlying deliverable security or instrument.

Open Interest—Refers to the number of futures contracts outstanding for a given delivery month in an individual futures contracts. The mechanics of futures trading require that for every open long futures contract there is an open short futures contract. For example, an open interest of 10,000 futures contracts means that there are 10,000 long contract holders and 10,000 short contract holders.

Options Contracts—Option contracts require that the buyer of the option pay the seller (or writer) of the option a premium for the right, but not the obligation, to exercise an option to buy (call option) or sell (put option) the instrument underlying the option at a stated price (strike or exercise price) on a stated date (European style option) or at any time before or on the stated expiration date (American style option). There are also exchange traded options contracts: (1) put and call options on futures contracts that are traded on commodities exchanges; and (2) put and call options that specify delivery of securities or money market instruments (or that are cash settled) that are traded on securities exchanges. The key economic distinction between options on futures and options on securities, is that the party who exercises an option on a futures contract receives a long or short futures position rather than accepting or making delivery of the underlying security or financial instrument.

Pair-Off Clause—A pair-off clause specifies that if the same two parties to a forward contract trade should subsequently execute an offsetting trade (e.g. a long contract against an outstanding short contract), settlement can be effected by one party sending the other party a difference check rather than having physical delivery and redelivery of securities.

Par Cap—This term refers to a provision in the contract of sale for Ginnie Mae mortgage-backed securities which restricts delivery only to pools which bear an interest rate sufficiently high so that the securities would trade at or below par when computed based on the agreed to yield.

Put Option—An option contract which gives

the holder the right, but not the obligation, to sell (put) a specified quantity of a financial instrument (money market) or commodity at a specified price on or before the stated expiration date of the contract. If price of the underlying instrument occurs, the purchaser will exercise or sell the option. If a decline in price of the underlying instrument does not occur, the option purchaser will let it expire and will lose only the cost (premium paid) of (for) the option.

Round Turn—Commissions for executing futures transactions are charged on a round turn basis. A round turn constitutes opening a futures position and closing it out with an offsetting contract, i.e. executing a short contract and closing out the position with a long contract or vice-versa.

Short Contract—A financial contract to sell securities or money market instruments at a specified price on a specified future date.

Short Hedge—The process by which a customer protects a cash or risk position by selling a futures or forward contract, i.e. taking a short financial contract position. The purpose of the short hedge is to lock in a selling price.

Standby Contract—Optional delivery forward contracts on U.S. government and agency securities arranged between securities dealers and customers that do not involve trading on organized exchanges. The buyer of a standby contract (put option) acquires, upon paying a fee, the right to sell securities to the other party at a stated price at a future time. The seller of a standby (the issuer) receives the fee, and must stand ready to buy the securities at the other party's option. See the fuller discussion of Standby Contracts under 2130.0.3.1.2)

TBA (To Be Announced) Trading—TBA is the abbreviation used in trading Ginnie Mae securities for forward delivery when the pool number of securities bought or sold is "to be announced" at a later date.

Variation Margin—is when, in very volatile markets, additional funds are required to be deposited to bring the account back to its initial margin level, while trading is in progress. Variation margin requires that the needed funds be deposited within the hour, or when reasonably possible. If the customer does not satisfy the variation or maintenance margin call(s), the futures position is closed. Unlike initial margin, variation margin must be in cash. Also refer to "Maintenance Margin".

Weighted Hedge—a hedge that is used to compensate for a greater decline in the dollar value of a cash bond as compared to a price decline of an accessible T-bond futures contract.

Yield Maintenance Contract—This is a forward contract written with terms which maintain the yield at a fixed rate until the delivery date. Such a contract permits the holder of a short forward contract to deliver a different coupon security at a comparable yield.

2130.0.3 FINANCIAL CONTRACT TRANSACTIONS

Futures, forward and options contracts are merely other tools for use in asset–liability management. These contracts are neither inherently a panacea nor a speculative vehicle for use by banks and bank holding companies. Rather, the benefit or harm resulting from engaging in financial contract activities results from the manner in which contracts are used. Proper utilization of financial contracts can reduce the risks of interest or exchange rate fluctuations. On the other hand, financial contracts can serve as leverage vehicles for speculation on rate movements.

2130.0.3.1 Markets and Contract Trading

Forward contract (OTC) trading of Government National Mortgage Association ("GNMA") or "Ginnie Mae" Mortgage-Backed Securities preceded exchange trading of GNMA futures contracts in 1975.

2130.0.3.1.1 Forward Contracts

Forward contracts are executed solely in an over-the-counter market. The party executing a contract to acquire securities on a specified future date is deemed to have a "long" forward contract; and the party agreeing to deliver securities on a future date is described as a party holding a "short" forward contract. Each contract is unique in that its terms are arrived at after negotiation between the parties.

For purposes of illustrating a forward contract, assume that SMC Corporation is an originator of government guaranteed mortgages and issuer of GNMA securities. SMC Corporation has a proven ability to manage and predict the volume of its loan originations over a time horizon of three to four months. To assure a profit or prevent a loss on current loan originations, SMC Corporation may enter binding over-the-counter commitments to deliver 75% of its

mortgage production which will be converted into GNMA securities three months in the future. If SMC agrees to sell $3 million of GNMA securities (11% coupon) to the WP Securities Firm at par in three months, SMC Corporation is considered to have entered a "short" (commitment to sell) forward contract. Conversely, WP has entered a "long" (commitment to buy) forward contract. The two parties to the transaction are both now obligated to honor the terms of the contract in three months, unless the contract is terminated by mutual agreement.

It should be noted that executing a "short" forward contract is not the same as executing the short sale of a security. Generally, a short sale of a security is understood to represent the speculative sale of a security which is not owned by the seller. The short seller either purchases the security prior to settlement date or borrows the security to make delivery; however, a "short" forward contract merely connotes the side of the contract required to make delivery on a future date. Short forward contracts should not be considered inherently speculative, but must be considered in light of the facts surrounding the contract.

Forward trading can be done on a mandatory delivery (sometimes referred to as "firm forward" contracts) basis or on an optional delivery basis ("standby" contract). With respect to a "mandatory" trade, the contract can also be written with a "pair-off" clause. A pair-off clause specifies that if the same two parties to a trade should subsequently execute an off-setting trade (e.g., the banking organization executes a long contract against an outstanding short contract), settlement can be effected by one party sending the other party a "difference check" rather than having a physical delivery and redelivery of securities.

When a forward contract is executed by a dealer, a confirmation letter or contract is sent to the other party to the transaction. The contract will disclose pertinent data about the trade, such as the size of the trade, coupon rate, the date upon which final delivery instructions will be issued, and the yield at which the trade was effected. In addition, the contract letter will specify whether it is permissible for the "short" side of the trade to deliver a different coupon security at a comparable yield ("yield maintenance contract") if the coupon specified in the contract is not available for delivery. Contracts which prohibit the delivery of securities requiring a premium over par are considered to have a "par cap." The initial contract letter generally does not specify which specific securities (e.g., GNMA mortgage-backed securities identified by a pool number) will be delivered. Instead, such contracts generally identify the deliverable securities as having been traded on a "TBA" basis ("to be announced"). Prior to settlement, the dealer holding the short contract will send a final confirmation to the other party specifying the actual securities to be delivered, accrued interest, dollar price, settlement date, coupon rate, and the method of payment.

Forward contracts are not typically marked-to-market. Both parties in a forward contract are exposed to credit risk, since either party can default on its obligation.

2130.0.3.1.2 Standby Contracts

Standby contracts are "put options" that trade over-the-counter, with initial and final confirmation procedures that are quite similar to those on forward transactions. Standby contracts were developed to allow GNMA issuers to hedge their production of securities, especially in instances where mortgage bankers have extended loan commitments in connection with the construction of new subdivisions. When a mortgage banker agrees to finance a subdivision with conventional and government guaranteed mortgages it is difficult to predict the actual number of FHA and VA guaranteed loans which will be originated. Hence, it is risky for a GNMA issuer to enter mandatory forward contracts to deliver the entire estimated amount of loans eligible to be pooled as GNMA securities. By entering an option contract and paying a fee for the option to "put" securities to another party, a GNMA issuer or securities dealer obtains downside market protection, but remains free to obtain the benefits of market appreciation since it can "walk away" from the option contract. In addition to the flexibility of walking away and selling securities at the prevailing market price when GNMA prices are rising, a GNMA issuer avoids the potential risk of purchasing mortgages or GNMA securities to cover short forward contracts in the event that production of GNMA securities falls below anticipated levels.

When a securities dealer sells a standby contract granting a GNMA issuer the right "to put" securities to it, the dealer, in turn, will attempt to purchase a matching standby contract from an investor because the dealer does not want to shoulder all of the downside market risk. There

is also potential for securities firms to deal in standby contracts having no relationship to the issuance of GNMA securities.

Some illustrations of standby contracts follow. They are intended to illustrate the mechanics of a standby contract when a banking organization has sold or issued a standby contract granting the contra party the option to "put" GNMA securities to the banking organization.

Assumptions

1. Fee paid to banking organization = 1% of contract value
2. Contract delivery price = 98
3. Coupon = 12%

Situation 1

On contract exercise date: Market Price = 100. Therefore, the dealer would sell securities at market rather than put them to the bank.

Dealer		*Banking organization*	
Sale price	100	Purchase price	N/A
Fee paid	(1)	Fee Received	1
	99		1

Result: Dealer sacrificed 1% to insure sale price.

Result: Banking organization earned 1% fee for "standing by."

Situation 2

On contract exercise date: Market price = 95. Therefore, dealer would deliver securities pursuant to the standby contract.

Dealer		*Banking organization*	
Sale price	98	Purchase price	98
Market price	95	Market price	95
Contract gain	3	Contract loss	(3)
Fee paid	(1)	Fee received	1
Actual gain	2	Actual loss	(2)

Result: Dealer paid 1% fee to avoid 3 point market loss.

Result: Banking organization received 1% fee to compensate for purchasing securities 3 points above market.

2130.0.3.1.3 Futures Contracts

Futures Contract transactions involve three types of participants: customers—the buyers or sellers of contracts, brokers, and a futures exchange. As in the forward markets, a buyer (party committed to take delivery of securities specified in the futures contract) of a futures contract has a "long" contract and the seller (party committed to deliver the underlying securities) has a "short" contract. If a customer desires to purchase (sell) a futures contract, the broker—possibly a member of a clearing house of an exchange—will take the order to the exchange floor and purchase (sell) a contract sold (bought) by another customer (through another broker).[1] All futures transactions are made

1. Brokers in commodities are required to register as futures commission merchants ("FCMs") with the Commodities Futures Trading Commission ("CFTC") in order to be eligible to solicit or accept orders to buy or sell futures contracts.

through and carried on the books of clearing house member brokers, who are treated by the exchange as their own customers. Hence, there are always an equal number of long and short contracts outstanding, referred to as the "open interest," since the auction process requires a buyer and seller for every contract.

All futures contracts are obligations of an exchange's clearing association or corporation, i.e. the clearing association is on the opposite side of each long and short contract; and all transactions are guaranteed within the resources of the exchange's clearing association (on most futures exchanges a small fee is collected on each transaction and placed into an insurance fund). Should an FCM default on a futures contract, the association pays the costs of completing the contract.

2130.0.4 MARGIN REQUIREMENTS

In order to insure the integrity of futures markets, the clearing house requires that member brokers (clearing house members) deposit initial margin in connection with new futures positions carried for the firm, other brokers or FCMs for whom the clearing house member clears transactions, and public customers. The clearing house members in turn require their customers—whether they are other FCMs or public customers—to deposit margin.[2] The FCMs generally require that public customers meet initial margin requirements by depositing cash, pledging government securities, or obtaining irrevocable standby letters of credit from substantial commercial banking organizations. Daily maintenance margin or variation margin calls (deposits of cash required to keep a certain minimum balance in the margin account) based upon each day's closing futures prices are calculated pursuant to rules of the various futures exchanges, and clearing house members are required to meet daily variation margin calls on positions carried for customers and the firm. In turn, the FCMs require customers to reimburse them for posting additional margin.

Once a customer has executed a futures contract to make or accept delivery of securities in the future it is obligated to fulfill the terms of the contract. A futures contract cannot be resold over-the-counter because futures contracts are not transferable. However, a customer may terminate its obligation under a futures contract either by making or accepting delivery of the securities as specified by the contract, or by executing an offsetting futures contract (long contract to cancel a short contract or vice-versa) with the same broker to cancel the original contract on the same exchange. The overwhelming majority of futures contracts are closed out by the execution of an offsetting contract prior to expiration.

The key to understanding futures transactions is the fact that futures contract prices on U.S. government and agency securities move in the same manner as bond prices; e.g. rising interest rates result in falling futures prices and falling interest rates result in rising futures prices. Hence, the purchase of a futures contract ("long" futures contract) at a price of 98 will result in a loss if future market participants perceive rising interest rates in the month of contract expiration and act accordingly; then the offsetting of a futures contract (executing a "short" futures contract) would have to be at a lower price; e.g. 96. As in the case of any commercial transaction, the participant has a loss if the sale price is lower than the purchase price, or a gain if the sale price is higher than the purchase price.

2130.0.4.1 Variation Margin Calls

Variation margin calls for each contract and expiration month are based upon the closing futures exchange price. If there is a change from the previous day's closing prices, the long contract holders will be required to post additional margin which will be passed through via the clearing house process to short contract holders or vice-versa. Subsequent to the computation of variation margin calls, the clearing house member brokers are required to post variation margin on behalf of the clearing firm and its customer accounts prior to commencement of the next day's trading. Then, the clearing brokers call their FCM and public customers requesting more margin to bring the accounts up to the

2. In general, the futures exchanges set different initial margin requirements based upon the types of activity engaged in by the customer. Margin requirements are higher for customer contracts characterized as "speculative" than for those contracts deemed to be "hedge" positions. The commodities industry traditionally defines someone with a business need for using the futures market as a hedger; others are defined as speculators. Therefore, in instances where there are different initial hedge and speculative margin requirements, it is assumed that banking organizations will only be required to meet margin required for hedgers.

required maintenance margin level.[3] Of course, if a futures position has a gain at the end of the day, the clearing firm receives a deposit in its margin account. The firm, in turn, increases the margin account balances of customers holding contracts with gains.

For illustrative purposes, we will again assume that a customer purchased a futures contract (long contract, face value $100,000) at a price of 98. If the next closing futures price is 97, the customer will have suffered a one point margin loss (if the customer chose to offset the long contract with a short contract, the transaction would be closed out at a one point loss). Conversely, the party with a short contract executed at 98 would receive a one point margin payment to his account.

Assuming that the initial margin requirement is $1,500 and the variation margin requirement is $1,000, the following summarizes the steps followed in administering a customer's (long position) margin account in connection with the previously described transaction.

Transaction	*Margin Account Balance*
1. Deposit initial margin	$1,500
2. Purchase $100,000 contract @ 98	500
3. Day 1—Closing futures price 97 (Reduction of $1,000 in margin account to reimburse broker for posting margin with clearing corporation).	
4. FCM calls customer to request $1,000 to bring account up to required initial margin level.	
5. Reimbursement to FCM of $1,000	1,500

It is important to note that once the margin account balance falls below the variation margin level, the customer is required to deposit additional funds to replenish the account balance to the initial margin level. If there is a drop in the value of the contract which places the margin account balance below the initial margin level but above the variation margin level, the customer is not required to deposit additional margin monies. Alternatively, if there is a positive flow of margin monies the customer is free to withdraw any amount which exceeds the initial margin requirement.

The entire marking-to-the-market process is repeated at the close of the next business day using a comparison of the previous day's closing price (97) to the current closing price. (The preceding example is simplified because it implies that the customer deposits promptly the required margin. In reality, margin is not always deposited so quickly.)

In summary, futures trading is a "zero sum game" because of the equal number of long and short contracts outstanding, and the variation margin payments reflect this fact, i.e. for every long contract holder posting variation margin, there is a short contract holder receiving margin.

2130.0.5 THE DELIVERY PROCESS

Futures contracts are defined as "standardized contracts traded on organized exchanges to purchase or sell a specified financial instrument or physical commodity on a future date at a specified price." Even when a participant keeps a contract open for delivery, the "specified price" (which corresponds to a specified yield) is actually obtained through a combination of past futures market gains or losses (incurred through the daily mark to market process) and the current futures market price. For invoicing purposes, the actual delivery price is based upon a closing futures market "settlement price" on a date designated by the exchange. In addition, the final calculation of a delivery price on a bond contract will typically involve an adjustment reflecting the fact that the coupon issue to be delivered against the contract grade (8 percent) futures contract is not an 8 percent bond. For example, when current U.S. treasury bond coupons are 12 percent it is highly unlikely that a party with a short futures position would deliver a bond with an 8 percent coupon.

2130.0.6 MECHANICS AND OPERATION OF FUTURES EXCHANGES

Certain technical factors should be noted with

3. It should be noted that public customers generally have more time to meet maintenance margin calls than do FCMs. However, if a customer fails to meet a variation margin call within three days, the FCM must take a charge against its net capital if it fails to close out the customer's contract (17 C.F.R. 1.17(c)5(viii)).

respect to futures markets. First, futures markets are not totally free markets. Rules of the exchanges put artificial constraints—daily price movement limits—upon the amount of daily market movement allowed in given types of futures contracts. For example, government securities prices in the cash market will move as far as the market participants deem necessary to reflect the "market" for those securities, while the futures market specifying delivery of the underlying security will be constrained from having the same potential unlimited market movement. There have been instances where persons desiring to close out a futures contract by executing an offsetting contract have been unable to do so for one or more days until the exchange's daily trading limits allowed futures prices to "ratchet" up or down to the level that reflected the true "market" price as perceived by hedgers, speculators, and arbitragers.

Although the preceding illustrates the basic nature of futures price movements, do not assume that futures and cash market prices always move in the same direction at the same velocity. Futures prices by definition predict future events, e.g., a market participant can buy a futures contract to take delivery of a three month Treasury bill two years in the future.[4] In such an instance, the holder of a long T-bill futures contract agrees to the future purchase of a government security which has not yet been issued. There is no reason to assume that a contract with a distant maturity will move in the same manner as the cash market for a three month Treasury bill. In addition, there is a relationship between the cash market price of an existing security and the price of that security in the futures market which is called the basis. The basis can vary significantly over the life of a given futures contract. In the contract delivery month, the futures market price will converge towards the cash market price (the basis approaches zero), adjusted for technical factors that reflect the costs of processing and delivering securities. If the futures market price did not converge towards the cash market price in the delivery month, the arbitragers would take offsetting futures and cash market positions to arbitrage away any profitable discrepancies between the two markets.

4. All financial futures contracts have a number of contract expiration months extending into the future. As the near term contract expires, a contract with a more distant expiration date is added.

2130.0.7 COMPARISON OF FUTURES, FORWARD, AND STANDBY CONTRACTS

Excluding the fact that futures contracts are traded on organized exchanges, there are many similarities between contracts. Conceptually, the contracts are interchangeable; each type of contract can be utilized for hedging, speculating, or arbitrage strategies, but none of the contracts are transferable to third parties. While engaging in contract activities allows the participants to either assume or shift the risks of interest rate changes associated with the security deliverable under the contract, such contracts fail to provide the other benefits of owning the underlying security. Specifically, financial contracts do not pay interest, do not have a U.S. government guaranty of payment of principal at maturity, and cannot be pledged to secure public deposits or be used as collateral for repurchase agreements. The forward markets are perceived to be delivery markets wherein there is a high percentage of delivery of the underlying security.

As in the case of other futures markets, the financial futures markets were not designed to be delivery markets. Nevertheless, there have been a number of instances when a relatively high percentage of financial futures contracts have resulted in delivery. Some persons suggest tax reasons and the deliverable supply of securities as two factors that have contributed to the much higher delivery of securities than delivery of physical commodities. It is, of course, also easier and cheaper to make delivery of securities rather than railroad carloads of grain.

Trading units on futures exchanges are standardized. The standardized trading unit in a physical commodity which may be a railroad car of grain; the typical trading unit in a government or agency security futures contract may be $100,000 or $1 million par principal at a coupon rate (on coupon issues) fixed by the exchange. On the other hand, forward and standby contracts are not traded in standardized units with given contract maturity months. Instead, forward and standby contracts are custom made to suit the needs of the two parties to the transaction.

While all contract holders are involved with market risks, the holders of forward and standby contracts are especially prone to credit risk. Unlike futures contracts where the mechanics of exchange trading provide for the futures exchange clearing association to guaranty perfor-

mance of each contract, forward and standby contracts are only as good as the entity on the other side of the contract. Anyone who reads the financial press should be aware that prior to the passage of the Government Securities Act of 1986, there were a number of defaults involving forward and standby contracts. In an effort to bring increased integrity into the unregulated forward contract markets, there has been a trend by some of the major securities dealers to require the posting of margin in connection with forward contract trading. There are no uniform margin requirements governing all aspects of forward contract trading, nor is there a uniform application of margin requirements by dealers requiring "house" margin (or internal margin requirements established and enforced by individual securities dealers). GNMA has established limited margin requirements (24 C.F.R. 390.52), as described below.

2130.0.8 OPTION CONTRACTS

Subsequent to the Board's initial adoption of a policy statement governing futures, forward, and standby contracts, trading of interest rate options began on organized futures and securities exchanges. Proponents of exchange traded options argue that such instruments are attractive to users because they permit the user to obtain down side price risk protection, yet benefit from favorable price movement. In contrast, futures and forward contracts allow the user to lock in a specific price, but the user must forgo future participation if the market should experience an upward price movement. Furthermore, the purchaser of an option pays a one time premium for this protection and is spared the contingent liabilities associated with futures margin calls.

An option is a contract that gives the buyer, or holder, the right, but not the obligation, to buy or sell a specified financial instrument at a fixed price, called the exercise or strike price, before or at a certain future date. Some options, however do not provide for the delivery of the underlying financial instrument and, instead, are cash settled. Moreover, in some cases, the underlying financial instrument is an index. Options that can be exercised before or at the expiration date are referred to as American options; if an option can be exercised only on the expiration date, it is termed a European option.

There are two basic types of options: calls and puts. The *call option* is any option which obligates the writer to deliver to the buyer at a set price (exercise or strike price) within a specified time limit the underlying financial instrument. When the market price of the underlying instrument is above the exercise (strike) price of the call, the call option is "in-the-money." Conversely, when the market price of the underlying financial instrument is below the exercise (strike) price of the call option, the call is "out-of-the-money." When the market price of the underlying instrument is equal to the strike price, the option is "at-the-money." At expiration, the buyer will exercise the option if it is "in-the-money" or let it expire unexercised if it is out-of-the-money. An out-of-the-money call option has no value at expiration, since buyers will not purchase the underlying instrument at a price above the current market price. Prior to expiration, the value of an "in-the-money" call option is at least equal to the market value of the underlying instrument minus the strike price. The ownership of a call provides significant leverage, but raises the breakeven price relative to ownership of the underlying instrument. Holding the call limits the amount of potential loss and offers unlimited potential for gains.

A *put option* gives the buyer the right, but not the obligation, to *sell* the underlying instrument at a specified price (exercise or strike price), before or at expiration. When the market price of the underlying instrument is below the strike price of the put option, the put is "in-the-money," and a put option is out-of-the-money when the market price of the underlying financial instrument is above the strike price of the put option. Ownership of a put option offers leveraged profitability if the market value of the underlying instrument declines.

Some portfolio managers commonly employ "covered" call writing strategies to gain fee income from options written on securities held in the portfolio. If an option position is covered, the seller owns the underlying financial instrument or commodity or has a futures position. For example, an option position would be "covered" if a seller owns cash market U.S. Treasury bonds or holds a long position on a Treasury bond futures contract. Writing "covered calls" has only limited potential for gain. Writing "covered calls" is not a proper strategy for a market that could rise or fall by substantial amounts. It is generally used in a flat market environment.

Referring to the above example, if a seller holds neither the cash market U.S. Treasury Bonds or was not long on the Treasury bond

futures contract, the writer would have an uncovered or "naked" position. In such instances, margin would be required (by the exchange, if an exchange traded option—not the case for an OTC option) since the seller would be obligated to satisfy the terms of the option contract if the option buyer exercises the contract. The risk potential for loss in writing "naked calls" (calls against which there are no securities held in portfolio) is great since the party required to deliver must purchase the required securities at current market prices. Naked "covered call" writing is generally viewed to be speculative since the risks are theoretically unlimited, particularly if it is done solely to generate fee income.

Options are purchased and traded either on organized exchanges or in the over-the-counter (OTC) market. Option contracts follow three-month expiration cycles (example: March/June/September/December). The option contracts expire on the Saturday following the third Friday in the expiration month. Thus, options are considered as "wasting assets" because they have a limited life since they expire on a certain day, even though it may be weeks, months, or years from now. The expiration date is the last day the option can be exercised. After that date the option is worthless.

Option premium valuation. The price (value) of an option premium is determined competitively by open outcry auction on the trading floor of the exchange. The premium value is affected by the inflow of buy and sell orders reaching the exchange floor. The buyer of the option pays the premium in cash to the seller of the option which is credited to the seller's account. Several factors affect the value of an option premium, as discussed below. The option premium consists of two parts, "intrinsic value" and "time value." *The intrinsic value* is the gross profit that would be realized upon immediate exercise of the option. Stated another way, it is the amount by which the option is in-the-money. It is the higher of: the value of an option if it is exercised today; or zero. For "in-the-money" *call* options, it is the difference between the price of the underlying financial instrument, and the exercise (strike) price of the option. For "in-the-money" *put* options, it is the difference of the exercise (strike) price of the put option and the price of the underlying financial instrument. The intrinsic value is zero for "at-the-money" or "out-of-the-money" options. The *time value* derives from the chance that an option will gain intrinsic value in the future or that its intrinsic value will increase before maturity of the contract. Time value is determined by subtracting intrinsic value from the option premium. For example,

Time value = Option premium – Intrinsic values

Time value = 5–10/64 – 4.00

Time value = 1.15384

The option premium is affected by several other factors. One factor involves the comparison of the underlying futures price versus the strike price of the option. An option's price is increased the more that it is in-the-money. A second factor is volatility. Volatile prices of the underlying financial instrument can help stimulate demand for the options, thus increasing the premium. A third factor that affects the premium of an option is the time until expiration. Option premiums are subject to greater price fluctuations because the underlying value of the futures contract changes more with a longer time period. Other factors that affect the option premium are the strike rate(s) and the domestic and foreign (if applicable) interest rates.

An exchange-traded option is often referred to as a "standardized" option, reflecting the fact that the terms of the contract are uniform with respect to the underlying instrument, amounts, exercise prices, and expiration dates. OTC options are characterized by terms and conditions which are unique to each transaction. Large financial institutions are often dealers in customized interest rate or foreign exchange options. For example, a banking organization might write a "cap," or series of put option on pounds sterling to protect the dollar value of a sterling denominated receivable due in one year. In this case, an option can be tailored to fit the exact needs of the buyer.

Like futures contracts, contract performance on exchange-traded options is guaranteed by the clearing corporation which interposes itself as a central counterparty to all transactions. It substitutes itself as a seller to all buyers and as a buyer to all sellers. Standardization combined with the clearing corporation's guarantee facilitates trading and helps to insure liquidity in the market. The buyer or seller of an exchange-traded option may always close out an open position by entering into an offsetting transaction, with the same strike price and expiration date, and for the same amount. Indeed, most exchange-traded options are liquidated prior to maturity with an offsetting transaction, rather than by exercising

the option in order to buy or sell the underlying instrument.

Buyers of exchange-traded options are not required to post funds to a margin account because their risk is limited to the premium paid for the option. However, writers (sellers) of options are required to maintain margin accounts because they face substantial amounts of risk. The amount of the margin varies depending upon the volatility in the price of the option. As the option moves closer and closer to being in-the-money, the writer is required to deposit more and more into his margin account, in order to guarantee his performance should the option eventually be exercised.

Options on futures contracts provide the holder with the right to purchase (call) or sell (put) a specified futures contract at the option's strike price. The difference between the strike price on the option and the quote on the futures contract represents the intrinsic value of the option. Options on futures contracts differ from traditional options in one key way: the party who exercises an option on a futures contract receives a long or short futures position (depending on whether he is exercising a call or put option) rather than accepting or making delivery of the underlying security or financial instrument. When the holder of a call option on a futures contract exercises the option and the futures contract is delivered, the option writer must pay the option holder the difference between the futures contract's current value and the strike price of the exercised call. The buyer takes on a long position, and the writer a short position in the futures contract. When a futures put option is exercised, the holder takes on a short futures position, and the writer a long position. The writer of the put pays the holder the difference between the current price of the futures contract and the strike price of the put option. The resultant futures position, like any other futures position, is subject to a daily marked-to-market valuation. In order to liquidate the futures position, both the buyer and the seller must undertake offsetting futures transactions.

2130.0.8.1 Other Option Contracts

2130.0.8.1.1 Stock Index Options

A stock index option is a call or a put that is based on a stock market index such as the S & P 500. As opposed to a regular call or put option on equity securities where there must be a sale and delivery of shares of stock, there is no delivery of the underlying instrument when an index option is exercised. Rather, settlement is in cash.

2130.0.8.1.2 Foreign Currency Options

The right to buy (call) or sell (put) a quantity of a foreign currency for a specified amount of the domestic currency is a foreign currency option. The size of the contract is standard for each currency. The contracts are quoted in cents per unit of foreign currency. As an example, one call option for the British pound is 12,500 pounds.

2130.0.8.2 Caps, Floors, and Collars

Caps, floors, and collars provide risk protection against floating interest rates. The market for these products is an outgrowth of the OTC market in fixed income (bond) options.

An interest rate cap contract pays the buyer cash if the short term interest index rises above the strike rate in the contract in exchange for a fee. In combination with a floating rate obligation, it effectively sets a maximum level on interest rate payments. If market rates are below the cap rate, no payments are made under the cap agreement. Thus, the buyer of a cap is able to place a ceiling on his floating rate borrowing costs without having to forego potential gains from any decline in market rates.

Cap agreements typically range in maturity from 6 months to as long as 12 years, with reset dates or frequencies that are usually monthly, quarterly, or semiannual. The London Interbank Offered Rate (LIBOR) is the most widely used reference rate for caps, floors, and collars. Other indexes used as reference rates are commercial paper rates, the prime interest rate, Treasury bill rates, and certain tax-exempt rates. Cap fees depend upon the cap level, the maturity of the agreement, the volatility of the index used as the reference rate, and market conditions. The higher the cap rate, the lower the premium. The fee is usually paid up front, but can be amortized.

An interest rate floor agreement is used to protect the overall desired rate of return associated with a floating-rate asset. In accordance with the agreement, the seller receives a fee for

the floor agreement from the holder of the underlying asset. When interest rates fall, the holder of the floor contract is protected by the agreement, which specifies the fixed per annum rate (floor rate) that will be retained on those assets, at specified times during the life of the agreement, even though floating interest rates may decline further.

An interest rate collar is a variation of a cap-only agreement. Under this arrangement the seller of the collar, for a fee, agrees to limit the buyer's floating rate of interest within one agreement by a simultaneous sale of a cap and purchase of a floor, or purchase of a cap and sale of a floor. When the reference rate is above the cap rate the seller makes payments to the buyer sufficient to return the buyer's floating rate interest cost to the cap rate. Conversely, the buyer makes payments to the collar provider to bring its rate back to the floor whenever the reference rate falls below the floor rate. In effect, under a collar agreement the buyer is selling a string of call options (the floor) back to the provider of the cap. The premium received from selling the floor reduces the overall cost of the cap to the buyer of the collar. Thus, the premium for a floor/ceiling, or collar, agreement, is lower than for a cap-only agreement with the cap at the same level. This is because the floor sold to the provider of the collar has a certain value, which is passed along to the buyer in the form of a lower premium.

The disadvantage to collars, of course, is that they limit the buyer's ability to profit from declines in market rates below the specified floor. Clearly, one's interest rate expectations play an important role in determining whether or not to use a collar agreement. It should also be noted that collar agreements involve credit risk on both sides of the agreement, similar to the credit risk considerations found in interest rate swap agreements. The buyer of the collar is exposed to the risk that the provider may default on payments due under the cap agreement; and the provider of the collar is exposed to the risk that the buyer may default on payments due under the floor agreement.

2130.0.9 REGULATORY FRAMEWORK

GNMA has adopted limited margin requirements. Specifically, the GNMA margin requirements (12 C.F.R. 390.52) require marking-to-market and the posting of maintenance margin.[5] However, the GNMA margin requirements exclude the majority of GNMA forward contracts and only pertain to contracts involving GNMA issuers with other parties.[6]

The Commodities Futures Trading Commission (''CFTC'') is the agency authorized by Congress to supervise the trading of ''commodities,'' including financial futures. Exchanges which trade commodities must register with the CFTC. In addition, the various futures exchanges must receive CFTC approval before they can begin trading a new futures instrument. Brokers and dealers who execute futures contracts for customers must register as Futures Commission Merchants (''FCM'') with the CFTC. There are also CFTC registration requirements pertaining to firms engaging in commodities activities similar to an investment advisor or mutual fund in the securities markets. Finally, the surveillance activities of the various futures exchange examiners are subject to oversight by the CFTC.

With the exception of reporting requirements concerning persons or entities with large futures positions, the CFTC's jurisdiction generally does not extend to financial institutions. Rather, the federal and state banking agencies, state insurance commissions, and the Office of Thrift Supervision are responsible for supervising regulated entities' future activities, if permitted, under statute or regulation.

2130.0.10 EXAMPLES OF CONTRACT STRATEGIES

For purposes of reporting large positions to the CFTC a market participant defines its future activities as ''speculative'' or as ''hedging.'' Basically, CFTC rules consider a participant to be a hedger if certain facets of such person's business can be hedged in the futures markets; persons who do not have a business need for participating are deemed to be speculators. It is anticipated that bank holding companies characterize their contract activities as ''hedging'', or possibly as arbitrage between various markets.

5. Initial margin requirements necessitate the pledging of something of value prior to initiation of a transaction. Depositing maintenance margin refers to pledging something of value in reaction to market movements; e.g. depositing cash representing the difference between a forward contract price and its current market value.

6. See SR-625 dated July 23, 1980.

Examiners must scrutinize contract positions for purposes of evaluating risk.

The Board policy statement concerning bank holding companies[7] states:

"... the Board believes that any positions that bank holding companies or their nonbank subsidiaries take in financial contracts should reduce risk exposure, that is, not be speculative." It should be noted, however, that a more liberal interpretation of the policy statement has been permitted for dealer subsidiaries. For example, in a government securities dealer subsidiary, it is permissible to use related financial contracts as a substitute trading instrument for cash market instruments. Thus, the use of financial contracts is not limited solely to reducing the risk of dealing activities.

Some examples of contract strategies are provided which reduce risk when viewed in isolation. A definition of a financial hedge is:

"to enter transactions that will protect against loss through a compensatory price movement."

In looking at a hedge transaction in isolation, there should be certain elements present to make a hedge workable:

1. The interest rate futures or forward contract utilized should have a high positive correlation (prices that tend to move in the same direction with similar magnitude) with the cash position being hedged. In other words, the futures or forward position taken should be structured so that an upward price movement in the contract offsets a downward price movement in the cash or risk position being hedged, and vice versa.
2. The type (e.g. T-bill, T-bond, etc.) and size of the contract position[8] taken should have a proportionate relationship to the cash or risk position being hedged, so that futures gains (losses) will approximately offset any losses (gains) on the hedged position.
3. The contract position taken should have a life which is equal to or greater than the end of the period during which the hedge will be outstanding. For example, if interest rate protection was deemed necessary for a six-month time span, it would not ordinarily be wise to enter a contract expiring in three months.

7. The Board's policy statement on engaging in futures, forwards, and option contracts.

8. Futures market participants engage in a practice, sometimes known as "factorweighting" or "overhedging," to determine the appropriate number of futures contracts necessary to have the proper amount of compensatory price movement against a hedged cash or risk position. For example, it would require 10 mortgaged-backed futures contracts (8% coupon, $100,000 face value) to hedge an inventory of $1,000,000 mortgage-backed (8% coupon) securities. Alternatively, 14 mortgage-backed futures contracts would be required to hedge a $1 million inventory of mortgage-backed securities with a 13½% coupon. Overhedging or factor weighting is necessary in hedging securities with higher coupons than those specified in futures contracts (currently 8% on bond futures) because higher coupon securities move more in price for a given change in yield than lower coupons.

2130.0.10.1 The Mortgage Banking Price Hedge

Assume that a mortgage banking subsidiary agrees in June to originate mortgages at a fixed yield in the following October. Unless the loan originator has a forward commitment to sell the loans to a permanent investor(s), it is exposed to a decline in the principal value of mortgages due to a rise in interest rates between the commitment date and ultimate sale of the loans. An example of a traditional "short hedge" would be the sale of futures contracts in an attempt to reduce the risk of price fluctuation and insure a profitable sale of the loans. However, in following this strategy the mortgage originator also chooses to forfeit its ability to reap a profit if interest rates should fall.

If interest rates increased, the loss on the sale of mortgages or a pool of mortgage-backed securities will probably be largely offset by a gain on the futures transaction; see example below. If interest rates fall, the mortgage originator would gain on the resale of mortgages but lose on the futures market transaction. Hence, in a true hedge, the hedger's earnings are relatively unaffected by a change in market interest rates in either direction.

Generally accepted accounting principles applicable to mortgage activity require that mortgages held for resale be periodically revalued to the lower of cost or market (Financial Accounting Standards Board Statement No. 65, "Accounting for Certain Mortgage Banking Activities"). Unrealized gains and losses on outstanding futures contracts are matched against related mortgages or mortgage commitments when the inventory is revalued to the lower of cost or market; i.e. the lower of cost or market valuation is based upon a net figure including unrealized related futures gains and losses.

2130.0.10.2 Basis

Basis is the difference between the cash (spot) price of a security (or commodity) and its futures price. In other words:

Basis = Spot price − Future price

For short-term and intermediate futures contracts, the futures price is the quoted futures price times an appropriate conversion factor. For short-term futures contracts the quoted futures price is 100 less the annualized futures interest rate. The invoice price must be determined using yield-to-price conventions for the financial instrument involved.

Basis may be expressed in terms of prices. Due to the complexities involved in determining the futures price, it is thus better to redefine price basis using actual futures delivery prices rather than quoted futures prices. Thus, the price basis for fixed income securities should be redefined as:

Price Basis = Spot price − Futures delivery price.

Basis may also be expressed in terms of interest rates. The *rate basis* is defined as:

Rate basis = Spot rate − Futures rate

The spot rate refers to the current rate on the instrument that can be held and delivered on the contract. The futures rate represents the interest rate that corresponds to the futures delivery price of the deliverable instrument.

The rate basis is useful in analyzing hedges of short-term instruments since it nets out all effects resulting from aging. For example, if a one year T-bill has a rate of 9 percent with a price of 85, and a 3-month T-bill has a rate of 9 percent and a price of 94, the price basis would be −9. If a cash security ages, it does not necessarily mean that a change in the rate basis has taken place.

2130.0.10.3 Trading Account Short Hedge

Another example of a short hedge pertains to securities dealers that maintain bond trading accounts. While bonds are held "long" (actually owned by the dealer) in trading accounts, dealers are subject to two risks. First, there is the risk that the cost can change regardless of whether the funds are generated through repurchase agreement financing or the dealer's other funding sources. When there is an inverted yield curve (short-term interest rates are higher than long-term rates), trading portfolio bonds in inventory yield less than the cost of funds required to carry them. Second, there is the risk that bond market interest rates will rise, thus forcing the dollar price of bonds down.

2130.0.10.3.1 Example 1: A Perfect Short Hedge[1]

Month	*Cash Market*	*Futures Market*
June	Mortgage department makes commitment to a builder to originate $1 million of mortgages (based on current GNMA 8's cash price) at 98-28⁄32 for $988,750	Sells 10 December mortgage-backed futures at 96-8⁄32 for $962,500 to yield 8.59 percent
October	Mortgage department originates then *sells* $1 million of pooled mortgages to investors at a price of 95-20⁄32, for $956,250	Buys 10 December mortgage-backed futures at 93, for $930,000 to yield 8.95 percent
	Loss: $32,500	Gain: $32,500

1. The effects of margin and brokerage costs on the transaction are not considered. It should be noted that "perfect hedges" generally do not occur.

The following example pertains to a bond trading account. Assume that the dealer purchases Treasury bonds on October 4 and simultaneously sells a similar amount of Treasury bond futures contracts. The illustration ignores commission charges and uses futures contracts maturing in March 19x9 because the dealer's

technical analysis discovered an advantage in using the March 19x9, rather than the previous December contract as a hedge. (At that time the previous December contract was the next available contract still trading.)

	Cash Market		*Futures Market*	
10/04/1998	Purchase $5MM T-bonds maturing Aug. 2005, 8% coupon at 87-10⁄32:		Sell $5MM T-bonds futures contracts expiring Mar. 1999 at 86-21⁄32:	
	Principal =	$4,365,625	Contract value =	$4,332,813
10/23/1998	Sell $5MM T-bonds at 79.0:		Buy $5MM T-bond futures Mar. 1999 at 79-1⁄32	
	Principal =	3,950,000	Contract value =	3,951,563
	Cash loss =	($415,625)	Futures gain =	$381,250

Although the hedge did not prevent the dealer's trading account from losing money, it limited the loss to $34,375 instead of $415,625.

It is worth noting that the preceding example also illustrates some of the dangers of using interest rate futures contracts. Although the futures market proved useful to the trading department, a futures contract could have serious consequences for a dealer using an alleged "long hedge to lock-in an attractive yield."

2130.0.10.4 Long Hedge

In certain areas of the country, financial institutions desiring to hold public deposits are required to bid competitively for deposits. The case discussed below pertains to a situation where the competitive bids must be tendered one calendar quarter in advance of receiving the deposit. In this example, the asset side of the balance sheet is not discussed since it is assumed that a banking organization paying the prevailing one-year C.D. interest rate can utilize the funds at a profitable spread.

In this type of situation the bidding institutions are generally vulnerable to falling interest rates; one can safely assume that an institution selected to hold public deposits would not be dismayed to learn subsequently that interest rates had risen and it had locked-in a funding source at or below market rates. However, the funds will not be received for another 3 months. Thus, there is the possibility that interest rates could drop in the interim, leaving a reduced or possibly negative net interest margin when the funds are deployed.

There are a number of approaches available to attempt to ensure that future time deposits can be obtained without paying higher than market interest rates. One method is forecasting the appropriate interest rate to be paid on a given time deposit three months in the future. However, forecasting has become increasingly difficult to do with accuracy in the recent periods of fluctuating interest rates. An alternative approach would be to quote the current C.D. rate (adjusted slightly for competitive factors) with an intent to hedge in the futures market if the banking organization's interest rate bid is accepted. Upon receiving notification that its deposit bid has been accepted, the institution can then purchase an appropriate number of futures contracts to insure a profitable investment spread three months hence when it actually receives the deposit.

The following example on June 1, 19x0; the facts are as follows:

Size of public deposits offered	$10 million
Date of deposit	September 2, 19x0
Term	1 year
Current C.D. rate	8¼%

For purposes of this illustration, assume that a bid was submitted to pay 8¼% for one year on $10 million. The bids were due June 1 and notification was given June 2 of the intention to provide the funds on September 2; and the banking organization decided to purchase futures contracts on June 2.

A Treasury bill futures contract, expiring in 3 months, is selected as the hedging vehicle because it reflects price movement of an instrument with a comparable maturity to one-year

C.D., and there was no C.D. futures contract trading. For purposes of this illustration, it is assumed that the contract offers sufficient liquidity to enable the banking organization to readily offset its open futures position when necessary. Using the bill contract is an example of "cross hedging" which is defined as the buying or selling of an interest rate futures contract to protect the value of a cash position of a similar, but not identical, instrument. This type of hedging is a measured risk since the outcome of such a transaction is a function of the price correlation of the instruments being hedged. At any given moment it is conceivable that a negative correlation could exist between two unlike instruments despite the presence of a strong correlation over an extended time period.

Date	*C.D. Rate*	*Transactions*	*T-bill*	*Futures* [1]
June 2, 19x0	8.25%	Purchase 40 Contracts	91.84	8.16%
Sept. 2, 19x0	11.00%	Sell 40 Contracts	90.05	9.95%

1. The size of the trading unit is based upon U.S. T-bills having a face value at maturity of $250,000 (40 × 250M = 10MM). Prices are quoted in terms of an index representing the difference between the actual T-bill yield and 100.00. Every one basis point movement on a contract is equal to $25.00 per contract.

2130.0.10.4.1 Evaluation of the Hedge

Total interest (not compounded) to be paid (8¼%)	$ 825,000
Alternative C.D. interest (not compounded) at current rate (11%)	1,100,000
Difference	275,000
Futures trading loss*	(179,000)
Net difference	$ 96,000

*Computation—Purchase price 91.84
Sale price 90.05
1.79 or 179 basis points
(179 × $25.00 × 40 contracts = $179,000)

In retrospect, it would have been better if the banking organization would not have hedged. By agreeing to an interest rate on June 2, it obtained deposits on September 2 and will pay approximately $275,000 less in interest payments to the municipality than is required on an ordinary C.D.(s) issued on September 2. The $179,000 futures trading loss, of course, reduced the windfall interest income due the banking organization. A net interest income spread of approximately $96,000, instead of a $275,000, demonstrates two principles: 1) cross hedging can cause unexpected results; and 2) it is quite difficult to find perfect hedges in the real world. The hedge was structured so that a cash gain was offset by a futures loss—incorporating the offsetting principles of a hedge transaction. If the general level of interest rates had fallen, a futures gain should have occurred to offset the higher (relative to prevailing market rates) cost of funds obtained on September 2.

2130.0.10.5 Using Options to Create an Interest Rate Floor

Assume that on September 28th it is decided to rollover a $1,000,000 investment in 13-week Treasury bills on November 28, which also happens to be the expiration date for call options on the December Treasury bill futures contract. The banking organization, concerned that interest rates will fall between September 28 and the rollover date, wishes to hedge the rollover of its investment. The portfolio manager can set a minimum yield on the rollover investment by either buying a Treasury bill future call option, or by buying a Treasury bill futures contract. Further assume that the December Treasury bill futures contract can be bought for a price of 93.70 which implies a discount yield of 6.30 percent. Treasury bill futures call options with a strike price of 93.75, implying a discount yield of 6.25 percent, sell for a premium of 20 basis points, or $600 (20 basis points × $25/basis point = $500).

If the banking organization could actually buy a Treasury bill futures contract that expired on exactly November 28, then there would be a perfect hedge since the rate of return on the bills would be explicitly fixed by the futures hedging strategy. However, the closest maturing Treasury bill futures contract expires in December, several weeks after the rollover date for the banking organization's investment. Uncertainty over the actual discount yield of the Treasury bills on the rollover date and the yield produced

by the hedge is known as "basis risk," the risk that the yield on the hedge may differ from the expected yield on the hedged item. For purposes of this example, assume that the yield on the futures contract equals the actual discount yield on the 13-week Treasury bills at the rollover date. Thus, the futures hedge in this example will provide an effective discount yield of 6.30 percent on the rollover of the 13-week Treasury bill investment.

Assume that rates fall after September 28 and that the discount yield on Treasury bill futures contracts declines from 6.30 percent to 6.00 percent at the November 28 expiration date of the December Treasury bill futures options contract. The option to buy the Treasury bill futures will be exercised since the strike price of 93.75 is below the market price of 94.00 for the underlying futures contract, yielding a profit of 25 basis points or \$625 (25 basis points × \$25/basis point). The profit must be offset by the 20 basis point cost of the option, which reduces the net profit to 5 basis points. The effective hedged discount yield is 6.05 percent (6.00 percent on the 13-week Treasury bills—assuming no basis risk—plus the 5 basis point profit from the hedge). The option hedge produces a yield that is 5 basis points higher than the unhedged yield, but 25 basis points lower than the 6.30 percent yield that would have resulted from hedging with futures.

Although the option hedge resulted in a lower effective yield than the futures hedge, it set an absolute floor on the investment. This is because any decline in the discount yield of the Treasury bills below 6.05 percent would be offset dollar for dollar by the additional profits from the hedge. The real advantage of the option hedge is that, although it establishes a floor that is lower than the rate fixed by the futures hedge, it allows the hedger to participate in any increase in interest rates above the cost of the call premium. For example, if interest rates increased such that the price on the December Treasury bill futures contract on November 28 falls to 93.00, implying a discount yield of 7.00 percent, the option would expire unexercised since the strike price is above the price of the underlying futures contract. Again, assuming that the spot price for the 13-week Treasury bills is equal to the futures price, the effective discount yield is 6.80 percent (7.00 percent minus the 20 basis point call option premium), 50 basis points higher than the yield that would have been provided by the futures hedge.

2130.0.10.6 Hedging a Borrowing with an Interest Rate Cap

In order to limit a borrower's interest rate risk, sophisticated banking institutions may offer cap agreements as part of a loan package to their clients. While such an arrangement provides some comfort that the borrower's ability to repay will not be jeopardized by a sharp increase in interest rates, it obviously transfers that interest rate risk back to the lender. Nevertheless, many banking institutions feel they are better able to manage that risk than are some of their clients. Cap agreements have also been utilized to cap the rate on issued liabilities. For example, an institution might be able to issue medium-term floating rate notes at 3-month LIBOR plus an eighth of a percent. Alternatively, that institution could issue a capped floating rate note at 3-month LIBOR plus three-eights of a percent. By subsequently selling the cap separately back into the market the institution could, achieve sub-LIBOR funding, depending on the proceeds from the sale of the cap.

A cap agreement is typically specified by following terms: notional principal amount; maturity; underlying index, frequency of reset, strike level. As an illustration, a cap agreement might have the following terms:

Notional Principal Amount	\$10,000,000
Maturity	2 Years
Underlying Index	3-month LIBOR
Rate Fixing	quarterly
Payment	quarterly, in arrears, on an actual/360-day basis
Cap Level	9%
Up Front Fee	1.11% of par (\$111,000)

Under the terms of this agreement, if at any of the quarterly rate fixing dates 3-month LIBOR exceeds the cap level then the seller of the cap would pay the buyer an amount equal to the difference between the two rates. For example, if at a reset date LIBOR was set at 10 percent, the payment would be:

10%(90/360 × $10,000,000)

−

9%(90/360 × $10,000,000)

=

$25,000

Thus, the writer of the cap would pay the buyer $25,000. If 3-month LIBOR for the quarter were set at or below the cap level of 9 percent, no payment would be made.

2130.0.11 ASSET-LIABILITY MANAGEMENT

Financial contracts can be used as a tool in an overall asset-liability management strategy. In order to use financial contracts in this context, a BHC or nonbank subsidiary must first identify where interest-rate exposure lies as indicated by mismatches between asset and liability structures. In those instances where the BHC or nonbank subsidiary has variable-rate assets and variable-rate liabilities with comparable maturities, there is, in theory, no need to hedge with financial contracts since that portion of the asset-liability structure is already hedged. The same holds true for fixed-rate assets and liabilities (yielding a positive interest-rate margin) of comparable maturities. Once a BHC or nonbank subsidiary has identified the undesired mismatches in assets and liabilities, financial contracts can be used to hedge against the identifiable mismatch—for example, long positions in contracts can be used as a hedge against funding interest-sensitive assets with fixed-rate sources of funds, and short positions in contracts can be used as a hedge against funding fixed-rate assets with interest-sensitive liabilities.

BHCs or nonbank subsidiaries that choose to employ financial contracts as a tool in their general asset-liability management program and properly use financial contracts are striving towards worthwhile goals. The discipline of identifying mismatches between assets and liabilities tends to focus the practitioner's attention on the entire balance sheet. Examiners should be aware that marketing efforts on behalf of the futures exchanges have attempted to focus upon just one side of the balance sheet by ''pairing'' a futures contract with an asset or a liability. In considering financial-contract activities, examiners need to remember that financial-contract activities must be evaluated in light of both sides of a balance sheet.

One final point should be made with respect to ''hedging'' based upon pairing a futures contract against a portfolio security. Since this type of ''hedging'' can be done while considering only the asset side of the balance sheet, it is possible that such a strategy could increase interest-rate risk rather than reduce it. For example, assume (unrealistically) that there is a perfect balance between variable-rate assets and liabilities, and the firm is evaluating fixed-rate assets and liabilities. Management determines that there is a perfect balance between fixed-rate assets and liabilities and then isolates the last fixed-rate asset and liability. Make the further assumption that the organization holds a six-month note yielding 12 percent which is financed by funds maturing in six months which costs the organization 10.5 percent. By executing a short futures contract ''paired'' against the six-month note, the organization would move from an overall ''hedged'' position to an ''unhedged'' position. In other words, the futures contract would move the organization from an overall neutral position and expose the organization to interest-rate risk.

It should be evident why it is more productive to consider the ''big picture'' in inspections rather than focusing upon individual or ''paired'' (futures against each position) transactions. The most meaningful approach is to evaluate hedging strategies and open financial contract positions in light of its business needs, operations, and asset-liability mix.

2130.0.12 INSPECTION OBJECTIVES

1. To determine the purpose of financial-contract positions. Any positions that bank holding companies or their nonbank subsidiaries (except certain authorized dealer subsidiaries) take in financial contracts should reduce risk exposure, that is, not be speculative.
2. To determine whether prudent written policies, appropriate limitations, and internal controls and audit programs have been established and whether management information systems are sufficiently adequate to monitor risks associated with contracts involving futures, forwards, and options (including caps, floors, and collars).
3. To determine whether policy objectives concerning the relationship of subsidiary banking organizations and the parent bank hold-

ing company specify that each banking organization in a holding company system must be treated as a separate entity.

4. To determine reporting compliance in accordance with the Board's bank holding company policy statements. See section 2130.0.17 for the appropriate cites.

2130.0.13 INSPECTION PROCEDURES

The term "banking organization" is used generally to refer to a bank holding company, the parent company, or nonbank subsidiary.

1. Determine if the banking organization's financial-contract activities are related to the basic business of banking.

   Consider whether the financial-contract activities are closely related to the basic business of banking; that is, taking deposits, making and funding loans, providing services to customers, and operating at a profit for shareholders without taking undue risks. Taking financial-contract positions solely to profit upon interest-rate forecasts is considered to be an unsafe and unsound practice. Profitability of contract activities is not the criterion for evaluating such activities. It is quite probable that a bona fide hedge strategy could result in a contract loss which would be offset by increased interest earnings or a higher price for an asset sold, for example, a pool of mortgages. Criticize contracts placed solely to profit upon interest-rate movements. Verify that contract activities are conducted in accordance with the Board's policy statement. Where contract positions are of excessive size and could jeopardize the financial health of the entity under examination, the gains or losses realized because of financial-contract activities should be criticized.

2. Ascertain whether policy objectives highlight the circumstances under which financial contracts should be used.

   Determine whether management and operating personnel have received sufficient guidance. Carefully constructed policy objectives should be formulated with the knowledge that although proper utilization of financial contracts limits loss potential, such utilization also limits potentials for gains. Policy objectives should be formulated to limit required resources (margin monies, commissions, and personnel to execute, monitor, and audit contract activities). A well-constructed policy should be designed to preclude various operating areas of a banking organization from taking offsetting financial contract positions. Finally, there should be established benchmarks for determining whether financial contracts are meeting desired objectives.

3. Determine if policy objectives concerning the relationship of subsidiary banking organizations and the parent bank holding company comply with the Board's directives.

   Each banking organization in a holding company system must be treated as a separate entity. The policy statement accommodates centralized holding companies in that the holding companies are free to provide guidance to subsidiary banking organizations and execute contracts as agent on behalf of the banking organization, provided that each banking organization maintains responsibility for financial contract transactions executed on its behalf. Accordingly, a holding company that has centralized management could, and perhaps should, consider the interest-rate exposure of its subsidiary banks on a consolidated basis in determining whether future contracts can usefully be employed to reduce that exposure, but any future contracts that are executed must be recorded on the books and records of a subsidiary bank that will directly benefit from such contracts.

   The question concerning the relationship of a subsidiary bank to its holding company may also lead one to consider the relationship of a subsidiary bank with its correspondent bank or broker. One might also query to what extent may less sophisticated institutions rely upon brokers and/or correspondent banking organizations for advice in this area?

   Less sophisticated institutions can place only limited reliance on others for advice in this area. The bank holding company policy statement[9] emphasizes that responsibility for financial-contract activities rests solely with management. Additional information on securities transactions and the selections of securities dealers can be found in section 2126.1.

4. Ascertain whether policy objectives and/or position limits require prudence on the part of authorized personnel entering into these new activities. If discretion is left to senior

9. The Board's policy statement on engaging in futures, forwards, and option contracts.

managers, determine whether management has issued instructions to ensure that the level of financial-contract activity is prudent relative to the capabilities of persons authorized to execute and monitor contracts.

A new activity such as financial contracts should, as a general rule, be entered slowly. In developing expertise, management should mandate a low level of activity until persons authorized to execute contracts gain sufficient expertise or until new personnel are employed that have sufficient training and experience to engage in financial-contract activities on a larger scale. Senior management must develop the expertise to understand and evaluate techniques and strategies employed to ensure that an experienced professional does not engage in improper or imprudent activities.

5. If a banking organization uses financial contracts as part of its overall asset-liability management strategy, determine whether the organization developed an adequate system for evaluating its interest-rate risk.

   Without a system for identifying and measuring interest-rate risk, it is impossible to engage in hedging activity in an informed and meaningful manner. Failure to identify the mismatches in the organization's asset-liability mix would make it difficult to select the proper number and types of financial contracts—for example, bond or bill financial contracts—to provide an appropriate amount of interest-rate-risk protection. Evaluate whether the organization's interest-rate-risk measurement techniques appear reasonable to determine whether the financial contracts employed were successful in providing the proper amount of futures gains (losses) to cover the hedged risk position.

6. Determine if the recordkeeping system is sufficiently detailed to permit personnel to document and describe in detail how financial-contract positions taken have contributed to the attainment of the banking organization's stated objectives.

   There is no universal, adequate recordkeeping system for this purpose. Examiners must evaluate each individual system relative to the organization's stated objectives and activities. If the recordkeeping system cannot be used to illustrate how financial contracts contributed to the attainment of the banking organization's stated objectives, the recordkeeping system is inadequate. BHCs with inadequate recordkeeping systems should be instructed to make appropriate modifications.

7. Ascertain whether the banking organization's board of directors has established written limitations with respect to financial-contract positions.

   NOTE: The bank holding company policy statement requires that the board of directors establish written policies and position limitations in connection with financial-contract activities. If a committee has been delegated similar responsibilities within the organization, and a committee makes the decision, its recommendation should be ratified by the board of directors.

8. If there is the potential to exceed the above limitations in certain instances, determine whether there are firm, written procedures in place concerning the authorizations necessary to exceed limits.

9. Determine whether the board of directors, a duly authorized committee thereof, or internal auditors review at least monthly financial-contract positions to ascertain conformance with limitations. (See item (b) of the bank holding company policy statement.)

10. Determine if the banking organization maintains general-ledger memorandum accounts or commitment registers to adequately identify and control all financial-contract commitments to make or take delivery of securities or money market instruments.

11. Determine if the banking organization issues or writes option contracts expiring in excess of 150 days which give the other party to the contract the option to deliver securities to it.

    Examiners should review the facts surrounding standby contracts issued by holding companies. Examiners should also review accounting entries connected with bank holding company standby contracts to determine whether standbys were issued to earn fee income "up front" and exploit the lack of generally accepted accounting principles.

12. Determine whether financial-contract positions are properly disclosed in notes to the statements of financial condition and income and that the contract positions have been properly reported on FR Y-9C, Schedule HC-F, "Off-Balance-Sheet Items."

13. Determine whether the banking organization has implemented a system for monitoring credit-risk exposure associated with

various customers and dealers with whom operating personnel are authorized to transact business.

All financial-contract trading involves market risks. However, forward and OTC options trading, as well as swap activities, also involve credit risk. The key concern is whether the contra party to a transaction will be ready, willing, and able to perform on contract settlement and payment dates. While maintaining control over credit-risk exposure should ensure that a financial organization will not enter excessive (relative to the financial condition of the contra party) forward or standby contracts, monitoring such exposure may not prevent default in all instances.

14. Ascertain whether the banking organization has implemented internal controls and internal audit programs to ensure adherence to written policies and prevent unauthorized trading and other abuses.
15. Determine if the Reserve Bank was notified at the inception of bank holding company futures, forward, and option activities as required by paragraph (f) of the holding company policy statement (*Federal Reserve Regulatory Service* 4–830).
16. Determine if the personnel engaged in financial-contract activities have sufficient knowledge and understanding of the markets to perform those functions.

2130.0.13.1 Evaluating the Risks of Contract Activities

Evaluating the organization's stated objectives and their effects on overall risk is a difficult task involving legitimate cause for concern because of the high degree of leverage involved in contract activities. Although there is an emerging trend towards dealers requiring margin on forward trades, forward contract transactions generally have not required margin deposits, and thus, grant users unlimited leverage. Although the amount of margin required for futures trades is extremely small (for example, $1,500 initial margin to take a $1 million futures position), the rules of the exchanges do require a daily mark to market and a requirement that members of the futures exchanges meet maintenance margin calls on behalf of their customers. Customers, of course, are generally required to promptly reimburse brokers for margin posted on their behalf. Nevertheless, engaging in contract activities requires market participants to assume the market risks of either owning securities or ''shorting'' securities. Issuing (or selling) standby contracts granting the other party to the contract the option to deliver securities is a practice which results in the issuer functioning as an insurer against downside market risk for the other party; in essence, the party receiving the standby fee assumes all of the interest-rate risks of security ownership, but receives none of the benefits.

2130.0.13.2 Reviewing Financial-Contract Positions

The preceding questions were designed to focus the examiner's attention on a bank holding company's stated objectives for engaging in financial contract activities and the manner in which such activities are conducted. It is also vital to review position records with respect to financial contracts or, if necessary, prepare a schedule grouping similar contracts by maturity. Once the various positions have been scheduled it will be possible to evaluate the risk of contract positions relative to the organization under inspection.

2130.0.13.3 Factors to Consider in Evaluating Overall Risk

To determine whether contract positions are reasonable, an examiner must evaluate positions in light of certain key factors: the size of the organization, its capital structure, its business needs, and its capacity to fulfill its obligations. For example, open contracts to purchase $7 million of GNMA securities would be viewed differently in a BHC with $24 million of assets than in a BHC with $1 billion of assets.

There is no guaranty that financial contract prices and cash market prices will move in the same direction at the same velocity; however, contract prices and cash market prices ultimately move towards price convergence in the delivery month. Keeping this fact in mind, the risk evaluating process can be simplified by thinking of the securities underlying the various contracts as a frame of reference. For example, if a BHC holds ''long'' futures contracts on $10 million (par value) of Treasury bonds the examiner should first evaluate the effect (excluding tangible benefits of ownership, e.g., interest income, pledging, etc.) on the organization of holding $10 million of bonds in its portfolio and the resultant appreciation or depreciation if interest rates rise or fall by a given amount. A ''short'' contract of $10 million Treasury bonds would be evaluated as if the banking

organization had executed a short sale for $10 million. In addition, the examiner would have to consider the positive or negative flow of funds received or disbursed as margin to reflect daily contract gains and losses. While commissions on futures contracts are not a major factor in hedging transactions, they also should be considered in this evaluation. Typically, commissions are charged on a "round turn" basis—meaning that commissions are charged based upon an assumption that each futures contract will be offset prior to maturity. Since each contract will have to be offset, or securities bought or delivered, it should be determined whether funds will be available to offset contracts or fund delivery. In the case of certain short contracts, a determination must be made as to whether deliverable securities are held or committed for purchase by the banking organization.

2130.0.13.4 Contract Liquidity

In addition to looking at the "big picture," examiners should consider a position in a given contract maturity month relative to the volume of contracts outstanding. For example, in futures trading there is generally a greater open interest in the next contract maturity month and perhaps the following one or two contract maturity months. As one moves away from the near term contracts, there is generally less trading and less "open interest" in the more distant contracts. "Open interest" or the amount of contracts outstanding is reported in financial newspapers and other publications. Generally, the contracts with the largest open interest and daily trading volume are considered to be the most liquid.

To illustrate the concept discussed above, one should consider the following example. A "red flag" should be apparent if a contract review discloses that the organization has taken a sizeable position in a contract expiring in two years. When the examiner checks financial newspapers and other publications, he or she may discover that the BHC's position represents 20 percent of the open interest in that contract. Such a situation would clearly be unsafe and unsound because the relatively huge position coupled with the typically less liquid conditions in distant contracts makes it highly unlikely that the BHC could quickly close out its position if necessary. In addition, one should also question why the distant maturity was chosen since there is no immediate reason to expect a close correlation to the cash market for the underlying security.

With respect to forward contracts, there is an active forward market for GNMA securities specifying delivery of the underlying securities up to four or five months in the future. If a banking organization is executing contracts for more distant maturities, management should be queried as to why it is necessary to trade outside the normal trading cycle.

2130.0.13.5 Relationship to Banking Activities

In evaluating contract activities, examiners should verify that contract strategies are carried to fruition in connection with their relationship to overall objectives. Examiners may find it useful to recommend additional recordkeeping in borderline cases when they encounter situations where financial-contract positions are closed out frequently during the hedge period, but not frequently enough to be considered trading rather than hedging activities. Examiners should suggest proper documentation with regard to financial contracts executed and any additional recordkeeping as needed. Specifically, users could be requested to establish written criteria specifying what circumstances will trigger the closing of such contracts. Then users would be judged by how well they adhered to the criteria as well as whether the plan reduced risk. Hopefully, such recordkeeping would give users the latitude to close out a financial-contract position working against them (as determined by some prearranged benchmark), yet still require sufficient discipline to prevent users from selectively executing financial contracts merely to profit upon interest-rate forecasts.

The preceding discussion should reinforce the fact that the actual utilization of financial contracts is not a clear-cut issue in terms of hedging verses speculation. However, certain key concepts should be kept in mind. First, a decision to hedge with futures or forward contracts involves making a decision that one is content to lock in an effective cost of funds, a sale price of a specific asset, etc. However, the decision to hedge which gives downside protection also means forfeiting the benefits which would result from a favorable market movement. Thus, in evaluating hedge strategies, the organization should be judged as to whether it maintained hedge positions long enough to accomplish its objectives.

Caution should be employed in performing the analysis of financial contracts used to obtain targeted effective interest rates. Examiners should not evaluate transactions solely on a "paired" basis, that is, looking at paired cash market and financial-contract positions and forgetting about financial-contract positions relative to the organization's entire balance sheet, nor should examiners fail to review the overall nature of financial-contract activities. For example, individual opening and closing of financial contracts could appear reasonable, but the aggregate activities may be indicative of an organization that is in reality operating a futures trading account solely to profit on interest-rate expectations.

2130.0.13.6 Parties Executing or Taking the Contra Side of a Financial Contract

In addition to monitoring contra-party credit risk, serious efforts should be made to ensure that the banking organization carefully scrutinizes the selection of brokers and dealers. In the case of futures contracts, the Commodity Exchange Act requires that an entity functioning as a futures commission merchant be registered with the CFTC. However, not every FCM may be a member of a commodities exchange. Members of an exchange are given additional supervision by the exchange, while nonmembers are subject to audit by the National Futures Association. In selecting any broker or dealer, an organization should give careful consideration to its reputation, financial viability, and length of time in business. If an organization intends to deal with a newly established FCM or broker-dealer, special efforts should be made to verify the reputation and integrity of its principals. (For additional discussion, see *Federal Reserve Regulatory Service* 3–1562). Although such measures cannot ensure that problems will not subsequently develop with an FCM or broker-dealer, some careful forethought can tend to ensure that relationships will not be developed with persons or firms who had serious problems in the past.

2130.0.14 ACCOUNTING FOR FUTURES CONTRACTS

All futures contracts, except for foreign-currency futures contracts, shall be reported in the Consolidated Financial Statements for Bank Holding Companies in accordance with Financial Accounting Standards Board (FASB) Statement No. 80, "Accounting for Futures Contracts." Foreign-currency futures contracts shall be reported in accordance with the guidance in FASB Statement No. 52, "Foreign Currency Translation."

2130.0.14.1 Performance Bonds under Futures Contracts

When the reporting banking organization, as either buyer or seller of futures contracts, has posted a performance bond in the form of a margin account deposited with a broker or exchange, the current balance (as of the report date) of that margin account shall be reported in Other Assets. The balance in the margin account includes the following:

1. the original margin deposit, plus (less)
2. any additions (deductions) as a result of daily fluctuations in the market value of the related contracts (i.e., "variation margin"), plus
3. any additional deposits made to the account to meet margin calls or otherwise (i.e., "maintenance margin"), less
4. any withdrawals of excess balances from the account

When the performance bond takes the form of a pledge of assets with a broker rather than a margin account, the pledged assets shall be maintained on the books of the pledging banking organization and no other balance-sheet entry is made for the performance bond. In this case, gains and losses resulting from daily fluctuations in the market value of the related contracts are generally settled with the broker in cash. However, if the pledging banking organization also maintains a working balance with the broker against which recognized daily market gains and losses are posted, the working balance should be reported in Other Assets, and treated in the same manner as a margin account.

2130.0.14.2 Valuation of Open Positions

All open positions in futures contracts must be reviewed at least monthly (or more often, if material) and their current market values determined. The market value of a futures contract is to be based on published price quotations. These futures positions must be revalued at their cur-

rent market values on these valuation dates and any changes in these values reported in accordance with the guidance presented below for hedge or nonhedge contracts, as appropriate.

2130.0.14.3 Criteria for Hedge-Accounting Treatment

A futures contract shall be accounted for as a hedge when the following conditions are met:

1. The banking organization must have determined that the item or group of items to be hedged (that is, the identifiable assets, liabilities, firm commitments, or anticipated transactions) will expose it to price or interest-rate risk.
2. The futures contract must reduce the exposure to risk. This will be demonstrated if, at the inception of the hedge and *throughout the hedge period, high correlation* is expected to exist between the changes in the prices of both the contract and the hedged item or group of items.[10] In other words, the banking organization must monitor the price movements of both the hedge contract and the hedged items to determine that it is probable that changes in the market value of the futures contract will offset the effects of price changes on the hedged items.
3. The futures contract must be designated in writing as a hedge by management at the inception of the hedge.

   In order for a futures contract to qualify as a hedge of an anticipated transaction, the following two additional criteria must be met:

   a. The significant characteristics and expected terms of the anticipated transaction must be identified.
   b. The occurrence of the anticipated transaction must be probable.[11]

2130.0.14.4 Gains and Losses from Monthly Contract Valuations of Futures Contracts That Qualify as Hedges

If the hedge criteria are met, the accounting for the futures contract shall be related to the accounting for the hedged item so that changes in the market value of the futures contract are recognized in income when the effects of related changes in the price or interest rate of the hedged item are recognized. If a banking organization must include unrealized changes in the fair value of a hedged item in income, a change in the market value of the related futures contract shall be recognized in income when the change occurs. Otherwise, a change in the market value of a futures contract that qualifies as a hedge of an existing asset or liability shall be recognized as an adjustment of the carrying amount of the hedged item. A change in the market value of a futures contract that is a hedge of a firm commitment shall be included in the measurement of the transaction that satisfies the commitment. A change in the market value of a futures contract that is a hedge of an anticipated transaction shall be included in the measurement of the subsequent transaction.

Once the carrying amount of an asset or liability has been adjusted for the change in the market value of a futures contract, the adjustment must be recognized in income in the same manner as other components of the carrying amount of that asset or liability (for example, using the interest method). If the item being hedged is an interest-bearing financial instrument otherwise reported at amortized historical cost, then the changes in the market value of the hedge contract that have been reflected as adjustments in the carrying amount of the financial instrument shall be amortized as an adjustment of interest income or expense over the expected remaining life of the hedged item.

If a futures contract that has been accounted for as a hedge of an anticipated transaction is closed before the date of the related transaction, the accumulated change in value of the contract shall be carried forward (assuming high correlation continues to exist) and included in the measurement of the related transaction. When it becomes probable that the quantity of the anticipated transaction will be less than that originally hedged, a pro rata portion of the futures results that would have been included in the measurement of the transaction shall be recognized as a gain or loss.

When futures contracts that are hedges are terminated, the gain or loss on the terminated contracts must be deferred and amortized over the remaining life of the hedged item.

10. Generally, banking practice maintains that correlation in the changes in the market values of the futures contract and the hedged item must be at least 80 percent for the "high correlation" criteria in FASB Statement No. 80 to be met.

11. It will be particularly difficult to meet this criteria when an anticipated transaction is not expected to take place in the near future.

2130.0.14.5 Gains and Losses from Monthly Contract Valuations of Futures Contracts That Do Not Qualify as Hedges

For futures contracts that are not accounted for as hedges, the change that has occurred in the market value of open positions since the last call report date shall be reflected in current income, either as "other noninterest income" for net gains or "other noninterest expense" for net losses.

If high correlation ceases to exist, the banking organization should discontinue accounting for a futures contract as a hedge. When this occurs, the portion of the change in the market value of the contract that has not offset the market value changes of the hedged item, since the inception of the hedge, must be reflected in the Report of Income as "other noninterest income" or "other noninterest expense," as appropriate. The contract should thereafter be accounted for as a nonhedge contract with subsequent changes in the contract's market value reflected in current period income.

When futures contracts that are not hedges are terminated, the gain or loss on the terminated contract must be recognized currently in the Report of Income as "other noninterest income" or "other noninterest expense," as appropriate.

There is the potential for holding companies and nonbank subsidiaries to follow the referenced accounting applications and break "hedges" with unrealized futures gains to recognize income, and maintain hedges with futures losses and adjust the carrying basis of the paired, that is, "hedged" asset. Examiners should look for patterns of taking gains and losses with a view to determining whether the opening and closing of contracts is consistent with the organization's risk-reducing strategies.

2130.0.15 PREPARING INSPECTION REPORTS

Unsatisfactory comments pertaining to a bank holding company's financial-contract activities should be noted on the "Examiner's Comments," "Policies and Supervision," and "Analysis of Financial Factors" or other appropriate page depending on the severity of the comments within the bank holding company inspection report.

2130.0.16 INTERNAL CONTROLS AND INTERNAL AUDIT

The following is designed to illustrate desirable internal controls and internal audit procedures applicable to the organization's activities in financial contracts. This illustration is not intended to serve as an absolute standard relating to contract activities, but is designed to supplement examiners' knowledge relating to internal controls and internal audits in this context. In evaluating internal controls and audits, the examiner will need to evaluate the scope of futures, forward, and options activities to determine whether internal controls and audit procedures are adequate in relation to the volume and nature of the activities.

2130.0.16.1 Internal Controls

It is a management's responsibility to minimize the risks inherent in financial-contract activities through the establishment of policies and procedures covering organizational structure, segregation of duties, operating and accounting system controls, and comprehensive management reporting. Formal written procedures should be in place in connection with purchases and sales, processing, accounting, clearance and safekeeping activities relating to these transactions. In general, these procedures should be designed to ensure that all financial contracts are properly recorded and that senior management is aware of the exposure and gains or losses resulting from these activities. Some examples of desirable controls follow:

1. Written documentation indicating what types of contracts are eligible for purchase by the organization, which individual persons are eligible to purchase and sell contracts, which individual persons are eligible to sign contracts or confirmations, and the names of firms or institutions with whom employees are authorized to conduct business.
2. Written position limitations for each type of contract established by the banking organization's board of directors and written procedures for authorizing trades, if any, in excess of those limits.
3. A system to monitor the organization's exposure with customers and those broker-dealers and institutions eligible to do business with it. To implement this, management must determine the amount of credit risk permissible with various parties and then institute surveillance procedures to ensure

that such limits are not exceeded without written authorization from senior management.

4. Separation of duties and supervision to ensure that persons executing transactions are not involved in approving the accounting media and/or making accounting entries. Further, persons executing transactions should not have authority to sign incoming or outgoing confirmations or contracts, reconcile records, clear transactions, or control the disbursement of margin payments.
5. A clearly defined flow of order tickets and confirmations. Confirmations generated should, preferably, be prenumbered. In addition to promptly recording all commitments in a daily written commitment ledger, the related documentation should be filed separately for purposes of audit and examination. The flow of confirmations and order tickets should be designed to verify accuracy and enable reconciliations throughout the system, for example, to ensure that a person could not execute unauthorized transactions and bypass part of the accounting system, and to enable the reconcilement of traders' position reports to those positions maintained by an operating unit.
6. Procedures to route incoming confirmations to an operations unit separate from the trading unit. Confirmations received from brokers, dealers, or others should be compared to confirmations (or other control records) prepared by the banking organization to ensure that it will not accept or make delivery of securities, or remit margin payments, pursuant to contracts unless there is proper authorization and documentation.
7. Procedures for promptly resolving fails to receive or fails to deliver securities on the date securities are due to be received or sent pursuant to contracts.
8. Procedures for resolving customer complaints by someone other than the person who executed the contract.
9. Procedures for verifying brokers' reports of margin deposits and contract positions (use an outside pricing source), and reconciling such reports to the records.
10. Procedures for daily review of outstanding contracts and supervision of traders. In addition, there should be periodic reports to management reflecting the margin deposits and contract positions.
11. Selecting and training competent personnel to follow the written policies and guidelines.

2130.0.16.2 Internal Audit

The scope and frequency of the internal audit program should be designed to review the internal control procedures and verify that the internal controls purported to be in effect are being followed. Further, the internal auditor should verify that there are no material inadequacies in the internal control procedures that would permit a person acting individually to perpetrate errors or irregularities involving the records of the organization or assets that would not be detected by the internal control procedures in time to prevent material loss or misstatement of the banking organization's financial statements or serious violation of applicable banking, bank holding company, or securities rules or regulations. Any weaknesses in internal control procedures should be reported to management, along with recommendations for corrective action. If internal auditors do not report to an audit committee, the person to whom they report should not be in a position to misappropriate assets. In addition, auditors should occasionally spot-check contract prices and mark-to-market adjustments.

2130.0.17 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Statement of policy concerning bank holding companies engaging in futures, forward, and options contracts on U.S. government and agency securities and money market instruments		225.142	4–830	
Policy Statement on Financial Contracts			3–1535	
Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities			3–1562	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Financial institutions, including bank holding company subsidiaries, are lending securities with increasing frequency, and, in some instances, a financial institution may lend its own investment or trading-account securities. Financial institutions lend customers' securities held in custody, safekeeping, trust, or pension accounts. Because the securities available for lending often greatly exceed the demand for them, inexperienced lenders may be tempted to ignore commonly recognized safeguards. Bankruptcies of broker-dealers have heightened regulatory sensitivity to the potential for problems in this area.

2140.0.1 SECURITIES-LENDING MARKET

Securities brokers and commercial banks are the primary borrowers of securities. They borrow securities to cover securities fails (securities sold but not available for delivery), short sales, and option and arbitrage positions. Securities lending, which used to involve principally corporate equities and debt obligations, increasingly involves loans of large blocks of U.S. government and federal-agency securities.

Securities lending is conducted through open-ended "loan" agreements, which may be terminated on short notice by the lender or borrower. Repurchase agreements are generally used by owners of securities as financing vehicles and, in certain respects, are closely analogous to securities lending. The objective of securities lending, however, is to receive a safe return in addition to the normal interest or dividends. Securities loans in industry practice are generally collateralized by U.S. government or federal-agency securities, cash, or letters of credit.[1] At the outset, each loan is collateralized at a predetermined margin. If the market value of the collateral falls below an acceptable level during the time a loan is outstanding, a margin call is made by the lender institution. If a loan becomes over-collateralized because of appreciation of collateral or market depreciation of a loaned security, the borrower usually has the opportunity to request the return of any excessive margin.

When a securities loan is terminated, the securities are returned to the lender and the collateral to the borrower. Fees received on securities loans are divided between the lender and the customer account that owns the securities. In situations involving cash collateral, part of the interest earned on the temporary investment of cash is returned to the borrower, and the remainder is divided between the lender and the customer account that owns the securities.

1. Broker-dealers borrowing securities are subject to the restrictions of the Federal Reserve's Regulation T (12 C.F.R. 220.10), which specifies acceptable borrowing purposes.

2140.0.2 DEFINITIONS OF CAPACITY

Securities lending may be done in various capacities and with differing associated liabilities. It is important that all parties involved understand in what capacity the lender is acting. For the purposes of these guidelines, the relevant capacities are as follows:

1. *Principal.* A lender offering securities from its own account is acting as principal. A lender institution offering customers' securities on an undisclosed basis is also considered to be acting as principal.
2. *Agent.* A lender offering securities on behalf of a customer-owner is acting as an agent. For the lender to be considered a bona fide or "fully disclosed" agent, it must disclose the names of the borrowers to the customer-owners (or give notice that names are available upon request), and must disclose the names of the customer-owner to borrowers (or give notice that names are available upon request). In all cases, the agent's compensation for handling the transaction should be disclosed to the customer-owner. Undisclosed agency transactions, that is, "blind brokerage" transactions in which participants cannot determine the identity of the contra party, are treated as if the lender was the principal.
3. *Directed agent.* A lender which lends securities at the direction of the customer-owner is acting as a directed agent. The customer directs the lender in all aspects of the transaction, including to whom the securities are loaned, the terms of the transaction (rebate rate and maturity/call provisions on the loan), acceptable collateral, investment of any cash collateral, and collateral delivery.
4. *Fiduciary.* A lender which exercises *discretion* in offering securities on behalf of and for the benefit of customer-owners is acting as a fiduciary. For purposes of these guidelines,

the underlying relationship may be as agent, trustee, or custodian.

5. *Finder.* A finder brings together a borrower and a lender of securities for a fee. Finders do not take possession of the securities or collateral. Delivery of securities and collateral is direct between the borrower and the lender, and the finder does not become involved. The finder is simply a fully disclosed intermediary.

2140.0.3 GUIDELINES

All bank holding companies or their subsidiaries that participate in securities lending should establish written policies and procedures governing these activities. Other than commercial banks with trust departments, the bank holding company subsidiaries most likely to be engaged in securities lending are non-deposit-taking trust companies and certain discount brokers which provide custody services and make margin loans. At a minimum, policies and procedures should cover each of the topics in these guidelines.

2140.0.3.1 Recordkeeping

Before establishing a securities-lending program, a financial firm or institution must establish an adequate recordkeeping system. At a minimum, the system should produce daily reports showing which securities are available for lending, and which are currently lent, outstanding loans by borrower, outstanding loans by account, new loans, returns of loaned securities, and transactions by account. These records should be updated as often as necessary to ensure that the lender institution fully accounts for all outstanding loans, that adequate collateral is required and maintained, and that policies and concentration limits are being followed.

2140.0.3.2 Administrative Procedures

All securities lent and all securities standing as collateral must be marked to market daily. Procedures must ensure that any necessary calls for additional margin are made on a timely basis.

In addition, written procedures should outline how to choose the customer account that will be the source of lent securities when they are held in more than one account. Possible methods include loan volume analysis, automated queue, a lottery, or some combination of these. Securities loans should be fairly allocated among all accounts participating in a securities-lending program.

Internal controls should include operating procedures designed to segregate duties and timely management reporting systems. Periodic internal audits should assess the accuracy of accounting records, the timeliness of management reports, and the lender's overall compliance with established policies and the firm's procedures.

2140.0.3.3 Credit Analysis and Approval of Borrowers

In spite of strict standards of collateralization, securities-lending activities involve risk of loss. Such risks may arise from malfeasance or failure of the borrowing firm or institution. Therefore, a duly established management or supervisory committee of the lender should formally approve, in advance, transactions with any borrower.

Credit and limit approvals should be based upon a credit analysis of the borrower. A review should be performed before establishing such a relationship and reviews should be conducted at regular intervals thereafter. Credit reviews should include an analysis of the borrower's financial statement, and should consider capitalization, management, earnings, business reputation, and any other factors that appear relevant. Analyses should be performed in an independent department of the lender, by persons who routinely perform credit analyses. Analyses performed solely by the person(s) managing the securities-lending program are not sufficient.

2140.0.3.4 Credit and Concentration Limits

After the initial credit analysis, management of the lender should establish an individual credit limit for the borrower. That limit should be based on the market value of the securities to be borrowed, and should take into account possible temporary (overnight) exposures resulting from a decline in collateral values or from occasional inadvertent delays in transferring collateral. Credit and concentration limits should take into account other extensions of credit by the lender to the same borrower or related interests.

Procedures should be established to ensure that credit and concentration limits are not exceeded without proper authorization from management.

2140.0.3.5 Collateral Management

Securities borrowers generally pledge and maintain collateral at a level equal to at least 100 percent of the value of the securities borrowed.[2] The minimum amount of excess collateral, or "margin," acceptable to the lender should relate to price volatility of the loaned securities and the collateral (if other than cash).[3] Generally, the minimum initial collateral on securities loans is at least 102 percent of the market value of the lent securities plus, for debt securities, any accrued interest.

Collateral must be maintained at the agreed margin. A daily "mark-to-market" or valuation procedure must be in place to ensure that calls for additional collateral are made on a timely basis. The valuation procedures should take into account the value of accrued interest on debt securities.

Securities should not be lent unless collateral has been received or will be received simultaneously with the loan. As a minimum step toward perfecting the lender's interest, collateral should be delivered directly to the lender or an independent third-party trustee.

2140.0.3.6 Cash as Collateral

When cash is used as collateral, the lender is responsible for making it income productive. Lenders should establish written guidelines for selecting investments for cash collateral. Generally, a lender will invest cash collateral in repurchase agreements, master notes, a short-term investment fund (STIF), U.S. or Eurodollar certificates of deposit, commercial paper, or some other type of money market instrument. If the lender is acting in any capacity other than as principal, the written agreement authorizing the lending relationship should specify how cash collateral is to be invested.

Using cash collateral to pay for liabilities of the lender or its holding company would be an improper *conflict of interest* unless that strategy was specifically authorized in writing by the owner of the lent securities.

2140.0.3.7 Letters of Credit as Collateral

If a lender plans to accept letters of credit as collateral, it should establish guidelines for their use. Those guidelines should require a credit analysis of the banks issuing the letter of credit before securities are lent against that collateral. Analyses must be periodically updated and reevaluated. The lender should also establish concentration limits for the banks issuing letters of credit, and procedures should ensure they are not exceeded. In establishing concentration limits on letters of credit accepted as collateral, the lender's total outstanding credit exposures from the issuing bank should be considered.

2140.0.3.8 Written Agreements

Securities should be lent only pursuant to a written agreement between the lender and the owner of the securities, specifically authorizing the institution to offer the securities for loan. The agreement should outline the lender's authority to reinvest cash collateral (if any) and responsibilities with regard to custody and valuation of collateral. In addition, the agreement should detail the fee or compensation that will go to the owner of the securities in the form of a fee schedule or other specific provision. Other items which should be covered in the agreement have been discussed earlier in these guidelines.

A lender must also have written agreements with the parties who wish to borrow securities. These agreements should specify the duties and responsibilities of each party. A written agreement may detail acceptable types of collateral (including letters of credit); standards for collateral custody and control, collateral valuation and initial margin, accrued interest, marking to market, and margin calls; methods for transmitting coupon or dividend payments received if a security is on loan on a payment date; conditions which will trigger the termination of a loan (including events of default); and acceptable

2. Employee benefit plans subject to the Employee Retirement Income Security Act are specifically required to collateralize securities loans at a minimum of 100 percent of the market value of loaned securities (see section 2140.0.3.10 below).

3. The level of margin should be dictated by level of risk being underwritten by the securities lender. Factors to be considered in determining whether to require margin above the recommended minimum include the type of collateral, the maturity of collateral and lent securities, the term of the securities loan, and the costs which may be incurred when liquidating collateral and replacing loaned securities.

methods of delivery for loaned securities and collateral.

2140.0.3.9 Use of Finders

Some lenders may use a finder to place securities, and some financial institutions may act as finders. A finder brings together a borrower and a lender for a fee. Finders should not take possession of securities or collateral. The delivery of securities loaned and collateral should be direct between the borrower and the lender. A finder should not be involved in the delivery process.

The finder should act only as a fully disclosed intermediary. The lender must always know the name and financial condition of the borrower of any securities it lends. If the lender does not have that information, it and its customers are exposed to unnecessary risks.

Written policies should be in place concerning the use of finders in a securities-lending program. These policies should cover circumstances in which a finder will be used, which party pays the fee (borrower or lender), and which finders the lender institution will use.

2140.0.3.10 Employee Benefit Plans

The Department of Labor has issued two class exemptions which deal with securities-lending programs for employee benefit plans covered by the Employee Retirement Income Security Act (ERISA): Prohibited Transaction Exemption 81-6 (46 FR 7527 (January 23, 1981) and correction (46 FR 10570 (February 3, 1981))), and Prohibited Transaction Exemption 82-63 (47 FR 14804 (April 6, 1982)). The exemptions authorize transactions which might otherwise constitute unintended ''prohibited transactions'' under ERISA. Any firm engaged in the lending of securities for an employee benefit plan subject to ERISA should take all steps necessary to design and maintain its program to conform with these exemptions.

Prohibited Transaction Exemption 81-6 permits the lending of securities owned by employee benefit plans to persons who could be ''parties in interest'' with respect to such plans, provided certain conditions specified in the exemption are met. Under those conditions, neither the borrower nor an affiliate of the borrower can have discretionary control over the investment of plan assets, or offer investment advice concerning the assets, and the loan must be made pursuant to a written agreement. The exemption also establishes a minimum acceptable level for collateral based on the market value of the loaned securities.

Prohibited Transaction Exemption 82-63 permits compensation of a fiduciary for services rendered in connection with loans of plan assets that are securities. The exemption details certain conditions which must be met.

2140.0.3.11 Indemnification

Certain lenders offer participating accounts indemnification against losses in connection with securities-lending programs. Such indemnifications may cover a variety of occurences including all financial loss, losses from a borrower default, or losses from collateral default. Lenders that offer such indemnification should obtain a legal opinion from counsel concerning the legality of their specific form of indemnification under federal and/or state law.

A lender which offers an indemnity to its customers may, in light of other related factors, be assuming the benefits and, more importantly, the liabilities of a principal. Therefore, lenders offering indemnification should also obtain written opinions from their accountants concerning the proper financial statement disclosure of their actual or contingent liabilities.

2140.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Securities Lending policy statement of the Federal Financial Institutions Examination Council, adopted by the Federal Reserve Board on May 6, 1985			3–1579.5	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Depository institutions and others involved with the purchase of United States Government and Agency obligations under agreements to resell (reverse repurchase agreements),[2] have sometimes incurred significant losses. The most important factors causing these heavy losses have been inadequate credit risk management and the failure to exercise effective control over securities collateralizing the transactions.[3]

The following minimum guidelines address the need for managing credit risk exposure to counterparties under securities repurchase agreements and for controlling the securities in those transactions, and should be followed when entering into repurchase agreements with securities dealers and others.

Depository institutions and nonbank subsidiaries that actively engage in repurchase agreements are encouraged to have more comprehensive policies and controls to suit their particular circumstances. The examining staffs of the Federal Reserve should review written policies and procedures of dealers to determine their adequacy in light of these minimum guidelines and the scope of each subsidiary's operations.

2150.0.1 CREDIT POLICY GUIDELINES

The apparent safety of short-term repurchase agreements which are collateralized by highly liquid, U.S. Government and Federal agency obligations has contributed to an attitude of complacency. Some portfolio managers have underestimated the credit risk associated with the performance of the counterparty to the transactions, and have not taken adequate steps to assure control of the securities covered by the agreement.

All firms that engage in securities repurchase agreement transactions should establish written credit policies and procedures governing these activities. At a minimum, those policies and procedures should cover the following:

Written policies should establish ''know your counterparty'' principles. Engaging in repurchase agreement transactions in volume and in large dollar amounts frequently requires the services of a counterparty who is a dealer in the underlying securities. Some firms which deal in the markets for U.S. Government and Federal agency securities are subsidiaries of, or related to, financially stronger and better known firms. However, these stronger firms may be independent of their U.S. Government securities subsidiaries and affiliates and may not be legally obligated to stand behind the transactions of related companies. Without an express guarantee, the stronger firm's financial position cannot be relied upon in assessing the creditworthiness of a counterparty.

It is important to know the legal entity that is the actual counterparty to each repurchase agreement transaction. Know about the actual counterparty's character, integrity of management, activities, and the financial markets in which it deals. Be particularly careful in conducting repurchase agreements with any firm that offers terms that are significantly more favorable than those currently prevailing in the market.

In certain situations firms may use, or serve as, brokers or finders in order to locate repurchase agreement counterparties or particular securities. When using or acting as this type of agent the names of each counterparty should be fully disclosed. Do not enter into undisclosed agency or ''blind brokerage'' repurchase transactions in which the counterparty's name is not disclosed.

2150.0.1.1 Dealings with Unregulated Securities Dealers

A dealer in U.S. Government and Federal agency obligations is not necessarily a Federally insured bank or thrift, or a broker/dealer registered with the Securities and Exchange Commission. Therefore, the dealer firm may not

1. A repurchase agreement is a transaction involving the *sale* of assets by one party to another, subject to an agreement by the seller to repurchase the assets at a specified date or in specified circumstances.

2. In order to avoid confusion among market participants who sometimes use the same term to describe different sides of the same transaction, the term ''repurchase agreement'' will be used in the balance of this statement to refer to both repurchase and reverse repurchase agreements. A repurchase agreement is one in which a party that owns securities acquires funds by transferring the securities to another party under an agreement to repurchase the securities at an agreed upon future date. A reverse repurchase (resale) agreement is one in which a party provides funds by acquiring securities pursuant to an agreement to resell them at an agreed upon future date.

3. Throughout this document repurchase agreements are generally discussed in terms of secured credit transactions. This usage should not be deemed to be based upon a legal determination.

be subject to any Federal regulatory oversight.

A firm doing business with an unregulated securities dealer should be certain that the dealer voluntarily complies with the Federal Reserve Bank of New York's minimum capital guideline, which currently calls for liquid capital to exceed measured risk by 20 percent (that is, the ratio of a dealer's liquid capital to risk of 1.2:1). This ratio can be calculated by a dealer using either the Securities and Exchange Commission's Net Capital Rule for Brokers and Dealers (Rule 15c31) or the Federal Reserve Bank of New York's Capital Adequacy Guidelines for United States Government Securities Dealers. To ensure that an unregulated dealer complies with either of those capital standards, it should certify its compliance with the capital standard and provide the following three forms of certification:

1. A letter of certification from the dealer that the dealer will adhere on a continuous basis to the capital adequacy standard;
2. Audited financial statements which demonstrate that as of the audit date the dealer was in compliance with the standard and the amount of liquid capital; and
3. A copy of a letter from the firm's certified public accountant stating that it found no material weaknesses in the dealer's internal systems and controls incident to adherence to the standard.[4]

Periodic evaluations of counterparty creditworthiness should be conducted by individuals who routinely make credit decisions and who are not involved in the execution of repurchase agreement transactions.

Prior to engaging in initial transactions with a new counterparty, obtain audited financial statements and regulatory filings (if any) from counterparties, and insist that similar information be provided on a periodic and timely basis in the future. Recent failures of government securities dealers have typically been foreshadowed by delays in producing these statements. Many firms are registered with the Securities and Exchange Commission as broker/dealers and have to file financial statements and should be willing to provide a copy of these filings.

The counterparty credit analysis should consider the financial statements of the entity that is to be the counterparty as well as those of any related companies that could have an impact on the financial condition of the counterparty. When transacting business with a subsidiary, consolidated financial statements of a parent are not adequate. Repurchase agreements should not be entered into with any counterparty that is unwilling to provide complete and timely disclosure of its financial condition. As part of this analysis, the firm should make inquiry about the counterparty's general reputation and whether there have been any formal enforcement actions against the counterparty or its affiliates by State or Federal securities regulators.

Maximum position and temporary exposure limits for each approved counterparty should be established based upon credit analysis performed. Periodic reviews and updates of those limits are necessary.

Individual repurchase agreement counterparty limits should consider overall exposure to the same or related counterparty. Repurchase agreement counterparty limitations should include the overall permissible dollar positions in repurchase agreements, maximum repurchase agreement maturities and limits on temporary exposure that may result from decreases in collateral values or delays in receiving collateral.

2150.0.2 GUIDELINES FOR CONTROLLING REPURCHASE AGREEMENT COLLATERAL

Repurchase agreements can be a useful asset and liability management tool, but repurchase agreements can expose a firm to serious risks if they are not managed appropriately. It is possible to reduce repurchase agreement risk by negotiating written agreements with all repurchase agreement counterparties and custodian banks. Compliance with the terms of these written agreements should be monitored on a daily basis. If prudent management control requirements of repurchase agreements are too burdensome, other asset/liability management tools should be used.

The marketplace perceives repurchase agreement transactions as similar to lending transactions collateralized by highly liquid Government securities. However, experience has shown that the collateral securities will probably *not* serve as protection if the counterparty becomes insolvent or fails, and the purchasing firm does not have control over the securities. Ultimate responsibility for establishing adequate control procedures rests with management of the firm. Management should obtain a written legal opin-

4. This letter should be similar to that which must be given to the SEC by registered broker/dealers.

ion as to the adequacy of the procedures utilized to establish and protect the firm's interest in the underlying collateral.

A written agreement specific to a repurchase agreement transaction or master agreement governing all repurchase agreement transactions should be entered into with each counterparty. The written agreement should specify all the terms of the transaction and the duties of both the buyer and seller. Senior managers should consult legal counsel regarding the content of the repurchase and custodial agreements. The repurchase and custodial agreements should specify, but should not be limited to, the following:

- Acceptable types and maturities of collateral securities;
- Initial acceptable margin for collateral securities of various types and maturities
- Margin maintenance, call, default and sellout provisions;
- Rights to interest and principal payments;
- Rights to substitute collateral; and
- The persons authorized to transact business on behalf of the firm and its counterparty.

2150.0.2.1 Confirmations

Some repurchase agreement confirmations may contain terms that attempt to change the firm's rights in the transaction. The firm should obtain and compare written confirmations for each repurchase agreement transaction to be certain that the information on the confirmation is consistent with the terms of the agreement. The confirmation should identify specific collateral securities.

2150.0.2.2 Control of Securities

As a general rule, a firm should obtain possession or control of the underlying securities and take necessary steps to protect its interest in the securities. The legal steps necessary to protect its interest may vary with applicable facts and law and accordingly should be undertaken with the advice of counsel. Additional prudential management controls may include:

- delivery of either physical securities to, or in the case of book entry securities, making appropriate entries in the books of a third party custodian designated under a written custodial agreement which explicitly recognizes the firm's interest in the securities as superior to that of any other person; or
- appropriate entries on the books of a third party custodian acting pursuant to a tripartite agreement with the firm and the counterparty, ensuring adequate segregation and identification of either physical or book-entry securities.

Where control of the underlying securities is not established, the firm may be regarded only as an unsecured general creditor of the insolvent counterparty. In such instance, *substantial losses are likely to be incurred.* Accordingly, a firm should not enter into a repurchase agreement without obtaining control of the securities unless all of the following minimum procedures are observed: (1) it is completely satisfied as to the creditworthiness of the counterparty; (2) the transaction is within credit limitations that have been pre-approved by the board of directors, or a committee of the board, for unsecured transactions with the counterparty; (3) periodic credit evaluations of the counterparty are conducted; and (4) the firm has ascertained that collateral segregation procedures of the counterparty are adequate. Unless prudential internal procedures of these types are instituted and observed, the firm may be cited for engaging in unsafe or unsound practices.

All receipts and deliveries of either physical or book-entry securities should be made according to written procedures, and third party deliveries should be confirmed in writing directly by the custodian. It is not acceptable to receive confirmation from the counterparty that the securities are segregated in a firm's name with a custodian; the firm should, however, obtain a copy of the advice of the counterparty to the custodian requesting transfer of the securities to the firm. Where securities are to be delivered, payment for securities should not be made until the securities are actually delivered to the firm or its agent. The custodial contract should provide that the custodian takes delivery of the securities subject to the exclusive direction of the firm.

Substitution of securities should not be allowed without the prior consent of the firm. The firm should give its consent before the delivery of the substitute securities to it or a third party custodian. Any substitution of securities should take into consideration the following discussion of "margin requirements."

2150.0.2.3 Margin Requirements

The amount paid under the repurchase agreement should be less than the market value of the securities, including the amount of any accrued interest, with the difference representing a predetermined margin. Factors to be considered in establishing an appropriate margin include the size and maturity of the repurchase transaction, the type and maturity of the underlying securities, and the creditworthiness of the counterparty. Margin requirements on U.S. Government and Federal agency obligations underlying repurchase agreements should allow for the anticipated price volatility of the security until the maturity of the repurchase agreement. Less marketable securities may require additional margin to compensate for less liquid market conditions. Written repurchase agreement policies and procedures should require daily mark-to-market of repurchase agreement securities to the bid side of the market. Repurchase agreements should provide for additional securities or cash to be placed with the firm or its custodian bank to maintain the margin within the predetermined level.

Margin calculations should also consider accrued interest on underlying securities and the anticipated amount of accrued interest over the term of the repurchase agreement, the date of interest payment and which party is entitled to receive the payment. In the case of pass-through securities, anticipated principal reductions should also be considered when determining margin adequacy.

Prudent management procedures should be followed in the administration of any repurchase agreement. Longer term repurchase agreements require management's daily attention to the effects of securities substitutions, margin maintenance requirements (including consideration of any coupon interest or principal payments) and possible changes in the financial condition of the counterparty. Engaging in open repurchase agreement transactions without maturity dates may be regarded as an unsafe and unsound practice unless the firm has retained rights to terminate the transaction quickly to protect itself against changed circumstances. Similarly, automatic renewal of short-term repurchase agreement transactions without reviewing collateral values and adjusting collateral margin may be regarded as an unsafe and unsound practice. If additional margin is not deposited when required, the firm's rights to sell securities or otherwise liquidate the repurchase agreement should be exercised without hesitation.

2150.0.2.4 Overcollateralization

A firm should use current market values, including the amount of any accrued interest, to determine the price of securities that are sold under repurchase agreements. Counterparties should not be provided with excessive margin. Thus, the written repurchase agreement contract should provide that the counterparty must make additional payment or return securities if the margin exceeds agreed upon levels. When acquiring funds under repurchase agreements it is prudent business practice to keep at a reasonable margin the difference between the market value of the securities delivered to the counterparty and the amount borrowed. The excess market value of securities sold may be viewed as an unsecured loan to the counterparty subject to the unsecured lending limitations for the firm and should be treated accordingly for credit policy and control purposes.

2150.0.3 OPERATIONS

A firm's operational functions should be designed to regulate the custody and movement of securities and to adequately account for trading transactions. Because of the dollar volume and speed of trading activities, operational inefficiencies can quickly result in major problems.

In some cases, a firm may not receive or deliver a security by settlement date. When a firm fails to receive a security by the settlement date, a liability exists until the transaction is consummated or cancelled. When the security is not delivered to the contra-party by settlement date, a receivable exists until that "fail" is resolved. "Fails" to deliver for an extended time, or a substantial number of cancellations, are sometimes characteristic of poor operational control or questionable trading activities.

Fails should be controlled by prompt reporting and follow-up procedures. The use of multicopy confirmation forms enables operational personnel to retain and file a copy by settlement date and should allow for prompt fail reporting and resolution.

2150.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Federal Financial Institutions Examination Council policy statement, adopted by the Federal Reserve Board on November 12, 1985, on repurchase agreements			3–1579	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Risk management is an important responsibility of any bank holding company. The objective of this responsibility is to determine and limit the extent of the holding company organization's vulnerability to uncontrollable variables. While all companies perform risk evaluation in some form and exercise some degree of control over its magnitude, the precise processes used differ considerably across organizations in terms of formality, extensiveness, and effectiveness. It should be recognized that many organizations have only an implicit risk evaluation process, and that it may be appropriate to recommend that this process be formalized. Ultimately, the board of directors of the parent company should be held accountable for the consolidated risk evaluation and control.

Risk management at any level involves two basic elements: evaluation and control. Risk evaluation involves three steps: determination of exposures; specification of uncontrollable variables that have an impact on each exposure; and quantification of the expected effect of each variable on exposure. After the extent of existing or potential risk is determined, decisions to limit or control risk are made. This procedure is ever present, since most transactions create exposure, and every exposure has some element of risk. The following two sections discuss the risk evaluation and the risk control processes in very broad terms in an attempt to provide a framework that can be applied to most organizations.

2160.0.1 RISK EVALUATION

The risk identification process begins with a determination of exposures that an institution has to the environment.

Exposure conceptually occurs in every transaction undertaken by a banking organization. Because of the magnitude of the list of potential exposures, institutions generally limit their efforts to extremely large exposures, to areas where losses appear likely, and to activities where the market is changing and new exposures are created. The size of an exposure generally is dependent on the size of a transaction. This is true both for transactions recorded on accounting balance sheets and for those which occur off balance sheet. Exposure is not necessarily determined by the likelihood of loss. For example, many holding company organizations have a large "exposure" in Treasury bills, but do not consider these transactions to be risky.

The list of exposures that banks commonly identify has increased dramatically in the past decade. Historically, the primary focus has been on the exposure of the loan portfolio centering on the financial security of each individual loan; recently industry and geographical exposure of loans has increased in importance. The exposure of fixed assets, such as buildings, to fires, floods and other problems also has been recognized. In more recent years, exposure of mismatched maturities of assets and liabilities to interest rate movements has increased in importance as interest-rate movements have sharply fluctuated. While this exposure had always existed, it had not been recognized as particularly dangerous until recently. Another example of an exposure that historically was considered safe is repurchase agreements backed by government securities. When Drysdale Government Securities, Inc. failed, several risks were brought to light—whether the instrument is a loan (that would be tied up in case of bankruptcy) or a sale and potential liability when serving as an agent of a government securities firm that fails. A particularly difficult area to evaluate is exposure to legal action. For example, a suit against a bank over lending terms and representations is difficult to anticipate and the exposure could be significant.

Numerous exposures exist that many holding company organizations may not recognize. For example, the Federal Reserve System encourages evaluation of wire transfer exposure. This exposure is very large and theoretically a breakdown on the framework or compromise of internal systems could result in major failures. Exposure from foreign exchange contracts also can be large, and may not always be recognized. Fraud and exposure of management to kidnapping continue to increase in importance. And finally, some major holding company organizations have found that dependence on short-term market funds creates a risky exposure. When access to a funding market may be suddenly withdrawn, the exposure of the entire funding process is an issue.

The second step of the risk identification process is specification of the variables that could affect an exposure and determination of what the impact would be.

This process is difficult, since any number of variables may influence an exposure. Furthermore, as the environment changes new variables

may appear relevant and the effects of variables may change. For example, the recent problems of public sector lending to foreign countries with loans denominated in dollars having floating interest rates during inflationary periods may not have been fully evaluated at the time of the lending process.

Determining influential variables is particularly difficult with new products. A historical examination cannot be made of these new products and questions may go unanswered regarding the stability of the new markets. For example, problems have occurred in hedging operations as underlying instruments did not move as expected, thus negating the hedging contract. Consequently, the hedge created an exposure rather than reducing an exposure.

The final step of the risk identification process is risk quantification.

Conceptually, this involves calculation of an expected loss of value related to variance of a particular environmental factor. This has two parts: (1) estimation of the probability that a given variance will occur; and (2) determination of the cost impact of each potential variance. Probabilities are often drawn up in general terms. In some cases historical records facilitate estimation of probabilities. Measurement of credit risk in an organization that specializes by industry or geography may be an example of this. In the most recent recession, however, many past records have proven not to be accurate predictors. In other situations, the holding company organization may evaluate the effect of a change but be unwilling to estimate probabilities of the change occurring. An example of this is managing asset and liability maturities. The effect of a change in interest rates on profits may be determined; but, in many cases, institutions will not derive probabilities on the direction and/or magnitude of interest rate movements.

The difficulty of quantifying costs and probabilities is exacerbated by emergence of new products and by environmental changes. With a new product, it is particularly difficult to determine the cost of a variance. For example, attention to interest rate risk has induced organizations to resort to hedging to reduce exposure. Innovative instruments are difficult to hedge, however, since the issuer may inaccurately gauge price movements. In this case, the exposure results not from price movements, but from inability to predict the relationship between market and price fluctuations. Furthermore, as the environment changes, the effect of a variable on an exposure changes as does the cost and probability of the occurrence. For example, in the 1970's the impact of inflation on the banking system would have been very different without the concurrent economic downturn and the technological advances.

2160.0.2 RISK CONTROL

After management has identified and evaluated risk, they may decide the risk or cost of an action is sufficiently low (and management is confident all possible variables have been identified) that the holding company can take on the risk as it is; if not there are a number of options that can be used to control the risk. Attempts to control risk can be accomplished through a combination of three general techniques: purchase of insurance, limitation of exposure size, and reduction of the expected cost associated with a variance. The use of insurance to decrease the effect of a loss on the corporation is common for exposure to fire, theft, kidnapping, and internal fraud. Various types of loans are underwritten by third parties. The innovative use of insurance may prove to have various applications to risk control in the banking industry. As with other contracts, the financial strength and reputation of the counterparty (the insurer) are important, and the organization's method of selecting and monitoring underwriters should be evaluated.

Management generally limits the level of exposure in relationship to the size of assets, capital or earnings. In most situations, relating the level of exposure to capital would appear appropriate. Reduction of exposure will automatically reduce risk, assuming other variables remain constant. Constraints should be determined by line management at a seniority level commensurate with the degree of perceived risk. Depending on the degree of risk, there may be a need for the board of directors to approve the constraints.

The third method of reducing the potential loss to the corporation involves decreasing the probability of a variance occurring or decreasing the probable effect when a variance occurs. This is exemplified by the exposure to fire. Installation of fire alarms and other precautions could reduce the expected loss substantially. Similarly, hedging with financial futures is a method used to reduce the effect of interest rate movement on the profits of the holding company organization when the maturities of assets and liabilities are not equal.

The final option management has, after risk

has been evaluated, is simply not to participate in the activity if the risk is determined to be too high for the expected return.

The inspection procedures should include a broad-based evaluation of parent level risk management. Management's effectiveness in identifying risk, its willingness to accept risk, and its ability to control risk should be regularly evaluated. In an environment of rapid change and emerging financial instruments, there needs to be sufficient expertise to recognize the existence of "new" sources of risk concentration to evaluate the company's command of those sources.

2160.0.3 INSPECTION OBJECTIVES

1. To review the risk evaluation and control process.
2. To determine if management's system of identifying risks is effective, and if the parent company is adequately informed of risks throughout the organization.
3. To determine management's recognition of new risks that may arise from the changing environment.
4. To determine the reasonableness of the holding company's exposure-risk figures.
5. To assess the effect on the holding company's financial condition if the risk figures are realized.
6. To determine what actions are necessary to rebalance transactions of a holding company organization to a prudent level.

2160.0.4 INSPECTION PROCEDURES

1. Review the financial condition and the operations of the holding company organization to detect substantive exposure-risk situations.
2. Review management's policies, procedures, and practices in recognizing exposure-risk factors.
3. Determine awareness that all management levels need to be cognizant of exposures related to transactions of their respective operations.
4. Review the holding company's exposure-risk figures, or constraints placed on types of transactions.
5. Discuss with management the significance of exposure-risks facing the holding company and whether or not those risks are set at seemingly prudent levels.
6. Recommend that the organization address any areas where the holding company is perceived to have assumed an imprudent level of risk.

Purchase and Sale of Loans Guaranteed by the U.S. Government — Section 2170.0

2170.0.1 INTRODUCTION

On April 10, 1985, the Board approved a supervisory policy, via the Federal Financial Institutions Examination Council, for supervising banking organizations that participate in the purchase and sale of loans guaranteed by the U.S. government. The policy reminds those organizations that premiums received in lieu of servicing fees, with respect to the selling and servicing entity, are to be amortized over the life of the loan; and that, with respect to the purchaser, the premiums paid over the face value of the note are not guaranteed and are not paid by the guaranteeing federal agency when the loans are prepaid or in default. The statement thus cautions against paying inappropriate or excessive premiums.

2170.0.2 RECOMMENDATIONS FOR ORIGINATING AND SELLING INSTITUTIONS

Examiners should review the extent and nature of activities in connection with the sale of government guaranteed loans. Lax or improper management of the selling institution's servicing responsibilities should be criticized. Out-of-trade area lending for the purpose of resale of any portion of U.S. government guaranteed loans should be carefully reviewed to ensure that the practice is conducted in a safe and sound manner.

All income, including servicing fees and premiums charged in lieu of servicing fees, associated with the sale of U.S. government guaranteed loans, should be recognized only as earned and amortized to appropriate income accounts over the life of the loan.

2170.0.3 RECOMMENDATIONS FOR PURCHASING INSTITUTIONS

Purchasers of U.S. government guaranteed loans should be aware that the purchase premiums are not guaranteed and are not paid by the guaranteeing Federal agency when the loans are prepaid. Because payment of premiums which do not reasonably relate to the yield on the loan can distort published financial reports by overstating the value of a banking organization's assets, it will generally be viewed as an unsafe and unsound practice to pay purchase premiums which result in a significant overstatement in the value of bank assets.

Many government guaranteed loans currently being originated and sold are variable rate. These variable rate loans normally should not trade at anything more than a modest premium or discount from par. Examiners will carefully review any loans being sold or purchased at significant premiums and will criticize any involvement with excessive premiums as an unsafe and unsound business practice. Excessive purchase premiums will be classified loss. The loans will be required to be revalued to the market value at the time of the acquisition and the excessive premiums will be charged against current earnings.

In addition, any unamortized loan premium on a government guaranteed loan must be immediately charged against income if the loan is prepaid, regardless of whether payment is received from the borrower or the guaranteeing agency.

Sale of Uninsured Annuities

Section 2175.0

2175.0.1 INTRODUCTION

Banking organizations have become increasingly involved in marketing third-party uninsured annuities to their retail customers either directly or through third-party companies. As annuity sales have grown, so have concerns that some methods used to sell these instruments could give purchasers the impression that the annuities are federally insured deposits or that they are obligations of a bank. In the event of default by an annuities underwriter, this impression could cause a loss of public confidence in a depository institution, leading to unexpected withdrawals and liquidity pressures. Moreover, a bank or bank holding company that advertises or markets annuities in a way viewed as misleading could potentially be held liable for losses sustained by annuity holders.

This manual section provides guidelines to examiners for reviewing the sale of uninsured annuities by bank holding companies and banks that have legal authority to act as agent in the sale of annuities. State member banks and bank holding companies should not market, sell, or issue uninsured annuities or allow third parties to market, sell, or issue uninsured annuities on depository-institution premises in a manner that conveys the impression or suggestion that such instruments are either (1) federally insured deposits or (2) obligations of or guaranteed by an insured depository institution. Consequently, state member banks should not sell these instruments at teller windows or other areas where retail deposits are routinely accepted.

2175.0.2 PERMISSIBILITY OF UNINSURED ANNUITY SALES

The legal status of annuities under the Bank Holding Company Act is somewhat uncertain at the present time. The Office of the Comptroller of the Currency has authorized national banks to act as agent in the sale of annuities on the basis that variable-rate annuities are securities and fixed-rate annuities are financial investment instruments.[1] These determinations, however, have been challenged by insurance associations on the basis that annuities are insurance products and, therefore, may be sold by national banks only in a town of less than 5,000.[2]

State member banks generally have been permitted to engage in the brokerage of both variable- and fixed-rate annuities consistent with their general corporate powers. In order to engage in this activity without filing a formal application, staff has advised interested banks that the brokerage of annuities must be expressly authorized under state law (or by the state banking regulatory agency on a case-by-case basis) and constitute an activity incidental to the bank's banking activities.

The authority of state member banks to continue to engage in this activity, in the same manner and subject to the conditions discussed above, does not appear to depend on a resolution of the issues.[3] State member banks have been permitted to engage in general insurance agency activities since 1937,[4] and to engage in brokerage activities under the same limitations applicable to bank holding companies. In addition, the Board has determined that the nonbanking restrictions in the Bank Holding Company Act do not apply to the direct activities of banks owned by a bank holding company.[5]

The authority of bank holding companies to engage directly or through a nonbanking subsidiary in the sale of annuities has not yet been determined. In *Norwest Corporation*,[6] the Board considered a proposal by a nonbanking affiliate to engage in the sale of variable- and fixed-rate annuities. The Board concluded that, under the specific facts of that case, it was unnecessary to reach the question of whether the sale of annuities is an insurance agency activity because Norwest is one of a small number of bank holding companies entitled to act as agent in the

1. Interpretive Letter No. 331, April 4, 1985, *reprinted in* [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶85,501; OCC Interpretive Letter No. 499 (February 12, 1990), *reprinted in* [1989–1990] Fed. Banking L. Rep. (CCH) ¶83,090. National banks are authorized to buy and sell securities for the account of customers and broker financial investment instruments.

2. *The Variable Annuity Life Insurance Company v. Clarke*, No. H-91-1016 (S.D. Tex. filed Apr. 16, 1991) ("NCNB litigation").

3. NCNB litigation.

4. Prior to 1937, the Board imposed as a condition of membership in the Federal Reserve System that a bank discontinue all insurance activities other than insurance activities in a town of less than 5,000. The purpose of this restriction was to conform insurance activities allowed for state member banks to those allowed for national banks.

5. *Merchants National Corp.*, 75 Federal Reserve Bulletin 388 (1989), *aff'd*, 890 F.2d 1275 (2d Cir. 1989), *cert. denied*, 111 S. Ct. 44 (1990).

6. 76 Federal Reserve Bulletin 873 (1990).

sale of any type of insurance pursuant to Exemption G of the Garn Act.[7]

2175.0.3 CHARACTERISTICS OF ANNUITY INSTRUMENTS

An annuity is an investment from which a person receives periodic payments based on earlier payments made to the obligor. Annuities are commonly underwritten by insurance companies, then marketed and sold either directly or through third parties, such as banks. Insurance companies retain the actuarial and underwriting risks on these annuities.

Annuities may be either variable or fixed-rate. An investor in a variable annuity contract purchases a share in an investment portfolio and then receives payments that vary according to the performance of the portfolio. A purchaser of a fixed-rate annuity contract, in contrast, receives a fixed-rate payment or minimum level of payments. Annuity payments can usually be received monthly, quarterly, semi-annually, or annually.

Variable- and fixed-rate annuities may be purchased in a single lump sum (''single premium'') or in periodic contributions (''flexible premium''). Minimum and maximum contributions to annuities vary among vendors. Some single-premium annuities have ''bail-out'' features which allow holders to withdraw all funds if the rate of return on the annuity contract falls below a specified rate.

The ability to take money out of an annuity prior to maturity varies by product, as does the imposition of a surrender penalty by the insurer when withdrawal occurs prior to maturity. When a penalty is imposed, the insurer generally calculates the penalty as a percentage of the annuity product's accumulated value. The penalty for withdrawal generally declines with the annuity's age. Normally, funds may not be withdrawn prior to the first anniversary date of the annuity.[8]

Annuities sold at depository institutions often include rate guarantees over the life of the instrument. They also frequently mature in one, three, or five years, similar to maturity ranges on certificates of deposit.

Insurance companies arrange for the sale of annuities on the premises of depository institutions in different ways. Some insurance companies approach banks directly. At other times, wholesalers (who market the products of a number of different insurance companies) may approach a bank. Depending on state restrictions on insurance activities, sales might be conducted by bank employees, employees of bank subsidiary insurance agencies, or by third-party insurance agents leasing space on the bank's premises.

Sales commissions on annuities vary by the type of annuity. Commissions earned on single-premium products generally vary from 4 percent to 6 percent, but they decline sharply when the product sold includes a ''bail-out'' provision. Wholesalers may also give retailers a commission when the annuity is renewed, based on the accumulated value of the annuity. Commissions in some instances are paid on a variable basis, rising as the volume of sales increases.

2175.0.4 IMPROPER MARKETING PRACTICES

Banks have become involved in the sale of uninsured annuities through marketing programs designed to appeal specifically to their retail customers. It is important that these programs not employ marketing practices that could mislead the bank's customers. For example, the use in annuities advertisements of terms such as ''CD,'' ''deposit,'' and ''interest plan'' to imply that the instruments are insured deposits would be inappropriate. Also, advertisements that prominently display the bank's name and logo in a way that suggests the product is an obligation of the bank are similarly inappropriate. Disclosure that the annuities are not federally insured and are not obligations of the bank should be displayed prominently in annuity contracts and related documentation, on printed

7. The Garn Act amended section 4(c)(8) of the Bank Holding Company Act to prohibit generally bank holding companies from engaging in insurance activities as a principal, agent, or broker with certain exceptions. Under the express language of the Garn Act, the sale of insurance is not ''closely related to banking'' and is not permissible for a bank holding company unless it qualifies under one of the seven specified exceptions (Exemptions A–G) in the Garn Act. Exemption G applies to a limited number of bank holding companies that received approval from the Board prior to January 1, 1971, to conduct insurance agency activities. In order to utilize Exemption G or any other Garn Act exemptions that may be applicable, the bank holding company must file an application and would be subject to the proposed restrictions through the application process.

8. If an investor withdraws tax-deferred income from an annuity before the investor is 59½ years old, the IRS levies a tax penalty on the person equal to 10 percent of the amount of tax-deferred income withdrawn. This penalty may be avoided only if the person reinvests annuity proceeds in another tax-deferred investment within 60 days of the withdrawal.

advices, and verbally emphasized in telemarketing contacts. Finally, personnel selling uninsured annuities should be distinguishable from bank employees conducting normal retail deposit-taking operations.

2175.0.5 INSPECTION OBJECTIVES

1. To review the marketing and sale of uninsured annuities sold by the bank holding company and its member banks, or those sold through a third party.

2. To determine whether the bank holding company and its banks have adequate policies and procedures in place and if they are monitored by the parent company.

3. To determine if, prior to agreeing to sell annuities, a comprehensive financial analysis is made of the financial condition of the annuities underwriter and whether products of only financially secure underwriters are sold.

4. To determine whether the contract and advertising and related documents disclose prominently that the annuities do not represent deposits or obligations of an insured depository institution and that they are not insured by the Federal Deposit Insurance Corporation.

5. To ascertain that annuities are not sold at teller windows or other areas where deposits are routinely accepted.

2175.0.6 INSPECTION PROCEDURES

1. Determine whether the bank holding company and its banks have adequate policies and procedures in place:

a. to assess the financial condition of the annuities underwriter;

Banking organizations engaged in the sale of annuities are expected to sell only products of financially secure underwriters. Prior to agreeing to sell annuities, a comprehensive financial analysis of the obligor should be performed and reviewed with the banking organization's directors. The policies should also include a program to evaluate the underwriter's financial condition at least annually and to review the credit ratings assigned to the underwriter by the independent agencies evaluating annuity underwriters.

b. to ensure that the marketing and sale of uninsured annuities is not misleading and is separated and distinguished from routine retail deposit-taking activities.

(1) With regard to the sale of annuities, determine whether the contract, advertising, and all related documents disclose prominently in bold print that the annuities:

(a) are not deposits or obligations of an insured depository institution; and

(b) are not insured by the Federal Deposit Insurance Corporation.

(2) State member banks should not sell annuity instruments at teller windows or other areas where retail deposits are routinely accepted. In assessing the adequacy of disclosures and the separation of the marketing and sale of uninsured annuities from the retail deposit-taking function, examiners should take into account whether:

(a) advertisements *do not* contain words, such as "deposit", "CD", etc., or a logo that could lead an investor to believe an annuity is an insured deposit instrument;

(b) the obligor of the annuity contract is prominently disclosed, and names or logos of the insured depository institution are not used in a way that might suggest the insured depository institution is the obligor;

(c) adequate verbal disclosures are made during telemarketing contacts and at the time of sale;

(d) retail deposit-taking employees of the insured depository institution *are not engaged* in the promotion or sale of uninsured annuities;

(e) information on uninsured annuities *is not* contained in retail deposit statements of customers or in the immediate retail deposit-taking area;

(f) account information on annuities owned by customers *is not* included on insured deposit statements; and

(g) officer or employee remuneration associated with selling annuities is limited to reasonable levels in relation to the individual's salary.

(3) If a bank allows a third-party entity to market annuities on depository institution premises, examiners should take into account whether:

(a) the depository institution has assured itself that the third-party company is properly registered or licensed to conduct this activity;

(b) depository institution personnel *are not* involved in sales activities conducted by the third party;

(c) desks or offices *are not* used to market or sell annuities, are separate and dis-

tinctly identified as being used by an outside party; and

(d) depository institution personnel *do not* normally use desks or offices used by a third party for annuities sales.

2. Determine that advertisements do not prominently display the bank's name and logo that suggests the product is an obligation of a BHC bank.

3. Determine whether the banks obtain a signed statement from the customer indicating that the customer understands that the annuity is not a deposit or any other obligation of the depository institution, that the depository institution is only acting as an agent for the insurance company (underwriter), and that the annuity is not FDIC insured.

Securities Activities in Overseas Markets

Section 2180.0

Existing regulations permit banks and bank holding companies to engage in a wide range of securities activities in overseas markets. For a number of years these activities were not considered to be significant in the context of total bank and bank holding company assets. Indigenous rules and market practice served to constrain to a degree securities activities of U.S. banking organizations overseas.

Changes in local rules now make it possible for members of the London stock exchange to be wholly-owned by non-member companies and by year-end 1986 will allow stockbrokers to act as principals or market makers in securities. These new rules are expected to change significantly the complexion of the London securities market. In this context, U.S. banking organizations are making substantial investments in U.K. securities firms, and are also significantly expanding their securities business in other foreign and international markets.

The Board has expressed its concerns, in connection with an application by a banking organization to expand its securities activities overseas, that proper safeguards, limits, and controls will be exercised to protect the organization from undue risk. Applications generally state the methods through which the banking organization plans to control risk and establish oversight over securities operations. While these safeguards are initially evaluated at the time the application is made, nevertheless, examinations of bank holding companies and Edge corporations should incorporate an assessment of all overseas securities activities in order to determine the degree to which these activities conform to high standards of banking and financial prudence. The affiliation of a securities company, especially one engaged in corporate debt and equities transactions, with a banking organization raises a potential for conflict of interest and in some cases could pose substantial additional risk to the institution.

In those U.S. banking organizations where overseas securities trading and brokering are significant in scope or are prominent in the scale of the local market, examination procedures must incorporate an assessment of the controls, limits, and safeguards implemented by the organization to monitor and contain risk. Securities activities should be subject to the same degree of scrutiny and rigorous assessment of risk as bank lending activities. In addition, examiners should monitor the substance and nature of all transactions.

In particular, the following kinds of activities should be reviewed to determine whether they raise considerations of safety and soundness or otherwise do not conform to standards of prudence required of U.S. banking organizations:

- The degree of lending by a bank holding company to its securities affiliate, especially when loans are extended to support or enhance the obligations underwritten by the securities affiliate;
- The extent to which securities underwritten by an affiliate are purchased by the bank holding company as principal or trustee; and,
- The extent to which the parent is liable to an exchange for any losses incurred by the affiliate due to failure to deliver securities or settle contracts.

Violations of Federal Reserve Margin Regulations Resulting from ''Free-Riding'' Schemes — Section 2187.0

Targeted examinations and investigations by the Federal Reserve and the Enforcement Division of the Securities Exchange Commission (SEC), as well as court actions, have found banks in violation of Regulation U, Credit by Banks for the Purpose of Purchasing or Carrying Margin Stock, (12 C.F.R. 221) when their trust departments, using bank or other fiduciary funds, have extended credit to individuals involved in illegal day trading or free-riding schemes. These activities also involved the aiding and abetting of violations of two other securities credit regulations: Regulation T, Credit by Brokers and Dealers (12 C.F.R. 220), and Regulation X, Borrowers of Securities Credit, (12 C.F.R. 224).

Day trading and free-riding schemes involve the purchase and sale of stock on the same day (or within a very short period of time) and the funding of the purchases with the proceeds of the sale. Banking organizations[1] engaging in such illegal activities may subject themselves to disciplinary proceedings, as well as to substantial credit risk.

Federal Reserve examiners should ensure that banks and bank holding companies (including the broker-dealer and trust activities of banking and nonbanking subsidiaries of state member banks and bank holding companies) are not engaged in such illegal activities. Examiners must make certain that these entities have taken all steps necessary to prevent their customers from involving them in free-riding. Prompt enforcement action may be needed to eliminate free-riding activities. (See SR-93-13.)

2187.0.1 TYPICAL DAY TRADING OR FREE-RIDING ACTIVITIES

The free-riding conduct in question typically involves trading large amounts of securities without depositing the necessary money or appropriate collateral in their customer accounts. The customer seeks to free-ride, that is, purchase and sell the same securities and pay for the purchase with the proceeds of the sale. Often, free-riding schemes involve initial public offerings because broker-dealers are prohibited from financing these new issues. If the money to pay for the securities is not in the account when the securities are delivered in a delivery-versus-payment (DVP) transaction, a bank that permits completion of the transaction creates a temporary overdraft in the customer's account. This overdraft is an extension of credit that subjects the banks to Regulation U.

The typical free-riding scheme involves a new customer's opening a custodial agency account into which a number of broker-dealers will deliver securities or funds in DVP transactions. Although a deposit may be made into the custodial agency account, the amount of trading is greatly in excess of the original deposit, causing the financial institution to extend its own credit to meet the payment and delivery obligations of the account. Therefore, although the financial institution may be earning fees as a result of the activity in these accounts, it is subjecting itself to substantial losses if the market prices for the purchased securities fall or the transactions otherwise fail. In addition, other liabilities under federal banking and securities laws may be involved.

2187.0.2 SECURITIES CREDIT REGULATIONS

2187.0.2.1 Regulation U, Credit by Banks or Persons Other Than Brokers or Dealers for the Purpose of Purchasing or Carrying Margin Stocks

Any extension of credit in the course of settling customer securities transactions, including those occuring in a trust department or trust subsidiary of a bank holding company, must comply with all of the provisions of Regulation U.[2] Regulation U requires all extensions of credit for the purpose of buying or carrying margin

1. The use of the term ''banking organization'' in this section, with regard to Regulation U, means a bank, trust department of a bank, or trust company of a bank holding company that is subject to Regulation U. Regulation U includes any nondealer nonbank subsidiary of a bank holding company that extends purpose credit by margin stock. With regard to Regulation T, it refers to any nonbank company that conducts broker-dealer activities.

2. For purposes of the regulation, the definition of ''bank'' specifically includes institutions ''exercising fiduciary powers.'' (See 12 C.F.R. 221.2, 15 U.S.C. 78(c)(a)(6), and *Federal Reserve Regulatory Service* at 5–795 (1946).) When used in discussing a bank's trust department or any other type of financial institution exercising fiduciary powers, the term ''extension of credit'' includes overdrafts in settling customer's accounts that may be covered by advances from the banking organization, from other fiduciary customers, or from a combination of both.

stock that are secured by margin stock to be within the 50 percent limit. To avoid violations of the Board's securities credit regulations, on settlement date, the customer's account must hold sufficient funds, excluding the proceeds of the sale of the security, to pay for each security purchased. Although Regulation U applies only to transactions in margin stock, free-riding in nonmargin stocks in custodial agency accounts could result in a banking organization's aiding and abetting violations of Regulations T and X and other securities laws, and could raise financial safety-and-soundness issues.

2187.0.2.2 Regulation T, Credit by Brokers and Dealers, and Regulation X, Borrowers of Securities Credit

Because the custodial agency accounts are used to settle transactions effected by the customer at broker-dealers, a banking organization that opens this type of account should have some general understanding of how Regulation T restricts the customer's use of the account at the institution. Regulation T requires the use of a cash account for customer purchases or sales on a DVP basis. Section 220.8(a) of Regulation T specifies that cash-account transactions are predicated on the customer's agreement that the customer will make full cash payment for securities before selling them and does not intend to sell them before making such payment. Therefore, free-riding is prohibited in a cash account. A customer who instructs his or her agent financial institution to pay for a security by relying on the proceeds of the sale of that security in a DVP transaction is causing, or aiding or abetting, the broker-dealer to violate the credit restrictions of Regulation T. Regulation X, which generally prohibits borrowers from willfully causing credit to be extended in violation of Regulations T or U, also applies to the customer in such cases.

As described above, banking organizations[3] involved in customer free-riding schemes may be aiding and abetting violations of Regulation T by the broker-dealers who deliver securities or funds to the banking organization's customers' accounts. As long as a financial institution uses its funds to complete a customer's transactions, broker-dealers may not discover that they are selling securities to the customer in violation of Regulation T. A similar aiding and abetting violation of Regulation X could occur if a customer used the financial institution to induce a broker-dealer to violate Regulation T.

3. For a discussion of Regulation T as it applies to a bank holding company's broker-dealer nonbank subsidiary, see section 3230.0.

2187.0.3 NEW-CUSTOMER INQUIRIES AND WARNING SIGNALS

Examiners should make certain that all banks and other financial-institution subsidiaries of a bank holding company are administering and following appropriate written policies and procedures concerning the establishment of custodial agency accounts or any new account involving customer securities transactions. Such policies and procedures should address, among other things, ways an institution can protect itself against free-riding schemes. One way is to obtain adequate background and credit information from new clients, including whether the customer intends to obtain credit to use with the account. This type of activity requires more extensive monitoring than the typical DVP account in which no credit is extended. It would be prudent to inquire why a new customer is not using the margin-account services of its broker-dealers. If the account is to be used as a margin account, a financial institution must obtain Form FR U-1 from the customer and must sign and constantly update the form.

The financial institution should obtain from the customer a list of broker-dealers that will be sending securities to or receiving funds from the account in DVP transactions. If a number of broker-dealers may be used, the institution should obtain from the customer a written statement that all transactions with the broker-dealer will conform with Regulations T and X and that the customer is aware that a security purchased in a cash account is not to be sold until it is paid for. Similarly, when obtaining instructions for settling DVP transactions for a customer, the financial institution should clarify that it will not rely upon the proceeds from the sale of those securities to pay for the purchase of the same securities.

2187.0.4 SCOPE OF THE INSPECTION FOR FREE-RIDING ACTIVITIES

Examiners, bank holding companies, state member banks, and financial-institution and trust subsidiaries owned by bank holding companies (also U.S. branches and agencies of foreign

banks exercising trust powers) should ensure that their banking organizations monitor accounts closely for an initial period to detect patterns typical of free-riding, including intraday overdrafts, and to ensure that sufficient funds or margin collateral are on deposit at all times. Frequent transactions in securities being offered in an initial public offering may suggest an avoidance of Regulations T and X. If it appears that a customer is attempting to free-ride, the financial institution should immediately alert the broker-dealers involved in transferring securities and take steps to minimize its own credit risk and legal liability.

At a minimum, examiners should also evaluate a trust institution's ability to ensure that it does not extend to a customer more credit on behalf of a bank or other financial institution than is permitted under Regulation U. If there are any questions in this regard, examiners should consult with their Reserve Bank's trust examiners. Any overdraft that is related to a purchase or sale of margin stock, and that is secured by margin stock, is an extension of credit subject to the regulation, including overdrafts that are outstanding for less than a day. Board staff have published a number of opinions discussing the application of Regulation U to various transactions relating to free-riding.

Free-riding violations that could endanger the banking organization (for example, fraudulent activities that could subject the organization to losses or lawsuits), as well as significant violations that were previously noted but have not yet been corrected, should be noted in the inspection report. Violations of the Board's Regulation T, U, or X, as applicable to the inspection, should be reported on the Examiner's Comments and Violations report pages. The report should discuss what action has or will be taken to correct those violations.

2187.0.5 SEC AND FEDERAL RESERVE SANCTIONS AND ENFORCEMENT ACTIONS

The SEC, in exercising its broad authority to enforce the Board's securities credit regulations, requires banks to (1) establish credit compliance committees to formulate written policies and procedures concerning the extension of purpose credit in their securities-clearance business, (2) establish training programs for bank personnel responsible for the conduct of their securities-clearance business, and (3) submit to outside audits to verify their compliance with the conditions of injunctions. The Board may also institute enforcement proceedings against the banking organizations it supervises and against any institution-affiliated parties involved in these activities, including cease-and-desist orders, civil money penalty assessments, and removal and permanent-prohibition actions.

2187.0.6 INSPECTION OBJECTIVES

1. To make certain that policies of the bank holding company's board, and the supervisory operating procedures, internal controls, and audit procedures will ensure, in the course of settling customers' securities transactions—
   a. that bank extensions of credit within the holding company comply with the provisions of Regulation U (including the requirement that initial extensions of credit that are secured by margin stock are within the initial 50 percent margin limit) and
   b. that customer accounts hold sufficient funds on the settlement date for each security purchased.
2. To determine—
   a. whether the banking organizations of the bank holding company can adequately monitor compliance with Regulation U through systems of internal controls, training, and compliance procedures (i.e., use of credit compliance committees) that address free-riding activities within the "back-office function"[4] and
   b. whether noncompliance is properly reported.
3. To initiate corrective action when policies, practices, procedures, or internal controls are not sufficient to prevent free-riding schemes, and when violations of the Board's regulations have been noted by bank examiners or self-regulatory organizations.

2187.0.7 INSPECTION PROCEDURES

1. Review the bank holding company's board of directors' policies for its banking institution subsidiaries regarding supervisory operational policies, procedures, and internal controls for loans extended for the purpose

4. Refers to the movement of cash and securities relating to trades and to the processing and recording of trades. This process is also called the "securities-clearance cycle."

of buying or carrying margin stock and secured directly or indirectly by margin stock.

a. Determine whether the policies require, for *each* extension of credit not specifically exempted under Regulation U, that a Form FR U-1 be executed and signed by the customer and accepted and signed by a duly authorized officer of the banking organization acting in good faith.

b. Determine whether the policies limit extensions of credit to no more than the maximum allowed loan value of the collateral, as set by section 221.7 of Regulation U, and whether those policies require adherence to margin requirements.

2. Review the bank holding company's board of directors' credit policies and operating policies, internal controls, and internal audit procedures to determine if they provide adequate safeguards against customers' free-riding practices. In so doing—

a. determine if new-customer accounts are required to be approved by appropriate personnel; and

b. establish whether the bank holding company's credit-system policies require—

- controlling securities positions and financial-instrument contracts that serve as collateral for loans;
- monitoring established restrictions and limits placed on the amounts and types of transactions to be executed with each customer and the dollar amounts placed on unsettled trades;
- obtaining appropriate documentation consisting of essential facts pertaining to each customer, and in particular, financial information evidencing the customer's ability to pay for ordered securities, repay extensions of credit, and meet other financial commitments;
- monitoring the location of all collateral;
- ensuring that there are no overdrawn margin accounts; and
- monitoring the status of failed transactions for the purpose of detecting free-riding schemes.

3. Determine if the bank holding company's audit committee or its internal or external auditors are required to review a selected random sample of individual or custodial agency accounts for customer free-riding activities.

2187.0.8 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Credit by brokers and dealers		220 (Reg. T)		
Regulation U, Credit by Banks or Persons Other Than Brokers or Dealers for the Purpose of Purchasing or Carrying Margin Stocks		221 (Reg. U)		
Purpose credit—delivery-versus-payment transactions			5–942.15, 5–942.18, 5–942.2, 5–942.21, 5–942.22	
Borrowers of securities credit		224 (Reg. X)		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

2220.3.1 NOTE ISSUANCE FACILITY (NIF)

One type of off-balance-sheet activity is the note issuance facility (NIF). The first public facility was arranged in 1981. A NIF is a medium-term arrangement under which a borrower can issue short-term paper. The paper is issued on a revolving basis, with maturities ranging from as low as 7 days to up to one year. Underwriters are committed either to purchasing any unsold notes or to providing standby credit. Bank borrowing usually involves commercial paper consisting of short-term certificates of deposit and for nonbank borrowers it would generally be promissory notes (Euronotes). NIF is the most common term used for this type of arrangement. Other terms include the revolving underwriting facility (RUF), and the standby note issuance facility (SNIF). NIFs, RUFs, and SNIFs are essentially the same credit product. The NIF is usually structured for 5 to 7 years.

Euronotes are denominated in US dollars and are issued with high face values (often $500,000 or more), being intended for the more sophisticated investor (professional or institutional investors). Holders of the notes show them as an asset on their balance sheets. The underwriting commitment represents an off-balance sheet item. The NIF allows the various functions performed by a single institution in a syndicated credit to be separated and performed by different institutions.

Instead of lending money, as in a syndicated credit, the NIF arranger provides a mechanism for placing notes with other investors when funds are needed. The underwriting commitment transforms the maturity, assuring the borrower access to short-term funds over the medium term, which remains off-balance sheet, unless drawn upon. The underwriters take the short-term credit risk since they face the risk of lending to a borrower that has difficulty in obtaining full confidence from investors.

NIFs can be arranged with an issuer-set margin whereby the issuer determines the margin over LIBOR (the London Interbank Offered Rate), or some other index at which notes will be offered. The issuer thus benefits from any improvement in market conditions. The notes are placed by the placing agent, but senior underwriters have the option of purchasing a prearranged share of any notes issued. Any notes not taken up at the issuer-set margin are distributed to underwriters at the pre- established maximum (cap) rate.

2220.3.2 REVOLVING UNDERWRITING FACILITY (RUF)

Another type of facility, a revolving underwriting facility (RUF), was introduced in 1982. A revolving underwriting facility is a medium-term revolving commitment to guarantee the overseas sale of short-term negotiable promissory notes (usually a fixed-spread over LIBOR) issued by the borrower at or below a predetermined interest rate. RUFs separate the roles of the medium-term risk-taker and the providers of the funding (the short-term investors). RUFs and NIFs allow access to capital sources at interest rates considerably below conventional financing rates. The savings in interest cost are derived because the borrower obtains the lower interest costs prevailing in the short-term markets, while still retaining the security of longer term financing commitments. The notes issued under RUFs are attractive for institutional investors since they permit greater diversification of risk than the certificates of deposit of only one bank. Underwriters favor them because their commitments do not appear on the statement of financial condition. RUFs are usually structured for periods of four to seven years.

A revolving underwriting facility (RUF) differs from a (NIF) in that it separates the functions of underwriting and distribution. With a RUF, the lead bank (manager or arranger) acts as the only placing agent. The arranger retains total control over the placing of the notes. The lead bank provides assistance to a borrower who forms a lending group of banks. The borrower, assisted by a lead bank (arranger), obtains a medium term revolving commitment that guarantees the sale of short-term negotiable promissory notes at or below a pre-determined interest rate. The participating group of banks arrange the funding, subject to certain lending conditions and rates, for the duration of the facility. In return, the borrower pays a facility fee to the revolving credit banks.

When the borrower desires funds, a placement agent or tender panel[1] places short-term notes with other banks and institutional investors (usually having maturities of 90 days, 180 days or 12 months). The short term notes can be issued to these investors at significantly lower interest rates than would be available from a revolving credit facility that the same banks would have been willing to provide. The note purchasers generally have a rollover option at maturity and new note purchasers are added as needed. The note purchasers bear the risk of loss in the event of default by the borrower. New note purchasers are added as needed. In the event the full line of credit is not placed with the note purchasers on any rollover date, the revolving credit banks must make funding available for the difference at the previously committed revolving credit interest rates, subject to the terms and conditions within the agreement.

With the RUF, and the use of a sole placing agent, the underwriters are not assured of securing any notes that they could place themselves nor can they benefit from any improvement in terms available in the market. The hindrance is removed by the use of NIFs with an issuer-set margin whereby the issuer determines the margin over an index at which notes will be offered.

Another form of a RUF is a transferable revolving underwriting facility (TRUF). With this arrangement the underwriter is able, with the borrower's approval, to transfer all rights and obligations under the underwriting commitment to another institution at any time during the life of the facility.

2220.3.3 RISK

The loan commitments involved in NIF and RUF transactions contain substantially the same terms as other loan commitments extended to similar borrowers. The failure of the borrower to satisfy the revolving standby agreement relieves the banks of any obligation to fund the transaction. The major source of risk is thus the liquidity risk that is derived from the uncertainty of the timing or amount of required funding. If the underlying notes cannot be marketed at or below the interest rate specified in the agreement, the bank would need to discount the notes to whatever rate would be necessary to make the notes attractive to investors, perhaps taking an up-front loss to avoid funding a low margin loan.

NIFs and RUFs involve less credit risk than extensions of credit because of the additional step that is required before funding takes place, a step that is not present with a revolving credit agreement. In other words, no funding is required until: (1) a decision is made by the borrower to issue notes; and (2) the placing agent becomes unable to place the short-term notes with short-term investors. Further, the risk of loss rests with the note investors. The underwriter's risk of nonpayment is not present until the rollover date. If there has been a significant deterioration in the issuer/borrower's financial condition on that date, the issuer/borrower may be prevented from drawing under the facility. This would be dependent on the funding conditions or the cancellation provisions stipulated in the agreement.

2220.3.4 PRICING AND FEES

The forms of compensation involving a NIF and RUF are: the underwriting and commitment fee; the one-time arrangement fee, and the periodic placement fees. An annual fixed underwriting fee is paid by the borrower on the amount of underlying commitment. This fee must be paid regardless of the frequency of usage of the facility or whether or not the underwriters are required to make any purchases of the short-term paper. This compensation is for the commitment to underwrite the issuance of the notes. The arranger receives a one-time arrangement fee based on a percentage of the amount of the facility. The issuer pays the borrowing costs on the notes issued, usually at a spread above or below an index. A portion of this borrowing fee is retained by the placement agent or the tender panel members as compensation for placing the paper.

Competitive pricing on NIFs and RUFS causes them to be very thinly margined. Commitment fees may be as low as 5 basis points for blue chip customers, while "BBB" credit-rated or equivalent borrowers might be charged as much as 20 basis points. Because of the thin spread some banks may only be serving as an

1. The tender panel was introduced in 1983. It is usually made up of several commercial investment banks and other institutional investors. The panel members bid for any notes issued, up to a predetermined maximum spread. The revolving credit banks can bid as part of the tender panel, but they are not required to do so. Any notes not bid for are purchased by the revolving credit banks or they extend credit of an equal amount. The tender panel may be a continuous tender panel whereby the underwriters are entitled to purchase notes from the lead manager up to their pro rata share at any time during the offer period, if available, at the market price.

arranger, preferring to not participate in the market. Typical fees for this service may consist of: an up-front arrangement fee of 20 basis points on the total principal amount of the facility, and an annual placement fee such as 12.5 basis points on the short-term notes sold. Revolving credit banks usually receive facility fees and annual maintenance fees.

If the underwriters have to purchase the notes, the backup rate of interest may be the index plus 10 to 15 basis points for blue chip companies to plus 37.5 basis points over the index for ''BBB'' rated borrowers. The interest rates charged (if funded) are usually lower because of market-pricing conventions (lower spreads) and the intense competition within the market.

2220.3.5 STANDBY RUFS

Some RUFS may provide for a utilization fee or may provide for a higher yield on the notes in the event that more than a nominal amount of paper is allocated to the underwriters. Such a provision would more likely be found in a standby facility. Standby facilities are backup commitments under which notes are not expected to be issued. This provision essentially protects the underwriter from having to book loans that are earning an insufficient yield. The structure of the facility generally determines its pricing depending upon the requirements of the issuer/borrower.

Standby RUFs substitute for committed bank lines which may be used, for example, as backup commitments for issuance of U.S. commercial paper. Commitment fees will be low because of the low probability that funds will need to be advanced. A standby facility will make borrowing from the underwriter very expensive in relation to what the issuer might have to pay. Otherwise, the underlying notes are issued on a regular basis, the maximum yield on the notes is set to approximate the normal market level for the issuer's short term borrowings.This facility would have a higher underwriting fee than a standby facility, because the regular issuances of notes increase the likelihood that the underwriting bank will have to purchase notes that cannot be placed.

2220.3.6 RUF DOCUMENTS

The *revolving credit agreement* is the primary document in a RUF. It includes the principal agreement of the transaction, executed by the revolving credit banks and the borrower. It contains the terms and conditions under which the borrower can draw on the facility. The document includes the financial covenants and events of default.

An *agency agreement* between the borrower and the placement agent designates the placement agent for the notes and sets forth the conditions of the agent's obligations for arranging the sale of the notes. Included are representations and warranties of the borrower regarding the authority to enter into the agreement and to issue the notes.

A description of the terms and conditions of the facility is contained within an *information memorandum*. Detail is provided with regard to the use of the proceeds, current and historical financial information, a description of the company, its finances and operations. It is distributed to prospective credit banks and note purchasers.

The *note* is the last document involving a RUF. Usually the notes will be unsecured obligations of the borrower and will include representations and warranties of the company regarding authorization and the absence of material litigation and bankruptcy proceedings. It will also contain a statement that a revolving credit facility is available to the borrower.

The Board has a long-standing policy on real estate appraisals, which emphasizes the importance of sound appraisal policies and procedures in a banking organization's real estate lending activity. In December 1987, the Board and the other bank regulatory agencies jointly adopted guidelines for real estate appraisal policies and review procedures. With the passage of the Federal Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the Board, in August 1990, as well as the other federal financial institutions regulatory agencies, adopted regulations to implement the statute's title XI provisions (12 U.S.C. 3310, 3331–3351, and 1844(b)) relating to the performance and use of appraisals by federally regulated financial institutions. On June 7, 1994, the Board and the federal financial institutions regulatory agencies adopted several amendments to their appraisal regulations to clarify the agencies' appraisal requirements.[1] Additionally, the Board revised its guidelines for real estate appraisal and evaluation programs in September 1992 and October 1994. (See SR-94-50, SR-94-55, SR-95-16, SR-95-27, and SR-95-31 (SUP).)

The intent of title XI of FIRREA and subpart G of the Board's Regulation Y (12 CFR 225) is to protect federal financial and public policy interests in real estate–related financial transactions requiring the services of an appraiser. The statute requires that real estate appraisals be prepared in writing, in accordance with uniform standards, and by individuals with demonstrated competency and whose professional conduct is subject to effective supervision.

Title XI permitted each state to establish a program for certifying and licensing real estate appraisers who are qualified to perform appraisals in connection with *federally related transactions*.[2] Additionally, title XI designated the Appraisal Foundation, a nonprofit appraisal industry group, as the authority for establishing qualifications criteria for appraiser certification and standards for the performance of an appraisal. The states were authorized by title XI to establish qualification standards for licensing. It established the Appraisal Subcommittee of the Federal Financial Institutions Examination Council to monitor the requirements established to meet the intent of title XI.

The Board's appraisal regulation requires appraisals performed in connection with federally related transactions entered into after August 9, 1990, to comply with the regulation. Real estate–related financial transactions entered into before August 9, 1990, would have had to comply with the Board's supervisory guidelines, issued in 1987, as well as with safe and sound banking practices. Transactions are deemed to have been entered into and a loan is deemed to have been originated if there was a binding commitment to perform before the effective date. The requirement to use a state-certified or -licensed appraiser has a separate effective date, December 31, 1992.[3]

2231.0.1 APPRAISAL AND EVALUATION POLICY

A banking organization's board of directors is responsible for adopting policies and procedures that establish effective real estate appraisal and evaluation programs. Analyzing real estate collateral at a loan's inception and over its life requires a sufficient understanding of appraisals and evaluations to fully assess credit risk. While the appraisal plays an important role in the loan-approval process, undue reliance should not be placed on the collateral value in lieu of an

1. The appraisal standards for federally related transactions are found in sections 225.61 to 225.67 of subpart G of Regulation Y. Section 225.63 was amended, effective December 28, 1998, to exclude from the Board's appraisal requirements transactions that involve underwriting or dealing in mortgage-backed securities. The amendment permits bank holding company subsidiaries engaged in underwriting and dealing in securities to underwrite and deal in mortgage-backed securities without demonstrating that the loans underlying the securities are supported by appraisals that meet the Board's appraisal requirements. See 1999 FRB 50.

2. *Federally related transaction* refers to any real estate–related financial transaction entered into on or after August 9, 1990, that (1) the Board or any regulated institution engages in or contracts for and (2) requires the services of an appraiser. A *real estate–related financial transaction* is any transaction involving (1) the sale, lease, purchase, investment in, or exchange of real property, including interests in property, or the financing thereof; (2) the refinancing of real property or interests in real property; or (3) the use of real property or interests in property as security for a loan or investment, including mortgage-backed securities.

3. States have the flexibility to adopt an earlier implementation date regarding state requirements that an appraiser be certified or licensed to perform an appraisal within his or her state. Financial institutions doing business in a state that has an earlier effective date for mandatory use of a certified or licensed appraiser than the federally mandated effective date will have to abide by any state laws.

adequate assessment of the borrower's repayment ability. However, when a credit becomes troubled, the primary source of repayment often shifts from the borrower's capacity to repay to the value of the collateral. For these reasons, it is important to have sound appraisal policies and procedures.

2231.0.1.1 Appraisal and Evaluation Programs

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

Appraisal and evaluation programs should also establish the manner in which the institution selects, evaluates, and monitors individuals who perform real estate appraisals or evaluations. Key elements of the programs should ensure that individuals are fairly considered for the assignment, possess the requisite expertise to satisfactorily complete the assignment, hold the proper state certification or license if applicable, and are capable of rendering a high-quality, written appraisal or evaluation.

2231.0.1.2 Real Estate Appraisal Compliance Procedures

To ensure compliance with the Board's real estate appraisal regulation and supervisory guidelines, the banking organization should have established regulatory compliance procedures for all appraisals and evaluations. The compliance review may be part of a loan officer's overall credit analysis and may take the form of a narrative or checklist. The individual who prepared the appraisal or evaluation should take corrective action for noted deficiencies. Unreliable appraisals or evaluations should be replaced before the final credit decision. Formal documentation or evidence of the review should be maintained.

Additionally, a banking organization should have comprehensive analytical procedures that focus on certain types of loans, such as large-dollar credits, loans secured by complex or specialized properties, nonresidential construction loans, or out-of-area real estate loans. The banking organization should establish criteria for identifying which appraisals should be considered for more comprehensive analytical procedures. These comprehensive analytical procedures should be designed to verify the appropriateness of the methods and approaches used in the appraisal and assess the reasonableness of the appraiser's analysis, opinions, and conclusions.

Formal documentation to support the comprehensive analytical procedures should be maintained. An individual performing this analysis, either an employee of the banking organization or an outside consultant, should have real estate–related training or experience and be independent of the transaction. The individual may not change the appraisal's or evaluation's estimate of value as a result of the review—unless that person is appropriately licensed or certified and performs the review according to procedures in the Uniform Standards of Professional Appraisal Practice (USPAP), standard 3.

2231.0.1.3 Reappraisals and Reevaluations

A program should be developed for obtaining reappraisals or reevaluations as part of a program of prudent portfolio review and monitoring techniques—even when additional financing is not being contemplated. Examples include large-credit exposures and out-of-area loans. The decision to reappraise or reevaluate the real estate collateral for a subsequent transaction should be guided by the appraisal exemption for renewals, refinancings, and other subsequent transactions. Loan workouts, debt restructurings, loan assumptions, and similar transactions involving the addition or substitution of borrowers may qualify for the exemption for renewals, refinancings, and other subsequent transactions. Use of this exemption, however, depends upon the condition and quality of the loan, the soundness of the underlying collateral, and the validity of the existing appraisal or evaluation.

A loan may be renewed or refinanced based on a valid appraisal or evaluation if the planned future use of the property is consistent with the use identified in the appraisal or evaluation. However, if the property has reportedly appreciated because of a planned change in use, such as rezoning, an appraisal would be required for a federally related transaction—unless another exemption applied (for example, if the amount financed is below the appraisal threshold).

While the Board's appraisal regulation generally allows appropriate evaluations of real estate collateral in lieu of an appraisal for loan renewals and refinancings, in certain situations an appraisal is required. If new funds in excess of reasonable closing costs are advanced, a new appraisal for the renewal of an existing transaction should be obtained when there is a material change in market conditions that threatens the banking organization's real estate collateral protection.

For loan workouts, a reappraisal or reevaluation may be prudent, even if it is obtained after the modification. If there is an expected delay in obtaining the appraisal or evaluation, the banking organization should first protect its interest to facilitate the orderly collection of the loan or to reduce the risk of loss. In a troubled-loan situation, a reappraisal would not be required when a banking organization advances funds to protect its interest in a property, such as to repair damaged property, because these funds are being used to restore the damaged property to its original condition.

Real estate posted as collateral that has been acquired by a banking organization through foreclosure or deed in lieu of qualifies for the appraisal exemption for subsequent transactions. Therefore, the banking organization is only required to have an evaluation but may first initiate the foreclosure proceedings to protect its collateral interests before obtaining the evaluation. Because the sale or disposal and the financing of the sale of other real estate owned (OREO) do not arise from an existing extension of credit, these OREO transactions do not qualify for the appraisal exemption. Thus, a banking organization is required to have a valid appraisal to support the sale of OREO unless the transaction qualifies for another appraisal exemption. If the banking organization already has a valid appraisal (or an evaluation) of the real estate, it need not obtain a new appraisal.

2231.0.2 TRANSACTIONS NOT REQUIRING THE SERVICES OF A LICENSED OR CERTIFIED APPRAISER

The Board has determined that certain categories of real estate–related financial transactions do not require the services of a certified or licensed appraiser and, as such, are not considered federally related transactions.

Transactions not requiring the services of a certified or licensed appraiser include transactions in which—

1. the transaction value[4] is $250,000 or less;
2. a lien on real property has been taken as collateral in an abundance of caution;
3. the transaction is not secured by real estate;
4. a lien on real estate has been taken for purposes other than the real estate's value;
5. the transaction is a business loan that has a transaction value of $1 million or less and is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment;
6. a lease of real estate is entered into, unless the lease is the economic equivalent of a purchase or sale of the leased real estate;
7. the transaction involves an existing extension of credit at the lending institution, provided that there has been no obvious and material change in market conditions or physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies, or there is no advancement of new monies, other than funds necessary to cover reasonable closing costs;
8. the transaction involves the purchase, sale, investment in, exchange of, or extension of credit secured by a loan or interest in a loan, pooled loans, or interests in real property, including mortgage-backed securities, and each loan or interest in a loan, pooled loan, or real property interest met the Board's regulatory requirements for appraisals at the time of origination;
9. the transaction is wholly or partially insured or guaranteed by a U.S. government agency or U.S. government–sponsored agency;
10. the transaction either qualifies for sale to a U.S. government agency or U.S. government–sponsored agency, or involves a residential real estate transaction in which the appraisal conforms to the Federal National Mortgage Association or Federal Home Loan Mortgage Corporation appraisal standards applicable to that category of real estate;

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

11. the regulated institution is acting in a fiduciary capacity and is not required to obtain an appraisal under any other law;
12. the transaction involves underwriting or dealing in mortgage-backed securities;[5] or
13. the Board determines that the services of an appraiser are not necessary to protect federal financial and public policy interests in real estate–related financial transactions or to protect the safety and soundness of the institution.

For transactions below the appraisal threshold, qualifying for the $1 million or less business-loan exemption, or qualifying for the existing extension-of-credit exemption, the Board still requires an appropriate evaluation of the real property collateral that is consistent with safe and sound banking practices.

The Board reserves the right to require an appraisal on an exempt transaction whenever it is necessary to address safety-and-soundness concerns. Whether a banking organization will be required to obtain an appraisal for a particular transaction or an entire group of credits will depend on its condition. For example, if a banking organization is in troubled condition that is attributable to underwriting problems in its real estate loan portfolio, the Board may require the banking organization to obtain an appraisal for all new transactions below the threshold. However, regardless of a banking organization's condition, an examiner may require an appraisal for a particular real estate–related transaction to address safety-and-soundness concerns.

2231.0.3 OBTAINING AN APPRAISAL

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

5. This Regulation Y exemption from the Board's appraisal standards was effective on December 28, 1998.

For a multiphased development or construction loan, the appraisal of an earlier phase cannot be used for a new phase due to the change in risk. However, if the original appraisal was prepared for all phases of the project, the project appraisal may be used if the appraisal's value for the new phase is still valid at the time additional credit is extended.

2231.0.4 USEFUL LIFE OF AN APPRAISAL

Since a banking organization may wish to use an existing appraisal or evaluation for a subsequent loan or investment, its appraisal and evaluation program should include criteria to determine the validity of an existing appraisal or evaluation. The useful life of an appraisal will vary, depending on the circumstances surrounding the property and the marketplace. When deciding if an appraisal or evaluation may be used for a subsequent transaction, a banking organization should determine if any material changes to the underlying assumptions have occurred that would affect the original estimate of value.

Examples of factors that could cause material changes to reported values include the passage of time; the volatility of the local market; the availability of financing; the inventory of competing properties; new improvements to, or lack of maintenance of, the subject or competing, surrounding properties; a change in zoning; or environmental contamination. The banking organization should document its information sources and analyses used to determine if an existing appraisal or evaluation remains valid. It should also document whether the banking organization will be using that appraisal or evaluation in a subsequent transaction.

2231.0.5 APPRAISAL REQUIREMENTS

The objective of an appraisal is to communicate the appraiser's reasoning and conclusions logically so that the reader is led to the appraiser's estimation of market value. The contents of appraisals should conform to the standards of the Board's appraisal regulation and to those established in USPAP as promulgated by the Appraisal Standards Board of the Appraisal Foundation. The actual form, length, and content of appraisal reports may vary, depending on the type of property being appraised and the nature of the assignment. Standard forms com-

pleted in compliance with the regulation and USPAP are also acceptable.

2231.0.5.1 Appraisal Standards

The minimum standards for appraisals performed in connection with federally related transactions are those set forth in USPAP, as well as any other standards that the Board deems necessary. In summary, an appraisal must—

1. conform to the generally accepted appraisal standards as evidenced by USPAP, unless principles of safe and sound banking require compliance with stricter standards;
2. be written and contain sufficient information and analysis to support the banking organization's decision to engage in the transaction;
3. analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units;
4. be based on the definition of market value as set forth in the regulation; and
5. be performed by state-licensed or -certified appraisers in accordance with the requirements in the regulation.

The Board's appraisal regulation also permits banking organizations to use appraisals prepared according to the USPAP Departure Provision, which permits limited exceptions to ''specific guidelines'' in USPAP. Appraisers using the Departure Provision still must comply with all ''binding requirements'' of USPAP and must be sure that the resulting appraisal will not be misleading.

2231.0.5.2 Appraisal Assignment

A banking organization may engage an appraiser to perform an appraisal assignment, either a complete or a limited appraisal. In a complete appraisal assignment, an appraiser must meet all USPAP standards and guidelines in estimating market value. In a limited appraisal assignment, the appraiser elects to depart from certain specific guidelines by invoking the Departure Provision. Before beginning the appraisal, the appraiser must obtain the banking organization's concurrence that the use of the Departure Provision is appropriate for the transaction. The appraiser must ensure that the resulting appraisal report will not mislead the banking organization or other intended users of the appraisal report. The banking organization should realize that as the degree of departure increases, the extent of reliability of the limited appraisal decreases, resulting in a higher level of risk.

2231.0.5.3 Appraisal Reports

The appraisal report usually includes a disclosure of sales history and an opinion as to the highest value and best use of the property. After preparing a report, appraisers must certify that—

1. statements of fact are true and correct,
2. limiting conditions have been disclosed,
3. they have no interest (present or future) in the transaction or property,
4. compensation is not contingent on rendering a specified value,
5. they have complied with USPAP,
6. an inspection of the property was or was not performed, and
7. assistance was or was not received in the preparation of the appraisal.

Three different report formats can be used for either the complete or the limited appraisal assignment: a self-contained report, a summary report, and a restricted report. Since USPAP requires all appraisal reports to encompass all aspects of the assignment, reports will differ based on the degree of detail presented. The self-contained appraisal report provides the most detail; the summary appraisal report condenses the information; and the restricted appraisal report presents minimal information, with supporting details maintained in the appraiser's work files.

The restricted report is not appropriate for a significant number of federally related transactions because the minimal amount of information limits the usefulness of the document for underwriting, compliance, and other decision-making purposes. However, a restricted report might be used when providing ongoing collateral monitoring of a banking organization's real estate transactions and under other circumstances when a banking organization's program requires an evaluation.

2231.0.5.4 Appraisal Content

The appraisal must reflect a market value of the real estate. The regulation defines market value

as the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from the seller to the buyer under conditions whereby—

1. the buyer and seller are typically motivated,
2. both parties are well informed or well advised and acting in what they consider their own best interests,
3. a reasonable time is allowed for exposure in the open market,
4. payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto, and
5. the price represents the normal consideration for the property sold, unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

To properly underwrite a construction loan, a banking organization may need to know the prospective value of a property and its market value as of the appraisal date. Prospective value is based on events yet to occur, such as completion of construction or renovation, reaching stabilized occupancy, or some other event yet to be determined. Thus, more than one value may be reported in an appraisal as long as all values are clearly described and reflect the projected dates when future events could occur. Assumptions and projections used to develop prospective value estimates must be fully supported and reasonable in light of current market conditions.

2231.0.6 APPRAISAL VALUATION APPROACHES

The appraiser typically uses three market-value approaches to analyze the value of property:

1. cost approach
2. comparable-sales approach
3. capitalization-of-income approach

All three approaches have particular merits depending on the type of real estate being appraised. For single-family residential property, the cost and comparable-sales approaches are most frequently used since the common use of the property is the personal residence of the owner. However, if a single-family residential property is intended to be used as a rental property, the appraiser would have to consider the income approach as well as the cost and comparable-sales approaches. For special-use commercial properties, the appraiser may have difficulty obtaining sales data on comparable properties and may have to base the value estimate on the cost and capitalization of income approach. If an approach is not used in the appraisal, the appraiser should disclose the reason the approach was not used and whether this had an impact on the value estimate.

2231.0.6.1 Value Correlation

The three value estimates—cost, market, and income—must be evaluated by the appraiser and correlated into a final value estimate based on the appraiser's judgment. Correlation does not imply averaging the value estimates obtained by using the three different approaches. When these value estimates are relatively close together, correlating them and setting the final market-value estimate presents no special problem. However, if widely divergent values are obtained by using the three appraisal approaches, the appraiser must exercise judgment in analyzing the results and determining the estimate of market value.

2231.0.6.1.1 Cost Approach

In the cost approach to value estimation, the appraiser obtains a preliminary indication of value by adding the estimated depreciated reproduction cost of the improvements to the estimated land value. This approach is based on the assumption that the reproduction cost is the upper limit of value and that a newly constructed building would have functional and mechanical advantages over an existing building. The appraiser would evaluate any depreciation, that is, disadvantages or deficiencies, of the existing building in relation to a new structure.

The cost approach consists of four basic steps: (1) estimate the value of the land as though vacant, (2) estimate the current cost of reproducing the existing improvements, (3) estimate depreciation and deduct from the reproduction-cost estimate, and (4) add the estimate of land value and the depreciated reproduction cost of improvements to determine the value estimate.

2231.0.6.1.2 Comparable-Sales Approach

The focus of this approach is to determine the recent sales price of similar properties. Through an appropriate adjustment for differences in the subject property and the selected comparable properties, the appraiser estimates the market value of the subject property based on the sales price of the comparable properties. To determine the extent of comparability of two or more properties, the appraiser must judge their similarity with respect to age, location, condition, construction, layout, and equipment. The sales or list price of those properties that the appraiser determines to be most comparable will tend to set the range for the value of the subject property.

2231.0.6.1.3 Income Approach

The income approach estimates the project's expected income over time converted to an estimate of its present value. The income approach typically is used to determine the market value of income-producing properties such as office buildings, apartment complexes, hotels, and shopping centers. In the income approach, the appraiser can use several different capitalization or discounted-cash-flow techniques to arrive at a market value. These techniques include the band-of-investments method, mortgage-equity method, annuity method, and land-residual technique. The use of a particular technique will depend on whether there is project financing, there are long-term leases with fixed-level payments, and the value is being rendered for a component of the project such as land or buildings.

The accuracy of the income approach depends on the appraiser's skill in estimating the anticipated future net income of the property and in selecting the appropriate capitalization rate and method. The following data are assembled and analyzed to determine potential net income and value:

1. Rent schedules and the percentage of occupancy for the subject property and for comparable properties for the current year and several preceding years. This information provides gross rental data and the trend of rentals and occupancy, which are then analyzed by the appraiser to estimate the gross income the property should produce.
2. Expense data such as taxes, insurance, and operating costs being paid from revenues derived from the subject property and comparable properties. Historical trends in these expense items are also determined.
3. Timeframe for achieving "stabilized" or normal occupancy and rent levels (also referred to as holding period).
4. An appropriate capitalization rate and valuation technique, selected and applied to net income to establish a value estimate.

Basically, the income approach converts all expected future net operating income into a value estimate. When market conditions are stable and no unusual patterns of future rents and occupancy rates are expected, the direct-capitalization method is used to value income properties. This method calculates the value of a property by dividing an estimate of its stabilized annual income by a factor called a "cap" rate. Stabilized income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions. The cap rate—usually defined for each property type in a market area—is viewed by some analysts as the required rate of return stated in terms of current income.

The use of this technique assumes that either the stabilized income or the cap rate, used accurately, captures all relevant characteristics of the property relating to its risk and income potential. If the same risk factors, required rate of return, financing arrangements, and income projections are used, explicit discounting and direct capitalization will yield the same results.

For special-use properties, new projects, or troubled properties, the discounted-cash-flow (net present value) method is the more typical approach to analyzing a property's value. In this method, a timeframe for achieving a stabilized or normal occupancy and rent level is projected. Each year's net operating income during that period is discounted to arrive at the present value of expected future cash flows. The property's anticipated sales value at the end of the stabilization period (its terminal or reversion value) is then estimated. The reversion value represents the capitalization of all future income streams of the property after the projected occupancy level is achieved. The terminal or reversion value is then discounted to its present value and added to the discounted income stream to arrive at the total present market value of the property.

Most importantly, the analysis should be

based on the ability of the project to generate income over time based on reasonable and supportable assumptions. Additionally, the discount rate should reflect reasonable expectations about the rate of return that investors require under normal, orderly, and sustainable market conditions.

2231.0.7 OTHER DEFINITIONS OF VALUE

The Board's appraisal regulation requires that the appraisal contain a market value of the real estate collateral. Some other definitions of value that are encountered when appraising and evaluating real estate transactions are described below.

1. *Fair value* is an accounting term that is generally defined as the amount in cash or cash-equivalent value or other consideration that a real estate parcel would yield in a current sale between a willing buyer and a willing seller (selling price), other than a forced or liquidation sale.[6] According to accounting literature, fair value is generally used in valuing assets in nonmonetary transactions, troubled-debt restructuring, quasi-reorganizations, and business combinations accounted for by the purchase method. An accountant generally defines fair value as market value; however, depending on the circumstances, these values may not be the same for a particular property.
2. *Investment value* is based on the data and assumptions that meet a particular investor's criteria and objectives for a specific property or project. The investor's criteria and objectives are often substantially different than those of participants in a broader market. Thus, investment value can be significantly higher than market value in certain circumstances and should not be used in credit-analysis decisions.
3. *Liquidation value* assumes that there is little or no current demand for the property and that the property needs to be disposed of quickly. In this situation, the owner may have to sacrifice property appreciation for an immediate sale.
4. *Going-concern value* is based on the value of the business entity, rather than the value of the real estate. The valuation is based on the existing operations of a business that has a proven operating record, with the assumption that the business will continue to operate.
5. *Assessed value* represents the value on which a taxing authority bases its assessment. The assessed value and market value may differ considerably due to tax assessment laws, timing of reassessments, and tax exemptions allowed on properties or portions of a property.
6. *Net realizable value (NRV)* is recognized under generally accepted accounting principles[7] as "the estimated selling price in the ordinary course of business less estimated costs of completion (to the stage of completion assumed in determining the selling price), holding, and disposal." The NRV is generally used to evaluate the carrying amount of assets being held for disposition and properties representing collateral. While the market value or future selling price is generally used as the basis for the NRV calculation, the NRV also reflects the current owner's costs to complete the project and to hold and dispose of the property. For this reason, the NRV will generally be less than the market value.

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

2231.0.8 EVALUATION REQUIREMENTS

The Board's appraisal regulation requires an evaluation for certain real estate–related financial transactions that are exempt from the title XI appraisal requirement. These transactions include—

6. FASB Statement No. 67, "Accounting for Costs and Initial Rental Operations of Real Estate Projects," Appendix A—Glossary.

7. FASB Statement No. 67, "Accounting for Costs and Initial Rental Operations of Real Estate Projects," Appendix A—Glossary.

1. transactions below the $250,000 threshold;
2. transactions qualifying for the exemption for business loans of $1 million or less, when rental income or sales proceeds from real estate is not the primary source of repayment; and
3. subsequent transactions resulting from an existing extension of credit (for example, renewals and refinancings).

An evaluation should provide a general estimate of the value of the real estate and need not meet the detailed requirements of a title XI appraisal.[8] An evaluation must provide appropriate information to enable the banking organization to make a prudent decision regarding the transaction. Moreover, a banking organization is not precluded from obtaining an appraisal that conforms to the regulation for any exempt transaction. At a minimum, an evaluation should—

1. be written;
2. include the preparer's name, address, and signature, and the effective date of the evaluation;
3. describe the real estate collateral, its condition, and its current and projected use;
4. describe the sources of information used in the analysis;
5. describe the analysis and supporting information; and
6. provide an estimate of the real estate's market value, with any limiting conditions.

2231.0.8.1 Form and Content of Evaluations

The documentation for evaluations should fully support the estimate of value and include sufficient information to understand the evaluator's analysis, assumptions, and conclusions. The evaluator is not required to use a particular form or valuation approach, but the analysis should apply to the type of property and fully explain the value rendered.

An individual who conducts an evaluation should have real estate–related training or experience relevant to the type of property. However, the individual does not have to be a state-licensed or -certified appraiser. Prudent practices require that a more detailed evaluation be performed as the banking organization engages in more complex real estate–related financial transactions or as its overall exposure in a real estate–related financial transaction increases.

An evaluation for a transaction that needs a more detailed analysis should describe the property; give its location; and discuss its use, especially for nonresidential property. An evaluation for a transaction that requires a less detailed analysis may be based on information such as comparable property sales information from sales-data services (for example, the multiple-listing service or current tax-assessed value in appropriate situations).[9] Further, an evaluation may be based on the banking organization's own real estate loan portfolio experience and on value estimates prepared for recent loans on comparable properties, when appraisals meeting the regulatory requirements were obtained. Regardless of the method, the banking organization must document its analysis and findings in the loan file.

2231.0.9 SELECTION AND QUALIFICATIONS CRITERIA FOR APPRAISERS AND EVALUATORS

The accuracy of an appraisal or evaluation depends on the competence and integrity of the individual performing the appraisal or evaluation, as well as on that person's expertise at developing and interpreting pertinent data for the subject property. Appraisers and evaluators should have adequate training, experience, and knowledge of the local real estate market to make sound judgments concerning the value of a particular property. Their level of training, experience, and knowledge should be commensurate with the type and complexity of the property to be valued. Additionally, appraisers and evaluators should be independent of the credit decision, have no interest in the property being appraised, and have no affiliations or associations with the potential borrower. Absent absolute lines of independence, a banking organization must be able to demonstrate that it has prudent safeguards in place to isolate its collateral-evaluation process from influence or interference from the loan-production process.

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8. An appraisal means the kind of specialized opinion on the value of real estate that contains certain formal elements recognized by appraisal industry practices and standards.

9. Assessed values for tax purposes may be a specified fraction of market value, as determined by the tax assessor. Therefore, tax-assessed values should be adjusted to a market-value equivalent. In cases where the assessed value does not have a reliable correlation to current value, the use of assessed value would be inappropriate as the basis for an evaluation.

2231.0.9.1 Appraiser Qualifications

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

The Appraisal Subcommittee of the FFIEC is responsible for monitoring state compliance with title XI. The Board also has the authority to impose additional certification and licensing requirements on those adopted by a given state.

2231.0.9.2 Selection of an Appraiser

An independent appraisal is one in which the appraiser is not participating in the administration of the credit or in the approval of the transaction and has no interest, financial or otherwise, in the property. In certain instances involving small banking organizations, officers and directors who perform appraisals must take appropriate steps to ensure that they are independent from the transaction under consideration.

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

In that regard, banking organizations are expected to treat all appraisers fairly and equitably in determining whether to use the services of a particular appraiser. Generally, banking organizations have established procedures for selecting appraisers and maintaining an approved appraiser list. The practice of preapproving appraisers for ongoing appraisal work and maintaining an approved appraiser list is acceptable so long as all appraisers are required to follow the same approval process. However, a banking organization that requires appraisers who are not members of a particular appraisal organization to formally apply, pay an application fee, and submit samples of previous appraisal reports for review—but does not have identical requirements for appraisers who are members of other appraisal organizations—would be viewed as having a discriminatory selection process.

2231.0.9.3 Appraisals Performed by Certified or Licensed Appraisers

In summary, a banking organization is required to use a certified appraiser for (1) all federally related transactions over $1 million, (2) nonresidential federally related transactions of more than $250,000, and (3) complex residential federally related transactions of more than $250,000.[10] A banking organization may use either a state-certified or a state-licensed appraiser for noncomplex residential federally related transactions that are under $1 million.

2231.0.9.4 Other Appraiser Designations

Some states have adopted other appraiser designations that may cause confusion about whether a particular appraiser holds the appropriate designation for a given appraisal assignment. Additionally, some states use designations such as ''certified residential'' appraiser and ''certified general'' appraiser, which leads to further confusion. Other states have no specified license designation but have used the term ''certified residential'' based on the standards for licensing. For this reason, a banking organization needs to understand the qualification criteria set forth by the state appraiser regulatory body and whether these standards are equivalent to the federal designations accepted by the Appraisal Subcommittee.

The Appraisal Subcommittee has recognized two other appraiser designations: certified residential appraiser and transitional licensed appraiser. For the certified residential appraiser, the minimum qualification standards are those

10. Complex one- to four-family residential property appraisal means one in which the property to be appraised, the form of ownership, or the market conditions are atypical.

established by the Appraiser Qualifications Board for "certified residential real estate appraiser." Under the Board's regulation, a certified residential appraiser would be permitted to appraise real estate in connection with a federally related transaction designated for a "certified" appraiser, provided the individual is competent for the particular appraisal assignment.

The Appraisal Subcommittee and the Board are also willing to recognize a transitional license that would allow a state to issue a license to an appraiser, provided the individual has passed an examination and has satisfied either the education or experience requirement. A transitional licensed appraiser is permitted to appraise real estate collateral in connection with a federally related transaction as if licensed. The transitional licensed appraiser is expected to complete the missing requirement within a set timeframe or the license expires. Recognition of a transitional license was believed to be necessary to ease the initial problems and inefficiencies resulting from a new regulatory program. The Appraisal Subcommittee has advised the states that the use of the transitional licenses should be phased out once the appraiser regulatory program is fully established. As a result, the use of a transitional license and the applicable timeframe will vary from state to state.

2231.0.9.5 Qualifications of Individuals Who Can Perform Evaluations

Evaluations can be performed by a competent person who has experience in real estate–related activities, including, but not limited to, appraisals, real estate lending, real estate consulting, and real estate sales. A banking organization may also augment in-house expertise by hiring an outside consultant familiar with a certain market or a particular type of real estate. The evaluation procedures should have established standards for selecting qualified individuals to perform evaluations and for confirming their qualifications and independence to evaluate a particular transaction. An individual performing an evaluation need not be licensed or certified. However, if a banking organization desires, it may use state-licensed or -certified appraisers to prepare evaluations.

2231.0.10 EXAMINER REVIEW OF APPRAISAL AND EVALUATION POLICIES

A banking organization's appraisal and evaluation policies and procedures will be reviewed as part of the inspection of the organization's overall activities. This includes a review of the procedures for selecting an appraiser for a particular appraisal or evaluation assignment and for confirming that the appraiser is qualified, independent, and if applicable, licensed or certified to undertake the assignment. If an institution maintains a listing of qualified real estate appraisers acceptable for the banking organization's use, the examiner should ascertain whether the board of directors or senior management has reviewed and approved the list.

If a banking organization is in troubled condition that is attributable to underwriting problems in its real estate loan portfolio, the Board may require the banking organization to obtain appraisals for all new real estate–related financial transactions below the threshold that are not subject to another exemption. The Reserve Bank will determine if a particular banking organization will have to obtain appraisals below the threshold.

When analyzing individual credits, examiners will analyze appraisals or evaluations to determine that the methods, assumptions, findings, and conclusions are reasonable and comply with the Board's rule, policies, and supervisory guidelines. Examiners should not challenge the underlying assumptions, including the discount and capitalization rates used in appraisals, that differ only in a limited way from norms that would generally be associated with the property under review. Furthermore, an examiner is not bound to accept the appraisal or evaluation results, regardless of whether a new appraisal or evaluation was requested during the examination. An examiner who concludes that an appraisal or evaluation is deficient for any reason will take that fact into account when judging the quality of the credit.

When the examiner can establish that the underlying facts or assumptions are inappropriate and can support alternative assumptions, he or she may adjust the estimated value of the property for credit-analysis purposes. It is important to emphasize that an examiner's overall analysis and classification of a credit may be based on other credit or underwriting standards, even if the loan is secured by real property whose value is supported by an appraisal or evaluation.

Significant failures to meet standards and procedures as outlined above will be criticized and corrective action will be required. Furthermore, banking organizations that fail to maintain a

sound appraisal or evaluation program or that fail to comply with the agencies' appraisal regulations and policies, or to the Board's supervisory guidelines, will be cited in inspection reports and may be criticized for unsafe and unsound banking practices. Deficiencies will require corrective action.

The appraisal regulation and guidelines require that banking organizations use the services of qualified, independent, and certified or licensed appraisers to perform appraisals. Furthermore, a banking organization that knowingly uses the services of an individual who is not properly certified or licensed to perform an appraisal in connection with a federally related transaction is violating the Board's Regulation Y. Any action of a state-certified or -licensed appraiser that is contrary to the purpose of title XI should be reported to the Federal Reserve Bank for referral to the appropriate state appraiser regulatory agency for investigation.

2231.0.11 INSPECTION OBJECTIVES

1. To determine whether policies, practices, procedures, and internal controls regarding real estate appraisals and evaluations for real estate–related financial transactions are adequate.
2. To determine whether the banking organization's officers and employees are conforming with the board of directors' appraisal policies.
3. To determine whether appraisals performed in connection with federally related transactions comply with the minimum standards of the Board's appraisal regulation and the Uniform Standards of Professional Appraisal Practice.
4. To determine if appraisers used in connection with federally related transactions are certified or licensed as appropriate.
5. To determine whether appraisers are competent to render appraisals in federally related transactions and whether they are independent of the specific transaction or other lending, investment, or collection functions as appropriate.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient, or when violations of laws or regulations or noncompliance with provisions of supervisory guidelines have been noted.

2231.0.12 INSPECTION PROCEDURES

1. Test real estate–related financial transactions for compliance with approved real estate appraisal policies and established practices, procedures, and internal controls. Also, obtain a listing of any deficiencies noted in the latest review performed by internal and/or external auditors and determine if appropriate corrections have been made. Based on these results, determine the scope of the inspection for appraisals.
   a. Provide copies of the banking organization's appraisal and evaluation policies and procedures to examiners assigned to functional areas when real estate–related transactions may require the services of an appraiser or evaluator.
   b. Review appraisals and evaluations of individual real estate–related transactions during the inspection of loans, BHC premises, DPC assets, or OREO transactions. Review the appraisals and evaluations for compliance with the Board's appraisal regulation and appraisal guidelines and with the banking organization's appraisal and evaluation programs.
   c. When real estate–related transactions are examined on a portfolio basis, review the appraisal and evaluation processes. Determine whether the processes ensure that appraisals and evaluations comply with the Federal Reserve Board's appraisal regulation, the interagency appraisal guidelines, and the banking organization's appraisal and evaluation programs.
2. When performing the above procedures, determine whether—
   a. the board of directors approves and periodically reviews the appraisal policies and procedures that establish the appraisal and evaluation programs for real estate lending, as required by the Board's real estate lending regulation;
   b. the appraisal and evaluation programs include comprehensive analytical procedures;
   c. the banking organization engages competent individuals who are independent of the transaction to perform appraisals and evaluations, and whether the appraisal and evaluation programs establish the manner in which it selects, evaluates, and monitors those individuals;
   d. the appraisal program ensures that appraisals conform to the Board's appraisal regulation;
   e. the evaluation program ensures that eval-

uations conform to the Board's guidance on evaluations (SR-94-55 and SR-94-50);

f. the appraisal and evaluation programs appropriately reflect the banking organization's size, its location, and the nature and complexity of its real estate–related activities;

g. policies and procedures require appraisals and evaluations to be written;

h. criteria have been established for determining when to obtain reappraisals or reevaluations as part of a program of prudent portfolio review and monitoring; and

i. the banking organization has appropriate procedures to assess the validity of appraisals and evaluations for certain subsequent transactions that are exempt from the Board's appraisal requirements, or whether new appraisals or evaluations were obtained.

3. Review and assess the banking organization's compliance procedures to ensure that the appraisal and evaluation programs are effective and in compliance with regulatory requirements and that they review the appropriateness of appraisals and evaluations before final credit decisions. Determine if—
   a. The monitoring procedures demonstrate that appraisals and evaluations comply with the Board's appraisal regulation and the Board's appraisal and evaluation guidelines.
   b. The program provides that appraisals and evaluations are obtained before the final credit or other decision. However, for transactions involving loan workouts or restructurings to facilitate the orderly collection of the credit or to reduce the risk of loss, appraisals or evaluations were obtained in a reasonable time after the transaction occurs.
   c. The programs have review procedures to verify that the methods, assumptions, and conclusions in the appraisals or evaluations are reasonable and appropriate for the transaction and the property.
   d. Criteria are established to identify which transactions should have their appraisal or evaluation considered for more comprehensive analytical procedures. For example, certain types of transactions, such as large-dollar credits, loans secured by complex or specialized properties, nonresidential real estate construction loans, or out-of-area real estate, should ensure that the appraisal or evaluation provides adequate support for the particular transaction.
   e. The banking organization ensures that individuals who perform these reviews have appropriate training and experience and are independent of the transaction.
   f. There is adequate documentation to demonstrate that the review has occurred. While a checklist may serve this purpose for many of these transactions, a more comprehensive review would require a more detailed written analysis.
   g. Appropriate procedures exist for any deficiencies noted in the review, thus requiring (1) the individual who prepared the appraisal or evaluation to correct the deficiencies or (2) a new appraisal or evaluation to be obtained before the final credit or other decision.
   h. The program ensures that changes of an appraisal's estimate of value were made in accordance with standard 3 of the Uniform Standards of Professional Appraisal Practice (USPAP), and whether the changes were made by an appropriately qualified licensed or certified appraiser.
   i. Appropriate procedures exist for referring potential cases of misconduct by licensed and certified appraisers to the appropriate state appraiser regulatory authority.

4. Assess the procedures for determining whether a real estate–related transaction requires an appraisal or evaluation, or is otherwise exempt from the Board's appraisal regulation.
   a. For appraisals required under the appraisal program, determine that—
      - the banking organization engaged the appraiser or, if the appraiser was engaged directly by another financial services entity, the banking organization determined that the appraisal complies with its own program and the Board's appraisal regulation. (The banking organization may *not* accept an appraisal prepared for the borrower.);
      - the appraisal was obtained in sufficient time to be analyzed before the final credit or other decision;
      - the appraisal conforms to the generally accepted appraisal standards as evidenced by USPAP, for example—
        - — the appraiser uses the three market-value approaches—cost, comparable sales, and income—and corre-

lates the results into a final value estimate;
  - if the above-mentioned approaches were not used, the appraiser discloses the reason and whether this affected the value estimate;
  - the appropriate type of appraisal was obtained (complete or limited), and the appropriate report format (self-contained, summary, or restricted) was used for the particular transaction; and
  - if a limited appraisal was used (that is, the appraiser invoked the Departure Provision), the appraisal fully discloses the limiting conditions;
- the appraisal is written and contains sufficient information and analysis to support the banking organization's decision to enter into the transaction;
- if the appraisal is for proposed construction or renovation, partially leased buildings, nonmarket lease terms, or tract developments with unsold units, the appraisal includes an appropriate analysis and disclosure of deductions and discounts for holding costs, marketing costs, leasing commissions, rent losses, tenant improvements, and entrepreneurial profits;
- the appraisal contains an estimate of the current market value of the property in its actual physical condition and current zoning, as defined by the Board's appraisal regulation;
- the appraisal contains an estimate of the property's prospective market value based on the completion of improvements or stabilized occupancy, if the appraisal is for a property where improvements or renovations are to be made;
- the appraisal clearly identifies each value estimate and, for the prospective value, gives the projected dates when future events are expected to occur when more than one estimate of value is reported;
- the individual who performed the appraisal was independent of the transaction and appropriately licensed and certified for the assignment:
  - A certified appraiser must perform the appraisal for a transaction of $1,000,000 or more, a nonresidential transaction of $250,000 or more, or a complex residential transaction of $250,000 or more.
  - A licensed or certified appraiser must perform the appraisal for any other type of federally related transaction.
- the individual who performed the appraisal had appropriate training and experience demonstrating expertise in appraising similar types of properties and knowledge of the property's market; and
- incidents of possible appraiser misconduct are documented for possible referral by the Reserve Bank to the state appraiser regulatory agency.

b. For exempt transactions requiring an evaluation, such as transactions below the $250,000 threshold, business loans less than $1 million, and subsequent transactions, including renewals and refinancings, determine that—
- the evaluation at a minimum—
  - is written;
  - includes the preparer's name, address, and signature and the effective date;
  - describes the real estate collateral, its condition, and its current and projected use;
  - describes the source of information used in the analysis;
  - describes the analysis and supporting information; and
  - gives an estimate of the real estate's value with limiting conditions;
- the evaluation provides sufficient detail to support the estimate of collateral value in more complex real estate–related transactions, or when the overall exposure is high;
- the individual who performed the evaluation had the appropriate real estate training and sufficient experience and knowledge of the market to prepare the evaluation; and
- the individual who performed the evaluation, regardless of whether the banking organization's staff performed the evaluation, was independent of the transaction, credit decision, or function.

5. Assess management's compliance with its policies and procedures and with the Board's appraisal regulation and guidance by reviewing appraisals and evaluations.
6. If the review of appraisals or evaluations on one- to four-family residential loans or multi-

family loans indicates that the appraisals or evaluations do not meet the Board's requirements, or that the loan-to-value ratio at origination was higher than 80 percent for fixed-rate loans or 75 percent for floating-rate loans, then these loans may not be eligible for the 50 percent risk weight permitted under the Board's risk-based capital rule.

7. Evaluate the banking organization with respect to—
   a. the adequacy of written appraisal and evaluation programs;
   b. the methods used by the banking organization's officers to conform with established policy;
   c. internal control deficiencies or exceptions;
   d. the integrity of the appraisal and evaluation process, including appraisal and evaluation compliance procedures;
   e. the integrity of individual appraisals and evaluations for their adequacy, their reasonableness, and the appropriateness of the methods, assumptions, and techniques used, and for their compliance with the Board's appraisal regulation and real estate appraisal and evaluation guidelines;
   f. recommended corrective action when policies, practices, or procedures are deficient;
   g. the degree of any violations of the Board's appraisal regulation, and the extent of noncompliance with interagency appraisal guidelines, if noted; and
   h. the existence of other matters of significance, for example—
      - misrepresentation of data such as the omission of information on favorable financing, seller concessions, sales history, feasibility, zoning, easements, or deed restrictions;
      - inadequate techniques of analysis, that is, failure to use the cost, comparable sales, or income approach in the appraisal, when the approach is appropriate for the type of property;
      - use of dissimilar comparables in the comparable-sales approach to valuation (for example, the age, size, quality, or location of the comparable is significantly different from the subject property, making reconciliation of value difficult);
      - underestimating of factors such as construction cost, construction period, lease-up period, and rent concessions;
      - use of best-case assumptions for the income approach to valuation without performing a sensitivity analysis on the factors which would identify the lender's downside risk;
      - overly optimistic assumptions, such as a high absorption rate in an overbuilt market; and
      - demographic factors, such as existing housing inventory, projected completions, and expected market share, that are not reconciled to the value rendered, but are only discussed as background information.
8. Report any instances of questionable conduct by appraisers along with supporting documentation to the Reserve Bank for possible referral to the appropriate state appraisal authorities.
9. Update workpapers with any information that will facilitate future inspections.

2231.0.13 INTERNAL CONTROL QUESTIONNAIRE

Review the internal controls, policies, practices, and procedures for real estate appraisals and evaluations. The appraisal and evaluation system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. *The items marked with an asterisk (*) require substantiation by observation or testing.*

2231.0.13.1 Appraisal and Evaluation Policies

1. Has the board of directors, consistent with its duties and responsibilities, adopted written appraisal and evaluation policies that define—
   a. management's responsibility for selecting, evaluating, and monitoring the individual who is performing the appraisal or evaluation?
   b. the basis for selecting staff appraisers and engaging fee appraisers for a particular appraisal assignment? (This ensures that the individual is independent of the transaction, possesses the requisite expertise, and holds the proper state certification or license, if applicable.)
   c. the procedures as to when appraisals and evaluations should be obtained?

   d. the procedures for when to obtain a reappraisal or reevaluation, including frequency and scope?
   e. appraisal and evaluation compliance and review procedures? Will those procedures ascertain that the bank holding company's appraisals and evaluations are consistent with USPAP and the Board's regulations, policies, and guidelines?
2. Does the board of directors periodically review its appraisal, evaluation, and review policies and procedures to ensure that they meet the needs of the bank holding company's real estate lending activity?

2231.0.13.2 Appraisals

*1. Are appraisals in writing, dated, and signed?
*2. Does the appraisal meet the minimum standards of the Board's regulation and USPAP, including—
   a. purpose;
   b. market value;
   c. effective date;
   d. marketing period;
   e. sales history of subject property;
   f. reflection of the valuation using the cost, income, and comparable-sales approaches;
   g. evaluation and correlation of the three approaches into a final value estimate based on the appraiser's judgment;
   h. explanation of why an approach is inappropriate if not used in the appraisal; and
   i. full support for the assumptions and the value rendered through adequate documentation?
*3. Are appraisals received before making the final credit or other decision? (For example, is the date of the loan commitment letter later than the date of the appraisal—unless the loan commitment letter is conditioned on receipt of the appraisal?)
*4. If the bank holding company is depending on an appraisal obtained for another financial services institution as support for its transaction, does the bank holding company have appraisal review procedures to ensure that the appraisal meets the standards of the appraisal regulation? These types of transactions would include loan participations and mortgage-backed securities.
*5. If an appraisal for one transaction is used for a subsequent transaction, are the determinations that the appraisals are still valid sufficiently documented?

2231.0.13.3 Appraisers

1. Are appraisers fairly considered for assignments regardless of their membership or lack of membership in a particular appraisal organization?
2. Do appraisers have requisite knowledge and experience to complete the appraisal before taking the assignment?
3. Do appraisers who discover deficiencies in their expertise before taking the assignment or while performing the appraisal—
   a. disclose their lack of knowledge and/or experience to the client before accepting the assignment or when the deficiencies become readily apparent?
   b. describe in the appraisal their lack of knowledge and/or experience and the steps taken to competently complete the assignment?
4. Are appraisers independent of the transaction?
   a. Are staff appraisers independent of the lending, investment, and collection functions, and are they uninvolved, except as an appraiser, in the federally related transaction, with no direct or indirect interest, financial or otherwise, in the property?
   b. Are fee appraisers engaged directly by the banking organization or its agents, and are written assurances obtained that those appraisers have no direct or indirect interest, financial or otherwise, in the property or transaction?
5. If staff appraisers are used, does the bank holding company periodically have test appraisals performed by independent appraisers to check the organization's knowledge of trends, values, and markets?
6. If fee appraisers are used, are investigations performed to determine their qualifications and reputation?
7. Is the status of an appraiser's state certification or license verified with the state appraiser regulatory authority to ensure that the appraiser is in good standing?
8. Are fee appraisers paid the same fee whether or not the loan is granted?
9. If the transaction is outside the local geographic market, does the bank holding company engage appraisers or consultants with knowledge of the market where the real estate collateral is located?

2231.0.13.4 Evaluations

1. Are individuals performing evaluations independent of the transaction?
*2. Are evaluations required to be in writing, dated, and signed?
*3. Does the bank holding company require sufficient information and documentation to support the estimate of value and the evaluator's analysis?
*4. If an evaluation obtained for one transaction is used for a subsequent transaction, is the determination that the evaluation is still valid sufficiently documented?
*5. Are evaluations received before making the final credit decision?
*6. If the bank holding company is depending on an evaluation obtained for another financial services institution as support for its transaction, does the holding company have evaluation review procedures to ensure that the evaluation meets the Board's regulation and guidance?

2231.0.13.5 Evaluators

1. Are individuals who perform evaluations competent to complete the assignment?
2. Are evaluations prepared by individuals who are independent of the transaction?

2231.0.13.6 Reappraisals and Reevaluations

1. Is a formal reappraisal and reevaluation program followed?
2. Does the bank holding company sufficiently document and follow its criteria for obtaining reappraisals or reevaluations?

2231.0.14 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Appraisal standards for federally related transactions	3310, 3331, 3351	Subpart G, 225.61–67	4-053–4-054.4	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference

2231.0.15 APPENDIX A—GUIDELINES FOR REAL ESTATE APPRAISAL AND EVALUATION PROGRAMS

INTERAGENCY APPRAISAL AND EVALUATION GUIDELINES
October 27, 1994

Purpose

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (the agencies) are jointly issuing these guidelines, which supersede each of the agencies' appraisal and evaluation guidelines issued in 1992.[a] These guidelines address supervisory matters relating to real estate appraisals and evaluations used to support real estate–related financial transactions and provide guidance to examining personnel and federally regulated institutions about prudent appraisal and evaluation policies, procedures, practices, and standards.

Background

Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) requires the agencies to adopt regulations on the preparation and use of appraisals by federally regulated financial institutions.[b] Such real estate appraisals are to be in writing and performed in accordance with uniform standards by an individual whose competency has been demonstrated and whose professional conduct is subject to effective state supervision.

Common agency regulations[c] issued pursuant to section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) also require each regulated institution to adopt and maintain written real estate lending policies that are consistent with safe and sound banking practices and that reflect consideration of the real estate lending guidelines attached to the regulation. The real estate lending guidelines state that a real estate lending program should include an appropriate real estate appraisal and evaluation program.

Supervisory Policy

An institution's real estate appraisal and evaluation policies and procedures will be reviewed as part of the examination of the institution's overall real estate–related activities. An institution's policies and procedures should be incorporated into an effective appraisal and evaluation program. Examiners will consider the institution's size and the nature of its real estate–related activities when assessing the appropriateness of its program.

When analyzing individual transactions, examiners will review an appraisal or evaluation to determine whether the methods, assumptions, and findings are reasonable and in compliance with the agencies' appraisal regulations, policies,[d] supervisory guidelines, and the institution's policies. Examiners also will review the steps taken by an institution to ensure that the individuals who perform its appraisals and evaluations are qualified and are not subject to conflicts of interest. Institutions that fail to maintain a sound appraisal or evaluation program or to comply with the agencies' appraisal regulations, policies, or these supervisory guidelines will be cited in examination reports and may be criticized for unsafe and unsound banking practices. Deficiencies will require corrective action.

Appraisal and Evaluation Program

An institution's board of directors is responsible for reviewing and adopting policies and procedures that establish an effective real estate appraisal and evaluation program. The program should—

a. FRB: "Guidelines for Real Estate Appraisal and Evaluation Programs," September 28, 1992; OCC: BC-225, "Real Estate Appraisal and Evaluation Guidelines," September 28, 1992; FDIC: FIL-69-92, "Guidelines for Real Estate Appraisal and Evaluation Programs," September 30, 1992; OTS: Thrift Bulletin 55, "Real Estate Appraisal and Evaluation Guidelines," October 13, 1992.

b. OCC: 12 CFR 34, subpart C; FRB: 12 CFR 208.18 and 12 CFR 225, subpart G; FDIC: 12 CFR 323; and OTS: 12 CFR 564.

c. OCC: 12 CFR 34, subpart D; FRB: 12 CFR 208, subpart C; FDIC: 12 CFR 365; and OTS: 12 CFR 545 and 563.

d. The appraisal guidance contained in the "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans," November 7, 1991, generally applies to all transactions.

- establish selection criteria and procedures to evaluate and monitor the ongoing performance of individuals who perform appraisals or evaluations,
- provide for the independence of the person performing appraisals or evaluations,
- identify the appropriate appraisal for various lending transactions,
- establish criteria for contents of an evaluation,
- provide for the receipt of the appraisal or evaluation report in a timely manner to facilitate the underwriting decision,
- assess the validity of existing appraisals or evaluations to support subsequent transactions,
- establish criteria for obtaining appraisals or evaluations for transactions that are otherwise exempt from the agencies' appraisal regulations, and
- establish internal controls that promote compliance with these program standards.

Selection of Individuals Who May Perform Appraisals and Evaluations

An institution's program should establish criteria to select, evaluate, and monitor the performance of the individuals who perform a real estate appraisal or evaluation. The criteria should ensure that—

- the institution's selection process is nonpreferential and unbiased;
- the individual selected possesses the requisite education, expertise, and competence to complete the assignment;
- the individual selected is capable of rendering an unbiased opinion; and
- the individual selected is independent and has no direct or indirect interest, financial or otherwise, in the property or the transaction.

Under the agencies' appraisal regulations, the appraiser must be selected and engaged directly by the institution or its agent. The appraiser's client is the institution, not the borrower. An institution may use an appraisal that was prepared by an appraiser engaged directly by another financial services institution, as long as the institution determines that the appraisal conforms to the agencies' appraisal regulations and is otherwise acceptable.

Independence of the Appraisal and Evaluation Function

Because the appraisal and evaluation process is an integral component of the credit underwriting process, it should be isolated from influence by the institution's loan production process. An appraiser and an individual providing evaluation services should be independent of the loan and collection functions of the institution and have no interest, financial or otherwise, in the property or the transaction. If absolute lines of independence cannot be achieved, an institution must be able to clearly demonstrate that it has prudent safeguards to isolate its collateral evaluation process from influence or interference from the loan production process.

The agencies recognize, however, that it is not always possible or practical to separate the loan and collection functions from the appraisal or evaluation process. In some cases, such as in a small or rural institution or branch, the only individual qualified to analyze the real estate collateral may also be a loan officer, other officer, or director of the institution. To ensure their independence, such lending officials, officers, or directors should abstain from any vote or approval involving loans on which they performed an appraisal or evaluation.

Transactions That Require Appraisals

Although the agencies' appraisal regulations exempt certain categories of real estate–related financial transactions from the appraisal requirements, most real estate transactions over $250,000 are considered federally related transactions and thus require appraisals.[e] A "federally related transaction" means any real estate–related financial transaction in which the agencies engage, contract for, or regulate, and that requires the services of an appraiser. An agency also may impose more stringent appraisal requirements than the appraisal regulations require, such as when an institution's troubled condition is attributable to real estate loan underwriting problems.[f]

e. To facilitate recovery in designated major disaster areas, subject to safety-and-soundness considerations, section 2 of the Depository Institutions Disaster Relief Act of 1992 authorized the agencies to waive certain appraisal requirements for up to three years after a presidential declaration of a natural disaster.

f. As a matter of policy, OTS requires problem associations and associations in troubled condition to obtain appraisals for all real estate–related transactions over $100,000 (unless the transaction is otherwise exempt).

Minimum Appraisal Standards

The agencies' appraisal regulations include five minimum standards for the preparation of an appraisal. The appraisal must—

- conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board (ASB) of the Appraisal Foundation unless principles of safe and sound banking require compliance with stricter standards;

  Although allowed by USPAP, the agencies' appraisal regulations do not permit an appraiser to appraise any property in which the appraiser has an interest, direct or indirect, financial or otherwise.

- be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction;

  As discussed below, appraisers have available various appraisal development and report options; however, not all options may be appropriate for all transactions. A report option is acceptable under the agencies' appraisal regulations only if the appraisal report contains sufficient information and analysis to support an institution's decision to engage in the transaction.

- analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, nonmarket lease terms, and tract developments with unsold units;

  This standard is designed to avoid having appraisals prepared using unrealistic assumptions and inappropriate methods. For federally related transactions, an appraisal is to include the current market value of the property in its actual physical condition and subject to the zoning in effect as of the date of the appraisal. For properties where improvements are to be constructed or rehabilitated, the regulated institution may also request a prospective market value based on stabilized occupancy or a value based on the sum of retail sales. However, the sum of retail sales for a proposed development is not the market value of the development for the purpose of the agencies' appraisal regulations. For proposed developments that involve the sale of individual houses, units, or lots, the appraiser must analyze and report appropriate deductions and discounts for holding costs, marketing costs, and entrepreneurial profit. For proposed and rehabilitated rental developments, the appraiser must make appropriate deductions and discounts for items such as leasing commission, rent losses, and tenant improvements from an estimate based on stabilized occupancy.

- be based upon the definition of market value set forth in the regulation; and

  Each appraisal must contain an estimate of market value, as defined by the agencies' appraisal regulations.

- be performed by state-licensed or -certified appraisers in accordance with requirements set forth in the regulation.

Appraisal Options

An appraiser typically uses three market value approaches to analyze the value of a property—cost, income, and comparable sales—and reconciles the results of each to estimate market value. An appraisal will discuss the property's recent sales history and contain an opinion as to the highest and best use of the property. An appraiser must certify that he or she has complied with USPAP and is independent. Also, the appraiser must disclose whether the subject property was inspected and whether anyone provided significant assistance to the person signing the appraisal report.

An institution may engage an appraiser to perform either a Complete or Limited Appraisal.[g] When performing a Complete Appraisal assignment, an appraiser must comply with all USPAP standards without departing from any binding requirements and specific guidelines when estimating market value. When performing a Limited Appraisal, the appraiser elects to invoke the Departure Provision, which allows the appraiser to depart, under limited conditions, from standards identified as specific guidelines. For example, in a Limited Appraisal, the appraiser might not utilize all three approaches

g. USPAP Statement on Appraisal Standards No. 7 (SMT-7)—Permitted Departure from Specific Guidelines for Real Property Appraisal, issued March 30, 1994, effective July 1, 1994.

to value. Departure from standards designated as binding requirements is not permitted. An institution and appraiser must concur that use of the Departure Provision is appropriate for the transaction before the appraiser commences the appraisal assignment. The appraiser must ensure that the resulting appraisal report will not mislead the institution or other intended users of the appraisal report. The agencies do not prohibit the use of a Limited Appraisal for a federally related transaction, but the agencies believe that institutions should be cautious in their use of a Limited Appraisal because it will be less thorough than a Complete Appraisal.

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

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

Moreover, since the institution is responsible for selecting the appropriate appraisal report to support its underwriting decisions, its program should identify the type of appraisal report that will be appropriate for various lending transactions. The institution's program should consider the risk, size, and complexity of the individual loan and the supporting collateral when determining the level of appraisal development and the type of report format that will be ordered. When ordering an appraisal report, institutions may want to consider the benefits of a written engagement letter that outlines the institution's expectations and delineates each party's responsibilities, especially for large, complex, or out-of-area properties.

Transactions That Require Evaluations

A formal opinion of market value prepared by a state-licensed or -certified appraiser is not always necessary. Instead, less formal evaluations of the real estate may suffice for transactions that are exempt from the agencies' appraisal requirements. The agencies' appraisal regulations allow an institution to use an appropriate evaluation of the real estate rather than an appraisal when the transaction—

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

Institutions should also establish criteria for obtaining appraisals or evaluations for safety-and-soundness reasons for transactions that are otherwise exempt from the agencies' appraisal regulations.

Evaluation Content

An institution should establish prudent standards for the preparation of evaluations. At a minimum, an evaluation should—

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

An evaluation report should include calculations, supporting assumptions, and, if utilized, a discussion of comparable sales. Documentation should be sufficient to allow an institution to

understand the analysis, assumptions, and conclusions. An institution's own real estate loan portfolio experience and value estimates prepared for recent loans on comparable properties might provide a basis for evaluations.

An evaluation should provide an estimate of value to assist the institution in assessing the soundness of the transaction. Prudent practices also require that as an institution engages in more complex real estate–related financial transactions, or as its overall exposure increases, a more detailed evaluation should be performed. For example, an evaluation for a home equity loan might be based primarily on information derived from a sales data services organization or current tax assessment information, while an evaluation for an income-producing real estate property should fully describe the current and expected use of the property and include an analysis of the property's rental income and expenses.

Qualifications of Individuals Who Perform Evaluations

Individuals who prepare evaluations should have real estate–related training or experience and knowledge of the market relevant to the subject property. Based upon their experience and training, professionals from several fields may be qualified to prepare evaluations of certain types of real estate collateral. Examples include individuals with appraisal experience, real estate lenders, consultants or salespersons, agricultural extension agents, or foresters. Institutions should document the qualifications and experience level of individuals whom the institution deems acceptable to perform evaluations. An institution might also augment its in-house expertise and hire an outside party familiar with a certain market or a particular type of property. Although not required, an institution may use state-licensed or -certified appraisers to prepare evaluations. As such, Limited Appraisals reported in a Summary or Restricted format may be appropriate for evaluations of real estate–related financial transactions exempt from the agencies' appraisal requirements.

Valid Appraisals and Evaluations

The agencies allow an institution to use an existing appraisal or evaluation to support a subsequent transaction, if the institution documents that the existing estimate of value remains valid. Therefore, a prudent appraisal and evaluation program should include criteria to determine whether an existing appraisal or evaluation remains valid to support a subsequent transaction. Criteria for determining whether an existing appraisal or evaluation remains valid will vary depending upon the condition of the property and the marketplace, and the nature of any subsequent transaction. Factors that could cause changes to originally reported values include the passage of time; the volatility of the local market; the availability of financing; the inventory of competing properties; improvements to, or lack of maintenance of, the subject property or competing surrounding properties; changes in zoning; or environmental contamination. The institution must document the information sources and analyses used to conclude that an existing appraisal or evaluation remains valid for subsequent transactions.

Renewals, Refinancings, and Other Subsequent Transactions

While the agencies' appraisal regulations generally allow appropriate evaluations of real estate collateral in lieu of an appraisal for loan renewals and refinancings, in certain situations an appraisal is required. If new funds are advanced over reasonable closing costs, an institution would be expected to obtain a new appraisal for the renewal of an existing transaction when there is a material change in market conditions or the physical aspects of the property that threatens the institution's real estate collateral protection.

The decision to reappraise or reevaluate the real estate collateral should be guided by the exemption for renewals, refinancings, and other subsequent transactions. Loan workouts, debt restructurings, loan assumptions, and similar transactions involving the addition or substitution of borrowers may qualify for the exemption for renewals, refinancings, and other subsequent transactions. Use of this exemption depends on the condition and quality of the loan, the soundness of the underlying collateral, and the validity of the existing appraisal or evaluation.

A reappraisal would not be required when an institution advances funds to protect its interest in a property, such as to repair damaged property, because these funds should be used to restore the damaged property to its original condition. If a loan workout involves modification of the terms and conditions of an existing credit,

including acceptance of new or additional real estate collateral, which facilitates the orderly collection of the credit or reduces the institution's risk of loss, a reappraisal or reevaluation may be prudent, even if it is obtained after the modification occurs.

An institution may engage in a subsequent transaction based on documented equity from a valid appraisal or evaluation, if the planned future use of the property is consistent with the use identified in the appraisal or evaluation. If a property, however, has reportedly appreciated because of a planned change in use of the property, such as rezoning, an appraisal would be required for a federally related transaction, unless another exemption applied.

Program Compliance

An institution's appraisal and evaluation program should establish effective internal controls that promote compliance with the program's standards. An individual familiar with the appropriate agency's appraisal regulation should ensure that the institution's appraisals and evaluations comply with the agencies' appraisal regulations, these guidelines, and the institution's program. Loan administration files should document this compliance review, although a detailed analysis or comprehensive analytical procedures are not required for every appraisal or evaluation. For some loans, the compliance review may be part of the loan officer's overall credit analysis and may take the form of either a narrative or a checklist. Corrective action should be undertaken for noted deficiencies by the individual who prepared the appraisal or evaluation.

An institution's appraisal and evaluation program should also have comprehensive analytical procedures that focus on certain types of loans, such as large-dollar credits, loans secured by complex or specialized properties, nonresidential real estate construction loans, or out-of-area real estate. These comprehensive analytical procedures should be designed to verify that the methods, assumptions, and conclusions are reasonable and appropriate for the transaction and the property. These procedures should provide for a more detailed review of selected appraisals and evaluations prior to the final credit decision. The individual(s) performing these reviews should have the appropriate training or experience, and be independent of the transaction.

Appraisers and persons performing evaluations should be responsible for any deficiencies in their reports. Deficient reports should be returned to them for correction. Unreliable appraisals or evaluations should be replaced prior to the final credit decision. Changes to an appraisal's estimate of value are permitted only as a result of a review conducted by an appropriately qualified state-licensed or -certified appraiser in accordance with Standard III of USPAP.

Portfolio Monitoring

The institution should also develop criteria for obtaining reappraisals or reevaluations as part of a program of prudent portfolio review and monitoring techniques—even when additional financing is not being contemplated. Examples of such types of situations include large credit exposures and out-of-area loans.

Referrals

Financial institutions are encouraged to make referrals directly to state appraiser regulatory authorities when a state-licensed or -certified appraiser violates USPAP or applicable state law, or engages in other unethical or unprofessional conduct. Examiners finding evidence of unethical or unprofessional conduct by appraisers will forward their findings and recommendations to their supervisory office for appropriate disposition and referral to the state, as necessary.

These guidelines are designed to in ensure that troubled real estate loans receive consistent treatment nationwide. The guidelines are not intended to be a substitute for the examiner's judgment or for careful analysis of applicable credit and collateral factors. Use of the word "institution" in these guidelines refers to any lending source within the bank holding company organization, whether the lender is the parent company, a bank, thrift, or nonbanking subsidiary.

2240.0.1 EXAMINER REVIEW OF COMMERCIAL REAL ESTATE LOANS

2240.0.1.1 Loan Policy and Administration Review

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

The policies governing an institution's real estate lending activities must include prudent underwriting standards that are periodically reviewed by the board of directors and clearly communicated to the institution's management and lending staff. The institution must also have credit risk control procedures that include, for example, prudent internal limits on exposure, an effective credit review and classification process, and a methodology for ensuring that the allowance for loan and lease losses is maintained at an adequate level. The complexity and scope of these policies and procedures should be appropriate to the size of the institution and the nature of the institution's activities, and should be consistent with prudent banking practices and relevant regulatory requirements.

2240.0.1.2 Indicators of Troubled Real Estate Markets and Projects, and Related Indebtedness

In order to evaluate the collectibility of an institution's commercial real estate portfolio, examiners should be alert for indicators of weakness in the real estate markets served by the institution. They should also be alert for indicators of actual or potential problems in the individual commercial real estate projects or transactions financed by the institution.

There are several warning signs that real estate markets or projects are experiencing problems that may result in real estate values decreasing from original appraisals or projections. Adverse economic developments and/or an overbuilt market can affect a project's economic feasibility and may cause a real estate project and the loan to become troubled. Available indicators, such as permits for—and the value of—new construction, absorption rates, employment trends, and vacancy rates, are useful in evaluating the condition of commercial real estate markets. Weaknesses disclosed by these types of statistics may indicate that a real estate market is experiencing difficulties that may result in cash flow problems for individual real estate projects, declining real estate values, and ultimately, in troubled commercial real estate loans.

Indicators of potential or actual difficulties in commercial real estate projects may include:

- An excess of similar projects under construction.
- Construction delays or other unplanned adverse events resulting in cost overruns that may require renegotiation of loan terms.
- Lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions.
- Changes in concept or plan (for example, a condominium project converted to an apartment project because of unfavorable market conditions).
- Rent concessions or sales discounts resulting in cash flow below the level projected in the original feasibility study or appraisal.
- Concessions on finishing tenant space, moving expenses, and lease buyouts.
- Slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project's income potential, resulting in protracted repayment or default on the loan.
- Delinquent lease payments from major tenants.
- Land values that assume future rezoning.
- Tax arrearages.

As the problems associated with a commer-

cial real estate project become more pronounced, problems with the related indebtedness may also arise. Such problems include diminished cash flow to service the debt and delinquent interest and principal payments.

While some commercial real estate loans become troubled because of a general downturn in the market, others become troubled because they were originated on an unsound or a liberal basis. Common examples of these types of problems include:

- Loans with no or minimal borrower equity.
- Loans on speculative undeveloped property where the borrowers' only source of repayment is the sale of the property.
- Loans based on land values that have been driven up by rapid turnover of ownership, but without any corresponding improvements to the property or supportable income projections to justify an increase in value.
- Additional advances to service an existing loan that lacks credible support for full repayment from reliable sources.
- Loans to borrowers with no development plans or noncurrent development plans.
- Renewals, extensions and refinancings that lack credible support for full repayment from reliable sources and that do not have a reasonable repayment schedule.[1]

2240.0.1.3 Examiner Review of Individual Loans, Including the Analysis of Collateral Value

The focus of an examiner's review of a commercial real estate loan, including binding commitments, is the ability of the loan to be repaid. The principal factors that bear on this analysis are the income-producing potential of the underlying collateral and the borrower's willingness and capacity to repay under the existing loan terms from the borrower's other resources if necessary. In evaluating the overall risk associated with a commercial real estate loan, examiners consider a number of factors, including the character, overall financial condition and resources, and payment record of the borrower; the prospects for support from any financially responsible guarantors; and the nature and degree of protection provided by the cash flow and value of the underlying collateral.[2] However, as other sources of repayment for a troubled commercial real estate loan become inadequate over time, the importance of the collateral's value in the analysis of the loan necessarily increases.

The appraisal regulations of the federal bank and thrift regulatory agencies require institutions to obtain appraisals when certain criteria are met.[3] Management is responsible for reviewing each appraisal's assumptions and conclusions for reasonableness. Appraisal assumptions should not be based solely on current conditions that ignore the stabilized income-producing capacity of the property.[4] Management should adjust any assumptions used by an appraiser in determining value that are overly optimistic or pessimistic.

An examiner analyzes the collateral's value as determined by the institution's most recent appraisal (or internal evaluation, as applicable). An examiner reviews the major facts, assumptions, and approaches used by the appraiser (including any comments made by management on the value rendered by the appraiser). Under the circumstances described below, the examiner may make adjustments to this assessment of value. This review and any resulting adjustments to value are solely for purposes of an examiner's analysis and classification of a credit and do not involve actual adjustments to an appraisal.

A discounted cash flow analysis is an appropriate method for estimating the value of income-producing real estate collateral.[5] This analysis should not be based solely on the current performance of the collateral or similar

1. As discussed more fully in Manual section 2240.0.2, the refinancing or renewing of loans to sound borrowers would not result in a supervisory classification or criticism unless well-defined weaknesses exist that jeopardize repayment of the loans. Consistent with sound banking practices, institutions should work in an appropriate and constructive manner with borrowers who may be experiencing temporary difficulties.

2. The treatment of guarantees in the classification process is discussed in subsection 2240.0.3.

3. Department of the Treasury, Office of the Comptroller of the Currency, 12 CFR Part 34 (Docket No. 90–16); Board of Governors of the Federal Reserve System, 12 CFR Parts 208 and 225 (Regulation H and Y; Docket No. R–0685); Federal Deposit Insurance Corporation, 12 CFR 323 (RIN 3064–AB05); Department of the Treasury; Office of Thrift Supervision, 12 CFR Part 564 (Docket No. 90–1495).

4. Stabilized income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions.

5. The real estate appraisal regulations of the federal bank and thrift regulatory agencies include a requirement that an appraisal (a) follow a reasonable valuation method that addresses the direct sales comparison, income, and cost approaches to market value; (b) reconcile these approaches; and (c) explain the elimination of each approach not used. A discounted cash flow analysis is recognized as a valuation method for the income approach.

properties; rather, it should take into account, on a discounted basis, the ability of the real estate to generate income over time based upon reasonable and supportable assumptions.

When reviewing the reasonableness of the facts and assumptions associated with the value of the collateral, examiners may evaluate:

- Current and projected vacancy and absorption rates;
- Lease renewal trends and anticipated rents;
- Volume and trends in past due leases;
- Effective rental rates or sale prices (taking into account all concessions);
- Net operating income of the property as compared with budget projections; and
- Discount rates and direct capitalization ("cap") rates.

The capacity of a property to generate cash flow to service a loan is evaluated based upon rents (or sales), expenses, and rates of occupancy that are reasonably estimated to be achieved over time. The determination of the level of stabilized occupancy and rental rates should be based upon an analysis of current and reasonably expected market conditions, taking into consideration historical levels when appropriate. The analysis of collateral values should not be based upon a simple projection of current levels of net operating income if markets are depressed or reflect speculative pressures but can be expected over a reasonable period of time to return to normal (stabilized) conditions. Judgment is involved in determining the time that it will take for a property to achieve stabilized occupancy and rental rates.

Examiners do not make adjustments to appraisal assumptions for credit analysis purposes based on worst case scenarios that are unlikely to occur. For example, an examiner would not necessarily assume that a building will become vacant just because an existing tenant who is renting at a rate above today's market rate may vacate the property when the current lease expires. On the other hand, an adjustment to value may be appropriate for credit analysis purposes when the valuation assumes renewal at the above-market rate, unless that rate is a reasonable estimate of the expected market rate at the time of renewal.

When estimating the value of income-producing real estate, discount rates and "cap" rates should reflect reasonable expectations about the rate of return that investors require under normal, orderly and sustainable market conditions. Exaggerated, imprudent, or unsustainably high or low discount rates, "cap" rates, and income projections should not be used. Direct capitalization of nonstabilized income flows should also not be used.

Assumptions, when recently made by qualified appraisers (and, as appropriate, by institution management) and when consistent with the discussion above, should be given a reasonable amount of deference. Examiners should not challenge the underlying assumptions, including discount rates and "cap" rates used in appraisals, that differ only in a limited way from norms that would generally be associated with the property under review. The estimated value of the underlying collateral may be adjusted for credit analysis purposes when the examiner can establish that any underlying facts or assumptions are inappropriate and can support alternative assumptions.

2240.0.2 CLASSIFICATION GUIDELINES

As with other types of loans, commercial real estate loans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or the underlying collateral generally are not classified. Similarly, loans to sound borrowers that are refinanced or renewed in accordance with prudent underwriting standards, including loans to creditworthy commercial or residential real estate developers, should not be classified or criticized unless well-defined weaknesses exist that jeopardize repayment. An institution will not be criticized for continuing to carry loans having weaknesses that result in classification or criticism as long as the institution has a well-conceived and effective workout plan for such borrowers, and effective internal controls to manage the level of these loans.

In evaluating commercial real estate credits for possible classification, examiners apply standard classification definitions. In determining the appropriate classification, consideration should be given to all important information on repayment prospects, including information on the borrower's creditworthiness, the value of, and cash flow provided by, all collateral supporting the loan, and any support provided by financially responsible guarantors.

The loan's record of performance to date is important and must be taken into consideration. As a general principle, a performing commercial real estate loan should not automatically be

classified or charged-off solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. However, it would be appropriate to classify a performing loan when well-defined weaknesses exist that jeopardize repayment, such as the lack of credible support for full repayment from reliable sources.

These principles hold for individual credits, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each credit should be based upon the fundamental characteristics affecting the collectibility of the particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits that are not affected by the problems of the troubled sectors.

2240.0.2.1 Classification of Troubled Project-Dependent Commercial Real Estate Loans[6]

The following guidelines for classifying a troubled commercial real estate loan apply when the repayment of the debt will be provided solely by the underlying real estate collateral, and there are no other available and reliable sources of repayment. The guidelines are not intended to address loans that must be treated as "Other Real Estate Owned" for bank and BHC reporting purposes.

As a general principle, for a troubled project-dependent commercial real estate loan, any portion of the loan balance that exceeds the amount that is adequately secured by the value of the collateral, and that can clearly be identified as uncollectible, should be classified "loss."[7] The portion of the loan balance that is adequately secured by the value of the collateral should generally be classified no worse than "substandard." The amount of the loan balance in excess of the value of the collateral, or portions thereof, should be classified "doubtful" when the potential for full loss may be mitigated by the outcomes of certain pending events, or when loss is expected but the amount of the loss cannot be reasonably determined.

If warranted by the underlying circumstances, an examiner may use a "doubtful" classification on the entire loan balance. However, this would occur infrequently.

6. The discussion in this section is not intended to address loans that must be treated as "other real estate owned" for bank regulatory reporting purposes or "real estate owned" for thrift regulatory reporting purposes. Guidance on these assets is presented in supervisory and reporting guidance of the agencies.

7. For purposes of this discussion, the "value of the collateral" is the value used by the examiner for credit analysis purposes, as discussed in a previous section of this policy statement.

2240.0.2.2 Guidelines for Classifying Partially Charged-off Loans

Based upon consideration of all relevant factors, an evaluation may indicate that a credit has well-defined weaknesses that jeopardize collection in full, but that a portion of the loan may be reasonably assured of collection. When an institution has taken a charge-off in an amount sufficient that the remaining recorded balance of the loan (a) is being serviced (based upon reliable sources) and (b) is reasonably assured of collection, classification of the remaining recorded balance may not be appropriate. Classification would be appropriate when well-defined weaknesses continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally be classified no more severely than "substandard."

A more severe classification than "substandard" for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined, e.g., where significant risk exposures are perceived, such as might be the case for bankruptcy situations or for loans collateralized by properties subject to environmental hazards. In addition, classification of the remaining recorded balance would be appropriate when sources of repayment are considered unreliable.

2240.0.2.3 Guidelines for Classifying Formally Restructured Loans

The classification treatment previously discussed for a partially charged off loan would also generally be appropriate for a formally restructured loan when partial charge-offs have been taken. For a formally restructured loan, the focus of the examiner's analysis is on the ability of the borrower to repay the loan in accordance with its modified terms. Classification of a formally restructured loan would be appropriate, if, after the restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan in accordance with reasonable modified

terms.[8] Troubled commercial real estate loans whose terms have been restructured should be identified in the institution's internal credit review system, and closely monitored by management.

2240.0.3 TREATMENT OF GUARANTEES IN THE CLASSIFICATION PROCESS

Initially, the original source of repayment and the borrower's intent and ability to fulfill the obligation without reliance on third party guarantors will be the primary basis for the review and classification of assets.[9] The federal bank and thrift regulatory agencies will, however, consider the support provided by guarantees in the determination of the appropriate classification treatment for troubled loans. The presence of a guarantee from a "financially responsible guarantor," as described below, may be sufficient to preclude classification or reduce the severity of classification.

For purposes of this discussion, a guarantee from a "financially responsible guarantor" has the following attributes:

- The guarantor must have both the financial capacity and willingness to provide support for the credit;
- The nature of the guarantee is such that it can provide support for repayment of the indebtedness, in whole or in part, during the remaining loan term; and[10]
- The guarantee should be legally enforceable.

The above characteristics generally indicate that a guarantee may improve the prospects for repayment of the debt obligation.

2240.0.3.1 Considerations Relating to a Guarantor's Financial Capacity

The lending institution must have sufficient information on the guarantor's financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor's financial capacity to fulfill the obligation. Also, it is important to consider the number and amount of guarantees currently extended by a guarantor, in order to determine that the guarantor has the financial capacity to fulfill the contingent claims that exist.

2240.0.3.2 Considerations Relating to a Guarantor's Willingness to Repay

Examiners normally rely on their analysis of the guarantor's financial strength and assume a willingness to perform unless there is evidence to the contrary. This assumption may be modified based on the "track record" of the guarantor, including payments made to date on the asset under review or other obligations.

Examiners give due consideration to those guarantors that have demonstrated their ability and willingness to fulfill previous obligations in their evaluation of current guarantees on similar assets. An important consideration will be whether previously required performance under guarantees was voluntary or the result of legal or other actions by the lender to enforce the guarantee. However, examiners give limited credence, if any, to guarantees from obligors who have reneged on obligations in the past, unless there is clear evidence that the guarantor has the ability and intent to honor the specific guarantee obligation under review.

Examiners also consider the economic incentives for performance from guarantors:

- Who have already partially performed under the guarantee or who have other significant investments in the project;
- Whose other sound projects are cross-collateralized or otherwise intertwined with the credit; or
- Where the guarantees are collateralized by readily marketable assets that are under the control of a third party.

2240.0.3.3 Other Considerations as to the Treatment of Guarantees in the Classification Process

In general, only guarantees that are legally

8. An example of a restructured commercial real estate loan that does *not* have reasonable modified terms would be a "cash flow" mortgage which requires interest payments *only* when the underlying collateral generates cash flow but provides no substantive benefits to the lending institution.

9. Some loans are originated based primarily upon the financial strength of the guarantor, who is, in substance, the primary source of repayment. In such circumstances, examiners generally assess the collectibility of the loan based upon the guarantor's ability to repay the loan.

10. Some guarantees may only provide for support for certain phases of a real estate project. It would not be appropriate to rely upon these guarantees to support a troubled loan after the completion of these phases.

enforceable will be relied upon. However, all legally enforceable guarantees may not be acceptable. In addition to the guarantor's financial capacity and willingness to perform, it is expected that the guarantee will not be subject to significant delays in collection, or undue complexities or uncertainties about the guarantee.

The nature of the guarantee is also considered by examiners. For example, some guarantees for real estate projects only pertain to the development and construction phases of the project. As such, these limited guarantees would not be relied upon to support a troubled loan after the completion of those phases.

Examiners also consider the institution's intent to enforce the guarantee and whether there are valid reasons to preclude an institution from pursuing the guarantee. A history of timely enforcement and successful collection of the full amount of guarantees will be a positive consideration in the classification process.

During the early 1980s, open-end credit primarily consisted of credit card accounts with small lines of credit to the most creditworthy borrowers. Currently, open-end credit consists of much larger lines of credit that have been extended to diverse borrowers with a variety of risk profiles. In 1980, the Federal Financial Institutions Examination Council (FFIEC) (the Federal Reserve Board, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and, in 1987, the Federal Home Loan Bank Board (now the Office of Thrift Supervision)) adopted a uniform policy for the classification of installment credit based on delinquency status. The 1980 policy also provided for different charge-off time frames for open-end and closed-end credit.

Because open-ended borrowing practices had changed and institutional practices for charging off open-end accounts based on their past-due status were inconsistent, the agencies (the FRB, FDIC, OTS, and OCC) undertook a review of the 1980 FFIEC classification policy in concert with a review of all written policies, as mandated by section 303(a) of the Riegle Community Development and Regulatory Improvement Act of 1994 (RCDRIA). In February 1999, an updated policy was issued, effective for use on FFIEC bank call reports beginning December 31, 2000. This new policy was revised again and reissued in June 2000, with the same effective date. (The June 2000 policy supersedes both the 1980 policy and the updated February 1999 policy.) The June policy provides supervisory guidance for residential and home equity loans; fraudulent loans; loans to deceased persons; loans to borrowers in bankruptcy; treatment of partial payments involving past-due loans; and re-aging, deferrals, renewals, or rewrites of open-end and closed-end credit. The agencies are to use this expanded supervisory guidance when applying the uniform classifications to retail-credit loans extended by depository institutions. See SR-00-8.

While the terms of the revised policy apply only to federally insured depository institutions, the Federal Reserve believes the guidance is broadly applicable to bank holding companies (BHCs) and their nonbank lending subsidiaries. Accordingly, examiners should apply the revised policy, as appropriate, in the inspection of consumer finance subsidiaries of BHCs.

When reviewing consumer finance subsidiaries of banking organizations, examiners should consider the methodology used for aging retail loans. In accordance with the FFIEC bank call report instructions, banks and their consumer finance subsidiaries are required to use the contractual method, which ages loans based on the status of contractual payments. BHCs, in preparing their financial statements, are permitted to use the range of options available under GAAP. This, in effect, allows uninsured, nonbank consumer finance subsidiaries of BHCs to employ the recency method, which ages loans according to the date of the most recent payment, regardless of the contractual terms of the loan.

In general, the contractual method provides a more accurate reflection of loan performance and, therefore, is the *preferred* methodology, especially from the standpoint of financial-statement transparency and public disclosure. Examiners should encourage BHCs and their consumer finance subsidiaries to use the contractual method. However, BHCs should not change their aging methodology from contractual to recency without the prior concurrence of the Federal Reserve. A BHC subsidiary may not change its methodology if the intent or effect of such a change is to mask asset quality or financial weaknesses. Moreover, in the event that consumer receivables are transferred from a bank to its BHC or the BHC's nonbanking subsidiaries, the BHC or the nonbanking subsidiaries should continue to age the receivables according to the contractual method.

When a BHC uses the recency method, it should have adequate controls in place to accurately track the performance of loans within the retail portfolio and to demonstrate sound and compelling business reasons for the use of the recency method. Examiners should see section 3100.0 for further guidance on the review of consumer finance operations.

2241.0.1 UNIFORM RETAIL-CREDIT CLASSIFICATION AND ACCOUNT-MANAGEMENT POLICY

The uniform retail-credit classification and account-management policy issued by the FFIEC (and approved by the Federal Reserve Board) is reproduced below. The Board has clarified certain provisions of this policy. In this text, the Board's revisions are in brackets. Section numbers have also been added to the subtitles of the text.

The Uniform Retail-Credit Classification and Account-Management Policy[1] establishes standards for the classification and treatment of retail credit in financial institutions. Retail credit consists of open- and closed-end credit extended to individuals for household, family, and other personal expenditures, and includes consumer loans and credit cards. For purposes of this policy, retail credit also includes loans to individuals secured by their personal residence, including first mortgage, home equity, and home-improvement loans. Because a retail-credit portfolio generally consists of a large number of relatively small-balance loans, evaluating the quality of the retail-credit portfolio on a loan-by-loan basis is inefficient and burdensome for the institution being examined and for examiners.

Actual credit losses on individual retail credits should be recorded when the institution becomes aware of the loss, but in no case should the charge-off exceed the time frames stated in this policy. This policy does not preclude an institution from adopting a more conservative internal policy. Based on collection experience, when a portfolio's history reflects high losses and low recoveries, more conservative standards are appropriate and necessary.

The quality of retail credit is best indicated by the repayment performance of individual borrowers. Therefore, in general, retail credit should be classified based on the following criteria:

1. Open- and closed-end retail loans past due 90 cumulative days from the contractual due date should be classified substandard.
2. Closed-end retail loans that become past due 120 cumulative days and open-end retail loans that become past due 180 cumulative days from the contractual due date should be classified loss and charged off.[2] In lieu of charging off the entire loan balance, loans with non–real estate collateral may be written down to the value of the collateral, less cost to sell, if repossession of collateral is assured and in process.
3. One- to four-family residential real estate loans and home equity loans that are past due 90 days or more with loan-to-value ratios greater than 60 percent should be classified substandard. Properly secured residential real estate loans with loan-to-value ratios equal to or less than 60 percent are generally not classified based solely on delinquency status. Home equity loans to the same borrower at the same institution as the senior mortgage loan with a combined loan-to-value ratio equal to or less than 60 percent need not be classified. However, home equity loans where the institution does not hold the senior mortgage, that are past due 90 days or more should be classified substandard, even if the loan-to-value ratio is equal to, or less than, 60 percent.

   For open- and closed-end loans secured by residential real estate, a current assessment of value should be made no later than 180 days past due. Any outstanding loan balance in excess of the value of the property, less cost to sell, should be classified loss and charged off.
4. Loans in bankruptcy should be classified loss and charged off within 60 days of receipt of notification of filing from the bankruptcy court or within the time frames specified in this classification policy, whichever is shorter, unless the institution can clearly demonstrate and document that repayment is likely to occur. Loans with collateral may be written down to the value of the collateral, less cost to sell. Any loan balance not charged off should be classified substandard until the borrower re-establishes the ability and willingness to repay for a period of at least six months.
5. Fraudulent loans should be classified loss and charged off no later than 90 days of discovery or within the time frames adopted in this classification policy, whichever is shorter.
6. Loans of deceased persons should be classified loss and charged off when the loss is determined or within the time frames adopted in this classification policy, whichever is shorter.

1. [For the Federal Reserve's depository institution classification guidelines, see section 2060.1, "Classification of Credits," in the *Commercial Bank Examination Manual.]*

2. For operational purposes, whenever a charge-off is necessary under this policy, it should be taken no later than the end of the month in which the applicable time period elapses. Any full payment received after the 120- or 180-day charge-off threshold, but before month-end charge-off, may be considered in determining whether the charge-off remains appropriate.

OTS regulation 12 CFR 560.160(b) allows savings institutions to establish adequate (specific) valuation allowances for assets classified loss in lieu of charge-offs.

Open-end retail accounts that are placed on a fixed repayment schedule should follow the charge-off time frame for closed-end loans.

2241.0.1.1 Other Considerations for Classification

If an institution can clearly document that a past-due loan is well secured and in the process of collection, such that collection will occur regardless of delinquency status, then the loan need not be classified. A well-secured loan is collateralized by a perfected security interest in, or pledges of, real or personal property, including securities with an estimable value, less cost to sell, sufficient to recover the recorded investment in the loan, as well as a reasonable return on that amount. "In the process of collection" means that either a collection effort or legal action is proceeding and is reasonably expected to result in recovery of the loan balance or its restoration to a current status, generally within the next 90 days.

2241.0.1.2 Partial Payments on Open- and Closed-End Credit

Institutions should use one of two methods to recognize partial payments. A payment equivalent to 90 percent or more of the contractual payment may be considered a full payment in computing past-due status. Alternatively, the institution may aggregate payments and give credit for any partial payment received. For example, if a regular installment payment is $300 and the borrower makes payments of only $150 per month for a six-month period, [the institution could aggregate the payments received ($150 × six payments, or $900). It could then give credit for three full months ($300 x three payments) and thus treat the loan as] three full months past due. An institution may use either or both methods in its portfolio, but may not use both methods simultaneously with a single loan.

2241.0.1.3 Re-aging, Extensions, Deferrals, Renewals, and Rewrites

Re-aging of open-end accounts, and extensions, deferrals, renewals, and rewrites of closed-end loans[3] can be used to help borrowers overcome temporary financial difficulties, such as loss of job, medical emergency, or change in family circumstances like loss of a family member. A permissive policy on re-agings, extensions, deferrals, renewals, or rewrites can cloud the true performance and delinquency status of the portfolio. However, prudent use is acceptable when it is based on a renewed willingness and ability to repay the loan, and when it is structured and controlled in accordance with sound internal policies.

Management should ensure that comprehensive and effective risk management and internal controls are established and maintained so that re-ages, extensions, deferrals, renewals, and rewrites can be adequately controlled and monitored by management and verified by examiners. The decision to re-age, extend, defer, renew, or rewrite a loan, like any other modification of contractual terms, should be supported in the institution's management information systems. Adequate management information systems usually identify and document any loan that is re-aged, extended, deferred, renewed, or rewritten, including the number of times such action has been taken. Documentation normally shows that the institution's personnel communicated with the borrower, the borrower agreed to pay the loan in full, and the borrower has the ability to repay the loan. To be effective, management information systems should also monitor and track the volume and performance of loans that have been re-aged, extended, deferred, renewed, or rewritten and/or placed in a workout program.

2241.0.1.4 Open-End Accounts

Institutions that re-age open-end accounts should establish a reasonable written policy and adhere to it. To be considered for re-aging, an account should exhibit the following:

1. The borrower has demonstrated a renewed willingness and ability to repay the loan.

3. These terms are defined as follows. *Re-age:* Returning a delinquent, open-end account to current status without collecting (at the time of aging) the total amount of principal, interest, and fees that are contractually due. *Extension:* Extending monthly payments on a closed-end loan and rolling back the maturity by the number of months extended. The account is shown current upon granting the extension. If extension fees are assessed, they should be collected at the time of the extension and not added to the balance of the loan. *Deferral:* Deferring a contractually due payment on a closed-end loan without affecting the other terms, including maturity, (or the due date for subsequently scheduled payments,) of the loan. The account is shown current upon granting the deferral. *Renewal:* Underwriting a matured, closed-end loan generally at its outstanding principal amount and on similar terms. *Rewrite:* Underwriting an existing loan by significantly changing its terms, including payment amounts, interest rates, amortization schedules, or its final maturity.

2. The account has existed for at least nine months.
3. The borrower has made at least three consecutive minimum monthly payments or the equivalent cumulative amount. Funds may not be advanced by the institution for this purpose.

Open-end accounts should not be re-aged more than once within any twelve-month period and no more than twice within any five-year period. Institutions may adopt a more conservative re-aging standard; for example, some institutions allow only one re-aging in the lifetime of an open-end account. Additionally, an over-limit account may be re-aged at its outstanding balance (including the over-limit balance, interest, and fees), provided that no new credit is extended to the borrower until the balance falls below the predelinquency credit limit.

Institutions may re-age an account after it enters a workout program, including internal and third-party debt-counseling services, but only after receipt of at least three consecutive minimum monthly payments or the equivalent cumulative amount, as agreed upon under the workout or debt-management program. Re-aging for workout purposes is limited to once in a five-year period and is in addition to the once-in-twelve-months/twice-in-five-years limitation described above. To be effective, management information systems should track the principal reductions and charge-off history of loans in workout programs by type of program.

2241.0.1.5 Closed-End Loans

Institutions should adopt and adhere to explicit standards that control the use of extensions, deferrals, renewals, and rewrites of closed-end loans. The standards should exhibit the following:

1. The borrower should show a renewed willingness and ability to repay the loan.
2. The standards should limit the number and frequency of extensions, deferrals, renewals, and rewrites.
3. Additional advances to finance unpaid interest and fees should be prohibited.

Management should ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained to support the collection process and to ensure timely recognition of losses. To be effective, management information systems should track the subsequent principal reductions and charge-off history of loans that have been granted an extension, deferral, renewal, or rewrite.

2241.0.1.6 Examination Considerations

Examiners should ensure that institutions adhere to this policy. Nevertheless, there may be instances that warrant exceptions to the general classification policy. Loans need not be classified if the institution can document clearly that repayment will occur irrespective of delinquency status. Examples might include loans well secured by marketable collateral and in the process of collection, loans for which claims are filed against solvent estates, and loans supported by valid insurance claims.

The Uniform Retail-Credit Classification and Account-Management Policy does not preclude examiners from classifying individual retail-credit loans that exhibit signs of credit weakness regardless of delinquency status. Similarly, an examiner may also classify retail portfolios, or segments thereof, where underwriting standards are weak and present unreasonable credit risk, and may criticize account-management practices that are deficient.

In addition to reviewing loan classifications, the examiner should ensure that the institution's allowance for loan and lease losses provides adequate coverage for probable losses inherent in the portfolio. Sound risk- and account-management systems, including a prudent retail-credit lending policy, measures to ensure and monitor adherence to stated policy, and detailed operating procedures, should also be implemented. Internal controls should be in place to ensure that the policy is followed. Institutions that lack sound policies or fail to implement or effectively adhere to established policies will be subject to criticism.

Issued by the Federal Financial Institutions Examination Council on June 6, 2000.

Domestic and Other Reports to Be Submitted to the Federal Reserve

Section 2250.0

In carrying out its regulatory and supervisory responsibilities, the Board requires the submission of various reports from bank holding companies. These reports are an integral part of the Board's supervision, monitoring, and surveillance functions. Information from these reports is used to evaluate the performance of bank holding companies, appraise their financial condition, and determine their compliance with applicable laws and regulations. The examiner must review the reports (submitted to the Federal Reserve System) for accuracy and timeliness and insist on their being amended if material errors are found. If inaccurate data are submitted, the resulting ratios could conceal deteriorating trends in the company's financial condition and performance. Bank holding companies should maintain sufficient internal systems and procedures to ensure that reporting is accomplished according to appropriate regulatory requirements. Clear, concise, and orderly workpapers should support the data presented and provide a logical tie between report data and the financial records. For detailed current information on who must submit reports and what the reporting requirements are, see the Board's public site on the Internet at the following address: www.federalreserve.gov/boarddocs/reportforms.

2250.0.1 PENALTIES FOR ERRORS IN REPORTS

Section 8 of the Bank Holding Company Act (the act) was amended to provide for the assessment of civil money penalties for the submission of late, false, or misleading reports filed by bank holding companies that are required by the act and Regulation Y and for the failure to file the required regulatory reports. Financial institutions that have adequate procedures to avoid any inadvertent errors but that unintentionally submit incorrect information or are minimally late in publishing or transmitting the reports can be fined up to $2,000 per day. The financial institution has the burden of proving that the error was inadvertent. If the error was not inadvertent, a penalty of up to $20,000 per day can be assessed. If the submission was done in a knowing manner or with reckless disregard for the law, a fine of up to $1 million or 1 percent of the institution's assets can be assessed for each day of the violation. Institution-affiliated parties who participate in any manner in the filing of an institution's false or misleading required regulatory report, or who cause the failure to file or a late filing of a required regulatory report, may be assessed a civil money penalty of up to $25,000 per day.

2250.0.2 APPROVAL OF DIRECTORS AND SENIOR OFFICERS OF DEPOSITORY INSTITUTIONS

The Federal Deposit Insurance Act (12 U.S.C. 1811) was amended to require each insured depository institution and depository institution holding company to give 30 days' prior notification to the federal banking authority of (1) the proposed addition of any individual to its board of directors or (2) the employment of any individual as a senior executive officer. This requirement applies to the following institutions:

1. institutions that have been chartered less than two years
2. institutions that have undergone a change in control within the preceding two years
3. institutions that are in a troubled condition or whose capital is below minimum standards

The agencies have the authority to issue a notice of disapproval to stop the appointment or employment of an individual if they feel that appointing or employing the person would not be in the interests of the public, taking into account that individual's competence, experience, character, and integrity.

2250.0.3 INSPECTION OBJECTIVES

1. To determine that required reports are being filed on time.
2. To determine that the contents of reports are accurate and complete.
3. To recommend corrective and, if needed, formal enforcement action when official reporting practices, policies, or procedures are deficient.

2250.0.4 INSPECTION PROCEDURES

1. A bank holding company's historical record concerning the timely submission of reports should be ascertained by reviewing relevant

Reserve Bank files. The examiner should determine, from documentation in the files, which reports should have been filed because of the passage of time or the occurrence of an event. If a report is delinquent, the bank holding company should be instructed to prepare and submit the report expeditiously.

2. Copies of regulatory reports filed since the prior inspection should be reviewed and compared with company records on a random, line-by-line basis, using a significance test. In some cases, the review will necessarily extend to supporting schedules and workpapers that substantiate the data reflected in the reports. If the initial reports reviewed are found to be substantially correct, then the scope of subsequent reviews may be curtailed. If the reports are found to be incorrect, the overall review procedures should be intensified. When an error or misstatement is considered significant, the matter should be brought to management's attention and the bank holding company should be required to submit adjusted data. Improper methods used in preparing reports should be called to management's attention. The examiner should explain all changes carefully and assist bank holding company personnel in whatever way possible to ensure proper reporting in future reports.
3. At the conclusion of the review process, the examiner should discuss the following with management, when applicable:
   a. inaccuracies found in reports and the need for submission of amended pages or reports
   b. violations of law, rulings, or regulations
   c. recommended corrective action when policies or procedures have contributed to deficiencies noted in the reports or the untimely submission of report(s)
4. Details concerning the late or inaccurate preparation of reports should be listed in the inspection report on the Other Supervisory Issues report page. If the matter is considered significant, it should be noted on the Examiner's Comments and Matters Requiring Special Board Attention report page, as well. When the exceptions are considered minor and have been discussed with management and corrected, it will suffice to state this on the Other Supervisory Issues workpaper supporting page.
5. When it is determined that false, misleading, or inaccurate information is contained in financial statements or reports, consider whether formal enforcement action is needed to ensure that the offending bank holding company, financial institution, or other entity under the holding company structure will correct the statements and reports.

2250.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Submission of reports concerning compliance with the act, or regulations or orders under it	1844(c)			
Annual reports	1844(c)	225.5(b)		
Report on intercompany transactions	1844(c)	225.5(b)		
Reports emanating from inspection report recommendations	1844(c)	225.5(b)		
Reports emanating from cease-and-desist orders	1818(b), (c)			
Civil money penalties for errors on bank call and BHC Reports	324 1847			

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

2260.0.1 INTRODUCTION

Venture capital activities are usually conducted through one or more of the following types of entities: Small Business Investment Companies (SBIC); Minority Enterprise Small Business Investment Companies (MESBIC); Non-licensed Venture Capital Companies; and Partnerships or Venture Capital Funds. SBIC's and MESBIC's are licensed and regulated by the Small Business Administration (SBA); the other types are not. Both SBIC's and MESBIC's are limited by regulation to investing in and lending to small businesses; whereas, non-licensed venture capital companies and partnerships have greater latitude. The activities of MESBIC's (section 103d companies) are specifically limited to small firms owned by socially or economically disadvantaged persons. Most banks and bank holding companies engage in venture capital activities through an SBIC because of its broad ability to take equity positions in other companies. SBIC's are permitted to own up to 49.9 percent of the voting shares of a company. By contrast, a non-licensed venture capital company that is a subsidiary of a bank holding company may not own more than 4.9 percent of the voting shares of a business. To escape from this limitation some bank holding companies have formed partnerships or venture capital funds. However, a bank holding company can only participate as a limited partner with an ownership interest not to exceed 24.9 percent. Limited partnerships are preferred by those bank holding companies who do not possess the expertise for this type of activity but seek the potential opportunity for high returns.

Through the use of private capital and, in some cases, borrowed money, venture capital companies invest in and lend to new and growing business enterprises. They prefer to invest in and lend to companies that exhibit strong management talent and clearly defined strategies. Many of the companies are yet unknown to the public. Their products either have been introduced to the market or are due to arrive in the next few years. Venture capital companies do not favor pioneering research. Instead, they are interested in financing innovative products, i.e., those next in generation to existing ones, that have a wide market appeal and the potential for strong growth. Such products are preferred because of their shorter development time and possible faster realization of profits. One of the ways a venture capital company makes money is by purchasing the common stock of an emerging company and selling it when the company has grown and the stock has appreciated in value. It also generates earnings by making convertible preferred stock investments and by lending money in the form of subordinated debentures and term loans. Usually lending agreements contain provisions which enable a venture capital company to acquire shares or increase existing holdings through the exercise of warrants or stock options at a later date. Although in most cases some equity interest is taken, venture capital companies, generally, do not acquire a controlling interest in a business they finance.

Once financing commences, venture capital companies typically take an active role in the management of the companies. They usually receive representation on the company's board of directors, which enables them to review budgets and assist in structuring the company's long-range strategic plan. Guiding a company through its developing stages is considered essential for the achievement of equity appreciation and realization of the high returns sought by venture capital companies.

2260.0.2 LOANS AND INVESTMENTS

Investments and lending philosophy may differ among venture capital companies. Some choose to be equity-oriented; that is, they look for higher returns on investments through capital appreciation, while others favor lending in the form of loans or convertible debt securities which provide cash flow to fund operations and service debt. However, most companies will strive for a diversified portfolio in terms of the type of investment and industry mix. The range of financing possibilities associated with lending and/or investing is as follows:

First Step Financing	Funds needed for seed capital to help develop an idea.
Start-up Financing	Funds needed to cover the cost of preparing a business plan, conducting market studies and opening a business.
First Stage Financing	Funds needed to start manufacturing and selling the product(s).
Second Stage Financing	Funds needed for working capital to expand production and build inventories. Company is operating but not yet profitable.
Third Stage Financing	Funds needed to improve the product, build working capital and expand marketing and production facilities. At this point, the company should be generating a profit.
Fourth Stage Financing	Additional working capital funds needed prior to initial public offering which may be as much as a year later.

In addition to the above, venture capital companies will consider financing leveraged buyouts and turnaround situations.

The degree of risk assumed varies according to the stage of financing, i.e., lower stages contain greater risk because of the requirement for longer-term investment discipline than higher stages. Investments in start-up companies typically take five to seven years or more to mature. Because of the high risk involved, most bank-affiliated venture capital companies will avoid the earlier or lower stages of financing. Newly established venture capital companies and especially those that use leverage tend to focus on the intermediate and latter stages of financing. These stages are represented primarily by debenture financing, preferred stock investments, and straight term loans. In structuring a portfolio, a venture capitalist should consider both liquidity and capital protection. The ideal financing mix might entail a limited amount of money invested in common stock with the remainder distributed between debentures, loans, and preferred stock. These instruments will provide income to cover operating expenses and service debt as well as give some protection should the business start to decline. Limited holdings of common stock give the company the opportunity to enhance earnings through capital gains without adversely effecting cash flow. Regardless of the type of financing offered, the ability to exist from an investment or loan through either the issuance of public stock or a cash buyout by a larger company is the goal of a venture capital company.

2260.0.3 FUNDING

A venture capital company may use private capital, leverage, or a combination of both to fund its portfolio of loans and investments. Venture capital companies obtain private capital from their parent organization, either banks or bank holding companies. Generally, private capital is used to fund high-risk, lower-stage investments, although some companies may diversify their portfolio and deploy a portion of capital in loans, debentures and preferred stock. Leverage may be derived from internal and external borrowings. SBIC's that are banking subsidiaries may receive funding in the form of loans from their parent bank. For those companies that are a subsidiary of a bank holding company, internal funding may be provided by the bank holding company from internal cash flow or its external borrowing sources. A bank holding company might borrow from its available bank lines or other borrowing sources to fund venture capital operations. There is, however, one exception; that is, the use of commercial paper proceeds to fund venture capital investments and loans does not appear to qualify under the exemptive provisions of section 3(a)(3) of the Securities Act of 1933. SBIC's and MESBIC's can obtain external financing from the U.S. government and the private sector, while, non-licensed venture capital companies are limited to only private sources for their external financing. Under current SBA regulations, an SBIC can borrow up to $35 million from the federal financing bank with no limit as to the aggregate amount of private debt. Because of the investment restrictions on MESBIC's, the SBA allows them to incur higher leverage. MESBIC's are permitted to

borrow up to four times their capital base and issue preferred stock to the SBA up to two times their capital base. MESBIC's also have no limit on the aggregate amount of private debt. All government borrowings ings are through the federal financing bank and carry the guarantee of the SBA. Such borrowings are classified as senior debt.

2260.0.4 PROFITABILITY

Earnings of venture capital companies can fluctuate widely depending on the nature of their activities. Those companies that blend their portfolios with loans, debentures and preferred stock investments tend to be more predictable and less erratic in earnings performance than companies that are strictly equity-oriented. The difference being that loans, debentures and preferred stock provide income to cover operating expenses and debt service requirements, while common stock investments may not yield positive returns for several years. Portfolio diversification tends to smooth out earnings, although the potential for major fluctuations in earnings exists in the future should capital gains be realized on equity investments. In measuring earnings performance, one should consider the combination of net realized earnings (net investment income plus net realized gains (losses) on sale of investments) and net unrealized appreciation or depreciation on investment holdings found in the capital structure of the balance sheet. It is not uncommon to see aggregate returns on capital reach 50

or more. Typically, returns of this magnitude are influenced by either large gains realized on the sale of investments or a substantial amount of unrealized appreciation on investments held or a combination of both. Appreciation or depreciation in portfolio investments represents potential realized gains or losses and, therefore, should be considered in evaluating the company's earnings performance. Specifically, the change in year-to-year net unrealized appreciation or depreciation is a factor that should be considered in analyzing results. When measuring the company's contribution to consolidated earnings, net unrealized appreciation or depreciation should be ignored.

2260.0.5 CAPITALIZATION

In addition to the usual equity components of capital stock, surplus and retained earnings, the capital structure of a venture capital company includes a separate category for net unrealized appreciation (depreciation) on equity interests. Net unrealized appreciation (depreciation) on equity interests represents the gross amount reported under loans and investments less an appropriate provision for taxes. Since unrealized appreciation (depreciation) on equity interests represents future profits (losses) they are measured separately in the equity account rather than in earnings.

There are no industry norms with which to measure capital adequacy. What is known, however, is that the SBA requires a minimum capital investment of $1,000,000 to establish an SBIC. Moreover, regulations governing SBIC's limit the dollar amount of investments and/or loans to a single customer to 20 percent of an SBIC's capital base. Although banks are limited by statute to a maximum capital investment in an SBIC of 4.9 percent of their primary capital, statistics show that SBIC's have substantially less than this limit. By contrast, there are no restrictions as to the amount of capital that a bank holding company may invest in a nonbank affiliated venture capital company. Dependence on capital to fund portfolio loans and investments seems to be preferred as the cost of leverage, at present, cannot provide meaningful spreads. It can be assumed that the larger the capital position the higher the dollar amount available for investing and/or lending to a single customer.

Sustained profitability and satisfactory asset quality are required to maintain financial soundness and capital adequacy. The SBA will consider an SBIC's capital as impaired if net unrealized depreciation and/or operating losses equal 50 percent or more of its capital base. It would seem appropriate to use this guideline for measuring the adequacy of capital of non-licensed venture capital companies that are affiliated with a bank holding company.

2260.0.6 INSPECTION OBJECTIVES

1. To determine whether the company is operating within the scope of its approved activities and within the provisions of the Act and Regulation Y.
2. To determine whether transactions with affiliates, especially banks, are in accordance with applicable statutes and regulations.
3. To determine the quality of the asset portfolios and whether the allowance for losses is

adequate in relation to portfolio risk and whether the nonaccrual policy is appropriate.

4. To determine the viability of the company as a going concern, and whether its affiliate status represents a potential or actual adverse influence upon the parent holding company and its affiliated bank and nonbank subsidiaries and the condition of the consolidated corporation.

5. To determine whether the company has formal written policies and procedures relating to lending and investing.

6. To determine if such policies and procedures are adequate and that management is operating in conformance with the established policies.

7. To assess management's ability to operate the company in a safe and sound manner.

8. To suggest corrective action when policies, practices or procedures are deficient, or when asset quality is weak, or when violations of laws or regulations have been noted.

2260.0.7 INSPECTION PROCEDURES

2260.0.7.1 Pre-Inspection

All SBIC's and MESBIC's are subject to comprehensive regulations and annual examinations administered by the SBA. Therefore, it is not necessary to conduct a full scope inspection of these subsidiaries. The bank holding company inspection should focus on the quality of assets, as disclosed in the annual director's valuation and financial statements submitted to the SBA on an annual basis, transactions with affiliates and an overall financial evaluation.

The decision whether the operations of a non-licensed venture capital company will be inspected "on-site" is based on the availability and adequacy of data from either the parent holding company or that which is obtained upon request from the subsidiary. The following information should be obtained and thoroughly reviewed prior to making a decision to go "on-site":

1. Minutes of the board and executive committee meetings since inception of company or the date of the previous inspection;

2. Comparative interim and fiscal financial statements containing value accounting adjustments, including the year-end filing with the SBA;

3. Listing of contingent liabilities, including any pending material litigation;

4. Latest director's valuation of loans and investments and results of latest internal loan or credit review;

5. Copies of the most recent internal and external audit reports;

6. Trial balance of all loans and investments, indicating the percent ownership of a company involving an equity interest;

7. Listing of loans, debentures and preferred stock on which scheduled payments are in arrears 30 days or more or on which payments are otherwise not being made according to original terms;

8. Details of internal and external borrowing arrangements; and

9. Any agreements, guarantees or pledges between the subsidiary and its parent holding company or affiliates.

After reviewing the above information, a decision whether or not to conduct an on-site inspection must be made. Some of the determinants of this decision would include: relative size; current level and trend of earnings; asset quality as indicated in the director's valuation of loans and investments; and the condition of the company when last inspected. From the information provided, it might be determined that the company is operating properly and is in sound condition. In such a case, an on-site inspection may not be warranted. Conversely, a deteriorating condition might be detected which would warrant a visit even though a satisfactory condition had been determined during the previous inspection. All non-licensed venture capital companies should be inspected on-site at least once every three years.

2260.0.7.2 On-Site Inspection

If the decision was made to conduct an "on-site" inspection of the subsidiary, the examiner should expand the scope of the review to include these additional procedures:

1. Hold a brief meeting with the chief executive officer of the company to establish contact and present a brief indication of the scope of the inspection;

2. Review the company's policy statements for loans, investments, nonaccruals, and charge-offs;

3. Review the latest internal review by the company's directors or the loan review department of the bank affiliate or bank holding company;

4. Conduct an independent review of the portfolio;

a. Establish the minimum dollar of loans

and investments to be reviewed to achieve at least 70 percent coverage of the portfolio;

b. Review loans and investments in sample, giving consideration to the following:

- Latest balance sheet and income data;
- Profitability projections;
- Product(s) being produced by customer and their market acceptance;
- Business plan;
- Extent of relationship with customer;
- Funding sources; and
- Ultimate source of repayment.

c. Discuss the more serious problem loans and investments with management;

d. Classify, if necessary, those loans and investments that exhibit serious weaknesses where collectibility is problematical or worse. Lower classification criteria must accompany these assets, which possess a higher degree of credit risk than found in other types of nonbank lending;

e. Determine the diversification of risk within the portfolio, i.e., the mix of loans and investments and the type of industries financed;

f. Review the adequacy of the allowance for loan losses and determine the reasonableness of the amount of unrealized appreciation or depreciation reported on the balance sheet in conjunction with the asset evaluation; and

g. Determine whether the board of directors or parent holding company has established credit limits for the maximum amount of loans and investments to be extended to a single customer. Verify adherence to the limits.

5. Review equity investments for compliance with the 4.9 percent maximum limitation to any one customer;

6. Verify office locations and activities with system approvals;

7. Compare company's general ledger with statements prepared for the latest FR Y–6;

8. Review the quality and liquidity of other investment holdings;

9. Review and classify, if necessary, assets acquired in liquidation of a customer's business due to default. Determine compliance of divestiture period with section 4(c)(2) of The Bank Holding Company Act;

10. Review the manner and frequency in which subsidiary management reports to the parent holding company;

11. Follow-up on matters criticized in the most recent audit reports and the previous inspection report on the subsidiary; and

12. Assess the expertise of subsidiary management and awareness of subsidiary directors.

2260.0.7.3 Matters Warranting Recommendation in Inspection Report

Deficiencies or concerns that warrant citation in the inspection report for the attention of management are:

1. Lack of policies and/or controls in the lending and investing functions;

2. Improper diversification of risk in the loan and investment portfolio;

3. Adverse tie-in arrangements with the affiliate bank(s):

4. Lack of management expertise;

5. Impairment of capital as a result of operating losses or high unrealized depreciation on equity interests or a combination of both; and

6. Lack of adequate reporting procedures to parent holding company management.

2260.0.8 LAWS, REGULATIONS, INTERPRETATIONS AND ORDERS

Subject	*Laws* [1]	*Regulations* [1]	*Interpretations* [3]	*Orders*
Acquisition of SBIC by a bank holding company	1843(c)(8) 1843(c)(5)	225.111	4–173 4–175 4–174	
Limitations of an SBIC's control over business enterprises		13 C.F.R. 107.901(a)		
Criteria for various types of business investments of an SBIC		13 C.F.R. 121.3–10 13 C.F.R. 121.3–11		
Acquisition of a non-licensed venture capital company by a bank holding company	1843(c)(8)	225.112		
Formation of joint ventures (limited partnerships) for purpose of conducting venture capital activities	1843(c)(6)			
Limitation on equity interests of a non-licensed venture capital company affiliated with a bank holding company	1843(c)(6)			
Loans to affiliates—Section 23A of FR Act	371c			
Restrictions on transactions with affiliates	371c			
Acquisition of shares acquired DPC	1843(c)(2)			
Acquisition of assets acquired DPC	1843(c)(2)	225.132	4–175.1	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

2260.0.9 APPENDIX 1—VENTURE CAPITAL COMPANY SAMPLE BALANCE SHEET

	December 31, 19XX
ASSETS	
Cash	XXXX
Money Market investments	XXXX
Loans and investments	XXXX
Loans	XXXX
Debt securities	XXXX
Equity interests	XXXX
Total loans and investments	XXXX
Less: Allowance for losses on loans and investments	XXXX
Plus: Unrealized appreciation (depreciation) on equity interests	XXXX
Net loans and investments	XXXX
Interest and dividends receivable	XXXX
Assets acquired in liquidation of loans and investments	XXXX
Other assets	XXXX
Total assets	XXXX
LIABILITIES	
Notes payable—affiliates	XXXX
Notes payable—others	XXXX
Accrued taxes payable	XXXX
Deferred tax credits	XXXX
Other liabilities	XXXX
Total liabilities	XXXX
STOCKHOLDER'S EQUITY	
Common stock (par value XXX)	XXXX
Surplus	XXXX
Retained earnings	XXXX
Net unrealized appreciation (depreciation) of equity interests	XXXX
Total stockholder's equity	XXXX
Total liabilities and stockholder's equity	XXXX

2260.0.10 APPENDIX 2—VENTURE CAPITAL COMPANY—SAMPLE INCOME STATEMENT

	For Fiscal Year Ended December 31, 19XX
INTEREST INCOME	
Interest on loans and debt securities	XXX
Dividends on equity interests	XXX
Interest on money market investments	XXX
Total interest income	XXX
INTEREST EXPENSE	
Interest on notes payable to affiliates	XXX
Interest on notes payable to others	XXX
Total interest expense	XXX
NET INTEREST INCOME	XXX
PROVISION FOR LOAN LOSSES	XXX
Net interest after provision for loan losses	XXX
OTHER REVENUE	
Income from assets acquired in liquidation of loans and investments	XXX
Management Fees	XXX
Total other revenue	XXX
Net interest and other revenue	XXX
NONINTEREST EXPENSE	
Salaries and benefits	XXX
Management and service fees	XXX
Other expenses	XXX
Total noninterest expense	XXX
Income before taxes	XXX
Applicable taxes	XXX
Net investment income	XXX
Realized gain (loss) on sale of securities, net of tax	XXX
Net income	XXX