Federal Deposit Insurance Corporation
Risk Management Manual of Examination Policies

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RMS Manual of Examination Policies

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RATIONALE OF BANK EXAMINATIONS

The Federal Deposit Insurance Corporation conducts bank examinations to ensure public confidence in the banking system and to assess compliance with laws and regulations. Bank examinations help protect the Deposit Insurance Fund and facilitate the supervisory process.

Maintaining public confidence in the integrity of the banking system is essential because customer deposits are a primary funding source, without which banks would be unable to meet fundamental objectives, such as providing financial services. The financial stability of an institution or the existence of weak risk management practices are disclosed through examination of a bank's capital, assets, management, earnings, liquidity, and sensitivity to market risk.

Evaluating a bank's adherence to laws and regulations is best accomplished through periodic onsite examinations. Compliance with statutory and regulatory requirements is given high priority by bank supervisors and Congress.

Bank examinations play a vital role in protecting the integrity of the Deposit Insurance Fund. Examinations help identify problem situations and help prevent identified problems from deteriorating to the point where depositor payoffs or financial assistance by the FDIC become unavoidable.

Finally, examinations play a key role in the supervisory process by helping the FDIC to identify the nature, severity, and cause of a bank's problems; to recognize emerging risks in the financial services industry; and to develop effective corrective measures.

CONDUCT OF EXAMINATIONS

Comprehensive bank examinations enhance the FDIC's ability to maintain public confidence in financial institutions and the banking system. Given the fundamental reasons for conducting examinations, regulatory personnel must have access to all records and employees of a bank during an examination.

Sections 10(b) and (c) of the Federal Deposit Insurance Act empower examiners to make a thorough examination of a bank’s affairs. Examiners should contact their regional office for guidance if faced with serious impediments to an examination, including uncooperative executive officers, or restricted access to bank employees or records. The regional office will determine an appropriate solution to enable examiners to obtain the information needed to complete the examination. In such cases, examiners should document all significant examination obstacles and the regional office’s resolution of the situation.

Prohibition Against Political Communication

FDIC employees should avoid any form of political communication with insured depository institutions that could be perceived as suggesting the examination process is influenced by political considerations, or that the bank should take a particular position on legislative issues. Examinations must be kept free from political considerations, or the appearance of being influenced by political considerations, in order to maintain the integrity and effectiveness of the examination process. FDIC employees should promptly inform their regional office of any situation they feel compromised this policy.

RATING SYSTEM

Introduction

The Uniform Financial Institutions Rating System (UFIRS) was adopted by the Federal Financial Institutions Examination Council (FFIEC) on November 13, 1979, and updated in December 1996. Over the years, the UFIRS proved to be an effective supervisory tool for evaluating financial institutions on a uniform basis and for identifying institutions requiring special attention. Changes in the banking industry and regulatory policies prompted a revision of the 1979 rating system. The 1996 revisions to UFIRS include the addition of a sixth component addressing sensitivity to market risk, the explicit reference to the quality of risk management processes in the management component, and the identification of risk elements within the composite and component rating descriptions.

The UFIRS takes into consideration certain financial, managerial, and compliance factors that are common to all institutions. Under this system, the supervisory agencies endeavor to ensure all financial institutions are evaluated in a comprehensive and uniform manner, and that supervisory attention is appropriately focused on institutions exhibiting financial and operational weaknesses or adverse trends.

The UFIRS also serves as a useful vehicle for identifying institutions with deficiencies in particular component areas. Further, the rating system assists Congress in assessing the aggregate strength of the financial industry and following risk management trends. As such, the UFIRS assists regulatory agencies in fulfilling their mission of maintaining stability and public confidence in the nation's financial system.

UFIRS Overview

Under the UFIRS, each financial institution is assigned a composite rating based on an evaluation of six financial and operational components, which are also rated. The component ratings reflect an institution's capital adequacy, asset quality, management capabilities, earnings sufficiency, liquidity position, and sensitivity to market risk (commonly referred to as CAMELS ratings). When assigning ratings, examiners take into consideration an institution's size and sophistication, the nature and complexity of its activities, and its general risk profile.

Composite and component ratings are assigned based on a numerical scale from 1 to 5, with 1 indicating the highest rating, strongest performance and risk management practices, and least degree of supervisory concern. A 5 rating indicates the lowest rating, weakest performance and risk management practices, and highest degree of supervisory concern.

A bank's composite rating generally bears a close relationship to its component ratings. However, the composite rating is not derived by averaging the component ratings. Each component rating is based on a qualitative analysis of the factors comprising that component and its interrelationship with other components. When assigning a composite rating, some components may be given more weight than others depending on the situation at an institution. In general, assignment of a composite rating may incorporate any factor that bears significantly on the overall condition of the financial institution. Composite and component ratings are disclosed to an institution's board of directors and senior management. However, banks cannot, except in very limited circumstances, disclose the ratings or any part of a report of examination (ROE) without the prior written consent of their primary regulator.

Management's ability to respond to changing circumstances and address risks that result from new business conditions, activities, or products, is an important factor in determining an institution's risk profile and the level of supervisory concern. For this reason, the management component is given special consideration when assigning a composite rating.

The ability of management to identify and control the risks of its operations is also taken into account when assigning each component rating. All institutions are expected to properly manage their risks; however, it is recognized that appropriate management practices vary considerably among financial institutions depending on their size, complexity, and risk profile. Less complex institutions engaged solely in traditional banking activities and whose directors and senior managers are actively involved in the oversight and management of day-to-day operations may use relatively basic risk assessment, risk management, and internal control systems. At more complex institutions, formal, multifaceted systems and controls are needed to address their broader range of financial activities and to provide senior managers and directors with the information they need to monitor and direct day-to-day activities.

Consumer Compliance, Community Reinvestment Act, and specialty examination findings and ratings are also taken into consideration, as appropriate, when assigning component and composite ratings under UFIRS. The specialty examination areas include: Bank Secrecy Act, Information Technology, Trust, Government Security Dealers, Municipal Security Dealers, and Registered Transfer Agent.

An addendum at the end of this section contains UFIRS composite and component rating definitions and descriptions.

Disclosure of Ratings

The FDIC believes that disclosure of the UFIRS component and composite ratings to bank management is appropriate. The impact the financial services industry has on the general economy magnifies the importance of sound risk management practices. In this environment, the examination process is enhanced through disclosure of the UFIRS ratings by encouraging a more open and complete discussion of examination findings and recommendations. Disclosure also provides management with useful information for making effective risk management decisions.

Additionally, open discussion of the CAMELS ratings provides institutions with a better understanding of how ratings are derived, and enables management to better address any weaknesses in specific areas.

Discussions with Management

Generally, the examiner-in-charge (EIC) should discuss the recommended component and composite ratings with senior management and, when appropriate, the board of directors, within a reasonable proximity to the conclusion of the examination. Examiners should clearly explain that their ratings are tentative and subject to the review and final approval by the regional director or designee. Examiners should follow regional guidance regarding the disclosure of component and composite ratings of 3 or worse. Generally, in these situations, examiners should contact the regional office overseeing the institution and discuss the proposed ratings with the case manager or assistant regional director prior to disclosing the ratings to management or the board.

Examiners should discuss with management and the board, the key factors they considered when assigning component and composite ratings. Examiners should also explain the composite rating is not based on a numerical average, but rather a qualitative evaluation of an institution's overall managerial, operational, and financial performance.

The management component rating may be particularly sensitive and important. The quality of management is often the single most important element in the successful operation of an insured institution. It is usually the factor most indicative of how well risk is identified and controlled. For this reason, examiners should thoroughly review and explain the factors considered when assigning the management rating. Written comments in support of the management rating should include an assessment of the effectiveness of existing policies and procedures in identifying and managing risks.

Finally, management should be reminded that all examination findings, including the composite and component ratings, whether disclosed verbally or in the written report of examination, are subject to the confidentiality rules imposed by Part 309 of the FDIC's Rules and Regulations.

Examination Letters

The FDIC's expectations for troubled institutions should be clearly communicated to bank management between the close of an examination and the issuance of an enforcement action. An examination letter should be delivered by FDIC Field Supervisors to chief executive officers/presidents during examination exit meetings, or earlier, for any bank newly-assigned a CAMELS composite 3 rating or worse.

Examination letters should notify management their institution's composite rating was tentatively downgraded and convey the expectation that management stabilize their institution's risk profile and strengthen its financial condition. The letter should notify management that actions taken to materially expand the institution's balance sheet or risk profile are inconsistent with supervisory expectations. The letter should also inform management they are required to obtain a non-objection from their regional director before engaging in any transactions that would materially change the institution's balance sheet composition, such as significantly increasing total assets or volatile funding sources. If practical, state banking departments should be included as a joint issuer of examination letters relating to FDIC supervised examinations. Furthermore, arrangements should be made to issue an examination letter relating to state authority examinations in which a downgrade is anticipated.

Immediate corrective measures, including the issuance of a temporary order requiring an institution to cease and desist, may be appropriate in higher-risk situations, such as when management:

- Fails to follow instructions in the examination letter,
- Does not acknowledge, or is slow to address, the institution's problems,
- Takes actions that compound the institution's problems,
- Increases the use of volatile funding sources,
- Extends credit in an unsafe and unsound manner,
- Pays excessive dividends, salaries, or bonuses, or
- Makes unjustified payments to institution-affiliated parties.

EXAMINATION FREQUENCY

The first priority of the Division of Risk Management Supervision (RMS) is the effective oversight of banks requiring special attention. The identification and supervision of banks requiring special attention is best accomplished through the examination process.

Section 337.12 of the FDIC Rules and Regulations implements Section 10(d) of the FDI Act and governs the frequency of examinations for insured state nonmember banks. Section 347.211 governs the examination frequency of branches of foreign banks.

Section 337.12 requires an annual full-scope on-site examination of every insured state nonmember bank at least once during each 12-month period. Annual examination intervals may be extended to 18 months under the following conditions:

- The bank has total assets of $500 million or less,
- The bank is well capitalized as defined in Section 325.103 of the FDIC Rules and Regulations,
- The bank was assigned a management component rating of 1 or 2 at the most recent FDIC or applicable state banking agency examination,
- The bank was assigned a composite rating of 1 or 2 at the most recent FDIC or applicable state examination,
- The bank currently is not subject to a formal enforcement proceeding or order by the FDIC, OCC, or Federal Reserve System, and
- No person acquired control of the bank during the preceding 12-month period in which a full-scope on-site examination would have been required but for the above noted exceptions.

These rules apply similarly to U.S. branches or agencies of a foreign bank with total assets less than $500 million if the office received a composite ROCA rating of 1 or 2 at its most recent examination. In all cases, the FDIC reserves the right to examine more frequently if they deem it necessary.

The FDIC strives to provide risk management and specialty examinations of all state nonmember banks within prescribed intervals. If examination frequency requirements, other than a few nominal and non-recurring exceptions, cannot be met, regional directors should prepare and submit a memorandum to the Director of RMS. The memorandum should include a description of the nature and cause of the situation and a description of any needed, planned, or implemented corrective measures designed to maintain an adequate supervision program.

Alternate Examinations

Examinations may be conducted in alternate 12 (or 18) month periods if the FDIC determines that a full-scope, on-site examination completed by the appropriate state supervisory authority during the interim period is acceptable. However, such alternate examinations should be accepted only for the following institutions: composite 1- or 2-rated institutions, and for stable and improving composite 3-rated institutions if the composite rating is confirmed by the Statistical Camels Offsite Review (SCOR) review program and no adverse trends are noted from other available information. The length of time between the end of one examination and the start of the next (whether one or both of the examinations are conducted by a state supervisory agency or the FDIC) should not exceed 12 (or 18) months.

For purposes of monitoring compliance with examination frequency schedules, the end of the examination is defined as the earlier of the date the EIC submits the report for review, or 60 calendar days from the examination start date as defined in the Report of Examination Instructions.

Specialty Examination Intervals

The statutory requirements in Section 10(d) of the FDI Act do not apply to specialty examinations. Thus, specialty examinations are governed by internal RMS policy. Specialty examinations should generally be conducted concurrently with risk management examinations, except when the size or arrangement of a department makes it impractical or inefficient to do so. Although there will be some differences, specialty examinations are generally subject to the same examination intervals, including appropriate extensions, as risk management examinations.

Regional directors can make reasonable adjustments to specialty examination intervals to accommodate concurrent examinations where rating differences or alternate state examinations result in examination intervals that are not conducive to scheduling concurrent examinations. Reasonable adjustments include extending the examination cycle for 1- and 2-rated specialty areas. Although not permitted by statute for safety and soundness examinations, internal policy allows regional directors to also extend the examination cycle for 3-rated specialty areas. Specialty areas rated 4 or 5 should normally not be extended beyond a one-year interval. Additionally, since Municipal Securities Dealers are subject to a two-year examination cycle under Municipal Securities Rulemaking Board rules, any adjustment in this area should not exceed the two-year requirement. The possibility of conducting specialty examinations with state authorities should be explored if reasonable adjustments can be made.

When the state supervisory authority has examination responsibility for the safety and soundness examination of an institution, it will not be the responsibility of the FDIC to conduct any specialty examinations that are not conducted by the state supervisory authority, with the exception of BSA examinations. If safety and soundness examinations are conducted under the alternating examination cycle program, and the state does not conduct a BSA examination, then the FDIC is required to conduct a BSA examination.

Insured Branches of Foreign Banks

Insured branches of foreign banks are required to be examined every 12 months under Section 10(d) of the FDI Act. However, Section 347.211 of the FDIC Rules and Regulations specifies that domestic branches of foreign banks may be considered for an 18-month examination cycle when certain criteria are met and no other factors suggest more frequent examinations are necessary. To be eligible for an extended 18-month examination cycle, a US branch of a foreign bank must:

- Have total assets of less than $500 million,
- Have a composite ROCA supervisory rating of 1 or 2 at its most recent examination,
- Not be subject to a formal enforcement action,
- Not have undergone a change in control during the preceding 12-month period; and
- Have Tier 1 and total risk-based capital ratios (at the foreign bank) of at least 6 percent and 10 percent, respectively, when reported on a consolidated basis; or
- Has maintained on a daily basis, over the previous three quarters, eligible assets in an amount not less than 108 percent of the preceding quarter's average third party liabilities, and sufficient liquidity is currently available to meet its obligations to third parties.

Additional factors may also be considered in determining examination frequency, including certain discretionary standards outlined in Section 347.211.

EXAMINATION TYPES

Risk Focused Supervision

Effective risk management has always been central to safe and sound banking activities and has become more important as new technologies, product innovation, and the size and speed of financial transactions have changed the nature of banking. The objective of a risk-focused examination is to efficiently and effectively evaluate the safety and soundness of a bank. Examiners should focus their resources on a bank's highest risk areas when assessing risk management programs, financial conditions, internal controls, etc. The exercise of examiner judgment to determine the scope and depth of review in each functional area is crucial to the success of the risk-focused supervisory process.

The most effective examination approach focuses examiner resources on assessing management's ability to identify and control risks. Internal and external audits, loan reviews, and other control activities are integral considerations in an assessment of a bank's risk profile. Refer to the Internal Routine and Controls section of this Manual for an in depth discussion of this area.

Examiners should consider the adequacy of audit and control practices in determining a bank's risk profile and, when appropriate, try to reduce regulatory burdens by testing rather than duplicating the work of a bank's audit and control functions. Transaction testing remains a reliable and essential examination technique for use in the assessment of a bank's condition. However, the amount of transaction testing necessary to evaluate activities generally depends on the quality of the bank's risk management processes. Once the integrity of the bank's risk management system is verified through testing, conclusions regarding the extent of risks within an activity can often be based on the results of internal reports rather than in-depth, onsite assessments.

Full Scope Examinations

The minimum requirements of a full-scope examination are defined as the procedures necessary to complete the mandatory pages of the uniform ROE and evaluate all components of the UFIRS/CAMELS (Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk) rating system. The completion of additional steps and pages may often be appropriate.

In a full scope examination, all examination activities are considered in the overall assessment of the institution. These activities include the Risk Management, Information Technology, Bank Secrecy Act/Anti-Money Laundering and Office of Foreign Assets Control, Trust, Registered Transfer Agent, Municipal Securities Dealer, and Government Securities Dealer examination programs. Summary comments and ratings should be brought forward and consolidated in the risk management ROE. Compliance/Community Reinvestment Act examination activities are included in the overall supervision program, although separate reports and examination cycles will continue.

Limited Scope Examinations and Visitations

The terms limited scope examination and visitation are interchangeable and may be defined as any examination that does not meet the minimum requirements of a full-scope examination. Since limited scope examinations and visitations are not full-scope examinations, they do not satisfy the requirements of Section 10(d) of the FDI Act. Limited scope examinations and visitations have a flexible format and may be used to determine changes in an institution's risk profile, monitor compliance with a corrective program, or comply with SCOR follow-up requirements. They may also be used to investigate adverse or unusual situations, determine progress in correcting deficiencies, act as an investigative or supervisory tool, or to comply with schedules described under Other Situations below.

Limited scope examinations and visitations may address the overall condition of the institution, including material changes since the previous examination and areas that exhibit more than normal risk. Depending on the scope and purpose of the examination or visitation, examiners can assign composite ratings, as well as component ratings for areas that were sufficiently reviewed. Ratings of component areas that were not reviewed should be carried forward from the previous examination.

Completion of the standard examination report form is not required, although appropriate report pages may be included if considered necessary to clarify a finding or recommendation. Results should generally be conveyed in a memorandum from the examiner-in-charge (EIC) to the regional director. If the examination or visitation results are to be sent to the institution, they can be in any appropriate form (letter or other suitable format).

Other Situations

In addition to the preceding instructions, examinations should be performed in the following situations:

Institutions Subject to Corrective Actions

Supervisory strategies for institutions operating under an enforcement action, particularly formal actions, should, in most cases, include interim on-site limited scope examinations or visitations. The on-site reviews should include an evaluation of management's understanding of, and adherence to, the provisions of the corrective program. Limited scope examinations or visitations should be scheduled within six months after an enforcement action is issued to evaluate an institution's progress in addressing the corrective program. Particular attention should be focused on the primary cause of the institution's problems and the principal objectives of corrective programs. Where a decision is made to forego or delay the interim on-site activity, the reasons should be documented in regional office files.

Newly Chartered Insured Institutions

Adverse economic and other factors often negatively affect newly organized institutions more than they do established institutions. Further, failures of de novo institutions demonstrate that unseasoned institutions can pose a significant risk to the Deposit Insurance Fund and therefore, warrant enhanced supervision and monitoring.

Some newly organized institutions pursue early changes in established business plans. In some cases, those changes lead to increased risk and financial problems if accompanying controls and risk management practices are inadequate. Common risk elements observed at troubled or failed de novo institutions during their first seven years of operation include:

- Rapid growth,
- Over reliance on volatile funding sources,
- Concentrations without compensating controls,
- Significant deviations from approved business plans,
- Non-compliance with the order approving deposit insurance,
- Weak risk management practices,
- Unseasoned loan portfolios,
- Significant consumer protection problems, or
- Problematic third-party relationships.

Examination and Visitation Cycles

If a newly chartered and insured institution is a subsidiary of a multi-bank holding company that is in satisfactory condition, normal examination cycles should be followed at the regional director's discretion; otherwise, a limited scope examination should be conducted within the first six months of operation and a full-scope examination within the first twelve months of operation. Subsequent to the first examination and through the seventh year of operation, at least one examination should be performed each year. Extended examination intervals should not be applied in the first seven years of operation. After the initial full-scope examination, examinations may be alternated with the state supervisory authority.

Monitoring Activities

During the seven-year de novo period, regional offices have a responsibility to monitor de novo institutions' activities, review compliance with any conditions of deposit insurance orders, and track performance in relation to approved business plans. Significant changes to business plans must be submitted to the appropriate regional office for approval. Examiners assist in those monitoring activities by:

- Conducting general visitation and examination procedures,
- Assessing institutions' overall risk profiles and management capabilities,
- Reviewing institutions' conformity with business plans,
- Evaluating compliance with any outstanding conditions, and
- Documenting their findings in reports of examination.

Changes in Business Plans

There is a significant degree of judgment involved in determining a major deviation or material change in a business plan. Such changes may be evidenced by shifts in asset or liability mix, variances in loan, deposit, or total asset volumes from original projections, or the introduction or deletion of a specific business strategy (such as the initiation of subprime lending or the gathering of brokered deposits). Business plans generally address a number of factors which include, but are not limited to:

- Geographic markets,
- Loan products and services,
- Investment strategies and levels,
- Deposit products and services,
- Other services, such as private banking or trust services,
- Liquidity strategies and funding sources,
- Delivery channels, particularly through third party relationships,
- Fixed-assets (e.g. branches/loan production offices),
- Other activities (on- or off-balance sheet), including fee-for-service activities,
- Customer categories (such as money services businesses or foreign financial institutions), and
- Relationships with parent organizations and affiliates.

State nonmember banks requesting deposit insurance must agree to obtain the prior approval of the FDIC for any material change to their business plan. Any significant change in the items listed above should generally be viewed as a material change in business plan. Such changes may be evidenced by significant (+/- 25%) deviation in asset growth projections; changes in the asset/liability mix or products and services offered; or the introduction of new business strategies such as an unplanned establishment of loan production offices or use of third parties to broker, underwrite, or originate credit on behalf of the institution.

Converting to Insured Nonmember Status

A full-scope examination should be conducted within twelve months of the last examination prior to conversion for national, state member, and thrift institutions. For noninsured institutions converting to insured status, a full-scope examination should be conducted within twelve months of the last examination prior to conversion. If the last examination was conducted by the state authority, the regional director has the discretion to accept it. However, such an examination should be accepted only for composite 1- or 2-rated institutions.

Change of Ownership Control

A full-scope examination should be conducted within twelve months after a change of control. Thereafter, standard examination intervals apply.

COORDINATING EXAM SCHEDULES

State Authorities

Every effort should be made to coordinate examination schedules with state authorities to take advantage of state resources, to minimize duplications of effort, and to lessen business disruptions to institutions. A representative of the regional office should meet with representatives from each state banking authority to determine examination responsibilities for the upcoming year. Responsibilities may be defined by ratings, size, or location of institutions, or assigned by specific institutions as deemed appropriate. Such agreements should contain flexibility to allow either party to alter schedules with minimal notice. While state examination requirements should be considered in the coordination process, state requirements should not be the determining factor in the final agreement.

Holding Company Inspections and Subsidiary Institution Examinations

Examinations of holding company subsidiaries should be coordinated with other Federal agencies whenever possible. Particular emphasis for coordinating examinations should be placed on banking organizations with over $10 billion in consolidated assets and those banking organizations (generally with assets in excess of $1 billion) that exhibit financial weaknesses.

Examinations and inspections of insured subsidiary banks and bank holding companies that do not meet the foregoing criteria should be coordinated to the extent practical and where resources permit. regional directors (or designees) should meet periodically with representatives from other Federal agencies to develop coordinated schedules that will maximize the use of examination resources and enhance the efficiency of bank and bank holding company examinations. The coordination of examinations should focus on the use of common financial statement dates, where possible, and allow for joint discussions of examination findings with management. However, absolute concurrence, common as-of dates, and simultaneous starting dates are not required. Appropriate state regulatory agencies should also be kept informed and encouraged to participate in the coordinated Federal efforts affecting state chartered institutions.

Examinations of nonbank affiliates may be conducted at the discretion of the regional director, but independent examinations of holding companies supervised by the Federal Reserve may not be conducted without prior approval of the Washington Office.

Interstate Banking and Chain Banks

A coordinated supervisory strategy for interstate banking organizations (both intra- and inter-regional) should be developed. The supervisory strategy developed should combine traditional supervision of individual units with an appropriate top-down approach to assess risks and to monitor and coordinate supervisory actions. For these organizations, the regional director has discretion to omit, delay, or modify existing examination frequencies if the financial condition of the holding company and lead bank is considered satisfactory; the condition of the subsidiary units is believed to be satisfactory; control over all insured banks in the organization is effectively centralized; and, management is favorably regarded.

Regional directors are responsible for: (a) designating a lead Region to design an appropriate supervisory strategy for interstate banking organizations; and (b) ensuring pertinent information is conveyed in a timely manner to other RMS Regions and to appropriate Federal and State agencies.

Chain banking organizations generally involve a group of financial institutions or holding companies that are controlled by one individual or company. Regional directors are responsible for maintaining a record system for chain banking organizations and for developing an overall supervisory strategy for these organizations. It is the policy of the Division to supervise banks that are part of a chain banking organization in a manner that considers the financial impact of the consolidated chain on the individual institutions within that chain. Refer to Section 4.3, Related Organizations for additional details on, and a full description of, chain banking organizations.

SCHEDULING GUIDELINES

Periodic onsite examinations are critical to the supervisory process and are an integral part of the examination program. Diversified risks in the industry and the volatile performance and financial condition of individual institutions necessitate emphasis on more frequent and less structured supervision. Investigations, phone calls, e-mails, limited scope examinations, correspondence, and other forms of customized contact should be made as necessary. The purpose is to identify and obtain corrections in an institution's policies and procedures before serious financial problems develop.

Pre-examination activities should include efforts to determine the activities and condition of nonbank subsidiaries. If not determinable in advance, this information should be obtained early in the examination in order to assess the necessity for, and depth of, subsidiary examinations.

A major component of the risk-focused supervisory approach is the flexibility to conduct examination activities at various times during the examination cycle based on risk or staffing considerations. However, it is anticipated that most examination activities will be conducted as of a single point-in-time near the end of the risk management examination cycle, particularly in well-rated institutions.

Anticipatory Supervision

To effectively prevent or mitigate serious problems in an institution, the conditions that caused, or may cause, problems must be identified and corrected early. Corrective action should be taken immediately upon identifying problems or unacceptable risk management practices. Corrective action taken after conditions have seriously deteriorated is often too late to avoid institutional failures. Moral suasion and informal agreements are normally sufficient when unacceptable risk levels or risk management practices are identified early, but formal action must be considered, even when an institution is rated 1 or 2, if circumstances warrant.

A forward-looking supervisory approach that identifies and seeks to correct objectionable conditions requires serious thought and a balanced response by examiners. Critical comments must be well-supported and based on facts, logic, and prudent supervisory standards. Although examiners can not predict future events, they should consider the likelihood that identified weaknesses will cause material problems in the future, and consider the severity of damage to an institution if conditions deteriorate. In questionable circumstances where formal action is considered, examiners should consult with their regional office while the examination is in progress regarding the material needed to support a potential action.

Scheduling Considerations

The success of a risk focused examination program depends largely on the effectiveness of preplanning efforts and assignment scheduling. The objective of a risk focused examination process is to identify problems early and devise solutions in the quickest, most efficient manner possible. In some instances, evidence of objectionable practices or conditions may indicate the need for an accelerated examination or visitation. In less severe situations, the information is retained and factored into the scheduling of future examinations.

In order for examiners to proactively assess potential deficiencies, it is critical for Field Supervisors and other personnel to be aware of, and have access to, pertinent documentation. Regional directors should ensure copies of relevant correspondence and other information that may affect scheduling decisions is documented and made available to scheduling personnel.

The following list includes sources of information that may have an influence in prioritizing assignments. Some of these items, such as involvement in FDIC assistance transactions, have supervisory schedules specified in internal policies. Other items are merely information that may or may not raise a concern depending on what else is known about a bank. However, these or similar items may signal that further follow-up is warranted during the examination. The list, while not all inclusive, reflects the need for supervision to be anticipatory, and provides a reminder of common information sources that may warrant consideration when scheduling.

Offsite Analysis and Monitoring

- SCOR Monitoring System
- Comprehensive Analytical Reports
- Interim Financial Reports
- Growth Monitoring System
- UBPR Analysis
- Press Releases

Other Financial Indicators

- Unusually high or fluctuating profit levels
- Significant operating losses
- Significant provision expenses to the Allowance for Loan and Lease Loss (ALLL)
- Significant levels of delinquent loans
- Significant changes in balance sheet composition
- Unusually elevated or rapidly growing asset concentrations
- High reliance on brokered funds
- Excessive trading
- Excessive dividends
- Unusually high or low ratios or numbers

Applications or Other Bank-Provided Data

- Merger activity
- Large defalcation
- Change of control
- Adverse audit report findings
- Newly insured institution
- Change in external auditor
- New subsidiary(s) or line(s)-of-business
- Cancellation of blanket bond insurance
- Exercise of a new power or profit center
- Acquiring party in an FDIC assisted transaction
- Large paydown/payoff of previously classified loans
- Affiliation with a problem institution/holding company

Known Characteristics

- Unusually high or low salaries
- Compensation linked to performance (income, loan or deposit growth)
- Significant litigation
- Infighting among officers or directors
- Officers or directors with past due loans
- Dominating or self-serving management
- Operating at the margin of laws and regulations
- Inexperienced or questionable management
- Substantial outside business interests of a key officer
- Conducting business with questionable firms
- Lack of diversity in business lines
- Higher-risk business strategies
- Refinancing poor quality loans
- Advertising above-market interest rates
- Large blocks of bank stock pledged as collateral
- Numerous or unusual affiliated loan participations
- Improper handling of correspondent bank accounts
- Sacrificing price or quality to increase loan volumes
- Hiring of a dismissed, unethical, or marginal officer

Other Bank Regulators

- Improper handling of correspondent bank accounts
- Increased or unusual loan participations among affiliated or closely-held institutions
- Large blocks of stock pledged as collateral
- Affiliation with a 3-, 4-, or 5-rated institution or holding company
- Large defalcation
- Banker with past due loans at another institution
- Loans classified at other institutions

Media

- New chief executive officer or chief lending officer
- Adverse publicity
- Annual or interim period losses
- Adverse economic event in a community
- Natural disaster such as a flood, fire, or earthquake
- Large defalcation
- Large financial commitment as sponsor or lead bank in a major project or development
- Banker death or disappearance
- Announcement of major new activity or department

Rumors/Observations/Other

- Change in external auditor
- High or sudden employee turnover
- Significant litigation against the institution or insiders
- Unusual activity in stock of the institution (price movement up or down, or heavy trading volume)
- Institution advertising above market rates
- Significant change in asset/liability compositions
- Questionable loans being booked
- Relationships with borrowers of questionable character
- Confidential or anonymous tips

RELYING ON STATE EXAMINATIONS

Section 349 of the Riegle Community Development and Regulatory Improvement Act of 1994 requires the FFIEC to issue guidelines establishing standards for the purpose of determining the acceptability of state reports of examination under Section 10(d)(3) of the FDI Act. Under Section 10(d)(3), a Federal banking agency may conduct an annual, on-site examination of an insured depository institution in alternate 12 (or 18) month periods if the agency determines that a state examination conducted during the intervening period is adequate. The standards issued by the FFIEC are to be used at the discretion of the appropriate Federal banking agency.

The supervisory divisions of the FDIC and the Board of Governors of the Federal Reserve System responsible for the examination of state-chartered, insured depository institutions, and the branches and agencies of foreign banks that have been chartered by the states, have a long history of coordinating with state banking departments to fulfill a mutual goal of promoting a safe and sound banking system. It is recognized that this close cooperation between the Federal and State regulators promotes efficiency in the examination process, reduces the regulatory burden on state-chartered, insured depository institutions, and improves the supervisory process.

The Federal and State banking agencies have worked together, to varying degrees, in the following areas:

- Conducting alternate, joint, and concurrent examinations of insured depository institutions, and of the branches and agencies of foreign banks that have been chartered by the states;
- Processing safety and soundness examination reports and applications on a timely basis;
- Using common examination report and application forms;
- Developing and issuing informal (e.g., board resolutions, memoranda of understanding or other similar agreements) and formal enforcement actions;
- Exchanging supervisory information;
- Offering Federal agency training programs to state examiners; and
- Providing access to the Federal agency databases.

The FDIC intends to continue these cooperative efforts to the maximum extent possible. It is recognized, however, that the adequacy of state budgeting, examiner staffing, and training are important factors to enhancing Federal and State coordination. The FDIC has entered into formal and informal arrangements with most state banking departments. These arrangements or working agreements generally address the following areas:

- The number of state-chartered, insured institutions to be examined on an alternating basis by the state banking department and by the FDIC;
- The frequency of safety and soundness examinations;
- The type of examinations to be conducted (independent, joint, or concurrent) by each agency;
- The pre-examination procedures to be performed;
- The responsibilities of each agency for processing reports of examination;
- The responsibilities of each agency for conducting specialty examinations (Compliance, IT, Trust, etc.);
- The procedures for coordinating informal and formal enforcement actions;
- The procedures for processing joint applications; and
- The procedures for sharing supervisory information.

These arrangements are structured to permit both Federal and State agencies the flexibility to conduct an independent examination subject only to notification to the other party. Generally, only institutions rated 1 or 2 are examined on an alternating basis allowing for a reasonable interval between examinations.

A hallmark of a successful program has been the flexibility to tailor cooperation to the particulars of each state and to the specifics of individual banks within a state, plus the reality of changing circumstances at both the Federal and State levels. The FFIEC guidelines strive to maintain that flexibility.

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

- The completeness of the state examination report. The state report of examination should contain sufficient information to permit a reviewer to make an independent determination on the overall condition of the institution as well as each component factor and composite rating assigned under the UFIRS and commonly referred to as the CAMELS rating system, or the ROCA rating system used for branches and agencies of foreign banks.
- The adequacy of documentation maintained by state examiners to support observations made in examination reports.
- The ability over time of a state banking department to achieve examination objectives. At a minimum, the FDIC will consider the adequacy of state budgeting, examiner staffing and training, and the overall review and follow-up examination process of a state banking department. Accreditation of a state banking department by the Conference of State Bank Supervisors is among the factors that will be considered.
- The adequacy of any formal or informal arrangement or working agreement between a state banking department and the FDIC.

The FDIC, as part of its routine review of state examination reports, will assess the quality and scope of the reports to determine whether they continue to meet the general criteria noted above. The FDIC retains the option to conduct a follow-up examination in cases in which a state examination report appears insufficient or the condition of an insured institution appears to be seriously deteriorating.

If a state and the FDIC have cooperative examination programs, regional directors may involve FDIC examiners in state examinations if an institution's condition is deteriorating, or areas of concern are identified.

The FDIC will work with state banking departments to resolve any concerns regarding the acceptability of each other's work, the operation of cooperative programs, or any other issues of mutual interest.

PRE-EXAMINATION ACTIVITIES

Thorough pre-examination planning is critical to the efficient completion of an examination. Effective pre-examination planning helps support scoping decisions in terms of work performed and areas to receive special attention. It can also help determine staffing needs in regards to the number and expertise of personnel required. Finally, it can enhance examination efficiencies and reduce disruptions at institutions.

Part of the pre-examination planning should address the need for, or extent of, branch examinations. It is the FDIC's practice to examine the various offices of a branch banking system on an as-needed basis only. Such decisions are within the province of the regional director or may be delegated by the regional director to the Field Supervisor or EIC of a particular examination.

In general, examinations represent a comprehensive and coordinated effort between Risk Management and specialty examiners in the assessment of an institution's overall risk profile. Information request letters from various functions scheduled for the upcoming examination (for example Risk Management, Information Technology, Bank Secrecy Act, and Trust examinations) should be coordinated and combined whenever practical. Examiners should take special care to tailor information request letters to the specific characteristics of the institution, and remove unnecessary and redundant information from the request lists.

As a general rule, bankers should be given at least two weeks notice of an upcoming safety and soundness examination in order to provide them with enough time to complete pre-examination requests. A shorter period is permissible if the institution is not unduly burdened, or if a shorter period is occasionally needed due to resource requirements. Exceptions to this general policy may include problem institutions, situations where management and ownership of the institution are identical, or in situations where conditions appear to be deteriorating rapidly.

Examiners should make every effort to conduct as many pre-, post-, and other examination procedures as reasonably possible off-site in order to minimize disruptions to an institution's normal business activities. Additionally, supervisors should be mindful of an institution's space and personnel limitations and schedule the number of examiners working on bank premises accordingly.

An examination procedures module titled Risk Scoping Activities is included in the Examination Documentation Modules. This module identifies and lists several activities to be completed by examiners during the pre-examination process. Refer to this module for additional guidance.

Reviewing External Audit Workpapers

Examiners are generally required to review the workpapers of the independent public accountant or other auditor performing the external auditing program of certain insured institutions that have been or are expected to be assigned a UFIRS composite rating of 4 or 5. A workpaper review is intended to provide information prior to or during an examination relating to an institution's internal control environment and its financial reporting practices. Thus, a workpaper review assists examiners in determining the scope of the examination and the procedures to be applied to different areas of operations.

Shared Loss Agreements

A shared loss agreement (SLA) is a contract between the FDIC and institutions that acquire failed bank assets. Under the agreements, the FDIC agrees to absorb a portion of the losses, if incurred, on specific assets (usually loans), purchased by an institution. If an institution makes recoveries on covered assets, they must reimburse the FDIC for part of the recoveries. Loss share agreements cover specific timeframes and are often written so the FDIC absorbs 80 percent of incurred losses (up to a stated threshold), and receives 80 percent of recoveries. To maintain loss coverage, institutions must adhere to the terms of their agreement and make good faith efforts to collect loans.

Note: The FDIC's reimbursement for losses on assets covered by an SLA is measured in relation to an asset's book value on the records of the failed institution on the date of its failure, not in relation to the acquisition-date fair value at which covered assets must be booked by an acquiring bank.

The FDIC uses different types of agreements for commercial loans and residential mortgages. Both types cover credit losses and certain related expenses. However, for commercial assets, SLAs generally cover losses for five years and recoveries for eight years. For residential mortgages, SLAs generally cover losses and recoveries for ten years.

Shared loss agreements are designed to reduce the FDIC's burden of managing receivership assets and mitigate acquirers' losses. Banks should not allow shared loss considerations to unduly impact foreclosure decisions. Banks should only foreclose on properties after exhausting other loss-mitigation and workout options. To avoid unnecessary home foreclosures, most residential SLAs specifically require institutions to engage in loss-mitigation efforts in accordance with the FDIC's Mortgage Loan Modification Program or the national Home Affordable Modification Program.

Examination Considerations

Regional and field office personnel should regularly communicate with the Division of Resolutions and Receiverships (DRR) to coordinate activities and share SLA information. Pre-examination communication between examiners and DRR allows examiners to determine the type and extent of SLAs and find out if any issues exist that might affect an institution's safety and soundness. If any of a bank's assets are covered by a SLA, examiners should review the agreement and consider its implications when:

- Performing asset reviews,
- Assessing accounting entries,
- Assigning asset classifications, and
- Determining CAMELS ratings.

Risk management examiners should include a sample of SLA related commercial assets in their loan scope. The number of loans sampled should be sufficient to allow examiners to assess whether the assets are administered in a manner consistent with commercial assets not covered by SLAs. Examiners may determine it is unnecessary to include SLA related residential mortgages in their loan scope; however, SLA coverage should be considered when assigning adverse classifications to residential credits covered by SLAs.

In most cases, the portion of an asset covered by an SLA should not be subject to adverse classification because loss sharing represents a conditional guarantee from the FDIC. Generally, the amount that would otherwise be adversely classified (Substandard, Doubtful, or Loss), should be reduced by the applicable coverage rate (often 80 or 95 percent).

Risk management examiners are not expected to evaluate an institution's compliance with SLAs. Personnel from DRR evaluate compliance with SLAs; assess SLA related accounting, reporting, and recordkeeping systems; and review loss-claim certificates. However, risk management examiners should notify their regional office and DRR staff if they identify potential problems or nonconformance with an agreement.

Examiners should refer to internal directives for additional information.

Other Examination Considerations

As noted above, if any of a bank's assets are covered by a SLA, examiners should review the agreement and consider its implications during examinations or visitations. The following scheduling considerations apply to FDIC supervised institutions that received FDIC assistance, or were involved in purchase and assumption or deposit transfer transactions.

Acquiring institutions with total assets in excess of ten times the deposits acquired, which are rated composite 2 or better are exempt from the following requirements. State nonmember institutions: a visitation or limited scope examination should be conducted within 30 days of the transaction date to determine how funds from the FDIC are being used and whether the bank is in accordance with any applicable assistance agreement. A second visitation or limited scope examination should be conducted within six months of the transaction. A full-scope examination should be conducted within twelve months of the transaction. Thereafter, standard examination frequency schedules apply. A cooperative program should be established with the appropriate Federal agency for national, state member, and thrift institutions, to ensure that all institutions receiving FDIC funds are properly monitored and that the FDIC Regional Director is informed of important developments.

MEETINGS WITH MANAGEMENT

Ongoing communication between the examination staff and bank management is a critical element of effective bank supervision. Open communication helps ensure examination requests are met and disruptions to an institution's daily activities are minimized. During the pre-examination process, or on the first day of the examination, board members should be encouraged to attend any or all meetings conducted during an examination. Their attendance often improves communication with outside directors and increases director knowledge of the examination process. These meetings also provide an opportunity for directors to discuss their views with examiners on banking related matters, and give examiners the opportunity to gain further insight into the experience levels and leadership qualities of bank management. While encouraging participation in these meetings, the EIC should emphasize that attendance is voluntary and that a lack of participation will not be viewed negatively.

Pre-planning communication to coordinate examination activities should address information requests (including the names of contact individuals), work space plans, and the general scope of the examination. Other informal meetings should be held as needed throughout the examination to discuss various topics and to gain management's perspective on local economic conditions and bank-specific issues. Prior to the conclusion of the examination, examiners should thoroughly discuss their findings and recommendations with senior management. Such meetings are critical in communicating examination findings to the bank and providing management an opportunity to respond. Exit meetings should fully apprise bank management of all deficiencies and recommendations that will be cited in the Report of Examination.

The following examples represent situations that will prompt meetings and encourage dialogue between examiners and management during the course of an examination. The circumstances of each examination will determine the type and number of meetings necessary, as well as the degree of formality required to schedule and conduct the meetings.

Pre-Examination Planning: The EIC or designee should conduct an on-site pre-examination meeting with bank management, or conduct a telephone conversation with management if an on-site meeting is not feasible, well in advance of the examination. The discussion should focus on topics that assist the EIC in scoping the examination, identifying information needs, gathering documents, and planning examination logistics. The meeting provides an opportunity to get management's perspective on economic conditions, primary challenges/risks, significant audit findings since the prior examination, and key risk-management processes. Primary topics of conversation should generally include current financial conditions; significant changes (planned or completed) to bank policies, personnel, or strategic direction; and any other significant changes since the previous examination. The EIC should also discuss how and when information requests will be sent to the bank (electronic or hard copies), and the method and timing any requested information will be delivered to examiners (FDICconnect, external media, or hard copies). Importantly, the delivery method(s) must meet the security measures discussed in the FDIC's e-Exam policies for the exchange, use, and storage of electronic information.

First Day Generally, the EIC and examination team should meet with senior management and staff during the first day of the examination for introductions, to request additional information, and to discuss other general examination requirements. Such meetings provide an opportunity to establish open lines of communication.

Follow-up on Prior Examination Issues Early in the examination, it is useful for the EIC to meet with senior management and discuss the bank's progress in responding to prior supervisory recommendations, as well as outstanding internal and external audit recommendations. This is also a good opportunity for examiners to gain management's perspectives on other bank-specific concerns.

Strategic Planning and Budget The EIC and management should discuss asset and/or capital growth plans, new business or business products, and other strategic and budget issues during the course of the examination.

Loan Discussion Management should participate in loan discussions and the initial review of adverse classifications, as appropriate, considering the size and condition of the institution and loan portfolio.

Material Preliminary Findings Normally, the EIC should notify senior management of major findings and possible recommendations before the final management meeting.

Management Meeting All major examination issues should be discussed with senior management as soon as practical during an examination. At a minimum, all significant issues should be discussed at the end of the examination, prior to meeting with the board of directors. As noted in the Examination Letters for Troubled Institutions section above, the FDIC's expectations for troubled institutions should be clearly communicated to bank management between the close of an examination and the issuance of an enforcement action.

Regardless of the number or type of meetings held, it is critical that examiners ensure on-going two-way communication with management. Such communication enhances the effectiveness of the examination process by allowing all parties to freely exchange information.

Meetings with Directors

The following policies have been established for meetings with boards of directors. These policies are designed to encourage director involvement in, and enhance director awareness of, FDIC supervisory efforts, and to increase the effectiveness of such efforts. The bank's composite rating is the most important variable in deciding if and when these meetings should be held. .

Banks Assigned a Composite 4 or 5 Rating

The EIC and the regional director or designee should meet with the board of directors (with the required quorum in attendance) during or subsequent to the examination. Additional meetings or contacts with the board of directors or appropriate board committee may be scheduled at the regional director's discretion.

Banks Assigned a Composite 3 Rating

The EIC should meet with the board (with the required quorum in attendance) during or subsequent to the examination. Regional office representation is at the discretion of the regional director. Additional meetings or other contacts with the board of directors or appropriate board committee may be scheduled at the discretion of the regional director or designee.

Banks Assigned a Composite Rating of 1 or 2

The EIC will meet with the board or a board committee during or subsequent to the examination when: 36 months or more have elapsed since the last such meeting; the management component of the CAMELS rating is 3, 4 or 5; any other CAMELS performance rating is 4 or 5; or any two performance ratings are 3, 4 or 5. It is important to note that meeting with a board committee (in lieu of the entire board) in conjunction with an examination is permissible only when the committee is influential as to policy, meets regularly, contains reasonable outside director representation and reports regularly to the entire board. Other factors that may be relevant to the decision of holding a board meeting include recent changes in control, ownership, or top management; adverse economic conditions; requests by management or the board for a meeting; or any unique conditions or trends pertinent to the institution. Regional office participation in meetings with composite-rated 1 or 2 banks is at the regional director's discretion.

Other Considerations

When a meeting is held in conjunction with an examination, reference should be made on the Examination Conclusions and Comments schedule as to the committee or board members, bank managers or personnel, and regulators in attendance. A clear but concise presentation of the items covered at the meeting, including corrective commitments and/or reactions of management, should also be indicated. If a meeting is held, but not in conjunction with an examination, a summary of the meeting, including the items noted above, should be prepared and a copy mailed to the institution, via certified mail, for consideration by the board and inclusion in the official minutes of the directorate's next meeting.

When it is concluded that a meeting with a board committee rather than the full board is appropriate, selection of the committee must be based on the group's actual responsibilities and functions rather than its title. In all cases, the committee chosen should include an acceptable representation of board members who are not full-time officers.

The success of a board meeting is highly dependent upon the examiner's preparation. A written agenda that lists all areas to be discussed and provides supporting documents or schedules generally enhances examiners' explanations of findings and recommendations. Failure to adequately prepare for a meeting can substantially diminish the supervisory value of an examination.

To encourage awareness and participation, examiners should inform bank management that the examination report (or copies thereof) should be made available to each director for thorough and timely review, and that a signature page is included in the examination report to be signed by each director after review of the report. Management should also be reminded that the report is confidential, remains the property of the FDIC, and that utmost care should be exercised in its reproduction and distribution. The bank should be advised to retrieve, destroy, and record the fact of destruction of any reproduced copies when they have served their purpose.

OTHER SOURCES OF EXAMINATION INFORMATION AND POLICY GUIDANCE

The primary purpose of this Manual is to provide policy guidance and direction to the field examiner that should be applied in the risk management examination process. Other policy manuals or other instructional materials pertaining to additional areas of examination interest, such as trust department operations, IT activities, transfer agent, and consumer compliance have also been developed. Those areas were not addressed significantly in this Manual in order to enhance the organization of the primary risk management material and to keep the document reasonable in length. However, exclusion of these topics in no way implies that these activities do not impact a safety and soundness examination. To the contrary, deficiencies in other aspects of a bank's operations can have a major impact on an institution's overall condition. Therefore, it is critical for examiners to be aware of the existence and understand the significance of deficiencies in other areas.

Specialty examination findings should be addressed in the ECC section of the risk management report of examination (ROE). The placement and length of related comments should be commensurate with the significance of the findings and the impact on risk management ratings. There are no mandatory specialty examination pages; however, examiners may include specialty pages in the risk management ROE when separate pages are the most effective means to communicate findings.

If a specialty examination is conducted at a date substantially removed from other examination activities, examiners may communicate their findings through a visitation report and letter to the institution if warranted. However, summary comments should also be included in the risk management ROE and factored into risk management ratings.

In some situations, it may be necessary for examiners to conduct specialty examinations separately from the Risk Management examination. In these rare cases, a separate specialty examination report may be prepared, consistent with regional guidance and outstanding report preparation instructions.

To emphasize and illustrate how weaknesses in these ancillary activities can adversely affect the whole bank, a brief overview of trust, IT, BSA, and consumer protection activities is provided.

Trust Department

A bank's trust department acts in a fiduciary capacity when the assets it manages are not the bank’s, but belong to and are for the benefit of others. This type of relationship necessitates a great deal of confidence on the part of customers and demands a high degree of good faith and responsibility on a bank’s part. The primary objective of a trust department examination is to determine whether its operations or the administration of its accounts have given rise to possible or contingent liabilities, or direct liabilities (estimated losses), which could reduce the bank's capital accounts. If the terms of trust instruments are violated, if relevant laws and regulations are not complied with, or if generally accepted fiduciary standards are not adhered to, the department, and hence the bank, may become liable and suffer losses. If the magnitude of these losses is very high, the viability of the bank may be threatened. To aid examiners in evaluating a trust department, the Uniform Interagency Trust Rating System was devised. Composite ratings of 1 (highest level of performance) through 5 (most critically deficient level of performance) are assigned based on analysis of five critical areas of a trust department's administration and operations. These include Management; Operations, Internal Controls and Audits; Earnings; Compliance; and Asset Management.

Information Technology (IT)

Information technology services apply to virtually all recordkeeping and operational areas in banks. These IT services may be managed internally on a bank's own in-house computer system, or outsourced, wholly or in part, to an independent data center that performs most IT functions. Although some or all IT services may be outsourced, management and the board retain oversight responsibilities.

The potential consequences of receiving faulty data or suffering an interruption of services are serious and warrant comprehensive IT policies and procedures and thorough IT examinations. A primary objective of an IT examination is to determine the confidentiality, integrity, and availability of records produced by automated systems. Examination priorities include an evaluation of management's ability to identify risks and maintain appropriate compensating controls.

IT operations are rated in accordance with the Uniform Interagency Rating System for Information Technology (URSIT), which is based on an evaluation of four critical components: audit; management; development and acquisition; and support and delivery. The composite IT rating is influenced by the performance of the four component functions and reflects the effectiveness of a bank’s IT risk management and information security programs and practices. A scale of 1 through 5 is used, wherein 1 indicates strong performance and 5 denotes critically deficient operating performance.

Most IT examinations are embedded in risk management ROEs and only include an URSIT composite rating. However, with approval from a regional director or their designee, examiners may conduct full-scope IT examinations that include composite and component ratings.

Bank Secrecy Act (BSA)

The Financial Recordkeeping and Reporting of Currency and Foreign Transactions Act of 1970 is often referred to as the Bank Secrecy Act (BSA). The purpose of the BSA is to ensure U.S. financial institutions maintain appropriate records and file certain reports involving currency transactions and customer relationships. Several acts and regulations that strengthen the scope and enforcement of BSA, anti-money laundering, and counter-terrorist-financing measures have been signed into law. Some of these include:

Money Laundering Control Act - 1986
Annuzio-Wylie Anti-Money Laundering Act - 1992
Money Laundering Suppression Act - 1994
Money Laundering and Financial Crimes Strategy Act - 1998
USA PATRIOT Act - 2001

Findings from BSA examinations are generally included within the safety and soundness report; however, separate BSA examinations can be conducted. Although a separate rating system for BSA does not exist, BSA findings can affect both the management rating and the overall composite rating of the institution. Refer to the BSA section of this Manual for additional information.

Consumer Protection

The principal objective of consumer protection examinations is to determine a bank's compliance with various consumer, mortgage, and civil rights laws and regulations. Consumer protection statutes include, but are not limited to, Truth in Lending, Truth in Savings, Community Reinvestment Act, and Fair Housing regulations. Noncompliance with these regulatory restrictions and standards may result in an injustice to affected individual(s) and reflects adversely on an institution's management and reputation. Moreover, violations of consumer laws can result in civil or criminal liabilities, and consequently, financial penalties. If significant in amount, such losses could have an adverse financial impact on a bank. As is the case for IT and trust operations, an interagency rating system for consumer compliance has been designed. It provides a general framework for evaluating an institution's conformance with consumer protection and civil rights laws and regulations. A numbering scheme of 1 through 5 is used with 1 signifying the best performance and 5 the worst performance. A separate examination rating is assigned to each institution based on its performance in the area of community reinvestment. The four ratings are outstanding; satisfactory; needs to improve; and substantial noncompliance.

Summary

Risk management examiners should have a general knowledge of the key principles, policies, and practices relating to IT, BSA, consumer protection, trust, and other specialty examinations. Additionally, examiners should be knowledgeable of state laws and regulations that apply to the banks they examine; the rules, regulations, statements of policy and various banking-related statutes contained in the FDIC’s rule and regulations; and the instructions for completing Consolidated Reports of Condition and Income.

DISCLOSING REPORTS OF EXAM

The Report of Examination is highly confidential. Although a copy is provided to a bank, that copy remains the property of the FDIC. Without the FDIC's prior authorization, directors, officers, employees, and agents of a bank are not permitted to disclose the contents of a report. Under specified circumstances, FDIC regulations permit disclosures by a bank to its parent holding company or majority shareholder.

Standard FDIC regulations do not prohibit employees or agents of a bank from reviewing the Report of Examination if it is necessary for purposes of their employment. Accountants and attorneys acting in their capacities as bank employees or agents may review an examination report without prior FDIC approval, but only insofar as it relates to their scope of employment. The FDIC believes the definition of agent includes an accountant or accounting firm which performs an audit of the bank.

Reports of Examination are routinely provided to a bank's chartering authority. Therefore, state bank examiners may review the bank's copy of an FDIC examination during a state examination.

EXAMINATION WORKPAPERS

Introduction

Examiners should document their findings through a combination of brief summaries, source documents, report comments, and other workpapers that clearly describe financial conditions, management practices, and examination conclusions. Documentation should generally describe:

- Key audit/risk scoping decisions,
- Core source documents reviewed, and
- General examination procedures performed.

Documentation should include summary statements. Summary statements can take many forms, including notations on copies of source documents, separate hand-written notes, comments in Examination Documentation (ED) modules, and electronic or hard-copy memorandums. At a minimum, summary comments should:

- Detail examination findings and recommendations,
- Describe supporting facts and logic, and
- Record management responses.

Although examination documentation may be maintained in various ways, examiners must securely retain appropriate supporting records of all major examination conclusions, recommendations, and assertions detailed in the Report of Examination.

Safeguarding Examination Information

Examination information may contain non-public customer information as defined in Section 501(b) of the Gramm-

Leach-Bliley Act. Therefore, examiners must exercise a high degree of care to safeguard information and control the access, storage and transport of information stored on laptops, retained on other storage media, or paper copies.

Examiners must protect FDIC property and data and respond quickly to any security breech. Examiners should:

- Protect computer equipment and data in transit,
- Track data in transit, and
- Secure unattended equipment and data.

Examiners must report unauthorized access to data and equipment on a timely basis**.** Examiners should contact the FDIC's Help Desk Staff within one hour after discovery; their supervisor as soon as possible; and in instances where theft of equipment is involved, contact the local police.

FDIC regional offices must develop procedures for accessing, transporting, storing, and disposing of electronic and paper information. The procedures should include minimum technical, physical, and administrative safeguards, and include an incident response program.

Refer to internal directives for additional information.

Examination Documentation Modules

Examination procedures have been developed jointly by the FDIC, the Federal Reserve, and various state agencies to provide examiners with tools to scope examination activities, evaluate financial conditions and risk-management practices, and document examination findings. The use of these modules is discretionary. When not used, examination findings should be documented as discussed above.

The ED modules incorporate questions and points of consideration into examination procedures that specifically address a bank's risk management strategies for each of its major business activities. The modules direct examiners to evaluate areas of risk and associated risk-control practices, thereby facilitating an effective supervisory program. The ED module examination procedures are generally separated into three distinct tiers: Core Analysis, Expanded Analysis, and Impact Analysis. The extent to which an examiner works through each of these levels of analysis depends upon the conclusions reached regarding the presence of significant concerns or deficiencies.

Where significant deficiencies or weaknesses are noted in the Core Analysis review, the examiner should complete the Expanded Analysis section, but only for the decision factors that present the greatest degree of risk to the bank. On the other hand, if risks are properly managed, examiners can conclude their review after documenting conclusions concerning the Core Analysis Decision Factors and carrying forward any applicable comments to the Report of Examination. The Expanded Analysis section provides guidance to examiners to help determine if weaknesses are material to a bank's condition or if an activity is inadequately managed.

The use of the modules should be tailored to the characteristics of each bank based on its size, complexity, and risk profile. As a result, the extent to which each module is completed will vary. Individual procedures presented for each level are meant only to serve as a guide for answering the decision factors. Each procedure does not require an individual response.

Substance of Workpapers

Appropriate documentation should be prepared and retained in the workpapers for each significant job task performed. A checklist of examination procedures performed may be used to document completed tasks and included as part of the examination workpapers. The checklist may also be used as the final documentation of lower-risk areas that receive limited reviews and findings are not material.

Examiners should use standardized loan line sheets except in special situations where alternative forms, such as institution generated line sheets, provide a clear and substantial time savings and the same general loan information. Line sheets must contain sufficient, albeit sometimes brief, supporting data to substantiate a pass or adverse classification.

For BSA examinations, examiners should document preliminary, core, and expanded procedures as needed, in accordance with current guidance relating to BSA/AML workprograms for examination procedures.

Workpaper forms are available in GENESYS to supplement report pages for certain areas of review, such as risk-weighted assets and cash flow projections. When warranted, supplemental workpapers may be included in the Report of Examination to the extent that they provide material support for significant findings.

Filing of Workpapers

Workpapers relating to major assignments should be segregated and securely stored in separate folders, envelopes, or indexed binders. For example, workpapers generated for evaluating internal routines and controls may be filed together under one major heading or separately under the major categories reviewed. Line cards should be segregated from other workpapers, alphabetized, and securely banded.

When electronic workpapers are retained, the electronic media must be encrypted, password protected, and stored in a locked facility. Non-FDIC issued laptops, desktops, or other electronic devices may not be used to store institution-provided information or examination workpapers.

BSA workpapers should be maintained separately from the workpapers of the risk management examination and must be retained for five years. The separate retention of BSA workpapers will expedite their submission to the Treasury Department in the event that they are requested for an investigation.

Each folder, envelope, or binder should be labeled with the institution's name and location, the date of examination, and a list of documents that have been prepared and retained for each category. At its discretion, each region and field office may designate the major documentation categories and supplemental lists for their respective office(s). The workpaper folders, envelopes, or binders should then be organized in a labeled box, expandable file, or other appropriate centralized filing system and retained at the conclusion of the examination. The EIC is responsible for ensuring outdated workpapers are appropriately purged and current workpapers are properly organized and filed.

Retention of Workpapers

Line sheets should generally be retained for one examination cycle, after which they may be purged from the active loan deck. Risk Management, IT, and Trust Officer's Questionnaires and BSA workpapers should be retained for a minimum of five years from the examination start date. Officer Questionnaires should be retained indefinitely when irregularities are discovered or suspected, especially if the signed questionnaire may provide evidence of these irregularities. The examiner may submit a copy of the Officer's Questionnaire with the Report of Examination if circumstances warrant, such as when the examiner suspects that an officer knowingly provided incorrect information on the document. Retention of other workpapers beyond one examination should generally be confined to those banks with existing or pending administrative actions, special documents relating to past insider abuse, documents which are the subject of previous criminal referral letters, or other such sensitive documents. While the retention of workpapers beyond one examination cycle is generally discouraged, major schedules and other pertinent workpapers can be retained if deemed useful. Additionally, if a bank's composite rating is 3 or worse, most workpapers should be maintained until the bank returns to a satisfactory condition.

ADDENDUM TO SECTION 1.1

UFIRS RATINGS DEFINITIONS

Composite Ratings

Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance. The six key components used to assess an institution's financial condition and operations are: capital adequacy, asset quality, management capability, earnings quantity and quality, liquidity adequacy, and sensitivity to market risk. The composite ratings are defined as follows:

Composite 1

Financial institutions in this group are sound in every respect and generally have components rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by the board of directors and management. These financial institutions are the most capable of withstanding the vagaries of business conditions and are resistant to outside influences such as economic instability in their trade area. These financial institutions are in substantial compliance with laws and regulations. As a result, these financial institutions exhibit the strongest performance and risk management practices relative to the institution's size, complexity, and risk profile, and give no cause for supervisory concern.

Composite 2

Financial institutions in this group are fundamentally sound. For a financial institution to receive this rating, generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within the board of directors' and management's capabilities and willingness to correct. These financial institutions are stable and are capable of withstanding business fluctuations. These financial institutions are in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Composite 3

Financial institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

Composite 4

Financial institutions in this group generally exhibit unsafe and unsound practices or conditions. There are serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. Financial institutions in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk management practices are generally unacceptable relative to the institution's size, complexity, and risk profile. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems. Institutions in this group pose a risk to the deposit insurance fund. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

Composite 5

Financial institutions in this group exhibit extremely unsafe and unsound practices or conditions; exhibit a critically deficient performance; often contain inadequate risk management practices relative to the institution's size, complexity, and risk profile; and are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed in order for the financial institution to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the deposit insurance fund and failure is highly probable.

Component Ratings

Each of the component rating descriptions are divided into an introductory paragraph, a list of principal evaluation factors, and a brief description of each numerical rating. Some of the evaluation factors are reiterated under one or more of the other components to reinforce the interrelationship between components. The evaluation factors for each component rating are in no particular order of importance.

Capital Adequacy

A financial institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks. The effect of credit, market, and other risks on the institution's financial condition should be considered when evaluating the adequacy of capital. The types and quantity of risk inherent in an institution's activities will determine the extent to which it may be necessary to maintain capital at levels above required regulatory minimums to properly reflect the potentially adverse consequences that these risks may have on the institution's capital.

The capital adequacy of an institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The level and quality of capital and the overall financial condition of the institution;
- The ability of management to address emerging needs for additional capital;
- The nature, trend, and volume of problem assets, and the adequacy of allowances for loan and lease losses and other valuation reserves;
- Balance sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities;
- Risk exposure represented by off-balance sheet activities;
- The quality and strength of earnings, and the reasonableness of dividends;
- Prospects and plans for growth, as well as past experience in managing growth; and
- Access to capital markets and other sources of capital including support provided by a parent holding company.

Ratings

A rating of 1 indicates a strong capital level relative to the institution's risk profile.

A rating of 2 indicates a satisfactory capital level relative to the financial institution's risk profile.

A rating of 3 indicates a less than satisfactory level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, even if the institution's capital level exceeds minimum regulatory and statutory requirements.

A rating of 4 indicates a deficient level of capital. In light of the institution's risk profile, viability of the institution may be threatened. Assistance from shareholders or other external sources of financial support may be required.

A rating of 5 indicates a critically deficient level of capital such that the institution's viability is threatened. Immediate assistance from shareholders or other external sources of financial support is required.

Asset Quality

The asset quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, and other assets, as well as off-balance sheet transactions. The ability of management to identify, measure, monitor, and control credit risk is also reflected here. The evaluation of asset quality should consider the adequacy of the Allowance for Loan and Lease Losses (ALLL) and weigh the exposure to counter-party, issuer, or borrower default under actual or implied contractual agreements. All other risks that may affect the value or marketability of an institution's assets, including, but not limited to, operating, market, reputation, strategic, or compliance risks, should also be considered.

The asset quality of a financial institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices;
- The level, distribution, severity, and trend of problem, classified, nonaccrual, restructured, delinquent, and nonperforming assets for both on- and off-balance sheet transactions;
- The adequacy of the allowance for loan and lease losses and other asset valuation reserves;
- The credit risk arising from or reduced by off-balance sheet transactions, such as unfunded commitments, credit derivatives, commercial and standby letters of credit, and lines of credit;
- The diversification and quality of the loan and investment portfolios;
- The extent of securities underwriting activities and exposure to counter-parties in trading activities;
- The existence of asset concentrations;
- The adequacy of loan and investment policies, procedures, and practices;
- The ability of management to properly administer its

assets, including the timely identification and collection of problem assets;
- The adequacy of internal controls and management information systems; and
- The volume and nature of credit-documentation exceptions.

Ratings

A rating of 1 indicates strong asset quality and credit administration practices. Identified weaknesses are minor in nature and risk exposure is modest in relation to capital protection and management's abilities. Asset quality in such institutions is of minimal supervisory concern.

A rating of 2 indicates satisfactory asset quality and credit administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management's abilities.

A rating of 3 is assigned when asset quality or credit administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern. There is generally a need to improve credit administration and risk management practices.

A rating of 4 is assigned to financial institutions with deficient asset quality or credit administration practices. The levels of risk and problem assets are significant, inadequately controlled, and subject the financial institution to potential losses that, if left unchecked, may threaten its viability.

A rating of 5 represents critically deficient asset quality or credit administration practices that present an imminent threat to the institution's viability.

Management

The capability of the board of directors and management, in their respective roles to identify, measure, monitor, and control the risks of an institution's activities and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in this rating. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures, and practices have been established. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives, and risk limits into prudent operating standards.

Depending on the nature and scope of an institution's activities, management practices may need to address some or all of the following risks: credit, market, operating or transaction, reputation, strategic, compliance, legal, liquidity, and other risks. Sound management practices are demonstrated by active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls taking into consideration the size and sophistication of the institution; maintenance of an appropriate audit program and internal control environment; and effective risk monitoring and management information systems. This rating should reflect the board's and management's ability as it applies to all aspects of banking operations as well as other financial service activities in which the institution is involved.

The capability and performance of management and the board of directors is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The level and quality of oversight and support of all institution activities by the board of directors and management;
- The ability of the board of directors and management, in their respective roles, to plan for, and respond to, risks that may arise from changing business conditions or the initiation of new activities or products;
- The adequacies of, and conformance with, appropriate internal policies and controls addressing the operations and risks of significant activities;
- The accuracy, timeliness, and effectiveness of management information and risk monitoring systems appropriate for the institution's size, complexity, and risk profile;
- The adequacy of audits and internal controls to: promote effective operations and reliable financial and regulatory reporting; safeguard assets; and ensure compliance with laws, regulations, and internal policies;
- Compliance with laws and regulations;
- Responsiveness to recommendations from auditors and supervisory authorities;
- Management depth and succession;
- The extent that the board of directors and management is affected by, or susceptible to, dominant influence or concentration of authority;
- Reasonableness of compensation policies and avoidance of self-dealing;
- Demonstrated willingness to serve the legitimate banking needs of the community; and
- The overall performance of the institution and its risk profile.

Ratings

A rating of 1 indicates strong performance by management and the board of directors and strong risk management practices relative to the institution’s size, complexity, and risk profile. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

A rating of 2 indicates satisfactory management and board performance and risk management practices relative to the institution’s size, complexity, and risk profile. Minor weaknesses may exist, but are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

A rating of 3 indicates management and board performance that need improvement or risk management practices that are less than satisfactory given the nature of the institution’s activities. The capabilities of management or the board of directors may be insufficient for the type, size, or condition of the institution. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

A rating of 4 indicates deficient management and board performance or risk management practices that are inadequate considering the nature of an institution’s activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to preserve the soundness of the institution. Replacing or strengthening management or the board may be necessary.

A rating of 5 indicates critically deficient management and board performance or risk management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution. Replacing or strengthening management or the board of directors is necessary.

Earnings

This rating reflects not only the quantity and trend of earnings, but also factors that may affect the sustainability or quality of earnings. The quantity as well as the quality of earnings can be affected by excessive or inadequately managed credit risk that may result in loan losses and require additions to the ALLL, or by high levels of market risk that may unduly expose an institution's earnings to volatility in interest rates. The quality of earnings may also be diminished by undue reliance on extraordinary gains, nonrecurring events, or favorable tax effects. Future earnings may be adversely affected by an inability to forecast or control funding and operating expenses, improperly executed or ill-advised business strategies, or poorly managed or uncontrolled exposure to other risks.

The rating of an institution's earnings is based upon, but not limited to, an assessment of the following evaluation factors:

- The level of earnings, including trends and stability;
- The ability to provide for adequate capital through retained earnings;
- The quality and sources of earnings;
- The level of expenses in relation to operations;
- The adequacy of the budgeting systems, forecasting processes, and management information systems in general;
- The adequacy of provisions to maintain the allowance for loan and lease losses and other valuation allowance accounts; and
- The earnings exposure to market risk such as interest rate, foreign exchange, and price risks.

Ratings

A rating of 1 indicates earnings that are strong. Earnings are more than sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings.

A rating of 2 indicates earnings that are satisfactory. Earnings are sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings. Earnings that are relatively static, or even experiencing a slight decline, may receive a 2 rating provided the institution’s level of earnings is adequate in view of the assessment factors listed above.

A rating of 3 indicates earnings that need to be improved. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.

A rating of 4 indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. Institutions so rated may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous years.

A rating of 5 indicates earnings that are critically deficient. A financial institution with earnings rated 5 is experiencing losses that represent a distinct threat to its viability through the erosion of capital.

Liquidity

In evaluating the adequacy of a financial institution's liquidity position, consideration should be given to the current level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds management practices relative to the institution's size, complexity, and risk profile. In general, funds management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, funds management practices should ensure that liquidity is not maintained at a high cost, or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Liquidity is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The adequacy of liquidity sources compared to present and future needs and the ability of the institution to meet liquidity needs without adversely affecting its operations or condition;
- The availability of assets readily convertible to cash without undue loss;
- Access to money markets and other sources of funding;
- The level of diversification of funding sources, both on- and off-balance sheet;
- The degree of reliance on short-term, volatile sources of funds, including borrowings and brokered deposits, to fund longer term assets;
- The trend and stability of deposits;
- The ability to securitize and sell certain pools of assets; and
- The capability of management to properly identify, measure, monitor, and control the institution's liquidity position, including the effectiveness of funds management strategies, liquidity policies, management information systems, and contingency funding plans.

Ratings

A rating of 1 indicates strong liquidity levels and well-developed funds management practices. The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.

A rating of 2 indicates satisfactory liquidity levels and funds management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds management practices.

A rating of 3 indicates liquidity levels or funds management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds management practices.

A rating of 4 indicates deficient liquidity levels or inadequate funds management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.

A rating of 5 indicates liquidity levels or funds management practices so critically deficient that the continued viability of the institution is threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

Sensitivity to Market Risk

The sensitivity to market risk component reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or economic capital. When evaluating this component, consideration should be given to: management's ability to identify, measure, monitor, and control market risk; the institution's size; the nature and complexity of its activities; and the adequacy of its capital and earnings in relation to its level of market risk exposure.

For many institutions, the primary source of market risk arises from nontrading positions and their sensitivity to changes in interest rates. In some larger institutions, foreign operations can be a significant source of market risk. For some institutions, trading activities are a major source of market risk.

Market risk is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes in interest rates, foreign exchange rates, commodity prices, or equity prices;
- The ability of management to identify, measure,

monitor, and control exposure to market risk given the institution’s size, complexity, and risk profile;
- The nature and complexity of interest rate risk exposure arising from nontrading positions; and
- Where appropriate, the nature and complexity of market risk exposure arising from trading and foreign operations.

Ratings

A rating of 1 indicates that market risk sensitivity is well controlled and that there is minimal potential that the earnings performance or capital position will be adversely affected. Risk management practices are strong for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide substantial support for the degree of market risk taken by the institution.

A rating of 2 indicates that market risk sensitivity is adequately controlled and that there is only moderate potential that the earnings performance or capital position will be adversely affected. Risk management practices are satisfactory for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide adequate support for the degree of market risk taken by the institution.

A rating of 3 indicates that control of market risk sensitivity needs improvement or that there is significant potential that the earnings performance or capital position will be adversely affected. Risk management practices need to be improved given the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital may not adequately support the degree of market risk taken by the institution.

A rating of 4 indicates that control of market risk sensitivity is unacceptable or that there is high potential that the earnings performance or capital position will be adversely affected. Risk management practices are deficient for the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital provide inadequate support for the degree of market risk taken by the institution.

A rating of 5 indicates that control of market risk sensitivity is unacceptable or that the level of market risk taken by the institution is an imminent threat to its viability. Risk management practices are wholly inadequate for the size, sophistication, and level of market risk accepted by the institution.

INTRODUCTION

Purpose of Capital

Bank capital performs several very important functions. It absorbs losses, promotes public confidence, helps restricts excessive asset growth, and provides protection to depositors and the FDIC insurance funds.

Absorbs Losses

Capital allows institutions to continue operating as going concerns during periods when operating losses or other adverse financial results are experienced.

Promotes Public Confidence

Capital provides a measure of assurance to the public that an institution will continue to provide financial services even when losses have been incurred, thereby helping to maintain confidence in the banking system and minimize liquidity concerns.

Restricts Excessive Asset Growth

Capital, along with minimum capital ratio standards, restrains unjustified asset expansion by requiring that asset growth be funded by a commensurate amount of additional capital.

Provides Protection to Depositors and the FDIC Insurance Funds

Placing owners at significant risk of loss, should the institution fail, helps to minimize the potential "moral hazard" and promotes safe and sound banking practices.

As the insuring agency whose primary purpose is the protection of depositors, the FDIC has a direct and obvious financial stake in the last-mentioned function. Consequently, the FDIC focuses a great deal of attention in examination and supervisory programs relating to capital positions. For example, the appraisal of assets provides a determination of adjusted, as opposed to book, capital. Similarly, Substandard and Doubtful assets, or those listed for Special Mention or as Concentrations, are identified because these may have the potential of resulting in losses and a weakened capital position at some future point. Moreover, review of the policies and practices of management can disclose weaknesses that may bring about losses and dissipation of capital. An institution's earnings performance and dividend policies are analyzed for impact on the present and expected capitalization level. Also, serious contingent liabilities that may arise in conjunction with trust department activities, litigation in which the institution is the defendant, or that emanate from other sources, are carefully scrutinized since they may lead to capital depletion.

CAPITAL

Capital-based Regulations and Guidance

The FDIC issued several capital-based regulations affecting either insured state nonmember banks or all insured institutions. These regulations establish minimum capital standards, a framework for taking supervisory actions for institutions that are not adequately capitalized, a risk-related deposit insurance premium system based, in part, on capital levels, and restrictions prohibiting certain bank related activities.

An introduction to these capital-based regulations is as follows with more detail following later in this section:

Minimum Leverage Capital Standard

Part 325 of the FDIC Rules and Regulations establishes the criteria and standards the FDIC will use in calculating the minimum leverage capital requirement and in determining capital adequacy.

Minimum Risk-Based Capital Standard

Part 325 Appendix A - Statement of Policy on Risk-Based Capital, establishes a risk adjusted capital framework, which, together with the leverage capital standard, is used in the examination and supervisory process. The risk-based framework includes a definition of capital for risk-based capital purposes, a system for calculating risk-weighted assets by assigning assets and off-balance sheet items to broad risk categories, and a minimum supervisory ratio of capital to risk-weighted assets.

Statement of Policy on Capital Adequacy

Part 325 Appendix B – Statement of Policy on Capital Adequacy, provides some interpretational and definitional guidance as to how Part 325 will be administered and enforced.

Risk-Based Capital Standard - Market Risk

Part 325 Appendix C – Risk-Based Capital for State Non-Member Banks: Market Risk, was established to ensure that banks with significant exposure to market risk maintain adequate capital to support that exposure. This

Appendix supplements and adjusts the risk-based capital ratio calculations under Appendix A of Part 325.

Prompt Corrective Action (PCA)

Part 325 of the FDIC Rules and Regulations implements Section 38 of the Federal Deposit Insurance (FDI) Act by establishing a framework for taking prompt supervisory actions against insured state nonmember banks that are not adequately capitalized. A more thorough discussion is presented later in this section, as well as within the Formal Administrative Actions Section of this manual. Certain provisions of the FDIC's PCA rules apply to all insured depository institutions that are critically undercapitalized.

Other Areas

Capital-based standards are used in the following regulations to restrict or prohibit an institution's activities.

Risk-Related Insurance Premiums	Part 327 of the FDIC Rules and Regulations
Brokered Deposits	Section 337.6 of the FDIC Rules and Regulations
Limits on Extensions of Credit to Insiders	Section 337.3 of the FDIC Rules and Regulations & FRB Regulation O
Activities and Investments of Insured State Nonmember	Part 362 of the FDIC Rules and Banks Regulations
Limitations on Interbank Liabilities	Part 206 of FRB Regulations
Limitations on Federal Reserve Discount Window Advances	Section 10B of the Federal Reserve Act
Grounds for Appointing Conservator or Receiver	Section 11(c)(5) of the FDI Act

Capital-based Guidance

The FDIC issued substantive capital-based guidance and rules affecting either insured state nonmember banks or all insured institutions. A few of the more recent FILs are presented below. Examiners should refer to the Capital Markets Website (Resources) for more complete and up-to-date information.

FIL 54-2002: Capital Standards/Interagency Questions and Answers on the Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations

This document clarifies several issues arising from the final rule on the capital treatment of these exposures as originally presented in FIL 99-2001.

FIL 52-2002: Capital Standards/Interagency Guidance on Implicit Recourse in Asset Securitizations

This guidance highlights the fundamental concern that implicit recourse may expose a bank's earnings and capital to potential losses. The guidance sets forth a range of supervisory actions that may be taken against a bank that provides implicit support to its securitizations.

FIL 48-2002: Capital Standards/Interagency Advisory on the Regulatory Capital Treatment of Accrued Interest Receivable Related to Credit Card Securitizations

This Advisory clarifies the appropriate risk-based capital treatment for banking organizations that securitize credit card receivables and record an on-balance sheet asset commonly referred to as Accrued Interest Receivable (AIR). The advisory describes how the AIR asset is created, explains why this asset is considered a subordinated retained interest for regulatory capital purposes, and describes the regulatory capital treatment that applies to the AIR asset.

FIL 31-2002: Capital Standards/Final Rule Lowers Risk-Weightings for Claims on Securities Firms

This rule lowers the risk weight applied to certain claims on qualifying securities firms from 100 percent to 20 percent.

FIL 06-2002: Capital Standards/Final Capital Rule for Nonfinancial Equity Investments

Under this rule, covered equity investments are subject to a Tier 1 capital charge (for both risk-based and leverage capital purposes) that increases in steps as the banking organization's level of concentration in equity investments increases.

FIL 99-2001: Capital Standards (Final Rule to Amend the Regulatory Capital Treatment of Recourse Arrangements, Direct Credit Substitutes, Residual

Interests in Asset Securitizations, and Asset-Backed and Mortgage-Backed Securities)

This rule amends the regulatory capital treatment of recourse arrangements, direct credit substitutes, residual interests in asset securitizations, and asset- and mortgage-backed securities, better aligning regulatory capital requirements with the risk associated with these positions. The rule primarily affects banks involved in securitization-related activities. However, it also includes banks that service assets, guarantee the performance of a third party's assets, or invest in asset-backed and mortgage-backed securities.

Components of Capital

Leverage Capital

Banks must maintain at least the minimum leverage ratio requirement set forth in Part 325. The minimum leverage ratio requirement consists only of Tier 1 (Core) Capital.

Tier 1 Capital or Core Capital is defined in Part 325 and means the sum of:

- ***common stockholders' equity –*** the sum of common stock and related surplus, undivided profits, disclosed capital reserves that represent a segregation of undivided profits, and foreign currency translation adjustments, less net unrealized losses on available-for-sale equity securities with readily determinable fair values;
- ***noncumulative perpetual preferred stock –*** perpetual preferred stock (and related surplus) where the issuer has the option to waive payment of dividends and where the dividends so waived do not accumulate to future periods nor do they represent a contingent claim on the issuer. Preferred stock issues where the dividend is reset periodically based, in whole or in part, upon the bank's current credit standing, including but not limited to, auction rate, money market and remarketable preferred stock, are excluded from this definition of noncumulative perpetual preferred stock, regardless of whether the dividends are cumulative or noncumulative;
- ***minority interests in consolidated subsidiaries –*** minority interests in equity capital accounts of those subsidiaries that have been consolidated for the purpose of computing regulatory capital, except that minority interests which fail to provide meaningful capital support are excluded from this definition;

minus

- ***all intangible assets other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships eligible for inclusion in core capital as prescribed in Section 325.5. (F) –*** Intangible assets represent those assets that are required to be reported as intangible assets in a banking institution's "Reports of Condition and Income" (Call Report) or in a savings association's "Thrift Financial Report." Mortgage servicing assets and nonmortgage servicing assets (collectively servicing assets) as well as purchased credit card relationships (PCCRs) are eligible for inclusion in core capital with certain limitations. Generally, servicing assets and PCCRs are limited to 100 percent of Tier 1 capital. In addition, nonmortgage servicing assets and PCCRs are subject to a separate sublimit of 25 percent of Tier 1 capital. Section RC-R of the Call Report Instructions provides a worksheet that banks may use to determine the amount of disallowed servicing assets and PCCRs;
- ***noneligible credit-enhancing interest-only strips –*** A credit-enhancing interest-only strip is defined in the capital guidelines as "an on-balance sheet asset that, in form or in substance represents the contractual right to receive some or all of the interest due on transferred assets; and exposes the bank to credit risk directly or indirectly associated with the transferred assets that exceeds a pro rata share of the bank's claim on the assets, whether through subordination provisions or other credit enhancement techniques." Credit-enhancing interest-only strips include other similar "spread" assets and can be either retained or purchased. In general, credit-enhancing interest-only strips are limited to 25 percent of Tier 1 capital. Section RC-R of the Call Report Instructions provides a worksheet that banks may use to determine the amount of noneligible credit-enhancing interest-only strips;
- ***deferred tax assets in excess of the limit set forth in Section 325.5(g) –*** Deferred tax assets represent reductions in future taxes payable as a result of "temporary differences" and net operating loss or tax credit carryforwards that exist at the reporting date. Generally, deferred tax assets that are dependent upon future taxable income are limited to the lesser of: (i) the amount of such deferred tax assets that the bank expects to realize within one year of the calendar quarter-end date, based on its projected future taxable income for that year or (ii) 10% of the amount of the bank's Tier 1 capital; prior to deductions.
- ***identified losses (to the extent that Tier 1 capital would have been reduced if the appropriate accounting entries to reflect the identified losses had been recorded on the institution's books) –*** Identified losses represent those items that have been determined by an evaluation made by a state or federal examiner to be chargeable against income, capital, and/or

general valuation allowances such as the allowance for loan and lease losses (examples of identified losses would be assets classified loss, off-balance sheet items classified loss, any provision expenses that are necessary for the institution to record in order to replenish its general valuation allowances to an adequate level, liabilities not shown on the institution's books, estimated losses in contingent liabilities, and differences in accounts which represent shortages);

- ***investments in financial subsidiaries subject to 12 CFR Part 362 (Subpart E)–*** Any insured state bank that wishes to conduct or continue to conduct as principal activities through a subsidiary that are not permissible for a subsidiary of a national bank must deduct from its Tier one capital the investment in equity investment of the subsidiary as well as the bank's pro rata share of any retained earnings of the subsidiary; and
- ***the amount of the total adjusted carrying value of nonfinancial equity investments subject to deduction as set forth in Appendix A of Part 325 –*** If a bank has nonfinancial equity investments that are subject to Tier 1 capital deductions, these deductions should be reported in this item. Under the capital rules on nonfinancial equity investments, a nonfinancial equity investment is any equity investment that a bank holds in a nonfinancial company through a small business investment company (SBIC), under the portfolio investment provisions of Federal Reserve Regulation K, or under section 24 of the Federal Deposit Insurance Act. The capital rules impose Tier 1 capital deductions on nonfinancial equity investments that increase as the aggregate amount of nonfinancial equity investments held by a bank increases. These marginal capital charges are based on the adjusted carrying value of the investments as a percent of the bank's Tier 1 capital as presented in the Call Report Instructions.

Risk-Based Capital

While the leverage capital standard serves as a useful tool for assessing capital adequacy, there is a need for a capital measure that is more explicitly and systematically sensitive to the risk profiles of individual banks. As a result, the Statement of Policy on Risk-Based Capital (Appendix A to Part 325) was adopted to supplement the existing Part 325 leverage capital regulation.

Under the risk-based framework, a bank's qualifying total capital base consists of two types of capital elements, "core capital elements" (Tier 1) and "supplementary capital elements" (Tier 2). To qualify as an element of Tier 1 or Tier 2 capital, a capital instrument should not contain or be subject to any conditions, covenants, terms, restrictions, or provisions that are inconsistent with safe and sound banking practices.

Tier 1 Capital for risk-based capital standards is the same as under the leverage capital standard.

Tier 2 (Supplementary) Capital consists of:

- ***allowances for loan and lease losses (ALLL), up to a maximum of 1.25 percent of gross risk-weighted assets –*** For risk-based capital purposes, the allowance for loan and lease losses equals Schedule RC, item 4.c, "Allowance for loan and lease losses," less Schedule RI-B, part II, Memorandum item 1, "Allocated transfer risk reserve included in Schedule RI-B, part II, item 7, above," plus Schedule RC-G, item 3, "Allowance for credit losses on off-balance sheet credit exposures";
- ***cumulative perpetual preferred stock, long-term preferred stock (original maturity of at least 20 years) and any related surplus*** – Perpetual preferred stock is defined as preferred stock that does not have a maturity date, that cannot be redeemed at the option of the holder, and that has no other provisions that will require future redemption of the issue. The cumulative nature entails that dividends, if omitted, accumulate until paid out. Long-term preferred stock is preferred stock with an original weighted average maturity of at least 20 years. The portion of qualifying long-term preferred stock includible in Tier 2 capital is discounted in accordance with the worksheet in the Call Report Instructions. The discounting begins when the remaining maturity falls below five years;
- ***perpetual preferred stock where the dividend is reset periodically based, in whole or part, on the bank's current credit standing –*** This entails perpetual preferred stock issues that were excluded from Tier 1 capital such as noncumulative perpetual preferred where the dividend is reset periodically based, in whole or in part, upon the bank's current credit standing (including, but not limited to, auction rate, money market, and remarketable preferred stock);
- ***hybrid capital instruments, including mandatory convertible debt –*** Hybrid capital instruments include instruments that are essentially permanent in nature and that have certain characteristics of both equity and debt. Such instruments may be included in Tier 2 without limit. This category also includes mandatory convertible debt, i.e., equity contract notes, which is a form of subordinated debt that obligates the holder to take the common or perpetual preferred stock of the issuer in lieu of cash for repayment of principal;
- ***term subordinated debt and intermediate-term preferred stock (original average maturity of five years or more and not redeemable at the option of***

***the holder prior to maturity, except with the prior approval of the FDIC)* –** Subordinated debt is debt over which senior debt takes priority. In the event of bankruptcy, subordinated debtholders receive payment only after senior debt claims are paid in full. Intermediate-term preferred stock is preferred stock with an original weighted average maturity of between five and twenty years. The portion of qualifying term subordinated debt and intermediate-term preferred stock includible in Tier 2 capital is discounted in accordance with the worksheet in the Call Report Instructions. The discounting begins when the remaining maturity falls below five years. The portion of qualifying term subordinated debt and intermediate-term preferred stock that remains after discounting and is includible in Tier 2 capital is limited to 50 percent of Tier 1 capital; and
- ***net unrealized holding gains on equity securities, up to 45%, pretax* –** the pretax net unrealized holding gain (i.e., the excess of fair value as reported in Schedule RC-B, item 7, column D, over historical cost as reported in Schedule RC-B, item 7, column C), if any, on available-for-sale equity securities is subject to the limits specified by the capital guidelines of the reporting bank's primary federal supervisory authority. The amount reported in this item cannot exceed 45 percent of the bank's pretax net unrealized holding gain on available-for-sale equity securities with readily determinable fair values.

The maximum amount of Tier 2 capital that may be recognized for risk-based capital purposes is limited to 100 percent of Tier 1 capital. Additionally, the combined amount of term subordinated debt and intermediate-term preferred stock that may be treated as Tier 2 capital is limited to 50 percent of Tier 1 capital.

Tier 3 Capital is limited in use to situations where the market risk risk-based capital rules apply. The market risk risk-based capital rules and calculations only apply to insured state nonmember banks whose trading activity (on a worldwide basis) equals 10 percent or more of total assets or $1 billion or more (the FDIC can apply the rules to other institutions if necessary for safe and sound banking practices). The rules supplement and adjust calculations under Appendix A of Part 325. The calculations are used to ensure that banks with significant exposures have adequate capital allocated for market risk. Appendix C to Part 325 outlines how risk-based capital calculations are adjusted for banks with applicable trading activity and introduces Tier 3 capital. Tier 3 capital includes subordinated debt with specific characteristics and just applies to these market risk rules. Tier 3 capital is used in conjunction with Tier 1 and Tier 2 capital (subject to certain limitations) to calculate a market risk capital measure that is based on value-at-risk capital charges, specific add-ons, and de minimis exposures.

A bank subject to the market risk rules must:
- use a value-at-risk model to estimate the maximum amount that the bank's covered positions could decline during a fixed holding period,
- have a risk management system, which defines a risk control unit that reports directly to senior management and is independent from business trading units, and
- have an internal risk measurement model that is integrated into the daily management process, and must have policies and procedures that identify appropriate stress tests and back tests, which the bank must conduct.

Total Capital (used in the risk-based calculation) is calculated by summing Tier 1 capital and Tier 2 capital, less investments in unconsolidated banking and finance subsidiaries and reciprocal holdings of capital instruments of other banks. The FDIC may also consider deducting investments in other subsidiaries, either on a case-by-case basis or, as with securities subsidiaries, based on the general characteristics or function nature of the subsidiaries.

Capital Account Adjustments

Various adjustments need to be made when calculating the capital elements based on the rules outlined in the regulations.

Deductions from Tier 1 Capital for Identified Losses and Inadequate ALLL

Part 325 provides that, on a case-by-case basis and in conjunction with supervisory examinations, other deductions from capital may be required, including any adjustments deemed appropriate for assets classified Loss. Further, the definition of Tier 1 capital under the Part 325 leverage capital standard specifically provides for the deduction of identified losses (which may include items classified Loss and any provision expenses that are necessary to replenish the ALLL to an adequate level).

When it is deemed appropriate during an examination to adjust capital for items classified Loss or for an inadequate ALLL, the following method should be used by examiners. This method avoids adjustments that may otherwise result in a "double deduction" (e.g., for loans classified Loss), particularly when Tier 1 capital already has been effectively reduced through provision expenses recorded in establishing an adequate ALLL. Additionally, the following method addresses those situations where an institution overstated the amount of Tier 1 capital by failing to take necessary provision expenses to establish and maintain an adequate ALLL.

Method

- Deduct the amount of Loss for items other than loans and leases in the calculation of Tier 1 capital. If Other Real Estate (ORE) general reserves exist, see the following discussion of "Capital Treatment of ORE Reserves."
- Deduct the amount of Loss for loans and leases from the ALLL in the calculation of Tier 2 capital.
- If the ALLL is considered inadequate, an estimate of the provision expense needed for an adequate ALLL should be made. The estimate is after identified losses have been deducted from the ALLL. Loans and leases classified Doubtful should not be directly deducted from capital. Rather, they should be included in the evaluation of the ALLL and, if appropriate, will be accounted for by the inadequate ALLL adjustment.
- An adjustment from Tier 1 capital to Tier 2 capital for an inadequate ALLL should be made only when the amount is considered significant. The decision as to what is significant is a matter of judgment.

Capital Treatment of Other Real Estate Reserves

ORE reserves, whether considered general reserves or specific reserves, are not recognized as a component of capital for either risk-based capital or leverage capital standards. However, these reserves would be considered when accounting for ORE that is classified Loss. Examiners should take into account the existence of any general ORE reserves when deducting ORE classified Loss. To the extent ORE reserves adequately cover the risks inherent in the ORE portfolio as a whole, including any individual ORE properties classified Loss, there would be no actual deduction from Tier 1 capital. The ORE Loss in excess of ORE reserves should be deducted from Tier 1 capital under "Assets Other Than Loans & Leases Classified Loss."

Liabilities Not Shown on Books

Non-book liabilities have a direct bearing on the adjusted capital computation. These definite and direct, but unbooked liabilities (contingent liabilities are treated differently) should be carefully verified and supported by factual comments. Examiners are to recommend that bank records be adjusted so that all liabilities are properly reflected. Deficiencies in a bank's accrual accounting system, which are of such magnitude that the institution's capital accounts are significantly overstated constitutes an example of non-book liabilities for which an adjustment should be made in the examination capital analysis. Similarly, an adjustment to capital should be made for material deferred tax liabilities or for a significant amount of unpaid bills that are not reflected on the bank's books.

Regulatory Capital Minimum and Categories

Institutions are expected, at a minimum, to maintain capital levels that meet both the leverage capital ratio requirement and the risk-based capital ratio requirement.

Part 325 sets forth minimum acceptable capital requirements for fundamentally sound, well-managed institutions having no material or significant weaknesses. The FDIC is not precluded from requiring an institution to maintain a higher capital level based on the institution's particular risk profile. Where the FDIC determines that the financial history or condition, managerial resources and/or the future earnings prospects of an institution are not adequate, or where an institution has sizeable off-balance sheet or funding risks, significant risks from concentrations of credit or nontraditional activities, excessive interest rate risk exposure, or a significant volume of assets adversely classified, the FDIC may determine that the minimum amount of capital for that institution is greater than the minimum standards outlined below.

Minimum Leverage Capital Requirement:

- Not less than 3 percent Tier 1 capital to total assets if the bank has a composite "1" rating and is not anticipating or experiencing any significant growth and has well-diversified risk, including interest rate risk, excellent asset quality, high liquidity, and good earnings.
- All others not meeting the above criteria should maintain a ratio of Tier 1 capital to total assets of not less than 4 percent.

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Any bank that has less than the minimum leverage capital requirement is deemed to be in violation of Part 325 and engaged in an unsafe or unsound practice pursuant to section 8(b) and/or 8(c) of the FDI Act, unless the bank has entered into and is in compliance with a written plan approved by the FDIC.

If a bank has a leverage ratio less than two percent, it is deemed to be operating in an unsafe or unsound condition pursuant to section 8(a) of the FDI Act.

Minimum Risk-Based Capital Requirement:

- Qualifying total capital to risk-weighted assets must be at least 8 percent, at least half of which (4 percentage points) must be comprised of Tier 1 capital.

Capital Categories

Part 325 Subpart B – Prompt Corrective Action (PCA) is issued by the FDIC pursuant to Section 38 of the FDI Act. The purpose is to define, for FDIC-insured state-chartered nonmember banks, the capital measures and capital levels used for determining the supervisory actions authorized under Section 38 of the FDI Act. This Subpart also establishes procedures for submission and review of capital restoration plans and for issuance and review of directive and orders pursuant to Section 38.

The following chart summarizes the PCA categories; refer to Section 10 of this manual for a discussion of PCA directives.

Prompt Corrective Action Categories

	Leverage	**Tier 1 Risk-Based**	**Total Risk-Based**
Well Capitalized	≥ 5% and	≥ 6% and	≥ 10%
	And is not subject to any written agreement, order, capital directive, or prompt corrective action directive to meet and maintain a specific capital level for any capital measure.		
Adequately Capitalized	≥ 4%***** and	≥ 4% and	≥ 8%
	And does not meet the definition of a well capitalized bank. ***or** a Leverage ratio of ≥ 3% if the bank is rated a composite 1 and is not experiencing or anticipating significant growth		
Undercapitalized	< 4%***** or	< 4% or	< 8%
	***or** < 3% if the bank is rated composite 1 and is not experiencing or anticipating significant growth		
Significantly Undercapitalized	< 3% or	< 3% or	< 6%
Critically Undercapitalized	Tangible equity capital ratio that is ≤ 2%		

Risk-Weight Calculations

Under the risk-based capital framework, a bank's balance sheet assets and credit equivalent amounts of off-balance sheet items are generally assigned to one of four broad risk categories (0, 20, 50, and 100 percent) according to the obligor, or if relevant, the guarantor or the nature of the collateral. At each bank's option, assets and the credit equivalent amounts of derivative contracts and off-balance sheet items that are assigned to a risk weight category of less than 100 percent may be included in the amount reported for a higher risk weight category (e.g., the 100 percent category) than the risk weight category to which the asset or credit equivalent amount of the off-balance sheet item would otherwise be assigned.

Although the majority of assets and off-balance sheet items fall within one of the four broad risk categories, there are exceptions that fall outside of the general categories. Other off-balance sheet credit equivalent conversions are available for derivative contracts and short-term liquidity facilities supporting asset-backed commercial paper programs. There is also a ratings-based approach that applies only to recourse obligations, direct credit substitutes, residual interests, and asset- and mortgage-backed securities in connection with asset securitizations and structured financings. In a 1999 Financial Institution Letter (FIL-99-2001), the agencies introduced a 200 percent risk weight category. This category applies to externally rated recourse obligations, direct credit substitutes, residual interest (other than credit-enhancing interest-only strips), and asset- and mortgage-backed securities that are rated one category below the lowest investment grade category or non-rated positions for which the bank deems that the credit risk is equivalent to one category below investment grade (e.g., BB).

The term recourse refers to the credit risk that a bank organization retains in connection with the transfer of its assets. Today, recourse arrangements frequently are also associated with asset securitization programs. Depending on the type of securitization transaction, the sponsor of a securitization may provide a portion of the total credit enhancement internally. When internal enhancements are provided, the enhancements are residual interests for regulatory capital purposes. Such residual interests are a form of recourse. A residual interest is an on-balance sheet asset created in an asset sale that exposes a bank to credit risk in excess of its pro rata claim on the asset. Examples of residual interests include credit-enhancing interest-only strips receivable; spread accounts; cash collateral accounts; retained subordinated interests; accrued but uncollected interest on transferred assets that, when collected, will be available to serve in a credit-enhancing capacity; and similar on-balance sheet assets that function as a credit enhancement.

A seller may also arrange for a third party to provide credit enhancement in an asset securitization. If the third-party enhancement is provided by another banking organization, that organization assumes some portion of the assets' credit risk. All arrangements in which a banking organization assumes credit risk from third-party assets or other claims that it has not transferred, are referred to as direct credit substitutes.

For a residual interest or other recourse exposure in a securitization that qualifies for the ratings-based approach, the required amount of risk-based capital is determined based on its relative risk of loss. The face amount of the position is multiplied by a risk weight that ranges from 20 percent to 200 percent, depending upon the ratings assigned by one or more nationally recognized statistical rating organizations and whether the position is traded. Additionally, when certain banks engage in trading activities, they must refer to Appendix C of Part 325 to calculate their risk-based capital ratio, which incorporates capital charges for certain market risks.

Note: Typically, any asset deducted from a bank's capital accounts when computing the numerator of the risk-based capital ratio will also be excluded from risk-weighted assets when calculating the denominator for the ratio.

Ratings-Based Approach

The risk-based capital guidelines include a ratings-based approach that sets requirements for asset- and mortgage-backed securities and other positions in securitization transactions (except credit-enhancing interest-only strips) using credit ratings from nationally recognized statistical rating organizations. (The ratings-based approach does **not** apply to corporate bonds, municipal bonds, or other debt securities that have been rated by a rating agency.) In general, under the ratings-based approach, the risk-based capital requirement is computed by multiplying the face amount of the position by the risk-weight appropriate for the external credit rating of the position as presented in the Call Report Instructions. There is also specific guidance for the regulatory capital treatment of recourse obligations, direct credit substitutes, and residual interests in asset securitizations.

Recourse and Direct Credit Substitutes

A recourse obligation typically arises when an institution transfers assets in a sale and retains an obligation to repurchase the assets or absorb losses due to a default of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may also exist implicitly where a bank provides credit enhancement beyond any contractual obligation to support assets it sold. In general, a bank must hold risk-based capital against the entire outstanding amount of assets sold with recourse; however, there are some exceptions to this general rule.

The risk-based capital standards include a low-level exposure rule, which states that if the maximum exposure to loss retained or assumed by a bank in connection with a recourse arrangement, a direct credit substitute, or a residual interest, is less than the effective risk-based capital requirement for the credit-enhanced assets (generally, four percent for qualifying first lien 1-4 family residential mortgages and eight percent for most other assets), the risk-based capital requirement is limited to the bank's maximum contractual exposure, less any recourse liability account established in accordance with generally accepted accounting principles. However, for residual interests (other than credit-enhancing interest-only strips that have been deducted from Tier 1 capital and assets) not eligible for the ratings-based approach, a bank must maintain risk-based capital equal to the face amount of the residual interest, even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. The effect of this requirement is that, notwithstanding the low level exposure rule, a bank must hold one dollar in total risk-based capital against every dollar of the face amount of its residual interests, which are not eligible for the ratings based approach (a dollar-for-dollar capital requirement).

When an examiner encounters these items (commonly found in securitization and mortgage banking operations) they should refer to the outstanding Financial Institution Letters, the Call Report Instructions, and Part 325 of the FDIC Rules and Regulations for more information.

Off-Balance Sheet Items

The risk-weighted amounts for all off-balance sheet items are determined by a two-step process. First, the "credit equivalent amount" is determined by multiplying the face value or notional amount of the off-balance sheet item by a credit conversion factor. Second, the credit equivalent amount is assigned to the appropriate risk category, like any other balance sheet asset.

Enforcement of Capital Standards

The Statement of Policy on capital adequacy, which is Appendix B to Part 325, provides some interpretational and definitional guidance as to how the regulation will be administered and enforced by the FDIC. Additionally, the PCA provisions of Section 38 of the FDI Act and the previously discussed Subpart B of Part 325 also provide guidance regarding institutions with inadequate capital levels.

Banks failing to meet the minimum leverage and/or risk-based capital ratios normally can expect to have any application submitted to the FDIC denied (if such application requires the FDIC to evaluate the adequacy of the institution's capital structure) and also can expect to be subject to the use of capital directives or other formal enforcement action by the FDIC to increase capital.

Capital Adequacy

Capital adequacy in banks that have capital ratios at or above the minimums will be assessed based on the following factors.

Banks which are Fundamentally Sound and Well-Managed

The minimum leverage and risk-based capital ratios generally will be viewed as the minimum acceptable standards for banks whose overall financial condition is fundamentally sound, which are well-managed, and which have no material or significant financial weaknesses. While the FDIC will make this determination in each case based on the bank's own condition and specific circumstances, the definition generally applies to those banks evidencing a level of risk, which is no greater than that normally associated with a Composite rating of “1” or “2.” Banks meeting this definition, which are in compliance with the minimum capital requirements, will not generally be required by the FDIC to raise new capital from external sources.

Problem Banks

Banks evidencing a level of risk at least as great as that normally associated with a Composite rating of “3,” “4,” or “5,” will be required to maintain capital higher than the minimum regulatory requirement and at a level deemed appropriate in relation to the degree of risk within the institution. These higher capital levels should normally be addressed through Memoranda of Understanding between the FDIC and the bank or, in cases of more pronounced risk, through the use of formal enforcement actions under Section 8 of the FDI Act.

Capital Requirements of Primary Regulator

Notwithstanding the above, all banks will be expected to meet any capital requirements established by their primary State or Federal regulator, which exceed the minimum capital requirement set forth by regulation. The FDIC will consult with the bank's primary State or Federal regulator when establishing capital requirements higher than the minimum set forth by regulation.

Capital Plans

Section 325.4(b) specifies that any bank that has less than its minimum leverage capital requirement is deemed to be engaging in an unsafe and unsound banking practice unless it has submitted, and is in compliance with, a plan approved by the FDIC to increase its Tier 1 leverage capital ratio to a level that the FDIC deems appropriate. Under the PCA regulations, a bank must file a written capital restoration plan within 45 days of the date that the bank receives notice or is deemed to have notice that the bank is undercapitalized, significantly undercapitalized, or critically undercapitalized, unless the FDIC notifies the bank in writing that the plan is to be filed within a different period.

Written Agreements

Section 325.4(c) provides that any insured depository institution with a Tier 1 capital to total assets ratio of less than 2 percent must enter into and be in compliance with a written agreement with the FDIC (or with its primary Federal regulator with the FDIC as a party to the agreement) to increase its Tier 1 leverage capital ratio to a level that the FDIC deems appropriate or may be subject to a Section 8(a) termination of insurance action by the FDIC. Except in the very rarest of circumstances, the FDIC will require that such agreements contemplate immediate efforts by the depository institution to acquire the required capital. The guidance in this section is not intended to preclude the FDIC from taking Section 8(a) or other enforcement action against any institution, regardless of its capital level, if the specific circumstances deem such action to be appropriate.

Regulatory Authority to Enforce Capital Standards

The FDIC's authority to enforce capital standards in operating banks includes the use of written agreements and capital directives, as well as discretionary action in connection with FDI Act Section 18 matters (capital retirements, capital adjustments, branch bank applications, and changes in location) and recourse to the enforcement provisions of Section 8(a) and 8(b) of the FDI Act and the PCA provisions in Section 38 of the FDI Act and FDIC's Part 325 Regulation. A discussion on the use of these powers is included in the Formal Administrative Actions Section. Specific recommendations regarding capital adequacy should not be made solely on the examiner's initiative; coordination between the examiner and Regional Director is essential in this often sensitive area. If the level or trend of the bank's capital position is adverse, the matter should be discussed with management with a comment included in the examination report. It is particularly important that management’s plans to correct the capital deficiency be accurately determined and noted in the report, along with the examiner's assessment of the feasibility and sufficiency of those plans.

Disallowing the Use of Bankruptcy to Evade Commitment to Maintain the Capital of a Federally Insured Depository Institution

Section 2522(c) of the Crime Control Act of 1990 amended the Bankruptcy Code to require that in Chapter 11 bankruptcy cases the trustee shall seek to immediately cure any deficit under any commitment by a debtor to maintain the capital of an insured depository institution. Chapter 11 cases are those in which a debtor company seeks to reorganize its debt. In addition, Section 2522(d) provides an eighth priority in distribution for such commitments. These provisions place the FDIC in a strong, preferred position with respect to a debtor if a commitment to maintain capital is present and the institution is inadequately capitalized.

This provision will only be useful to the FDIC if commitments to maintain capital can be obtained from owners of institutions such as holding companies, or other corporations or financial conglomerates. Examples of situations where opportunities might exist include situations where a prospective owner might be attempting to mitigate a factor such as potential future risk to the insurance funds or when the FDIC is providing assistance to an acquirer. Also, in accordance with the PCA provisions in Part 325, undercapitalized state nonmember banks are required to file a capital plan with the FDIC and, before such a capital plan can be accepted, any company having control over the institution would need to guarantee the bank's compliance with the plan. However, in any case, a commitment to maintain capital should be considered only as an additional enhancement and not as a substitute for actual capital.

Increasing Capital in Operating Banks

To raise capital ratios, management of an institution must increase capital levels and/or reduce asset growth to the point that the capital formation rate exceeds asset growth. The following is a description of alternatives available for increasing the capital level in banks.

Increased Earnings Retention

Management may attempt to increase earnings retention through a combination of higher earnings and lower cash dividend rates. Earnings may be improved, for example, by tighter controls over certain expense outlays; repricing of loans, fees, or service charges; upgrading credit standards and administration to reduce loan or securities losses, or through various other adjustments. An increase in retained earnings will improve capital ratios assuming the increase exceeds asset growth.

Sale of Additional Capital Stock

Sometimes increased earnings retention is insufficient to address capital requirements and the sale of new equity must be pursued. One adverse effect of this option is shareholder dilution. If the sale of additional stock is a consideration, examiners should indicate in the examination report the sources from which such funds might be obtained. This notation will be helpful as background data for preliminary discussions with the State banking supervisor on corrective programs to be developed and serves to inform the Regional Director as to the practical possibilities of new stock sales. The following information could be incorporated into the report, at the examiner's discretion:

- A complete list of present shareholders, indicating amounts of stock held and their financial worth, insofar as available. Small holdings may be aggregated if a complete listing is impractical.
- Information concerning individual directors relative to their capacity and willingness to purchase stock.
- A list of prominent customers and depositors who are not shareholders, but who might possibly be interested in acquiring stock.
- A list of other individuals or possible sources of support in the community who, because of known wealth or for other reasons, might desire to subscribe to new stock.

Any other data bearing upon the issue of raising new capital, along with the examiner's opinions regarding the most likely prospects for the sale of new equity, should be included in the examination report. Obviously, the more severe the capital deficiency, the more detailed these background facts and circumstances need to be.

Reduce Asset Growth

Bank management may also increase capital ratios by reducing asset growth to a level below that of capital formation. Some institutions will respond to supervisory concerns regarding the bank's capitalization level by attempting to reduce the institution's total assets. Sometimes this intentional asset shrinkage will be accomplished by disposing of short-term, marketable assets and allowing volatile liabilities to run off. This reduction results in a relatively higher capital-to-assets ratio, but it may leave the bank with a strained liquidity posture. Therefore, it is a strategy that can have adverse consequences from a safety and soundness perspective and examiners should be alert to the possible impact this strategy could have in banks that are experiencing capital adequacy problems.

CONTINGENT LIABILITIES

Contingent liabilities may be described as potential claims on bank assets for which any actual or direct liability is contingent upon some future event or circumstance. For examination purposes, contingent liabilities are divided into two general categories: Category I and Category II. Category I contingent liabilities are those that will result in a concomitant increase in bank assets if the contingencies convert to actual liabilities. These contingencies usually result from off-balance sheet lending activities such as loan commitments and letters of credit. When a bank is required to fund a loan commitment or honor a draft drawn on a letter of credit, it generally originates a loan for the amount of liability incurred. Additional information on off-balance sheet lending activities is contained in the Off-Balance Sheet Activities section of this Manual.

Category II contingent liabilities include those in which a claim on assets arises without an equivalent increase in assets. Common examples of this category are pending litigation in which the bank is defendant and contingent liabilities arising from trust operations.

Examination Policies

Examination interest in contingent liabilities is predicated upon an evaluation of the impact contingencies may have on a bank's condition. Contingent liabilities that are significant in amount and/or have a high probability of becoming direct liabilities must be considered when the bank's component ratings are assigned. The amount of contingent liabilities and the extent to which they may be funded must be considered in the analysis of liquidity, for example. Determination of the management component may appropriately include consideration of contingencies, particularly off-balance sheet lending practices. Contingent liabilities arising from off-balance sheet fee producing activities have increased in significance as a means of enhancing bank earnings. In rating earnings, the impact of this type of fee income should be analyzed with consideration given to the present amount, quality, and expected future level.

The extent to which contingent liabilities may ultimately result in charges against capital accounts is always part of the examination process and this analysis is important in the assessment of the capital rating. Examiners should consider the degree of off-balance sheet risk in their analysis of the bank's overall capital adequacy and the determination of compliance with Part 325 of the FDIC Rules and Regulations. Part 325 does not explicitly include off-balance sheet activities in the leverage capital calculations, but it does indicate that off-balance sheet risk is one of the factors that will be considered in determining whether a higher minimum amount of capital should be required for any particular bank. Off-balance sheet risks are explicitly included in the risk-based capital calculations. The total dollar amount of all contingent liabilities is included in the memorandum section of the Capital Calculations schedule of the examination report.

A distinction is made between Category I and Category II contingent liabilities in determining adjustments to be made to capital. The examination procedures for adversely classified Category I contingent liabilities are described under the heading for Adversely Classified Contingent Liabilities in the Off-Balance Sheet Activities section, while procedures for Category II contingencies are included below under the heading for Potential and Estimated Losses in Contingent Liabilities.

Potential and Estimated Losses in Contingent Liabilities

As described above, Category I contingent liabilities are defined as those which will give rise to a concomitant increase in bank assets if the contingencies convert into actual liabilities. Such contingencies should be evaluated for credit risk and, if appropriate, listed for Special Mention or subjected to adverse classification. If a Category I contingent liability is classified Loss, it would be included in the Assets Other Than Loans & Leases Classified Loss category on the Capital Calculations page. This examination treatment does not apply to Category II contingent liabilities since there is no equivalent increase in assets if a contingency becomes a direct liability.

A bank's exposure to Category II contingent liabilities normally depends solely on the probability of the contingencies becoming direct liabilities. To reflect the degree of likelihood that a contingency may result in a charge to the capital accounts, the terms Potential Loss and Estimated Loss are used. A loss contingency is an existing condition, situation, or set of circumstances that involves uncertainty as to possible loss that will be resolved when one or more future events occur or fail to occur. Potential Loss refers to contingent liabilities in which there is substantial and material risk of loss to the bank. An Estimated Loss from a loss contingency (for example, pending or threatened litigation) should be recognized if it is probable that an asset has been impaired or a liability incurred as of the examination date and the amount of the loss can be reasonably estimated. For further information, examiners should refer to Statement of Financial Accounting Standards No. 5 (FAS 5) Accounting for Contingencies.

The memorandum section of the Capital Calculations page includes the dollar amount of Category II contingent liabilities, as well as the Category I contingencies. Any Potential Loss identified is also reflected in the memorandum section and only refers to Category II contingent liabilities. Estimated Losses related to Category II contingent liabilities are reflected in this schedule as adjustments to capital by including them in the Other Adjustments to (from) Tier 1 capital line item. Estimated Losses are not included as adjustments to assets.

Common Forms of Contingent Liabilities

It is impossible to enumerate all the types and characteristics of contingent liabilities encountered in bank examinations. Some of the more common ones are discussed below. In all cases, the examiner's fundamental objectives are to ascertain the likelihood that such contingencies may result in losses to the bank and assess the pending impact on the financial condition.

Litigation

If the bank is involved in a lawsuit where the outcome may impact the bank’s financial condition, the examiner should include the facts in the examination report. Comments should address the essential points upon which the suit is based, the total dollar amount of the plaintiff's claim, the basis of the bank's defense, the status of any negotiations toward a compromise settlement, and the opinion of bank management and/or counsel relative to the probability of a successful defense. In addition, corroboration of information and opinions provided by bank management regarding significant lawsuits should be obtained from the bank's legal counsel. At the examiner's discretion, reference to suits that are small or otherwise of no consequence may be omitted from the examination report.

Determination of Potential or Estimated Losses in connection with lawsuits is often difficult. There may be occasions where damages sought are of such magnitude that, if the bank is unsuccessful in its defense, it could be rendered insolvent. In such instances, examiners should consult their Regional Office for guidance. All Potential and Estimated Losses must be substantiated by comments detailing the specific reasons leading to the conclusion.

Trust Activities

Contingent liabilities may develop within the trust department from actions or inactions on the part of the bank in its fiduciary capacity. These contingencies may arise from failure to abide by governing instruments, court orders, generally accepted fiduciary standards, or controlling statutes and regulations. Deficiencies in administration by the trust department can lead to lawsuits, surcharges, or other penalties, which must be absorbed by the bank's capital accounts. Therefore, the dollar volume and severity of such contingencies must be analyzed during the safety and soundness examination. For further information refer to the Trust Examination Manual.

Consigned Items and Other Nonledger Control Accounts

Banks often provide a large number of customer services that normally do not result in transactions subject to entry on the general ledger. These customer services include safekeeping, rental of safe deposit box facilities, purchase and sale of investments for customers, sale of traveler's checks, sale of United States Savings Bonds, and collection department services. It is management’s responsibility to ensure that collateral and other nonledger items are properly recorded and protected by effective custodial controls. Proper insurance protection must be obtained to protect against claims arising from mishandling, negligence, mysterious disappearance, or other unforeseen occurrences. Failure to take protective steps may lead to contingent liabilities. The following is a brief description of customer service activities involving consigned items.

Customer Safekeeping

- *Safe Deposit Boxes* - The bank and customer enter into a contract whereby the bank receives a fee for renting safe deposit boxes and assumes responsibility of exercising reasonable care and precaution against loss of the box's contents. When a loss does occur, unless the bank can demonstrate that it employed "reasonably prudent" care, it could be held liable. Safe deposit box access should be granted only after verifying the lessee's signature at each visit. The bank generally cannot gain access to a customer's safe deposit box except as allowed under certain statutes and/or court orders.

- *Safekeeping* - In addition to items held as collateral for loans, banks occasionally hold customers' valuables. Banks should attempt to discourage this practice by emphasizing the benefits of a safe deposit box, but when not possible or practical to do so, the same procedures employed in handling loan collateral must be followed.

- *Custodial Accounts* - Banks may act as custodian for customers' investments such as stocks, bonds, or gold. When serving as custodian, the bank has only the duties of safekeeping the property involved and performing ministerial acts as directed by the principal. As a rule, no management or advisory duties are exercised. Before providing such services, the bank should seek advice of legal counsel concerning applicable State and Federal laws governing this type of relationship. In addition, use of signed agreements or contracts, which clearly define the bank's duties and responsibilities and the functions it is to perform, is a vitally important first step in limiting potential liability.

Collection Items

The collection department may act as an agent for others in receiving, collecting, and liquidating items. In consideration for this service, a fee is generally received. An audit trail must be in place to substantiate proper handling of all items to reduce the bank's potential liability.

Consigned Items

These typically include traveler's checks and United States Savings Bonds. Banks share a fee with the consignor of traveler's checks. Savings Bond proceeds are retained until remitted to the Federal Reserve. A working supply is generally maintained at the selling station(s) and the reserve supply should be maintained under dual control in the bank's vault.

Reserve Premium Accounts

The American Bankers Association (ABA) sponsored the creation of the American Bankers Professional and Fidelity Insurance Company Ltd. (ABPFIC). The ABPFIC is a mutual insurance company that reinsures a portion of Progressive Company's directors and officers liability and fidelity bond insurance programs, which are available to banks that are ABA members. Banks that obtain insurance coverage from Progressive become members of ABPFIC. As a mutual reinsurance company, ABPFIC established a mechanism (a Reserve Premium Account) by which its members are required to provide additional funds to ABPFIC to cover losses.

The "Reserve Premium Account Agreement" between the bank and the ABPFIC provides for the bank "to deposit into the Account an amount equal to the insurance premiums quoted by Progressive for the bank's first year combined Director and Officer Liability insurance, Financial Institution Bond, and such other coverages written by Progressive." No funds are actually placed with or transferred to ABPFIC when a Reserve Premium Account is established. Rather, a bank can satisfy this "deposit" requirement by pledging or otherwise earmarking specific bank assets for this purpose.

Unless ABPFIC makes a demand for payment from Reserve Premium Accounts to cover losses, the assets in such accounts remain bank assets and any associated earnings are the banks'. Any demand for payment would reportedly be made on a pro rata basis to all banks that must maintain a Reserve Premium Account. Establishing a Reserve Premium Account results in a Category II contingent liability equal to the bank's "deposit" into the account.

Under FAS 5 a bank would accrue an estimated loss from the contingent liability resulting from having entered into a Reserve Premium Account Agreement with ABPFIC when and if available information indicates that (1) it is probable that ABPFIC will make a demand for payment from the account and (2) the amount of the payment can be reasonably estimated.
The asset used to satisfy the Reserve Premium Account requirement should be shown in the proper balance sheet category and considered a pledged asset. If a bank pledged or otherwise earmarked any "short term and marketable assets" (e.g., securities) for its Reserve Premium Account, the amount of the bank's contingent liability should be reflected in management's internal liquidity analysis since the assets used to satisfy Reserve requirement are not available to meet liquidity needs.

EVALUATION OF A BANK'S CAPITAL ADEQUACY

Banks are expected to meet any capital requirements properly established by its primary State or Federal regulator, which exceed the minimum capital requirement set forth in the regulation. Once these minimum capital requirements are met, the evaluation of capital adequacy extends to factors that require a combination of analysis and judgment. Banks are too dissimilar to permit use of standards based on one or only a few criteria. Generally, a financial institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks.

It is important to note that what is adequate capital for safety and soundness purposes may differ significantly from minimum leverage and risk-based standards and the "Well Capitalized" and "Adequately Capitalized" definitions that are used in the PCA regulations and certain other capital-based rules. The minimums set forth in the leverage and risk-based capital standards apply to sound, well-run institutions. Most banks do, and generally are expected to, maintain capital levels above the minimums, based on the institution's particular risk profile. In all cases, institutions should maintain capital commensurate with the level and nature of risks to which they are exposed, including the volume and severity of adversely classified assets.

The capital adequacy of an institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

The Level and Quality of Capital and the Overall Financial Condition of the Institution

Capital, like all of the CAMELS components, cannot be reviewed in a vacuum. The institution's overall condition is vitally important to the assessment of capital adequacy. Asset quality problems can quickly deplete capital. Poor earnings performance can hinder internal capital formation. Examiner judgment is required to review capital adequacy in relation to the institution's overall condition. Additionally, all capital is not created equally. While two institutions may have very similar regulatory capital ratios, the composition of such capital is important. For instance, all things being equal, voting common equity is a preferred capital source compared to hybrid capital instruments given the debt-like features inherent in the latter.

The Ability of Management to Address Emerging Needs for Additional Capital

Management's ability to address emerging needs for additional capital depends on many factors. A few of these factors include earnings performance and growth prospects, the financial capacity of the directorate, and the strength of a holding company. A combination of ratio analysis and examiner judgment is required to address this evaluation factor.

The Nature, Trend, and Volume of Problem Assets, and the Adequacy of the ALLL and Other Valuation Reserves

The nature, trend, and volume of problem assets (including off-balance sheet activity) and the ALLL adequacy are vital factors in determining capital adequacy. The examiner should reference prior Reports of Examination and Uniform Bank Performance Report ratios to perform a level and trend analysis. The review of the nature of problem assets will require a careful analysis of examination findings. The examiner may find the optional Analysis of Loans Subject to Adverse Classification page of the Report helpful in performing this analysis. In reviewing the ALLL adequacy, the examiner will review the bank's ALLL methodology in accordance with outstanding regulatory and accounting pronouncements.

Balance Sheet Composition, Including the Nature and Amount of Intangible Assets, Market Risk, Concentration Risk, and Risks Associated with Nontraditional Activities

The quality, type, and diversification of on- and off-balance sheet items are important with respect to the review of capital adequacy. Examiners should ensure that management identifies, measures, monitors, and controls the balance sheet risks and that the economic substance of the risks are recognized and appropriately managed. Risk-weighted capital ratios will help the examiner to a degree, but judgment is required to adequately address capital adequacy. Specifically, a portfolio of 100 percent risk-weighted commercial loans at two different institutions may have different risk characteristics depending on the risk tolerance of the management teams. Additionally, regulatory capital ratios alone do not account for concentration risk, market risk, or risks associated with nontraditional activities on the balance sheet. Examiner judgment is integral in assessing both the level of risk and management's ability to adequately manage such risk.

Risk Exposure Represented By Off-Balance Sheet Activities

The risk exposure from off-balance sheet activities will vary between institutions, but must be considered in the capital evaluation. The volume and nature of business transacted in a fiduciary capacity can be significant in the assessment of capital needs. Contingencies where the bank is acting in a fiduciary or nontraditional banking capacity can expose the bank to surcharges and therefore, operations, controls, and potential exposures must be carefully appraised. Similarly, lawsuits involving the bank as defendant or any other contingent liability, such as off-balance sheet lending, may indicate a need for a greater level of capital protection. Refer to the Contingent Liabilities and Off-Balance Sheet Activities sections for additional discussion.

The Quality and Strength of Earnings, and the Reasonableness of Dividends

A bank's current and historical earnings record is one of the key elements to consider when assessing capital adequacy. Good earnings performance enables a bank to fund asset growth and remain competitive in the marketplace while at the same time retaining sufficient equity to maintain a strong capital position. The institution's dividend policy is also of importance. Excessive dividends can negate even exceptional earnings performance and result in a weakened capital position, while an excessively low dividend return lowers the attractiveness of the stock to investors, which can be a detriment should the bank need to raise additional equity. Generally, earnings should first be applied to the elimination of losses and the establishment of necessary reserves and prudent capital levels. Thereafter, dividends can be disbursed in reasonable amounts. Refer to the Earnings section for additional discussion on the subject.

Prospects and Plans for Growth, as well as Past Experience in Managing Growth

Management's ability to adequately plan for and manage growth is important with respect to assessing capital adequacy. A review of past performance and future prospects would be a good starting point for this review. The examiner may want to compare asset growth to capital formation during recent periods. The examiner may also want to review the current budget and strategic plan to review growth plans. Through this analysis, the examiner will be able to assess management's ability to both forecast and manage growth.

Access to Capital Markets and Other Sources of Capital, Including Support Provided by a Parent Holding Company

Management's access to capital sources, including holding company support is a vital factor in analyzing capital. If management has ample access to capital on reasonable terms, the institution may be able to operate with less capital than an institution without such access. Also, the strength of a holding company will factor into capital requirements. If a holding company previously borrowed funds to purchase newly issued stock of a subsidiary bank (a process referred to as double leverage), the holding company may be less able to provide additional capital. The examiner would need to extend beyond ratio analysis of the bank to assess management's access to capital sources.

RATING THE CAPITAL FACTOR

Adequacy of the capital base is one of the elements that must be evaluated to arrive at a composite rating in accordance with the Uniform Financial Institutions Rating System. This determination is a judgmental process and necessitates that the examiner take into account all of the subjective and objective variables, concepts, and guidelines that have been discussed throughout this Section. The rating scheme itself is based on a scale of "1" through "5." Banks with capital ratings of "1" or "2" are considered to presently have adequate capital and are expected to continue to maintain adequate capital in future periods. Although both have adequate capital, "1" rated banks will generally have capital ratios that exceed ratios in "2" rated banks and/or their qualitative and quantitative factors will be such that a lower capital level is acceptable. A "3" rating should be assigned when the relationship of the capital structure to the various qualitative and quantitative factors comprising the analysis is adverse, or is expected to become adverse in the relatively near future (12 to 24 months) even after giving weight to management as a mitigating factor. Banks rated "4" or "5" are clearly inadequately capitalized, the latter representing a situation of such gravity as to threaten viability and solvency.

Uniform Financial Institution Rating System

A financial institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks. The effect of credit, market, and other risks on the institution's financial condition should be considered when evaluating the adequacy of capital. The types and quantity of risk inherent in an institution's activities will determine the extent to which it may be necessary to maintain capital at levels above required regulatory minimums to properly reflect the potentially adverse consequences that these risks may have on the institution's capital. The capital adequacy of an institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The level and quality of capital and the overall financial condition of the institution.
- The ability of management to address emerging needs for additional capital.
- The nature, trend, and volume of problem assets, and the adequacy of allowances for loan and lease losses and other valuation reserves.
- Balance sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities.
- Risk exposure represented by off-balance sheet activities.
- The quality and strength of earnings, and the reasonableness of dividends.
- Prospects and plans for growth, as well as past experience in managing growth.
- Access to capital markets and other sources of capital, including support provided by a parent holding company.

Ratings

A rating of 1 indicates a strong capital level relative to the institution's risk profile.

A rating of 2 indicates a satisfactory capital level relative to the financial institution's risk profile.

A rating of 3 indicates a less than satisfactory level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, even if the institution's capital level exceeds minimum regulatory and statutory requirements.

A rating of 4 indicates a deficient level of capital. In light of the institution's risk profile, viability of the institution may be threatened. Assistance from shareholders or other external sources of financial support may be required.

A rating of 5 indicates a critically deficient level of capital such that the institution's viability is threatened. Immediate assistance from shareholders or other external sources of financial support is required.

INTRODUCTION

Asset quality is one of the most critical areas in determining the overall condition of a bank. The primary factor affecting overall asset quality is the quality of the loan portfolio and the credit administration program. Loans typically comprise a majority of a bank's assets and carry the greatest amount of risk to their capital. Securities may also comprise a large portion of the assets and also contain significant risks. Other items which can impact asset quality are other real estate, other assets, off-balance sheet items and, to a lesser extent, cash and due from accounts, and premises and fixed assets.

Management often expends significant time, energy, and resources administering their assets, particularly the loan portfolio. Problems within this portfolio can detract from their ability to successfully and profitably manage other areas of the institution. Examiners should be diligent and focused when reviewing a bank's assets, as they can significantly impact most other facets of bank operations.

EVALUATION OF ASSET QUALITY

The asset quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, and other assets, as well as off-balance sheet transactions. The ability of management to identify and manage credit risk is also reflected here. The evaluation of asset quality should consider the adequacy of the Allowance for Loan and Lease Losses (ALLL) and weigh the exposure to counter-party, issuer, or borrower default under actual or implied contractual agreements. All other risks that may affect the value or marketability of an institution's assets, including, but not limited to, operating, market, reputation, strategic, or compliance risks, should also be considered.

Prior to assigning an asset quality rating, several factors should be considered. The factors should be reviewed within the context of any local and regional conditions that might impact bank performance. Also, any systemic weaknesses, as opposed to isolated problems, should be given appropriate consideration. The following is not a complete list of all possible factors that may influence an examiner’s assessment; however, all assessments should consider the following:

- The adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices.
- The level, distribution, severity, and trend of problem, classified, nonaccrual, restructured, delinquent, and nonperforming assets for both on- and off-balance sheet transactions.
- The adequacy of the ALLL and other asset valuation reserves.
- The credit risk arising from or reduced by off-balance sheet transactions, such as unfunded commitments, credit derivatives, commercial and standby letters of credit, and lines of credit.
- The diversification and quality of the loan and investment portfolios.
- The extent of securities underwriting activities and exposure to counter-parties in trading activities.
- The existence of asset concentrations.
- The adequacy of loan and investment policies, procedures, and practices.
- The ability of management to properly administer its assets, including the timely identification and collection of problem assets.
- The adequacy of internal controls and management information systems.
- The volume and nature of credit documentation exceptions.

When assigning component ratings, the above factors, among others, should be evaluated not only according to current adverse classification levels and risk management practices, but also considering any ongoing trends. The same classification levels and management practices might be looked on more or less favorably depending on any improving or deteriorating trends in one or more factors. The examiner should never look at things in a vacuum, instead, noting how the current level or status of each factor relates to previous and expected performance and the performance of other similar institutions.

RATING THE ASSET QUALITY FACTOR

The asset quality rating definitions are applied following a thorough evaluation of existing and potential risks and the mitigation of those risks. The definitions of each rating follow.

A rating of 1 indicates strong asset quality and credit administration practices. Identified weaknesses are minor in nature and risk exposure is modest in relation to capital protection and management’s abilities. Asset quality in such institutions is of minimal supervisory concern.

A rating of 2 indicates satisfactory asset quality and credit administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management’s abilities.

A rating of 3 is assigned when asset quality or credit administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern. There is generally a need to improve credit administration and risk management practices.

A rating of 4 is assigned to financial institutions with deficient asset quality or credit administration practices. The levels of risk and problem assets are significant, inadequately controlled, and subject the financial institution to potential losses that, if left unchecked, may threaten its viability.

A rating of 5 represents critically deficient asset quality or credit administration practices that present an imminent threat to the institution's viability.

INTRODUCTION

The examiner's evaluation of a bank's lending policies, credit administration, and the quality of the loan portfolio is among the most important aspects of the examination process. To a great extent, it is the quality of a bank's loan portfolio that determines the risk to depositors and to the FDIC's insurance fund. Conclusions regarding the bank's condition and the quality of its management are weighted heavily by the examiner's findings with regard to lending practices. Emphasis on review and appraisal of the loan portfolio and its administration by bank management during examinations recognizes, that loans comprise a major portion of most bank's assets; and, that it is the asset category which ordinarily presents the greatest credit risk and potential loss exposure to banks. Moreover, pressure for increased profitability, liquidity considerations, and a vastly more complex society have produced great innovations in credit instruments and approaches to lending. Loans have consequently become much more complex. Examiners therefore find it necessary to devote a large portion of time and attention to loan portfolio examination.

LOAN ADMINISTRATION

Lending Policies

The examiner's evaluation of the loan portfolio involves much more than merely appraising individual loans. Prudent management and administration of the overall loan account, including establishment of sound lending and collection policies, are of vital importance if the bank is to be continuously operated in an acceptable manner.

Lending policies should be clearly defined and set forth in such a manner as to provide effective supervision by the directors and senior officers. The board of directors of every bank has the legal responsibility to formulate lending policies and to supervise their implementation. Therefore examiners should encourage establishment and maintenance of written, up-to-date lending policies which have been approved by the board of directors. A lending policy should not be a static document, but must be reviewed periodically and revised in light of changing circumstances surrounding the borrowing needs of the bank's customers as well as changes that may occur within the bank itself. To a large extent, the economy of the community served by the bank dictates the composition of the loan portfolio. The widely divergent circumstances of regional economies and the considerable variance in characteristics of individual loans preclude establishment of standard or universal lending policies. There are, however, certain broad areas of consideration and concern that should be addressed in the lending policies of all banks regardless of size or location. These include the following, as minimums:

- General fields of lending in which the bank will engage and the kinds or types of loans within each general field;
- Lending authority of each loan officer;
- Lending authority of a loan or executive committee, if any;
- Responsibility of the board of directors in reviewing, ratifying, or approving loans;
- Guidelines under which unsecured loans will be granted;
- Guidelines for rates of interest and the terms of repayment for secured and unsecured loans;
- Limitations on the amount advanced in relation to the value of the collateral and the documentation required by the bank for each type of secured loan;
- Guidelines for obtaining and reviewing real estate appraisals as well as for ordering reappraisals, when needed;
- Maintenance and review of complete and current credit files on each borrower;
- Appropriate and adequate collection procedures including, but not limited to, actions to be taken against borrowers who fail to make timely payments;
- Limitations on the maximum volume of loans in relation to total assets;
- Limitations on the extension of credit through overdrafts;
- Description of the bank's normal trade area and circumstances under which the bank may extend credit outside of such area;
- Guidelines, which at a minimum, address the goals for portfolio mix and risk diversification and cover the bank's plans for monitoring and taking appropriate corrective action, if deemed necessary, on any concentrations that may exist;
- Guidelines addressing the bank's loan review and grading system ("Watch list");
- Guidelines addressing the bank's review of the Allowance for Loan and Lease Losses (ALLL); and
- Guidelines for adequate safeguards to minimize potential environmental liability.

The above are only as guidelines for areas that should be considered during the loan policy evaluation. Examiners should also encourage management to develop specific guidelines for each lending department or function. As with overall lending policies, it is not the FDIC's intent to suggest universal or standard loan policies for specific types of credit. The establishment of these policies is the responsibility of each bank's Board and management. Therefore, the following discussion of basic principles applicable to various types of credit will not include or allude to acceptable ratios, levels, comparisons or terms. These matters should, however, be addressed in each bank's lending policy, and it will be the examiner's responsibility to determine whether the policies are realistic and being followed.

Much of the rest of this section of the Manual discusses areas that should be considered in the bank's lending policies. Guidelines for their consideration are discussed under the appropriate areas.

Loan Review Systems

The term *loan review system* refers to the responsibilities assigned to various areas such as credit underwriting, loan administration, problem loan workout, or other areas. Responsibilities may include assigning initial credit grades, ensuring grade changes are made when needed, or compiling information necessary to assess ALLL.

The complexity and scope of a loan review system will vary based upon an institution's size, type of operations, and management practices. Systems may include components that are independent of the lending function, or may place some reliance on loan officers. Although smaller institutions are not expected to maintain separate loan review departments, it is essential that all institutions have an effective loan review system. Regardless of its complexity, an effective loan review system is generally designed to address the following objectives:

- To promptly identify loans with well-defined credit weaknesses so that timely action can be taken to minimize credit loss;
- To provide essential information for determining the adequacy of the ALLL;
- To identify relevant trends affecting the collectibility of the loan portfolio and isolate potential problem areas;
- To evaluate the activities of lending personnel;
- To assess the adequacy of, and adherence to, loan policies and procedures, and to monitor compliance with relevant laws and regulations;
- To provide the board of directors and senior management with an objective assessment of the overall portfolio quality; and
- To provide management with information related to credit quality that can be used for financial and regulatory reporting purposes.

Credit Grading Systems

Accurate and timely credit grading is a primary component of an effective loan review system. Credit grading involves an assessment of credit quality, the identification of problem loans, and the assignment of risk ratings. An effective system provides information for use in establishing valuation allowances for specific credits and for the determination of an overall ALLL level.

Credit grading systems often place primary reliance on loan officers for identifying emerging credit problems. However, given the importance and subjective nature of credit grading, a loan officer's judgement regarding the assignment of a particular credit grade should generally be subject to review. Reviews may be performed by peers, superiors, loan committee(s), or other internal or external credit review specialists. Credit grading reviews performed by individuals independent of the lending function are preferred because they can often provide a more objective assessment of credit quality. A loan review system should, at a minimum, include the following:

- A formal credit grading system that can be reconciled with the framework used by Federal regulatory agencies;
- An identification of loans or loan pools that warrant special attention;
- A mechanism for reporting identified loans, and any corrective action taken, to senior management and the board of directors; and
- Documentation of an institution's credit loss experience for various components of the loan and lease portfolio.

Loan Review System Elements

Management should maintain a written loan review policy that is reviewed and approved at least annually by the board of directors. Policy guidelines should include a written description of the overall credit grading process, and establish responsibilities for the various loan review functions. The policy should generally address the following items:

- Qualifications of loan review personnel;
- Independence of loan review personnel;
- Frequency of reviews;
- Scope of reviews;
- Depth of reviews;
- Review of findings and follow-up; and
- Workpaper and report distribution.

Qualifications of Loan Review Personnel

Personnel involved in the loan review function should be qualified based on level of education, experience, and extent of formal training. They should be knowledgeable of both sound lending practices and their own institution's specific lending guidelines. In addition, they should be knowledgeable of pertinent laws and regulations that affect lending activities.

Loan Review Personnel Independence

Loan officers should be responsible for ongoing credit analysis and the prompt identification of emerging problems. 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 over reliance upon loan officers. Management should ensure that, when feasible, all significant loans are reviewed by individuals that are not part of, or influenced by anyone associated with, the loan approval process.

Larger institutions typically establish separate loan review departments staffed by independent credit analysts. Cost and volume considerations may not justify such a system in smaller institutions. Often, members of senior management that are independent of the credit administration process, a committee of outside directors, or an outside loan review consultant fill this role. Regardless of the method used, loan review personnel should report their findings directly to the board of directors or a board committee.

Frequency of Reviews

The loan review function should provide feedback on the effectiveness of the lending process in identifying emerging problems. Reviews of significant credits should generally be performed annually, upon renewal, or more frequently when factors indicate a potential for deteriorating credit quality. A system of periodic reviews is particularly important to the ALLL determination process.

Scope of Reviews

Reviews should cover all loans that are considered significant. In addition to loans over a predetermined size, management will normally review smaller loans that present elevated risk characteristics such as credits that are delinquent, on nonaccrual status, restructured, previously classified, or designated as Special Mention. Additionally, management may wish to periodically review insider loans, recently renewed credits, or loans affected by common repayment factors. The percentage of the portfolio selected for review should provide reasonable assurance that all major credit risks have been identified.

Depth of Reviews

Loan reviews should analyze a number of important credit factors, including:

- Credit quality;
- Sufficiency of credit and collateral documentation;
- Proper lien perfection;
- Proper loan approval;
- Adherence to loan covenants;
- Compliance with internal policies and procedures, and applicable laws and regulations; and
- The accuracy and timeliness of credit grades assigned by loan officers.

Review of Findings and Follow-up

Loan review findings should be reviewed with appropriate loan officers, department managers, and members of senior management. Any existing or planned corrective action (including estimated timeframes) should be obtained for all noted deficiencies. All deficiencies that remain unresolved should be reported to senior management and the board of directors.

Workpaper and Report Distribution

A list of the loans reviewed, including the review date, and documentation supporting assigned ratings should be prepared. A report that summarizes the results of the review should be submitted to the board at least quarterly. Findings should address adherence to internal policies and procedures, and applicable laws and regulations, so that deficiencies can be remedied in a timely manner. A written response from management with corrective action outlined, should be provided in response to any substantive criticisms or recommendations.

Allowance for Loan and Lease Losses (ALLL)

Each bank must maintain an ALLL adequate to absorb estimated credit losses associated with the loan and lease portfolio, i.e., loans and leases that the bank has the intent and ability to hold for the foreseeable future or until maturity or payoff. Each bank should also maintain, as a separate liability account, an allowance sufficient to absorb estimated credit losses associated with off-balance sheet credit instruments such as off-balance sheet loan commitments, standby letters of credit, and guarantees. This separate allowance for credit losses on off-balance sheet credit exposures should not be reported as part of the ALLL on a bank's balance sheet. Because loans and leases held for sale are carried on the balance sheet at the lower of cost or fair value, no ALLL should be established for such loans and leases.

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 chargeoffs that are likely to be realized for a loan, or pool of loans. The 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.

Estimated credit losses should reflect consideration of all significant factors that affect repayment as of the evaluation date. Estimated losses on loan pools should reflect historical net charge-off levels for similar loans, adjusted for changes in current conditions or other relevant factors. Calculation of historical charge-off rates can range from a simple average of net charge-offs over a relevant period, to more complex techniques, such as migration analysis.

Portions of the ALLL can be attributed to, or based upon the risks associated with, individual loans or groups of loans. However, the ALLL is available to absorb credit losses that arise from the entire portfolio. It is not segregated for any particular loan, or group of loans.

Responsibility of the Board and Management

It is the responsibility of the board of directors and management to maintain the ALLL at an adequate level. The allowance adequacy should be evaluated, and appropriate provisions made, at least quarterly. In carrying out their responsibilities, the board and management are expected to:

- Establish and maintain a loan review system that identifies, monitors, and addresses asset quality problems in a timely manner.
- Ensure the prompt charge-off of loans, or portions of loans, deemed uncollectible.
- Ensure that the process for determining an adequate allowance level is based on comprehensive, adequately documented, and consistently applied analysis.

For purposes of Reports of Condition and Income (Call Reports) and Thrift Financial Reports (TFR) an adequate ALLL should, after deduction of all assets classified loss, be no less than the sum of the following items:

- 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.
- For loans and leases that are not classified, all estimated credit losses over the upcoming 12 months.
- Amounts for estimated losses from transfer risk on international loans.

Furthermore, management's analysis of an adequate reserve level should be conservative to reflect a margin for the imprecision inherent in most estimates of expected credit losses. This additional margin might be incorporated through amounts attributed to individual loans or groups of loans, or in an unallocated portion of the ALLL.

When determining an appropriate allowance, primary reliance should normally be placed on analysis of the various components of a portfolio, including all significant credits reviewed on an individual basis. Examiners should refer to Statement of Financial Accounting Standards No. (FAS) 114, *Accounting by Creditors for Impairment of a Loan*, for guidance in establishing reserves for impaired credits that are reviewed individually. When analyzing the adequacy of an allowance, portfolios should be segmented into as many components as practical. Each component should 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:

- Significant credits reviewed on an individual basis;
- Loans and leases that are not reviewed individually, but which present elevated risk characteristics, such as delinquency, adverse classification, or Special Mention designation;
- Homogenous loans that are not reviewed individually, and do not present elevated risk characteristics; and
- All other loans and loan commitments that have not been considered or provided for elsewhere.

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 Reserve (or charged to the ALLL), an institution must determine if their ALLL is adequate to absorb estimated losses from transfer risk associated with its cross-border lending exposure.

Factors to Consider in Estimating Credit Losses

Estimated credit losses should reflect consideration of all significant factors that affect the portfolio's collectibility as of the evaluation date. While historical loss experience provides a reasonable starting point, historical losses, or even recent trends in losses, are not by themselves, a sufficient basis to determine an adequate level. Management should also consider any factors that are likely to cause estimated losses to differ from historical loss experience, including, but not limited to:

- Changes in lending policies and procedures, including underwriting, collection, charge-off and recovery practices;
- Changes in local and national economic and business conditions;
- Changes in the volume or type of credit extended;
- Changes in the experience, ability, and depth of lending management;
- Changes in the volume and severity of past due, nonaccrual, restructured, or classified loans;
- Changes in the quality of an institution's loan review system or the degree of oversight by the board of directors; and,
- The existence of, or changes in the level of, any concentrations of credit.

Institutions are also encouraged to use ratio analysis as a supplemental check for evaluating the overall reasonableness of an ALLL. Ratio analysis can be useful in identifying trends in the relationship of the ALLL to classified and nonclassified credits, to past due and nonaccrual loans, to total loans and leases and binding commitments, and to historical chargeoff levels. However, while such comparisons can be helpful as a supplemental check of the reasonableness of management's assumptions and analysis, they are not, by themselves, a sufficient basis for determining an adequate ALLL level. Such comparisons do not eliminate the need for a comprehensive analysis of the loan and lease portfolio and the factors affecting its collectibility.

Examiner Responsibilities

Generally, following the quality assessment of the loan and lease portfolio, the loan review system, and the lending policies, examiners are responsible for assessing the adequacy of the ALLL. Examiners should consider all significant factors that affect the collectibility of the portfolio. Examination procedures for reviewing the adequacy of the ALLL are included in the Examination Documentation (ED) Modules..

In assessing the overall adequacy of an ALLL, it is important to recognize that the related process, methodology, and underlying assumptions require a substantial degree of judgement. Credit loss estimates will not be precise due to the wide range of factors that must be considered. Furthermore, the ability to estimate credit losses on specific loans and categories of loans improves over time. Therefore, examiners will generally accept management's estimates of credit losses in their assessment of the overall adequacy of the ALLL when management has:

- Maintained effective systems and controls for identifying, monitoring and addressing asset quality problems in a timely manner;
- Analyzed all significant factors that affect the collectibility of the portfolio; and
- Established an acceptable ALLL evaluation process that meets the objectives for an adequate ALLL.

If, after the completion of all aspects of the ALLL review described in this section, the examiner does not concur that the reported ALLL level is adequate, or the ALLL evaluation process is deficient, recommendations for correcting these problems, including any examiner concerns regarding an appropriate level for the ALLL, should be noted in the Report of Examination.

Regulatory Reporting of the ALLL

An ALLL established in accordance with the guidelines provided above should fall within a range of acceptable estimates. When an ALLL is deemed inadequate, management will be required to increase the provision for loan and lease loss expense sufficiently to restore the ALLL reported in its Call Report or TFR to an adequate level.

Accounting and Reporting Treatment

FAS 5, *Accounting for Contingencies*, provides the basic guidance for recognition of a loss contingency, such as the collectibility of loans (receivables), when it is probable that a loss has been incurred and the amount can be reasonably estimated. FAS 114, provides more specific guidance about the measurement and disclosure of impairment for certain types of loans. Specifically, FAS 114 applies to loans that are identified for evaluation on an individual basis. Loans are considered impaired when, based on current information and events, it is probable that the creditor will be unable to collect all interest and principal payments due according to the contractual terms of the loan agreement.

For individually impaired loans, FAS 114 provides guidance on the acceptable methods to measure impairment. Specifically, FAS 114 states that when a loan is impaired, a creditor should measure impairment based on the present value of expected future principal and interest cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price or the fair value of collateral, if the loan is collateral dependent. When developing the estimate of expected future cash flows for a loan, an institution should consider all available information reflecting past events and current conditions, including the effect of existing environmental factors.

Large groups of smaller-balance homogenous loans that are collectively evaluated for impairment are *not* included in the scope of FAS 114. Such groups of loans may include, but are not limited to, credit card, residential mortgage, and consumer installment loans. FAS 5 addresses the accounting for impairment of these loans. Also, FAS 5 provides the accounting guidance for impairment of loans that are not identified for evaluation on an individual basis and loans that are individually evaluated but are not individually considered impaired.

Institutions should not layer their loan loss allowances. Layering is the inappropriate practice of recording in the ALLL more than one amount for the same probable loan loss. Layering can happen when an institution includes a loan in one segment, determines its best estimate of loss for that loan either individually or on a group basis (after taking into account all appropriate environmental factors, conditions, and events), and then includes the loan in another group, which receives an additional ALLL amount.

While different institutions may use different methods, there are certain common elements that should be included in any ALLL methodology. Generally, an institution's methodology should:

- Include a detailed loan portfolio analysis, performed regularly;
- Consider all loans (whether on an individual or group basis);
- Identify loans to be evaluated for impairment on an individual basis under FAS 114 and segment the remainder of the portfolio into groups of loans with similar risk characteristics for evaluation and analysis under FAS 5;
- Consider all known relevant internal and external factors that may affect loan collectibility;
- Be applied consistently but, when appropriate, be modified for new factors affecting collectibility;
- Consider the particular risks inherent in different kinds of lending;
- Consider current collateral values (less costs to sell), where applicable;
- Require that analyses, estimates, reviews and other ALLL methodology functions be performed by competent and well-trained personnel;
- Be based on current and reliable data;
- Be well-documented, in writing, with clear explanations of the supporting analyses and rationale; and,
- Include a systematic and logical method to consolidate the loss estimates and ensure the ALLL balance is recorded in accordance with GAAP.

A systematic methodology that is properly designed and implemented should result in an institution's best estimate of the ALLL. Accordingly, institutions should adjust their ALLL balance, either upward or downward, in each period for differences between the results of the systematic determination process and the unadjusted ALLL balance in the general ledger.

Examiners are encouraged, with the acknowledgement of management, to communicate with an institution's external auditors and request an explanation of their rationale and findings, when differences in judgment concerning the adequacy of the institution's ALLL exist. In case of controversy, the auditors may be reminded of the consensus reached by the Financial Accounting Standards Board's Emerging Issues Task Force (EITF) on Issue No. 85-44, Differences Between Loan Loss Allowances for GAAP and RAP. This issue deals with the situation where regulators mandated that institutions establish loan loss allowances under regulatory accounting principles (RAP) that may be in excess of amounts recorded by the institution in preparing its financial statement under"GAAP. The EITF was asked whether and under what circumstances this can occur. The consensus indicated that auditors should be particularly skeptical in the case of GAAP/RAP differences and must justify them based on the particular facts and circumstances.

Additional guidance on the establishment of loan review systems and an adequate ALLL is provided in the Interagency Statement of Policy on the ALLL dated December 21, 1993, and the Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Associations, dated June 29, 2001.

PORTFOLIO COMPOSITION

Commercial Loans

General

Loans to business enterprises for commercial or industrial purposes, whether proprietorships, partnerships or corporations, are commonly described as commercial loans. In asset distribution, commercial or business loans frequently comprise one of the most important assets of a bank. They may be secured or unsecured and have short or long-term maturities. Such loans include working capital advances, term loans and loans to individuals for business purposes.

Short-term working capital and seasonal loans provide temporary capital in excess of normal needs. They are used to finance seasonal requirements and are repaid at the end of the cycle by converting inventory and accounts receivable into cash. Such loans may be unsecured; however, many working capital loans are advanced with accounts receivable and/or inventory as collateral. Firms engaged in manufacturing, distribution, retailing and service-oriented businesses use short-term working capital loans.

Term business loans have assumed increasing importance. Such loans normally are granted for the purpose of acquiring capital assets, such as plant and equipment. Term loans may involve a greater risk than do short-term advances, because of the length of time the credit is outstanding. Because of the potential for greater risk, term loans are usually secured and generally require regular amortization. Loan agreements on such credits may contain restrictive covenants during the life of the loan. In some instances, term loans may be used as a means of liquidating, over a period of time, the accumulated and unpaid balance of credits originally advanced for seasonal needs. While such loans may reflect a borrower's past operational problems, they may well prove to be the most viable means of salvaging a problem situation and effecting orderly debt collection.

At a minimum, commercial lending policies should address acquisition of credit information, such as property, operating and cash flow statements; factors that might determine the need for collateral acquisition; acceptable collateral margins; perfecting liens on collateral; lending terms, and charge-offs.

Accounts Receivable Financing

Accounts receivable financing is a specialized area of commercial lending in which borrowers assign their interests in accounts receivable to the lender as collateral. Typical characteristics of accounts receivable borrowers are those businesses that are growing rapidly and need year-round financing in amounts too large to justify unsecured credit, those that are nonseasonal and need year-round financing because working capital and profits are insufficient to permit periodic cleanups, those whose working capital is inadequate for the volume of sales and type of operation, and those whose previous unsecured borrowings are no longer warranted because of various credit factors.

Several advantages of accounts receivable financing from the borrower's viewpoint are: it is an efficient way to finance an expanding operation because borrowing capacity expands as sales increase; it permits the borrower to take advantage of purchase discounts because the company receives immediate cash on its sales and is able to pay trade creditors on a satisfactory basis; it insures a revolving, expanding line of credit; and actual interest paid may be no more than that for a fixed amount unsecured loan.

Advantages from the bank's viewpoint are: it generates a relatively high yield loan, new business, and a depository relationship; permits continuing banking relationships with long-standing customers whose financial conditions no longer warrant unsecured credit; and minimizes potential loss when the loan is geared to a percentage of the accounts receivable collateral. Although accounts receivable loans are collateralized, it is important to analyze the borrower's financial statements. Even if the collateral is of good quality and in excess of the loan, the borrower must demonstrate financial progress. Full repayment through collateral liquidation is normally a solution of last resort.

Banks use two basic methods to make accounts receivable advances. First, blanket assignment, wherein the borrower periodically informs the bank of the amount of receivables outstanding on its books. Based on this information, the bank advances the agreed percentage of the outstanding receivables. The receivables are usually pledged on a non-notification basis and payments on receivables are made directly to the borrower who then remits them to the bank. The bank applies all or a portion of such funds to the borrower's loan. Second, ledgering the accounts, wherein the lender receives duplicate copies of the invoices together with the shipping documents and/or delivery receipts. Upon receipt of satisfactory information, the bank advances the agreed percentage of the outstanding receivables. The receivables are usually pledged on a notification basis. Under this method, the bank maintains complete control of the funds paid on all accounts pledged by requiring the borrower's customer to remit directly to the bank.

In the area of accounts receivable financing, a bank's lending policy should address at least the acquisition of credit information such as property, operating and cash flow statements. It should also address maintenance of an accounts receivable loan agreement that establishes a percentage advance against acceptable receivables, a maximum dollar amount due from any one account debtor, financial strength of debtor accounts, insurance that "acceptable receivables" are defined in light of the turnover of receivables pledged, aging of accounts receivable, and concentrations of debtor accounts.

Leveraged Financing

The Federal bank regulatory agencies issued guidance on April 9, 2001 concerning sound risk management practices for institutions engaged in leveraged financing.

Leveraged financing is an important financing vehicle for mergers and acquisitions, business re-capitalizations and refinancings, equity buyouts, and business or product line build-outs and expansions. It is also used to increase shareholder returns and to monetize perceived "enterprise value" or other intangibles. A transaction is considered leveraged when the obligor's post-financing leverage as measured by debt-to-assets, debt-to-equity, cash flow-to-total debt, or other such standards unique to particular industries significantly exceeds industry norms for leverage. Leveraged borrowers typically have a diminished ability to adjust to unexpected events and changes in business conditions because of their higher ratio of total liabilities to capital. Consequently, leveraged financing can have significant implications for a banking organization's overall credit risk and presents unique challenges for its risk management systems.

Much of the leveraged financing activity ties into the merger and acquisition activity and the increasing values that were ascribed to firms as a result of a strong expansionary business climate. Leveraged financing transactions account for a sizeable portion of syndicated bank loans.

Institutions participate in leveraged financing on a number of levels. In addition to providing senior secured financing, they extend credit on a subordinated basis (mezzanine financing). Institutions and their affiliates also may take equity positions in leveraged companies with direct investments through affiliated securities firms, small business investment companies (SBICs), and venture capital companies or take equity interests via warrants and other equity "kickers" received as part of a financing package. Institutions also may invest in leveraged loan funds managed by investment banking companies or other third parties. Although leveraged financing is far more prevalent in large institutions, this type of lending can be found in institutions of all sizes.

The extent to which institutions should apply these practices will depend on the size and risk profile of their leveraged exposures relative to assets, earnings, and capital; and the nature of their leveraged financing activities (i.e., origination and distribution, participant, equity investor, etc.).

Risk Management Guidelines

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

Loan Policy

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

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

Underwriting Standards

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

- Describe appropriate leveraged loan structures;

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

Limits

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

Credit Analysis

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

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

Enterprise Value

Enterprise value can be defined as the imputed value of a business. This valuation is often based on the anticipated or imputed sale value, market capitalization, or net worth of the borrower. The sale value is normally some multiple of sales or cash flow based on recent mergers or acquisitions of other firms in the borrower's industry.

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

Because enterprise value is commonly derived from the cash flows of a business, it is closely correlated with the primary source of repayment. This interdependent relationship between primary and secondary repayment sources increases the risk in leveraged financing, especially when credit weaknesses develop. Events or changes in business conditions that negatively affect a company's cash flow will also negatively affect the value of the business, simultaneously eroding both the lender's primary and secondary source of repayment. Consequently, lenders that place undue reliance upon enterprise value as a secondary source of repayment or that utilize unrealistic assumptions to determine enterprise value are likely to approve unsound loans at origination or experience sizeable losses upon default.

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

Rating Leveraged Finance Loans

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

In cases where a borrower's condition or future prospects have significantly weakened, leverage finance loans will likely merit a Substandard classification based on the existence of well-defined weaknesses. If such weaknesses appear to be of a lasting nature and it is probable that a lender will be unable to collect all principal and interest owed, the loan should be placed on non-accrual and will likely have a Doubtful component. Such loans should be reviewed for impairment in accordance with FAS 114. If the primary source of repayment is inadequate and a loan is considered collateral dependent, it is generally inappropriate to consider enterprise value unless the value is well supported. Well supported enterprise values may be evidenced by a binding purchase and sale agreement with a qualified third party or through valuations that fully consider the effect of the borrower's distressed circumstances and potential changes in business and market conditions. For such borrowers, where a portion of the loan is not protected by pledged assets or a well supported enterprise value, examiners will generally classify the unprotected portion of the loan Doubtful or Loss.

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

Problem Loan Management

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

Portfolio Analysis

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

- Total exposure and segment exposures, including subordinated debt and equity holdings, compared to established limits;
- Risk rating distribution and migration data;
- Portfolio performance, noncompliance with covenants, restructured loans, delinquencies, non-performing assets, and impaired loans; and
- Compliance with internal procedures and the aggregate level of exceptions to policy and underwriting standards.

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

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

Internal Controls

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

Distributions

Asset sales, participations, syndication, and other means of distribution are critical elements in the rapid growth of leveraged financing. Both lead and purchasing institutions to adopt formal policies and procedures addressing the distribution and acquisition of leveraged financing transactions. Policies should include:

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

Participations Purchased

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

Process to Identify Potential Conflicts

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

<u>Conflicts of Interest</u>

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

<u>Securities Laws</u>

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

<u>Compliance Function</u>

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

Mezzanine Financing

Mezzanine financing represents those parts of a leveraged financing package that are neither equity nor senior debt. It usually is extended through subsidiaries of banks or nonbank subsidiaries of bank holding companies. Examiners should review policies for mezzanine financing to ensure that they generally include:

- Limits for both aggregate volume and individual transactions;
- Designated booking units;
- Credit approval and reporting processing;
- Management and other reporting requirements;
- An internal risk rating system and requirements for periodic reviews; and
- Procedures for legal review.

Allowance for Loan and Lease Losses

The potential impact of a bank's participation in leveraged financing should be carefully considered when reviewing the adequacy of the ALLL. The aggregate size and overall condition of the leveraged financing portfolio should be specifically addressed in any review of the overall ALLL adequacy. Examiners should review the bank's methodology for incorporating the special risks related to this financing in its determination of the adequacy of ALLL. Management's internal risk rating system is expected to include assessment of its equity and mezzanine financing portfolio in determining the need for valuation reserves.

Examination Risk Rating Guidance for Leveraged Financing

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

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

<u>Cash Flow/Debt Service Coverage</u>

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

<u>Enterprise Value</u>

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

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

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

<u>Deal Sponsors</u>

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

Oil and/or Gas Reserve-Based Loans

These guidelines apply to oil and/or gas reserve-based loans that are considered collateral dependent and are devoid of repayment capacity from other tangible sources.

The initial step to assessing the credit worthiness of reserve-based loans is an analysis of the engineering function. Cash flow generated from the future sale of encumbered oil and/or gas reserves is the primary, and in most cases the only intended, source of repayment. Therefore, engineering data integrity which depicts future cash stream, is critical to the initial lending decision and equally important to an examiner in the assessment of credit quality. For evaluation purposes, an acceptable engineering report must be an independent, detailed analysis of the reserve prepared by a competent engineering group. The report must address three critical concerns: pricing; discount factors; and timing. In those cases where the engineering reports do not meet one or more of these criteria, the examiner may need to use other methods, e.g., recent cash flow histories, to determine the current collateral value.

The extent of examiner analysis is a matter of judgment, but comprehensive analysis of the credit should definitely take place if:

- The loan balance exceeds 65 percent of the discounted present worth of future net income (PWFNI) of proved developed producing properties (PDP), or the cash flow analysis indicates that the loan will not amortize over four to five years;
- The credit is not performing in accordance with terms or repayment of interest and/or principal; or
- The credit is identified by the bank as a "problem" credit.

After performing the analysis, the examiner must determine if classification is warranted. The following guidelines are to be applied in instances where the obligor is devoid of primary and secondary repayment capacity or other reliable means of repayment, with total support of the debt provided solely by the pledged collateral. First, 65 percent of discounted PWFNI should be classified Substandard. A lesser percentage or less severe criticism may be appropriate in cases where a reliable alternate means of repayment exists for a portion of the debt. The 65 percent percentage should be used when the discounted PWFNI is determined using historical production data. When less than 75 percent of the reserve estimate is determined using historical production data, or the discounted PWFNI is predicated on engineering estimates of the volume of oil/gas flow (volumetric and/or analogy-based engineering data), the collateral value assigned to Substandard should be reduced accordingly. The balance, but not more than 100 percent of discounted PWFNI of PDP reserves, should be classified Doubtful. Any remaining deficiency balance should be classified Loss.

In addition to PDP, many reserve-based credit collateral values will include items variously referred to as proved (or proven) developed non-producing reserves, shut-in reserves, behind-the-pipe reserves and proved undeveloped properties (PUP) as collateral. Due to the nature of these other reserves, there are no strict percentage guidelines for the proportion of the credit supported by this type of collateral that should remain as a bankable asset. However, only in very unusual situations would the proportion of collateral values for these other reserves assigned to a classification category approach values for PDP.

The examiner must ascertain the current status of each reserve and develop an appropriate collateral value. Examples could be reserves that are shut-in due to economic conditions versus reserves that are shut-in due to the absence of pipeline or transportation. PDP require careful evaluation before allowing any bankable collateral value.

Real Estate Loans

General

Real estate loans are part of the loan portfolios of almost all commercial banks. Real estate loans include credits advanced for the purchase of real property. However, the term may also encompass extensions granted for other purposes, but for which primary collateral protection is real property.

The degree of risk in a real estate loan depends primarily on the loan amount in relation to collateral value, the interest rate, and most importantly, the borrower's ability to repay in an orderly fashion. It is extremely important that a bank's real estate loan policy ensure that loans are granted with the reasonable probability the debtor will be able and willing to meet the payment terms. Placing undue reliance upon a property's appraised value in lieu of an adequate initial assessment of a debtor's repayment ability is a potentially dangerous mistake.

Historically, many banks have jeopardized their capital structure by granting ill-considered real estate mortgage loans. Apart from unusual, localized, adverse economic conditions which could not have been foreseen, resulting in a temporary or permanent decline in realty values, the principal errors made in granting real estate loans include inadequate regard to normal or even depressed realty values during periods when it is in great demand thus inflating the price structure, mortgage loan amortization, the maximum debt load and repayment capacity of the borrower, and failure to reasonably restrict mortgage loans on properties for which there is limited demand.

A principal indication of a troublesome real estate loan is an improper relationship between the amount of the loan, the potential sale price of the property, and the availability of a market. The potential sale price of a property may or may not be the same as its appraised value. The current potential sale price or liquidating value of the property is of primary importance and the appraised value is of secondary importance. There may be little or no current demand for the property at its appraised value and it may have to be disposed of at a sacrifice value.

Examiners must appraise not only individual mortgage loans, but also the overall mortgage lending and administration policies to ascertain the soundness of its mortgage loan operations as well as the liquidity contained in the account. The bank should establish policies that address the following factors: the maximum amount that may be loaned on a given property, in a given category, and on all real estate loans; the need for appraisals (professional judgments of the present and/or future value of the real property) and for amortization on certain loans.

Real Estate Lending Standards

Section 18(o) of the FDI Act requires the Federal banking agencies to adopt uniform regulations prescribing standards for loans secured by liens on real estate or made for the purpose of financing permanent improvements to real estate. For FDIC-supervised institutions, Part 365 of the FDIC Rules and Regulations requires each institution to adopt and maintain written real estate lending policies that are consistent with sound lending principles, appropriate for the size of the institution and the nature and scope of its operations. Within these general parameters, the regulation specifically requires an institution to establish policies that include:

- Portfolio diversification standards;
- Prudent underwriting standards including loan-to-value limits;
- Loan administration procedures;
- Documentation, approval and reporting requirements; and
- Procedures for monitoring real estate markets within the institution's lending area.

These policies also should reflect consideration of the Interagency Guidelines for Real Estate Lending Policies and must be reviewed and approved annually by the institution's board of directors.

The interagency guidelines, which are an appendix to Part 365, are intended to help institutions satisfy the regulatory requirements by outlining the general factors to consider when developing real estate lending standards. The guidelines suggest maximum supervisory loan-to-value (LTV) limits for various categories of real estate loans and explain how the agencies will monitor their use.

Institutions are expected to establish their own internal LTV limits consistent with their needs. These internal limits should not exceed the following recommended supervisory limits:

- 65 percent for raw land;
- 75 percent for land development;
- 80 percent for commercial, multi-family, and other non-residential construction;
- 85 percent for construction of a 1-to-4 family residence;
- 85 percent for improved property; and
- Owner-occupied 1-to-4 family home loans have no suggested supervisory LTV limits. However, for any such loan with an LTV ratio that equals or exceeds 90 percent at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

Certain real estate loans are exempt from the supervisory LTV limits because of other factors that significantly reduce risk. These include loans guaranteed or insured by the Federal, State or local government as well as loans to be sold promptly in the secondary market without recourse. A complete list of excluded transactions is included in the guidelines.

Because there are a number of credit factors besides LTV limits that influence credit quality, loans that meet the supervisory LTV limits should not automatically be considered sound, nor should loans that exceed the supervisory LTV limits automatically be considered high risk. However, loans that exceed the supervisory LTV limit should be identified in the institution's records and the aggregate amount of these loans reported to the institution's board of directors at least quarterly. The guidelines further State that the aggregate amount of loans in excess of the supervisory LTV limits should not exceed the institution's total capital. Moreover, within that aggregate limit, the total loans for all commercial, agricultural and multi-family residential properties (excluding 1-to-4 family home loans) should not exceed 30 percent of total capital.

Institutions should develop policies that are clear, concise, consistent with sound real estate lending practices, and meet their needs. Policies should not be so complex that they place excessive paperwork burden on the institution. Therefore, when evaluating compliance with Part 365, examiners should carefully consider the following:

- The size and financial condition of the institution;
- The nature and scope of the institution's real estate lending activities;
- The quality of management and internal controls;
- The size and expertise of the lending and administrative staff; and
- Market conditions.

It is important to distinguish between the regulation and the interagency guidelines. While the guidelines are included as an appendix to the regulation, they are not part of the regulation. Therefore, when an apparent violation of Part 365 is identified, it should be listed in the Report of Examination in the same manner as other apparent violations. Conversely, when an examiner determines that an institution is not in conformance with the guidelines and the deficiency is a safety and soundness concern, an appropriate comment should be included in the examination report; however, the deficiency would not be a violation of the regulation.

Examination procedures for various real estate loan categories are included in the ED Modules.

Commercial Real Estate Loans

These loans comprise a major portion of many banks' loan portfolios. When problems exist in the real estate markets that the bank is servicing, it is necessary for examiners to devote additional time to the review and evaluation of loans in these markets.

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 cause real estate projects and loans to become troubled. Signs of troubled real estate markets or projects include, but are not limited to:

- Rent concessions or sales discounts resulting in cash flow below the level projected in the original appraisal.
- Changes in concept or plan: for example, a condominium project converting to an apartment project.
- Construction delays resulting in cost overruns which may require renegotiation of loan terms.
- Slow leasing or lack of sustained sales activity and/or increasing cancellations which may result in protracted repayment or default.
- Lack of any sound feasibility study or analysis.
- Periodic construction draws which exceed the amount needed to cover construction costs and related overhead expenses.
- Identified problem credits, past due and non-accrual loans.

Real Estate Construction Loans

A construction loan is used to construct a particular project within a specified period of time and should be controlled by supervised disbursement of a predetermined sum of money. It is generally secured by a first mortgage or deed of trust and backed by a purchase or takeout agreement from a financially responsible permanent lender. Construction loans are vulnerable to a wide variety of risks. The major risk arises from the necessity to complete projects within specified cost and time limits. The risk inherent in construction lending can be limited by establishing policies which specify type and extent of bank involvement. Such policies should define procedures for controlling disbursements and collateral margins and assuring timely completion of the projects and repayment of the bank's loans.

Before a construction loan agreement is entered into, the bank should investigate the character, expertise, and financial standing of all related parties. Documentation files should include background information concerning reputation, work and credit experience, and financial statements. Such documentation should indicate that the developer, contractor, and subcontractors have demonstrated the capacity to successfully complete the type of project to be undertaken. The appraisal techniques used to value a proposed construction project are essentially the same as those used for other types of real estate. The bank should realize that appraised collateral values are not usually met until funds are advanced and improvements made.

The bank, the builder and the property owner should join in a written building loan agreement that specifies the performance of each party during the entire course of construction. Loan funds are generally disbursed based upon either a standard payment plan or a progress payment plan. The standard payment plan is normally used for residential and smaller commercial construction loans and utilizes a preestablished schedule for fixed payments at the end of each specified stage of construction. The progress payment plan is normally used for larger, more complex, building projects. The plan is generally based upon monthly disbursements totaling 90 percent of the value with 10 percent held back until the project is completed.

Although many credits advanced for real estate acquisition, development or construction are properly considered loans secured by real estate, other such credits are, in economic substance, "investments in real estate ventures" and categorization of the asset as "other real estate owned" may be appropriate. A key feature of these transactions is that the bank as lender plans to share in the expected residual profit from the ultimate sale or other use of the development. These profit sharing arrangements may take the form of equity kickers, unusually high interest rates, a percentage of the gross rents or net cash flow generated by the project, or some other form of profit participation over and above a reasonable amount for interest and related loan fees. These extensions of credit may also include such other characteristics as nonrecourse debt, 100 percent financing of the development cost (including origination fees, interest payments, construction costs, and even profit draws by the developer), and lack of any substantive financial support from the borrower or other guarantors. Acquisition, Development, and Construction (ADC) arrangements that are in substance real estate investments of the bank should be reported accordingly.

On the other hand, if the bank will receive less than a majority of the expected residual profit, the ADC loan may be analogous to an interest in a joint real estate venture, which would be, considered an investment in unconsolidated subsidiaries and associated companies.

The following are the basic types of construction lending:

- <u>Unsecured Front Money</u> **-** Unsecured front money loans are working capital advances to a borrower who may be engaged in a new and unproven venture. Many bankers believe that unsecured front money lending is not prudent unless the bank is involved in the latter stages of construction financing. A builder planning to start a project before construction funding is obtained often uses front money loans. The funds may be used to acquire or develop a building site, eliminate title impediments, pay architect or standby fees, and/or meet minimum working capital requirements established by construction lenders. Repayment often comes from the first draw against construction financing. Unsecured front money loans used for a developer's equity investment in a project or to cover initial costs overruns are symptomatic of an undercapitalized, inexperienced or inept builder.

- <u>Land Development Loans</u> **-** Land development loans are generally secured purchase or development loans or unsecured advances to investors and speculators. Secured purchase or development loans are usually a form of financing involving the purchase of land and lot development in anticipation of further construction or sale of the property. A land development loan should be predicated upon a proper title search and/or mortgage insurance. The loan amount should be based on appraisals on an "as is" and "as completed" basis. Projections should be accompanied by a study explaining the effect of property improvements on the market value of the land. There should be a sufficient spread between the amount of the development loan and the estimated market value to allow for unforeseen expenses. The repayment program should be structured to follow the sales or development program. In the case of an unsecured land development loan to investors or speculators, bank management should analyze the borrower's financial statements for sources of repayment other than the expected return on the property development.

- <u>Commercial Construction Loans</u> **-** Loans financing commercial construction projects are usually collateralized, and such collateral is generally identical to that for commercial real estate loans. Supporting documentation should include a recorded mortgage or deed of trust, title insurance policy and/or title opinions, appropriate liability insurance and other coverages, land appraisals, and evidence that taxes have been paid to date. Additional documents relating to commercial construction loans include loan agreements, takeout commitments, tri-party (buy/sell) agreements, completion or corporate bonds, and inspection or progress reports.

- <u>Residential Construction Loans</u> **-** Residential construction loans may be made on a speculative basis or as prearranged permanent financing. Smaller banks often engage in this type of financing and the aggregate total of individual construction loans may equal a significant portion of their capital funds. Prudence dictates that permanent financing be assured in advance because the cost of such financing can have a substantial affect on sales. Proposals to finance speculative housing should be evaluated in accordance with predetermined policy standards compatible with the institution's size, technical competence of its management, and housing needs of its service area. The prospective borrower's reputation, experience, and financial condition should be reviewed. The finished project's marketability in favorable and unfavorable market conditions should be realistically considered.

In addition to normal safeguards such as a recorded first mortgage, acceptable appraisal, construction agreement, draws based on progress payment plans and inspection reports, a bank dealing with speculative contractors should institute control procedures tailored to the individual circumstances. A predetermined limit on the number of unsold units to be financed at any one time should be included in the loan agreement to avoid overextending the contractor's capacity. Loans on larger residential construction projects are usually negotiated with prearranged permanent financing. Documentation of tract loans frequently includes a master note allocated for the entire project and a master deed of trust or mortgage covering all land involved in the project. Payment of the loan will depend largely upon the sale of the finished homes. As each sale is completed, the bank makes a partial release of the property covered by its master collateral document. In addition to making periodic inspections during the course of construction, periodic progress reports (summary of inventory lists maintained for each tract project) should be made on the entire project. The inventory list should show each lot number, type of structure, release price, sales price, and loan balance.

The exposure in any type of construction lending is that the full value of the collateral does not exist at the time the loan is granted. The bank must ensure funds are used properly to complete construction or development of the property serving as collateral. If default occurs, the bank must be in a position to either complete the project or to salvage its construction advances. The various mechanic's and materialmen's liens, tax liens, and other judgments that arise in such cases are distressing to even the most seasoned lender. Every precaution should be taken by the lender to minimize any outside attack on the collateral. The construction lender may not be in the preferred position indicated by documents in the file. Laws of some states favor the subcontractors (materialmen's liens, etc.), although those of other states protect the construction lender to the point of first default, provided certain legal requirements have been met. Depending on the type and size of project being funded, construction lending can be a complex and fairly high-risk venture. For this reason, bank management should ensure that it has enacted policies and retained sufficiently trained personnel before engaging in this type of lending.

Home Equity Loans

A home equity loan is a loan secured by the equity in a borrower's residence. It is generally structured in one of two ways. First, it can be structured as a traditional second mortgage loan, wherein the borrower obtains the funds for the full amount of the loan immediately and repays the debt with a fixed repayment schedule. Second, the home equity borrowing can be structured as a line of credit, with a check, credit card, or other access to the line over its life.

The home equity line of credit has evolved into the dominant form of home equity lending. This credit instrument generally offers variable interest rates and flexible repayment terms. Additional characteristics of this product line include relatively low interest rates as compared to other forms of consumer credit, absorption by some banks of certain fees (origination, title search, appraisal, recordation cost, etc.) associated with establishing a real estate-related loan. The changes imposed by the Tax Reform Act of 1986 relating to the income tax deductibility of interest paid on consumer debt led to the increased popularity of home equity lines of credit.

Home equity lending is widely considered to be a low-risk lending activity. These loans are secured by housing assets, the value of which historically has performed well. Nevertheless, the possibility exists that local housing values or household purchasing power may decline, stimulating abandonment of the property and default on the debt secured by the housing. Certain features of home equity loans make them particularly susceptible to such risks. First, while the variable rate feature of the debt reduces the interest rate risk of the lender, the variable payment size exposes the borrower to greater cash flow risks than would a fixed-rate loan, everything else being equal. This, in turn, exposes the lender to greater credit risk. Another risk is introduced by the very nature of the home equity loan. Such loans are generally secured by a junior lien. Thus, there is less effective equity protection than in a first lien instrument. Consequently, a decline in the value of the underlying housing results in a much greater than proportional decline in the coverage of a home equity loan. This added leverage makes them correspondingly riskier than first mortgages.

Banks that make these kinds of loans should adopt specific policies and procedures for dealing with this product line. Management should have expertise in both mortgage lending as well as open-end credit procedures. Another major concern is that borrowers will become overextended and the bank will have to initiate foreclosure proceedings.

Therefore, underwriting standards should emphasize the borrower's ability to service the line from cash flow rather than the sale of the collateral, especially if the home equity line is written on a variable rate basis. If the bank has offered a low introductory interest rate, repayment capacity should be analyzed at the rate that could be in effect at the conclusion of the initial term.

Other important considerations include acceptable loan-to-value and debt-to-income ratios, and proper credit and collateral documentation, including adequate appraisals and written evidence of prior lien status. Another significant risk concerns the continued lien priority for subsequent advances under a home equity line of credit. State law governs the status of these subsequent advances. It is also important that the bank's program include periodic reviews of the borrower's financial condition and continuing ability to repay the indebtedness.

The variation in contract characteristics of home equity debt affects the liquidity of this form of lending. For debt to be easily pooled and sold in the secondary market, it needs to be fairly consistent in its credit and interest rate characteristics. The complexity of the collateral structures, coupled with the uncertain maturity of revolving credit, makes home equity loans considerably less liquid than straight first lien, fixed maturity mortgage loans.

While home equity lending is considered to be fairly low-risk, subprime home equity loans and lending programs exist at some banks. These programs have a higher level of risk than traditional home equity lending programs. Individual or pooled home equity loans that have subprime characteristics should be analyzed using the guidance provided in the subprime section of this Manual.

Agricultural Loans

Introduction

Agricultural loans are an important component of many community bank loan portfolios. Agricultural banks represent a material segment of commercial banks and constitute an important portion of the group of banks over which the FDIC has the primary Federal supervisory responsibility.

Agricultural loans are used to fund the production of crops, fruits, vegetables, and livestock, or to fund the purchase or refinance of capital assets such as farmland, machinery and equipment, breeder livestock, and farm real estate improvements (for example, facilities for the storage, housing, and handling of grain or livestock). The production of crops and livestock is especially vulnerable to two risk factors that are largely outside the control of individual lenders and borrowers: commodity prices and weather conditions. While examiners must be alert to, and critical of, operational and managerial weaknesses in agricultural lending activities, they must also recognize when the bank is taking reasonable steps to deal with these external risk factors. Accordingly, loan restructurings or extended repayment terms, or other constructive steps to deal with financial difficulties faced by agricultural borrowers because of adverse weather or commodity conditions, will not be criticized if done in a prudent manner and with proper risk controls and management oversight. Examiners should recognize these constructive steps and fairly portray them in oral and written communications regarding examination findings. This does not imply, however, that analytical or classification standards should be compromised. Rather, it means that the bank’s response to these challenges will be considered in supervisory decisions.

Agricultural Loan Types and Maturities

Production or Operating Loans **-** Short-term (one year or less) credits to finance seed, fuel, chemicals, land and machinery rent, labor, and other costs associated with the production of crops. Family living expenses are also sometimes funded, at least in part, with these loans. The primary repayment source is sale of the crops at the end of the production season when the harvest is completed.

<u>Feeder Livestock Loans</u> **-** Short-term loans for the purchase of, or production expenses associated with, cattle, hogs, sheep, poultry or other livestock. When the animals attain market weight and are sold for slaughter, the proceeds are used to repay the debt.

<u>Breeder Stock Loans</u> **-** Intermediate-term credits (generally three to five years) used to fund the acquisition of breeding stock such as beef cows, sows, sheep, dairy cows, and poultry. The primary repayment source is the proceeds from the sale of the offspring of these stock animals, or their milk or egg production.

<u>Machinery and Equipment Loans</u> **-** Intermediate-term loans for the purchase of a wide array of equipment used in the production and handling of crops and livestock. Cash flow from farm earnings is the primary repayment source. Loans for grain handling and storage facilities are also sometimes included in this category, especially if the facilities are not permanently affixed to real estate.

<u>Farm Real Estate Acquisition Loans</u> **-** Long-term credits for the purchase of farm real estate, with cash flow from earnings representing the primary repayment source. Significant, permanent improvements to the real estate,

such as for livestock housing or grain storage, may also be included within this group.

Carryover Loans - This term is used to describe two types of agricultural credit. The first is production or feeder livestock loans that are unable to be paid at their initial, short-term maturity, and which are rescheduled into an intermediate or long-term amortization. This situation arises when weather conditions cause lower crop yields, commodity prices are lower than anticipated, production costs are higher than expected, or other factors result in a shortfall in available funds for debt repayment. The second type of carryover loan refers to already-existing term debt whose repayment terms or maturities need to be rescheduled because of inadequate cash flow to meet existing repayment requirements. This need for restructuring can arise from the same factors that lead to carryover production or feeder livestock loans. Carryover loans are generally restructured on an intermediate or long-term amortization, depending upon the type of collateral provided, the borrower's debt service capacity from ongoing operations, the debtor's overall financial condition and trends, or other variables. The restructuring may also be accompanied by acquisition of Federal guarantees through the farm credit system to lessen risk to the bank.

Agricultural Loan Underwriting Guidelines

Many underwriting standards applicable to commercial loans also apply to agricultural credits. The discussion of those shared standards is therefore not repeated. Some items, however, are especially pertinent to agricultural credit and therefore warrant emphasis.

Financial and Other Credit Information - As with any type of lending, sufficient information must be available so that the bank can make informed credit decisions. Basic information includes balance sheets, income statements, cash flow projections, loan officer file comments, and collateral inspections, verifications, and valuations. Generally, financial information should be updated not less than annually (loan officer files should be updated as needed and document all significant meetings and events). Credit information should be analyzed by management so that appropriate and timely actions are taken, as necessary, to administer the credit.

Banks should be given some reasonable flexibility as to the level of sophistication or comprehensiveness of the aforementioned financial information, and the frequency with which it is obtained, depending upon such factors as the credit size, the type of loans involved, the financial strength and trends of the borrower, and the economic, climatic or other external conditions which may affect loan repayment. It may therefore be inappropriate for the examiner to insist that all agricultural borrowers be supported with the full complement of balance sheets, income statements, and other data discussed above, regardless of the nature and amount of the credit or the debtor's financial strength and payment record. Nonetheless, while recognizing some leeway is appropriate, most of the bank's agricultural credit lines, and all of its larger or more significant ones, should be sufficiently supported by the financial information mentioned.

Cash Flow Analysis - History clearly demonstrated that significant problems can develop when banks fail to pay sufficient attention to cash flow adequacy in underwriting agricultural loans. While collateral coverage is important, the primary repayment source for intermediate and long-term agricultural loans is not collateral but cash flow from ordinary operations. This principle should be incorporated into the bank's agricultural lending policies and implemented in its actual practices. Cash flow analysis is therefore an important aspect of the examiner's review of agricultural loans. Assumptions in cash flow projections should be reasonable and consider not only current conditions but also the historical performance of the farming operation.

Collateral Support - Whether a loan or line of credit warrants unsecured versus secured status in order to be prudent and sound is a matter the examiner has to determine based on the facts of the specific case. The decision should generally consider such elements as the borrower's overall financial strength and trends, profitability, financial leverage, degree of liquidity in asset holdings, managerial and financial expertise, and amount and type of credit. Nonetheless, as a general rule, intermediate and long-term agricultural credit is typically secured, and many times production and feeder livestock advances will also be collateralized. Often the security takes the form of an all-inclusive lien on farm personal property, such as growing crops, machinery and equipment, livestock, and harvested grain. A lien on real estate is customarily taken if the loan was granted for the purchase of the property, or if the borrower's debts are being restructured because of debt servicing problems. In some cases, the bank may perfect a lien on real estate as an abundance of caution.

Examiner review of agricultural related collateral valuations varies depending on the type of security involved. Real estate collateral should be reviewed using normal procedures and utilizing Part 323 of the FDIC's Rules and Regulations as needed. Feeder livestock and grain are highly liquid commodities that are bought and sold daily in active, well-established markets. Their prices are widely reported in the daily media; so, obtaining their market values is generally easy. The market for breeder livestock may be somewhat less liquid than feeder livestock or grain, but values are nonetheless reasonably well known and reported through local or regional media or auction houses. If such information on breeding livestock is unavailable or is considered unreliable, slaughter prices may be used as an alternative (these slaughter prices comprise "liquidation" rather than "going concern" values). The extent of use and level of maintenance received significantly affect machinery and equipment values. Determining collateral values can therefore be very difficult as maintenance and usage levels vary significantly. Nonetheless, values for certain pre-owned machinery and equipment, especially tractors, combines, and other harvesting or crop tillage equipment, are published in specialized guides and are based on prices paid at farm equipment dealerships or auctions. These used machinery guides may be used as a reasonableness check on the valuations presented on financial statements or in management's internal collateral analyses.

Prudent agricultural loan underwriting also includes systems and procedures to ensure that the bank has a valid note receivable from the borrower and an enforceable security interest in the collateral, should judicial collection measures be necessary. Among other things, such systems and procedures will confirm that promissory notes, loan agreements, collateral assignments, and lien perfection documents are signed by the appropriate parties and are filed, as needed, with the appropriate State, county, and/or municipal authorities. Flaws in the legal enforceability of loan instruments or collateral documents will generally be unable to be corrected if they are discovered only when the credit is distressed and the borrower relationship strained.

Structuring - Orderly liquidation of agricultural debt, based on an appropriate repayment schedule and a clear understanding by the borrower of repayment expectations, helps prevent collection problems from developing. Amortization periods for term indebtedness should correlate with the useful economic life of the underlying collateral and with the operation's debt service capacity. A too-lengthy amortization period can leave the bank under secured in the latter part of the life of the loan, when the borrower's financial circumstances may have changed. A too-rapid amortization, on the other hand, can impose an undue burden on the cash flow capacity of the farming operation and thus lead to loan default or disruption of other legitimate financing needs of the enterprise. It is also generally preferable that separate loans or lines of credit be established for each loan purpose category financed by the institution.

Administration of Agricultural Loans

Two aspects of prudent loan administration deserve emphasis: collateral control and renewal practices for production loans.

Collateral Control - Production and feeder livestock loans are sometimes referred to as self liquidating because sale of the crops after harvest, and of the livestock when they reach maturity, provides a ready repayment source for these credits. These self-liquidating benefits may be lost, however, if the bank does not monitor and exercise sufficient control over the disposition of the proceeds from the sale. In agricultural lending, collateral control is mainly accomplished by periodic on-site inspections and verifications of the security pledged, with the results of those inspections documented, and by implementing procedures to ensure sales proceeds are applied to the associated debt before those proceeds are released for other purposes. The recommended frequency of collateral inspections varies depending upon such things as the nature of the farming operation, the overall credit soundness, and the turnover rate of grain and livestock inventories.

Renewal of Production Loans - After completion of the harvest, some farm borrowers may wish to defer repayment of some or all of that season's production loans, in anticipation of higher market prices at a later point (typically, crop prices are lower at harvest time when the supply is greater). Such delayed crop marketing will generally require production loan extensions or renewals.. In these situations, the bank must strike an appropriate balance of, on the one hand, not interfering with the debtor's legitimate managerial decisions and marketing plans while, at the same time, taking prudent steps to ensure its production loans are adequately protected and repaid on an appropriate basis. Examiners should generally not take exception to reasonable renewals or extensions of production loans when the following factors are favorably resolved:

- The borrower has sufficient financial strength to absorb market price fluctuations. Leverage and liquidity in the balance sheet, financial statement trends, profitability of the operation, and past repayment performance are relevant indices.
- The borrower has sufficient financial capacity to support both old and new production loans. That is, in a few months subsequent to harvest, the farmer will typically be incurring additional production debt for the upcoming crop season.
- The bank has adequately satisfied itself of the amount and condition of grain in inventory, so that the renewed or extended production loans are adequately supported. Generally, this means that a current inspection report will be available.

Classification Guidelines for Agricultural Credit

When determining the level of risk in a specific lending relationship, the relevant factual circumstances must be reviewed in total. This means, among other things, that when an agricultural loan's primary repayment source is jeopardized or unavailable, adverse classification is **not** automatic. Rather, such factors as the borrower's historical performance and financial strength, overall financial condition and trends, the value of any collateral, and other sources of repayment must be considered. In considering whether a given agricultural loan or line of credit should be adversely classified, collateral margin is an important, though not necessarily the determinative, factor. If that margin is so overwhelming as to remove all reasonable prospect of the bank sustaining some loss, it is generally inappropriate to adversely classify such a loan. Note, however, that if there is reasonable uncertainty as to the value of that security, because of an illiquid market or other reasons, that uncertainty can, when taken in conjunction with other weaknesses, justify an adverse classification of the credit, or, at minimum, may mean that the margin in the collateral needs to be greater to offset this uncertainty. Moreover, when assessing the adequacy of the collateral margin, it must be remembered that deteriorating financial trends will, if not arrested, typically result in a shrinking of that margin. Such deterioration can also reduce the amount of cash available for debt service needs.

That portion of an agricultural loan(s) or line of credit, which is secured by grain, feeder livestock, and/or breeder livestock, will generally be withheld from adverse classification. The basis for this approach is that grain and livestock are highly marketable and provide good protection from credit loss. However, that high marketability also poses potential risks that must be recognized and controlled. The following conditions must therefore be met in order for this provision to apply:

- The bank must take reasonable steps to verify the existence and value of the grain and livestock. This generally means that on-site inspections must be made and documented. Although the circumstances of each case must be taken into account, the general policy is that, for the classification exclusion to apply, inspections should have been performed not more than 90 days prior to the examination start date for feeder livestock and grain collateral, and not more than six months prior to the examination start date for breeder stock collateral. Copies of invoices or bills of sale are acceptable substitutes for inspection reports prepared by bank management, in the case of loans for the purchase of livestock.
- Loans secured by grain warehouse receipts are generally excluded from adverse classification, up to the market value of the grain represented by the receipts.
- The amount of credit to be given for the livestock or grain collateral should be based on the daily, published, market value as of the examination start date, less marketing and transportation costs, feed and veterinary expenses (to the extent determinable), and, if material in amount, the accrued interest associated with the loan(s). Current market values for breeder stock may be derived from local or regional newspapers, area auction barns, or other sources considered reliable. If such valuations for breeding livestock cannot be obtained, the animals' slaughter values may be used.
- The bank must have satisfactory practices for controlling sales proceeds when the borrower sells livestock and feed and grain.
- The bank must have a properly perfected and enforceable security interest in the assets in question.

Examiners should exercise great caution in granting the grain and livestock exclusion from adverse classification in those instances where the borrower is highly leveraged, or where the debtor's basic operational viability is seriously in question, or if the bank is in an under-secured position. The issue of control over proceeds becomes extremely critical in such highly distressed credit situations. If the livestock and grain exclusion from adverse classification is not given in a particular case, bank management should be informed of the reasons why.

With the above principles, requirements, and standards in mind, the general guidelines for determining adverse classification for agricultural loans are as follows, listed by loan type.

<u>Feeder Livestock Loans</u> **-** The self-liquidating nature of these credits means that they are generally not subject to adverse classification. However, declines in livestock prices, increases in production costs, or other unanticipated developments may result in the revenues from the sale of the livestock not being adequate to fully repay the loans. Adverse classification may then be appropriate, depending upon the support of secondary repayment sources and collateral, and the borrower's overall financial condition and trends.

<u>Production Loans</u> **-** These loans are generally not subject to adverse classification if the debtor has good liquidity and/or significant fixed asset equities, or if the cash flow information suggests that current year's operations should be sufficient to repay the advances. The examiner should

also take into account any governmental support programs or Federal crop insurance benefits from which the borrower may benefit. If cash flow from ongoing operations appears insufficient to repay production loans, adverse classification may be in order, depending upon the secondary repayment sources and collateral, and the borrower's overall financial condition and trends.

Breeder Stock Loans **-** These loans are generally not adversely classified if they are adequately secured by the livestock and if the term debt payments are being met through the sale of offspring (or milk and eggs in the case of dairy and poultry operations). If one or both of these conditions is not met, adverse classification may be in order, depending upon the support of secondary repayment sources and collateral, and the borrower's overall financial condition and trends.

Machinery and Equipment Loans **-** Loans for the acquisition of machinery and equipment will generally not be subject to adverse classification if they are adequately secured, structured on an appropriate amortization program (see above), and are paying as agreed. Farm machinery and equipment is often the second largest class of agricultural collateral, hence its existence, general state of repair, and valuation should be verified and documented during the bank's periodic on-site inspections of the borrower's operation. Funding for the payments on machinery and equipment loans sometimes comes, at least in part, from other loans provided by the bank, especially production loans. When this is the case, the question arises whether the payments are truly being "made as agreed." For examination purposes, such loans will be considered to be paying as agreed if cash flow projections, payment history, or other available information, suggests there is sufficient capacity to fully repay the production loans when they mature at the end of the current production cycle. If the machinery and equipment loan is not adequately secured, or if the payments are not being made as agreed, adverse classification should be considered.

Carryover Debt **-** Carryover debt results from the debtor's inability to generate sufficient cash flow to service the obligation as it is currently structured. It therefore tends to contain a greater degree of credit risk and must receive close analysis by the examiner. When carryover debt arises, the bank should determine the basic viability of the borrower's operation, so that an informed decision can be made on whether debt restructuring is appropriate. It will thus be useful for bank management to know how the carryover debt came about: Did it result from the obligor's financial, operational or other managerial weaknesses; from inappropriate credit administration on the bank's part, such as over lending or improper debt structuring; from external events such as adverse weather conditions that affected crop yields; or from other causes? In many instances, it will be in the long-term best interests of both the bank and the debtor to restructure the obligations. The restructured obligation should generally be rescheduled on a term basis and require clearly identified collateral, amortization period, and payment amounts. The amortization period may be intermediate or long term depending upon the useful economic life of the available collateral, and on realistic projections of the operation's payment capacity.

There are no hard and fast rules on whether carryover debt should be adversely classified, but the decision should generally consider the following: borrower's overall financial condition and trends, especially financial leverage (often measured in farm debtors with the debt-to-assets ratio); profitability levels, trends, and prospects; historical repayment performance; the amount of carryover debt relative to the operation's size; realistic projections of debt service capacity; and the support provided by secondary collateral. Accordingly, carryover loans to borrowers who are moderately to highly leveraged, who have a history of weak or no profitability and barely sufficient cash flow projections, as well as an adequate but slim collateral margin, will generally be adversely classified, at least until it is demonstrated through actual repayment performance that there is adequate capacity to service the rescheduled obligation. The classification severity will normally depend upon the collateral position. At the other extreme are cases where the customer remains fundamentally healthy financially, generates good profitability and ample cash flow, and who provides a comfortable margin in the security pledged. Carryover loans to this group of borrowers will not ordinarily be adversely classified.

Installment Loans

An installment loan portfolio is usually comprised of a large number of small loans scheduled to be amortized over a specific period. Most installment loans are made directly for consumer purchases, but business loans granted for the purchase of heavy equipment or industrial vehicles may also be included. In addition, the department may grant indirect loans for the purchase of consumer goods.

The examiner's emphasis in reviewing the installment loan department should be on the overall procedures, policies and credit qualities. The goal should not be limited to identifying current portfolio problems, but should include potential future problems that may result from ineffective policies, unfavorable trends, potentially dangerous concentrations, or nonadherence to established policies. At a minimum, the direct installment lending policies should address the following factors: loan applications and credit checks; terms in relation to collateral; collateral margins; perfection of liens; extensions, renewals and rewrites; delinquency notification and follow-up; and charge-offs and collections. For indirect lending, the policy additionally should address direct payment to the bank versus payment to the dealer, acquisition of dealer financial information, possible upper limits for any one dealer's paper, other standards governing acceptance of dealer paper, and dealer reserves and charge-backs.

Direct Lease Financing

Leasing is a recognized form of term debt financing for fixed assets. While leases differ from loans in some respects, they are similar from a credit viewpoint because the basic considerations are cash flow, repayment capacity, credit history, management and projections of future operations. Additional considerations for a lease transaction are the property type and its marketability in the event of default or lease termination. Those latter considerations do not radically alter the manner in which an examiner evaluates collateral for a lease. The assumption is that the lessee/borrower will generate sufficient funds to liquidate the lease/debt. Sale of leased property/collateral remains a secondary repayment source and, except for the estimated residual value at the expiration of the lease, will not, in most cases, become a factor in liquidating the advance. When the bank is requested to purchase property of significant value for lease, it may issue a commitment to lease, describing the property, indicating cost, and generally outlining the lease terms. After all terms in the lease transaction are resolved by negotiation between the bank and its customer, an order is usually written requesting the bank to purchase the property. Upon receipt of that order, the bank purchases the property requested and arranges for delivery and, if necessary, installation. A lease contract is drawn incorporating all the points covered in the commitment letter, as well as the rights of the bank and lessee in the event of default. The lease contract is generally signed simultaneously with the signing of the order to purchase and the agreement to lease.

The types of assets that may be leased are numerous, and the accounting for direct leasing is a complex subject which is discussed in detail in FAS 13. Familiarity with FAS 13 is a prerequisite for the management of any bank engaging in or planning to engage in direct lease financing. The following terms are commonly encountered in direct lease financing:

- Net Lease, one in which the bank is not directly or indirectly obligated to assume the expenses of maintaining the equipment. This restriction does not prohibit the bank from paying delivery and set up charges on the property.
- Full Payout Lease, one for which the bank expects to realize both the return of its full investment and the cost of financing the property over the term of the lease. This payout can come from rentals, estimated tax benefits, and estimated residual value of the property.
- Leveraged Lease, in which the bank as lessor purchases and becomes the equipment owner by providing a relatively small percentage (20-40%) of the capital needed. Balance of the funds is borrowed by the lessor from long-term lenders who hold a first lien on the equipment and assignments of the lease and lease rental payments. This specialized and complex form of leasing is prompted mainly by a desire on the part of the lessor to shelter income from taxation. Creditworthiness of the lessee is paramount and the general rule is a bank should not enter into a leveraged lease transaction with any party to whom it would not normally extend unsecured credit.
- Rentals, which include only those payments reasonably anticipated by the bank at the time the lease is executed.

Bank management should carefully evaluate all lease variables, including the estimate of the residual value. Banks may be able to realize unwarranted lease income in the early years of a contract by manipulating the lease variables. In addition, a bank can offer the lessee a lower payment by assuming an artificially high residual value during the initial structuring of the lease. But this technique may present the bank with serious long-term problems because of the reliance on speculative or nonexistent residual values.

Often, lease contracts contain an option permitting the lessee to continue use of the property at the end of the original term, working capital restrictions and other restrictions or requirements similar to debt agreements and lease termination penalties. Each lease is an individual contract written to fulfill the lessee's needs. Consequently, there may be many variations of each of the above provisions. However, the underlying factors remain the same: there is a definite contractual understanding of the positive right to use the property for a specific period of time, and required payments are irrevocable.

Examination procedures for reviewing direct lease financing activities are included in the ED Modules in the Loan References section.

Floor Plan Loans

Floor plan (wholesale) lending is a form of retail goods inventory financing in which each loan advance is made against a specific piece of collateral. As each piece of collateral is sold by the dealer, the loan advance against that piece of collateral is repaid. Items commonly subject to floor plan debt are automobiles, home appliances, furniture, television and stereophonic equipment, boats, mobile homes and other types of merchandise usually sold under a sales finance contract. Drafting agreements are a relatively common approach utilized in conjunction with floor plan financing. Under this arrangement, the bank establishes a line of credit for the borrower and authorizes the good's manufacturer to draw drafts on the bank in payment for goods shipped. The bank agrees to honor these drafts, assuming proper documentation (such as invoices, manufacturer's statement of origin, etc.) is provided. The method facilitates inventory purchases by, in effect, guaranteeing payment to the manufacturer for merchandise supplied. Floor plan loans involve all the basic risks inherent in any form of inventory financing. However, because of the banker's inability to exercise full control over the floored items, the exposure to loss may be greater than in other similar types of financing. Most dealers have minimal capital bases relative to debt. As a result, close and frequent review of the dealer's financial information is necessary. As with all inventory financing, collateral value is of prime importance. Control requires the bank to determine the collateral value at the time the loan is placed on the books, frequently inspect the collateral to determine its condition, and impose a curtailment requirement sufficient to keep collateral value in line with loan balances.

Handling procedures for floor plan lines will vary greatly depending on bank size and location, dealer size and the type of merchandise being financed. In many cases, the term "trust receipt" is used to describe the debt instrument existing between the bank and the dealer. Trust receipts may result from drafting agreements between a bank and a manufacturer for the benefit of a dealer. In other instances, the dealer may order inventory, bring titles or invoices to the bank, and then obtain a loan secured or to be secured by the inventory. Some banks may use master debt instruments, and others may use a trust receipt or note for each piece of inventory. The method of perfecting a security interest also varies from state to state. The important point is that a bank enacts realistic handling policies and ensures that its collateral position is properly protected.

Examination procedures and examiner considerations for reviewing floor plan lending activities are included in the ED Modules in the Loan References section.

Check Credit and Credit Card Loans

Check credit is defined as the granting of unsecured revolving lines of credit to individuals or businesses. Check credit services are provided by the overdraft system, cash reserve system, and special draft system. The most common is the overdraft system. In that method, a transfer is made from a preestablished line of credit to a customer's demand deposit account when a check which would cause an overdraft position is presented. Transfers normally are made in stated increments, up to the maximum line of credit approved by the bank, and the customer is notified that the funds have been transferred. In a cash reserve system, customers must request that the bank transfer funds from their preestablished line of credit to their demand deposit account before negotiating a check against them. A special draft system involves the customer negotiating a special check drawn directly against a preestablished line of credit. In that method, demand deposit accounts are not affected. In all three systems, the bank periodically provides its check credit customers with a statement of account activity. Required minimum payments are computed as a fraction of the balance of the account on the cycle date and may be made by automatic charges to a demand deposit account.

Most bank credit card plans are similar. The bank solicits retail merchants, service organizations and others who agree to accept a credit card in lieu of cash for sales or services rendered. The parties also agree to a discount percentage of each sales draft and a maximum dollar amount per transaction. Amounts exceeding that limit require prior approval by the bank. Merchants also may be assessed a fee for imprinters or promotional materials. The merchant deposits the bank credit card sales draft at the bank and receives immediate credit for the discounted amount. The bank assumes the credit risk and charges the nonrecourse sales draft to the individual customer's credit card account. Monthly statements are rendered by the bank to the customer who may elect to remit the entire amount, generally without service charge, or pay in monthly installments, with an additional percentage charged on the outstanding balance each month. A cardholder also may obtain cash advances from the bank or dispensing machines. Those advances accrue interest from the transaction date. A bank may be involved in a credit card plan in three ways:

- Agent Bank, which receives credit card applications from customers and sales drafts from merchants and forwards such documents to banks described below, and is accountable for such documents during the process of receiving and forwarding.

- Sublicensee Bank, which maintains accountability for credit card loans and merchant's accounts; may maintain its own center for processing payments and drafts; and may maintain facilities for embossing credit cards.
- Licensee Bank, which is the same as sublicensee bank, but in addition may perform transaction processing and credit card embossing services for sublicensee banks, and also acts as a regional or national clearinghouse for sublicensee banks.

Check credit and credit card loan policies should address procedures for careful screening of account applicants; establishment of internal controls to prevent interception of cards before delivery, merchants from obtaining control of cards, or customers from making fraudulent use of lost or stolen card; frequent review of delinquent accounts, accounts where payments are made by drawing on reserves, and accounts with steady usage; delinquency notification procedures; guidelines for realistic charge-offs; removal of accounts from delinquent status (curing) through performance not requiring a catch-up of delinquent principal; and provisions that preclude automatic reissuance of expired cards to obligors with charged-off balances or an otherwise unsatisfactory credit history with the bank.

Examination procedures for reviewing these activities are included in the ED Modules. Also, the FDIC has separate manuals on Credit Card Specialty Bank Examination Guidelines and Credit Card Securitization Activities.

Credit Card-related Merchant Activities

Merchant credit card activities basically involve the acceptance of credit card sales drafts for clearing by a financial institution (clearing institution). For the clearing institution, these activities are generally characterized by thin profit margins amidst high transactional and sales volumes. Typically, a merchant's customer will charge an item on a credit card, and the clearing institution will give credit to the merchant's account. Should the customer dispute a charge transaction, the clearing institution is obligated to honor the customer's legitimate request to reverse the transaction. The Clearing Institution must then seek reimbursement from the merchant. Problems arise when the merchant is not creditworthy and is unable, or unwilling, to reimburse the clearing institution. In these instances, the clearing institution will incur a loss. Examiners should review for the existence of any such contingent liabilities.

In order to avoid losses and to ensure the safe and profitable operation of a clearing institution's credit card activities, the merchants with whom it contracts for clearing services should be financially sound and honestly operated. To this end, safe and sound merchant credit card activities should include clear and detailed acceptance standards for merchants. These standards include the following:

- A clearing institution should scrutinize prospective merchants with the same care and diligence that it uses in evaluating prospective borrowers.
- Financial institutions engaging in credit card clearing operations must closely monitor their merchants. Controls should be in place to ensure that early warning signs are recognized so that problem merchants can be removed from a clearing institution's program promptly to minimize loss exposure.
- In cases of merchants clearing large dollar volumes, a clearing institution should establish an account administration program that, at a minimum, incorporates periodic reviews of the merchants' financial statements and business activities.
- A clearing institution should establish an internal periodic reporting system of merchant account activities regardless of the amount or number of transactions cleared, and these reports should be reviewed for irregularities so that the Clearing Institution alerts itself quickly to problematic merchant activity.
- Clearing institutions should follow the guidelines that are established by the card issuing networks.

Another possible problem with merchant activities involves clearing institutions that sometimes engage the services of agents, such as an independent sales organization (ISO). ISOs solicit merchants' credit card transactions for a clearing institution. In some cases, the ISOs actually contract with merchants on behalf of clearing institutions. Some of these contracts are entered into by the ISOs without the review and approval of the clearing institutions. At times, clearing institutions unfortunately rely too much on the ISOs to oversee account activity. In some cases, clearing institutions have permitted ISOs to contract with disreputable merchants. Because of the poor condition of the merchant, or ISO, or both, these clearing institutions can ultimately incur heavy losses.

A financial institution with credit card clearing activities should develop its own internal controls and procedures to ensure sound agent selection standards before engaging an ISO. ISOs that seek to be compensated solely on the basis of the volume of signed-up merchants should be carefully scrutinized. A clearing institution should adequately supervise the ISO's activities, just as the institution should supervise any third party engaged to perform services for any aspect of the institution's operations. Also, it should reserve the right to ratify or reject any merchant contract that is initiated by an ISO.

Examination procedures for reviewing credit card related merchant activities are included in the Examination Documentation Modules in the Supplemental Modules Section and in the Credit Card Specialty Bank Examination Guidelines.

OTHER CREDIT ISSUES

Appraisals

Appraisals are professional judgments of the market value of real property. Three basic valuation approaches are used by professional appraisers in estimating the market value of real property; the cost approach, the market data or direct sales comparison approach, and the income approach. The principles governing the three approaches are widely known in the appraisal field and are referenced in parallel regulations issued by each of the Federal bank and thrift regulatory agencies. When evaluating collateral, the three valuation approaches are not equally appropriate.

- **Cost Approach -** In this approach, the appraiser estimates the reproduction cost of the building and improvements, deducts estimated depreciation, and adds the value of the land. The cost approach is particularly helpful when reviewing draws on construction loans. However, as the property increases in age, both reproduction cost and depreciation become more difficult to estimate. Except for special purpose facilities, the cost approach is usually inappropriate in a troubled real estate market because construction costs for a new facility normally exceed the market value of existing comparable properties.
- **Market Data or Direct Sales Comparison Approach -** This approach examines the price of similar properties that have sold recently in the local market, estimating the value of the subject property based on the comparable properties' selling prices. It is very important that the characteristics of the observed transactions be similar in terms of market location, financing terms, property condition and use, timing, and transaction costs. The market approach generally is used in valuing owner-occupied residential property because comparable sales data is typically available. When adequate sales data is available, an analyst generally will give the most weight to this type of estimate. Often, however, the available sales data for commercial properties is not sufficient to justify a conclusion.
- **The Income Approach -** The economic value of an income-producing property is the discounted value of the future net operating income stream, including any "reversion" value of property when sold. If competitive markets are working perfectly, the observed sales price should be equal to this value. For unique properties or in depressed markets, value based on a comparable sales approach may be either unavailable or distorted. In such cases, the income approach is usually the appropriate method for valuing the property. The income approach converts all expected future net operating income into present value terms. When market conditions are stable and no unusual patterns of future rents and occupancy rates are expected, the direct capitalization method is often used to estimate the present value of future income streams. For troubled properties, however, the more explicit discounted cash flow (net present value) method is more typically utilized for analytical purposes. In the rent method, a time frame for achieving a "stabilized", or normal, occupancy and rent level is projected. Each year's net operating income during that period is discounted to arrive at present value of expected future cash flows. The property's anticipated sales value at the end of the period until stabilization (its terminal or reversion value) is then estimated. The reversion value represents the capitalization of all future income streams of the property after the projected occupancy level is achieved. The terminal or reversion value is then discounted to its present value and added to the discounted income stream to arrive at the total present market value of the property.

Valuation of Troubled Income-Producing Properties

When an income property is experiencing financial difficulties due to general market conditions or due to its own characteristics, data on comparable property sales is often difficult to obtain. Troubled properties may be hard to market, and normal financing arrangements may not be available. Moreover, forced and liquidation sales can dominate market activity. When the use of comparables is not feasible (which is often the case for commercial properties), the net present value of the most reasonable expectation of the property's income-producing capacity - not just in today's market but over time - offers the most appropriate method of valuation in the supervisory process.

Estimates of the property's value should be based upon reasonable and supportable projections of the determinants of future net operating income: rents (or sales), expenses, and rates of occupancy. The primary considerations for these projections include historical levels and trends, the current market performance achieved by the subject and similar properties, and economically feasible and defensible projections of future demand and supply conditions. If current market activity is dominated by a limited number of transactions or liquidation sales, high capitalization and discount rates implied by such transactions should not be used. Rather, analysts should use rates that reflect market conditions that are neither highly speculative nor depressed.

Appraisal Regulation

Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 requires that appraisals prepared by certified or licensed appraisers be obtained in support of real estate lending and mandates that the Federal financial institutions regulatory agencies adopt regulations regarding the preparation and use of appraisals in certain real estate related transactions by financial institutions under their jurisdiction. In addition, Title XI created the Appraisal Subcommittee (Subcommittee) of the Federal Financial Institutions Examination Council (FFIEC) to provide oversight of the real estate appraisal process as it relates to federally related real estate transactions. The Subcommittee is composed of six members, each of whom is designated by the head of their respective agencies. Each of the five financial institution regulatory agencies which comprise the FFIEC and the U.S. Department of Housing and Urban Development are represented on Subcommittee. A responsibility of the Subcommittee is to monitor the state certification and licensing of appraisers. It has the authority to disapprove a state appraiser regulatory program, thereby disqualifying the state's licensed and certified appraisers from conducting appraisals for federally related transactions. The Subcommittee gets its funding by charging state certified and licensed appraisers an annual registration fee. The fee income is used to cover Subcommittee administrative expenses and to provide grants to the Appraisal Foundation.

Formed in 1987, the Appraisal Foundation was established as a private not for profit corporation bringing together interested parties within the appraisal industry, as well as users of appraiser services, to promote professional standards within the appraisal industry. The Foundation sponsors two independent boards referred to in Title XI, The Appraiser Qualifications Board (AQB) and The Appraisal Standards Board (ASB). Title XI specifies that the minimum standards for state appraiser certification are to be the criteria for certification issued by the AQB. Title XI does not set specific criteria for the licensed classification. These are individually determined by each state. Additionally, Title XI requires that the appraisal standards prescribed by the Federal agencies, at a minimum, must be the appraisal standards promulgated by the ASB. The ASB has issued The Uniform Standards of Professional Appraisal Practice (USPAP) which set the appraisal industry standards for conducting an appraisal of real estate. To the appraisal industry, USPAP is analogous to generally accepted accounting principles for the accounting profession.

In conformance with Title XI, Part 323 of the FDIC regulations identifies which real estate related transactions require an appraisal by a certified or licensed appraiser and establishes minimum standards for performing appraisals. Substantially similar regulations have been adopted by each of the Federal financial institutions regulatory agencies.

Real estate-related transactions include real estate loans, mortgage-backed securities, bank premises, real estate investments, and other real estate owned. All real estate-related transactions by FDIC-insured institutions not specifically exempt are, by definition, "federally related transactions" subject to the requirements of the regulation. Exempt real estate-related transactions include:

- The transaction value is $250,000 or less;
- A lien on real estate has been taken as collateral in an abundance of caution;
- The transaction is not secured by real estate;
- A lien on real estate has been taken for purposes other than the real estate’s value;
- The transaction is a business loan that: (i) has a transaction value of $1 million or less; and (ii) is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment;
- A lease of real estate is entered into, unless the lease is the economic equivalent of a purchase or sale of the leased real estate;
- The transaction involves 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 threatens 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;
- 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 FDIC regulatory requirements for appraisals at the time of origination;

- The transaction is wholly or partially insured or guaranteed by a United States government agency or United States government sponsored agency;
- The transaction either; (i) Qualifies for sale to a United States government agency or United States government sponsored agency; or (ii) 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;
- The regulated institution is acting in a fiduciary capacity and is not required to obtain an appraisal under other law; or
- The FDIC determines that the services of an appraiser are not necessary in order to protect Federal financial and public policy interests in real estate-related financial transaction or to protect the safety and soundness of the institution.

Section 323.4 establishes minimum standards for all appraisals in connection with federally related transactions. Appraisals performed in conformance with the regulation must conform to the requirements of the USPAP and certain other listed standards. The applicable sections of USPAP are the Preamble (ethics and competency), Standard 1 (appraisal techniques), Standard 2 (report content), and Standard 3 (review procedures). USPAP Standards 4 through 10 concerning appraisal services and appraising personal property do not apply to federally related transactions.

An appraisal satisfies the regulation if it is performed in accordance with all of its provisions and it is still current and meaningful. In other words, a new appraisal does not necessarily have to be done every time there is a transaction, provided the institution has an acceptable process in place to review existing appraisals.

Adherence to the appraisal regulation and appraisal guidelines should be part of the examiner's overall review of the lending function. An institution's written appraisal program should contain specific administrative review procedures that provide some evidence, such as a staff member's signature on an appraisal checklist that indicates the appraisal was reviewed and that all standards were met. In addition, the regulation requires that the appraisal contain the appraiser's certification that it was prepared in conformance with USPAP. When analyzing individual transactions, examiners should review appraisal reports to determine the institution's conformity to its own internal appraisal policies and for compliance with the regulation. Examiners may need to conduct a more detailed review if the appraisal does not have sufficient information, does not explain assumptions, is not logical, or has other major deficiencies that cast doubt as to the validity of its opinion of value. Examination procedures regarding appraisal reviews are included in the Examination Documentation Modules.

Loans in a pool such as an investment in mortgage- backed securities or collateralized mortgage obligations should have some documented assurance that each loan in the pool has an appraisal in accordance with the regulation. Appropriate evidence could include an issuer's certification of compliance.

All apparent violations of Part 323 should be listed in the examination report in the usual manner. Significant systemic failures to meet standards and procedures could call for formal corrective measures.

Interagency Appraisal and Evaluation Guidelines

These Interagency Appraisal and Evaluation Guidelines dated October 27, 1994 address supervisory matters relating to 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. The guidelines were reiterated and clarified in a Statement issued by the regulatory agencies on October 27, 2003.

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 should review an appraisal or evaluation to determine whether the methods, assumptions, and findings are reasonable and in compliance with the agencies' appraisal regulations, policies, supervisory guidelines, and internal 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:

- 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.

<u>Selection of Individuals Who May Perform Appraisals and Evaluations</u> **-** An institution's program should establish criteria to select, evaluate, and monitor the performance of the individual(s) who performs a real estate appraisal or evaluation. The criteria should ensure that:

- The institution's selection process is non-preferential 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. Also, an institution may not use an appraisal that has been “readdressed” – appraisal reports that are altered by the appraiser to replace any references to the original client with the institution’s name. 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.

<u>Independence of the Appraisal And Evaluation Function</u> **-** 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. In addition, individuals independent from the loan production area should oversee the selection of appraisers and individuals providing evaluation services. 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. That is, no single person should have sole authority to render credit decisions on loans which they ordered or reviewed appraisals or evaluations.

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.

<u>Transactions That Require Appraisals</u> **-** 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. 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.

<u>Minimum Appraisal Standards</u> **-** 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, non-market 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. Each appraisal must contain an estimate of market value, as defined by the agencies' appraisal regulations; and,
- Be performed by state licensed or certified appraisers in accordance with requirements set forth in the regulation.

<u>Appraisal Options</u> **-** An appraiser typically uses three market value approaches to analyze the value of a property cost, income, and sales market. The appraiser reconciles the results of each approach 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/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. 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 to value; however, departure from standards designated as binding requirements is not permitted. There are numerous binding requirements which are detailed in the USPAP. Use of the USPAP Standards publication as a reference is recommended. The book provides details on each appraisal standard and advisory opinions issued by the Appraisal Standards Board.

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 capsulated 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.

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 Evaluation Providers **-** 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 sales persons, 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 **-** The agencies' appraisal regulations generally allow appropriate evaluations of real estate collateral in lieu of an appraisal for loan renewals and refinancings; however, in certain situations an appraisal is required. If new funds are advanced in excess of reasonable closing costs, an institution is expected to obtain a new appraisal for the renewal of an existing transaction when there is a material change in market conditions or in 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, non-residential 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, 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.

Examination Treatment

All apparent violations of the appraisal regulation should be described in the schedule of violations of laws and regulations. Management's comments and any commitments for correcting the practices that led to the apparent violation should be included. Violations that are technical in nature and do not impact the value conclusion generally should not require a new appraisal. (These technical violations should not be relisted in subsequent examinations.) Since the point of an appraisal is to help make sound loan underwriting decisions, getting an appraisal on a loan already made simply to fulfill the requirements of the appraisal regulation, would be of little benefit. However, an institution should be expected to obtain a new appraisal on a loan in violation of the appraisal regulation when there is a safety and soundness reason for such action. For example, construction loans and lines of credit need to have the value of the real estate reviewed frequently in order for the institution to properly manage the credit relationship. A new appraisal might also be needed to determine the proper classification for examination purposes of a collateral dependent loan.

Loan Participations

A loan participation is a sharing or selling of ownership interests in a loan between two or more financial institutions. Normally, a lead bank originates the loan and sells ownership interests to one or more participating banks at the time the loan is closed. The lead (originating) bank retains a partial interest in the loan, holds all loan documentation in its own name, services the loan, and deals directly with the customer for the benefit of all participants. Properly structured, loan participations allow selling banks to accommodate large loan requests which would otherwise exceed lending limits, diversify risk, and improve liquidity. Participating banks are able to compensate for low local loan demand or invest in large loans without servicing burdens and origination costs. If not appropriately structured and documented, a participation loan can present unwarranted risks to both the seller and purchaser of the loan. Examiners should determine the nature and adequacy of the participation arrangement as well as analyze the credit quality of the loan.

Accounting and Capital Treatment - The proper accounting treatment for loan participations is governed by FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. FAS applies to both the transferor (seller) of assets and the transferee (purchaser).

Loan participations are accounted for as sales provided the sales criteria in FAS 140 are met. If the sales criteria are not met, participations are accounted for as secured borrowings. The sales criteria focus on whether or not control is effectively transferred to the purchaser. To qualify for sales treatment three criteria must be met:

- The purchaser's interest in the loan must be isolated from the seller, meaning that the purchaser's interest in the loan is presumptively beyond the reach of the seller and its creditors, even in bankruptcy or other receivership;
- Each purchaser has the right to pledge or exchange its interest in the loan, and there are no conditions that both constrain the purchaser from taking advantage of that right and provide more than a trivial benefit to the seller; and
- The agreement does not both entitle and obligate the seller to repurchase or redeem the purchaser's interest in the loan prior to the loan's maturity, and it does not provide the seller with the ability to unilaterally cause the purchaser to return its interest in the loan to the seller (other than through a cleanup call).

Right to Repurchase - Some loan participation agreements may give the seller a contractual right to repurchase the participated interest in the loan at any time. In this case, the seller's right to repurchase the participation effectively provides the seller with a call option on a specific asset and precludes sale accounting. If a loan participation agreement contains such a provision, the participation should be accounted for as a secured borrowing.

Recourse Arrangements - Recourse arrangements may, or may not, preclude loan participations from being accounted for as sales for financial reporting purposes. The date of the participation and the formality of the recourse provision affect the accounting for the transaction. Formal recourse provisions may affect the accounting treatment of a participation depending upon the date that the participation is transferred to another institution. Implicit recourse provisions would not affect the financial reporting treatment of a participation because the accounting standards look to the contractual terms of asset transfers in determining whether or not the criteria necessary for sales accounting treatment have been met. Although implicit recourse provisions would not affect the accounting treatment of a loan participation, they may affect the risk-based capital treatment of a participation.

Loan participations transferred prior to April 1, 2001, are accounted for based on FAS 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The sales criteria contained in FAS 125 are very similar to those contained in FAS 140, which are summarized above. However, for FDIC-insured institutions, the first of the sales criteria in FAS 140, known as the isolation test, applies to transfers occurring after December 31, 2001. As a result, loan participations transferred from April 1 through December 31, 2001, are subject to the isolation test in FAS 125, but are otherwise accounted for based on FAS 140. Based upon the FASB's initial understanding of the nature of the FDIC's receivership power to reclaim certain assets sold by institutions that subsequently failed when it was drafting FAS 125, the FASB deemed assets sold by FDIC-insured institutions to be beyond the reach of creditors in an FDIC receivership. Therefore in FAS 125, the FASB concluded that assets transferred by an FDIC-insured institution, including participations, generally met the isolation test for sales accounting treatment with respect to receiverships. (Depending on the terms of the transfer, the transferred assets might not meet the isolation test for other reasons.) As a result, the mere existence of formal (written, contractual) recourse provisions would not, in and of themselves, preclude loan participations transferred prior to January 1, 2002, from being accounted for as sales provided all other criteria necessary for sales accounting treatment are met. However, participations transferred prior to January 1, 2002, which are subject to formal recourse provisions, as well as those subject to implicit (unwritten, noncontractual) recourse provisions in which the seller demonstrates intent to repurchase participations in the event of default even in the absence of a formal obligation to do so, would be considered assets sold with recourse when calculating the seller's risk-based capital ratios.

After the issuance of FAS 125, the FASB further clarified its understanding of the FDIC's ability to reclaim certain assets in a receivership, and the FDIC clarified when it would not seek to reclaim loan participations sold in Part 360 of the FDIC Rules and Regulations. Section 360.6 limits the FDIC's ability to reclaim certain loan participations sold without recourse, but does not limit the FDIC's ability to reclaim loan participations sold with recourse. For purposes of Section 360.6, the phrase "without recourse" means that the participation is not subject to any agreement which requires the lead bank (seller) to repurchase the participant's (purchaser's) interest in the loan or to otherwise compensate the participant due to a default on the underlying loan. The FASB's new understanding of the FDIC's receivership powers, including Part 360, is addressed in FAS 140.

Loan participations transferred after December 31, 2001, must be accounted for pursuant to all of the provisions of FAS 140, including its isolation test. In accordance with FAS 140, loan participations sold by FDIC-insured institutions with recourse generally will not be considered isolated from creditors in the event of receivership due to the FDIC's power to reclaim the participated assets. As a result, loan participations transferred after December 31, 2001, which are subject to formal (written, contractual) recourse provisions should be accounted for as secured borrowings by both the seller and the purchaser for financial reporting purposes. This means that the seller must not reduce the loan assets on its balance sheet for the participation, and that the entire amount of the loan must be included in the seller's assets for both leverage and risk-based capital purposes. Participations transferred after December 31, 2001, which are subject to implicit (unwritten, noncontractual) recourse provisions may be accounted for as sales by both the seller and the purchaser for financial reporting purposes, provided the other sales criteria addressed above are met. However, if the seller demonstrates intent to repurchase participations sold in the event of default even in the absence of a formal obligation to do so, then these participations will be treated as assets sold with recourse when calculating the seller's risk-based capital ratios. Consistent with an AICPA auditing interpretation, FDIC-insured institutions which account for loan participations transferred after December 31, 2001, as sales rather than as secured borrowings for financial reporting purposes should generally do so only if the participation agreement is supported by a legal opinion explaining how the isolation test for sales accounting treatment is met given the FDIC's receivership powers.

Call Report Treatment - When a loan participation is accounted for as a sale, the seller removes the participated interest in the loan from its books. The purchaser reports its interest in the loan as Loans in the Report of Condition, and in Call Report Schedule RC-C - Loans and Lease Financing Receivables, based upon collateral, borrower, or purpose. If a loan participation is accounted for as a secured borrowing, the seller does not remove the loan from its books. The participated portion of the loan is reported as both Loans and Other Borrowed Money in the Report of Condition. The purchaser would report its interest in the loan as Loans in the Report of Condition, and as Loans to depository institutions and acceptances of other banks in Schedule RC-C. More detailed guidance on accounting for transfers of financial assets, including loan participations, is contained in the Transfers of Financial Assets entry in the Glossary of the Call Report Instructions.

Independent Credit Analysis - A bank purchasing a participation loan is expected to perform the same degree of independent credit analysis on the loan as if it were the originator. To determine if a participation loan meets its credit standards, a participating bank must obtain all relevant credit information and details on collateral values, lien status, loan agreements and participation agreements before a commitment is made to purchase. The absence of such information may be evidence that the participating bank has not been prudent in its credit decision.

During the life of the participation, the participant should monitor the servicing and the status of the loan. In order to exercise control of its ownership interest, a purchasing bank must ascertain that the selling bank will provide complete and timely credit information on a continuing basis.

The procedures for purchasing loan participations should be provided for in the bank's formal lending policy. The criteria for participation loans should be consistent with that for similar direct loans. The policy would normally require the complete analysis of the credit quality of obligations to be purchased, determination of value and lien status of collateral, and the maintenance of full credit information for the life of the participation.

Participation Agreements - A participation loan can present unique problems if the borrower defaults, the lead bank becomes insolvent, or a party to the participation arrangement does not perform as expected. These contingencies should be considered in a written participation agreement. The agreement should clearly state the limitations the originating and participating banks impose on each other and the rights all parties retain. In addition to the general terms of the participation transaction, participation agreements should specifically include the following considerations:

- The obligation of the lead bank to furnish timely credit information and to provide notification of material changes in the borrower's status;
- Requirements that the lead bank consult with participants prior to modifying any loan, guaranty, or security agreements and before taking any action on defaulted loans;
- The specific rights and remedies available to the lead and participating banks upon default of the borrower;
- Resolution procedures when the lead and participating banks cannot agree on the handling of a defaulted loan;
- Resolution of any potential conflicts between the lead bank and participants in the event that more than one loan to the borrower defaults; and
- Provisions for terminating the agency relationship between the lead and participating banks upon such events as insolvency, breach of duty, negligence, or misappropriation by one of the parties.

In some loan participation agreements, the participation agreement provides for the allocation of loan payments on some basis other than in proportion to ownership interest. For example, principal payments may be applied first to the participant's ownership interest and all remaining payments to the lead bank's ownership interest. In these instances, the participation agreement must also specify that in case of loan default, participants will share in all subsequent payments and collections in proportion to their respective ownership interest at the time of default. Without such a provision, the banks would not have a pro-rata sharing of credit risk. Provided the sales criteria contained in FAS 140 are met, loan participations sold in which the participation agreements provide for the allocation of loan payments, absent default, on some basis other than proportional ownership interests, may be treated as sold and removed from the balance sheet for financial reporting purposes. However, if the participation agreements do not also contain a provision requiring that all payments and collections received subsequent to default be allocated based on ownership interests in the loan as of the date of default, those participations will be treated as loans sold with recourse for risk-based capital purposes regardless of the financial reporting treatment. Further discussion of loans sold with recourse is contained in the Sales of Assets for Risk-Based Capital Purposes entry in the glossary of the Call Report Instructions.

Participations Between Affiliated Institutions - Examiners should ascertain that banks do not relax their credit standards when dealing with affiliated institutions and that participation loans between affiliated institutions are in compliance with Section 23A of the Federal Reserve Act. The Federal Reserve Board Staff has interpreted that the purchase of a participation loan from an affiliate is exempt from Section 23A provided that the commitment to purchase is obtained by the affiliate before the loan is consummated by the affiliate, and the decision to participate is based upon the bank's independent evaluation of the creditworthiness of the loan. If these criteria are not strictly met, the loan participation could be subject to the qualitative and/or quantitative restrictions of Section 23A. Refer to the Related Organizations Section of this Manual which describes transactions with affiliates.

Sales of 100 Percent Loan Participations - In some cases, depository institutions structure loan originations and participations with the intention of selling off 100 percent of the underlying loan amount. Certain 100 percent loan participation programs raise unique safety and soundness issues that should be addressed by an institution's policies, procedures and practices.

If not appropriately structured, these 100 percent participation programs can present unwarranted risks to the originating institution including legal, reputation and compliance risks. While this statement applies only to a small number of mostly very large insured depository institutions, the agreements should clearly state the limitations the originating and participating institutions impose on each other and the rights all parties retain. The originating institution should state that loan participants are participating in loans and are not investing in a business enterprise. The policies of an institution engaged in these originations should address safety and soundness concerns and include criteria to address:

- The program's objectives – these should be of a commercial nature (structured as commercial undertakings and not as investments in securities).
- The plan of distribution – participants should be limited to sophisticated financial and commercial entities and sophisticated persons and the participations should not be sold directly to the public.
- The credit requirements applicable to the borrower - the originating institution should structure 100% loan participation programs only for borrowers who meet the originating institution's credit requirements.
- Access afforded program participants to financial information on the borrower - the originating institution should allow potential loan participants to obtain and review appropriate credit and other information to enable the participants to make an informed credit decision.

Environmental Risk Program

A lending institution should have in place appropriate safeguards and controls to limit exposure to potential environmental liability associated with real property held as collateral. The potential adverse effect of environmental contamination on the value of real property and the potential for liability under various environmental laws have become important factors in evaluating real estate transactions and making loans secured by real estate. Environmental contamination, and liability associated with environmental contamination, may have a significant adverse effect on the value of real estate collateral, which may in certain circumstances cause an insured institution to abandon its right to the collateral. It is also possible for an institution to be held directly liable for the environmental cleanup of real property collateral acquired by the institution. The cost of such a cleanup may exceed by many times the amount of the loan made to the borrower. A loan may be affected adversely by potential environmental liability even where real property is not taken as collateral. For example, a borrower's capacity to make payments on a loan may be threatened by environmental liability to the borrower for the cost of a hazardous contamination cleanup on property unrelated to the loan with the institution. The potential for environmental liability may arise from a variety of Federal and State environmental laws and from common law tort liability.

Guidelines for an Environmental Risk Program

As part of the institution's overall decision-making process, the environmental risk program should establish procedures for identifying and evaluating potential environmental concerns associated with lending practices and other actions relating to real property. The board of directors should review and approve the program and designate a senior officer knowledgeable in environmental matters responsible for program implementation. The environmental risk program should be tailored to the needs of the lending institution. That is, institutions that have a heavier concentration of loans to higher risk industries or localities of known contamination may require a more elaborate and sophisticated environmental risk program than institutions that lend more to lower risk industries or localities. The environmental risk program should provide for staff training, set environmental policy guidelines and procedures, require an environmental review or analysis during the application process, include loan documentation standards, and establish appropriate environmental risk assessment safeguards in loan workout situations and foreclosures.

Examination Procedures

Examiners should review an institution's environmental risk program as part of the examination of its lending and investment activities. When analyzing individual credits, examiners should review the institution's compliance with its own environmental risk program. Failure to establish or comply with an appropriate environmental program should be criticized and corrective action required.

LOAN PROBLEMS

It would be impossible to list all sources and causes of problem loans. They cover a multitude of mistakes a bank may permit a borrower to make, as well as mistakes directly attributable to weaknesses in the bank's credit administration and management. Some well-constructed loans may develop problems due to unforeseen circumstances on the part of the borrower; however, bank management must endeavor to protect a loan by every means possible. One or more of the items in the following list is often basic to the development of loan problems.
Many of these items may also be indicative of potential bank fraud and/or insider abuse. Additional information on the warning signs and suggested areas for investigation are included in the Bank Fraud and Insider Abuse Section of this Manual.

Poor Selection of Risks

Problems in this area may reflect the absence of sound lending policies, and/or management's lack of sound credit judgment in advancing certain loans. The following are general types of loans which may fall within the category of poor risk selection. It should be kept in mind that these examples are generalizations, and the examiner must weigh all relevant factors in determining whether a given loan is indeed a poor risk.

- Loans to finance new and untried business ventures which are inadequately capitalized.
- Loans based more upon the expectation of successfully completing a business transaction than on sound worth or collateral.
- Loans for the speculative purchase of securities or goods.
- Collateral loans made without adequate margin of security.
- Loans made because of other benefits, such as the control of large deposit balances, and not based upon sound worth or collateral.
- Loans made without adequate owner equity in underlying real estate security.
- Loans predicated on collateral which has questionable liquidation value.
- Loans predicated on the unmarketable stock of a local corporation when the bank is at the same time lending directly to the corporation. Action which may be beneficial to the bank from the standpoint of the one loan may be detrimental from the standpoint of the other loan.
- Loans which appear to be adequately protected by collateral or sound worth, but which involve a borrower of poor character risk and credit reputation.
- Loans which appear to be adequately protected by collateral, but which involve a borrower with limited or unassessed repayment ability.
- An abnormal amount of loans involving out-of-territory borrowers (excluding large banks properly staffed to handle such loans).
- Loans involving brokered deposits or link financing.

Overlending

It is almost as serious, from the standpoint of ultimate losses, to lend a sound financial risk too much money as it is to lend to an unsound risk. Loans beyond the reasonable capacity of the borrower to repay invariably lead to the development of problem loans.

Failure to Establish or Enforce Liquidation Agreements

Loans granted without a well-defined repayment program violate a fundamental principle of sound lending. Regardless of what appears to be adequate collateral protection, failure to establish at inception or thereafter enforce a program of repayment almost invariably leads to troublesome and awkward servicing problems, and in many instances is responsible for serious loan problems including eventual losses. This axiom of sound lending is important not only from the lender's standpoint, but also the borrower's.

Incomplete Credit Information

Lending errors frequently result because of management's failure to obtain and properly evaluate credit information. Adequate comparative financial statements, income statements, cash flow statements and other pertinent statistical support should be available. Other essential information, such as the purpose of the borrowing and intended plan or sources of repayment, progress reports, inspections, memoranda of outside information and loan conferences, correspondence, etc., should be contained in the bank's credit files. Failure of a bank's management to give proper attention to credit files makes sound credit judgment difficult if not impossible.

Overemphasis on Loan Income

Misplaced emphasis upon loan income, rather than soundness, almost always leads to the granting of loans possessing undue risk. In the long run, unsound loans usually are far more expensive than the amount of revenue they may initially produce.

Self-Dealing

Pronounced self-dealing practices are often present in serious problem bank situations and in banks which fail. Such practices with regard to loans are found in the form of overextensions of unsound credit to insiders, or their interests, who have improperly used their positions to obtain unjustified loans. Active officers, who serve at the pleasure of the ownership interests, are at times subjected to pressures which make it difficult to objectively evaluate such loans. Loans made for the benefit of ownership interests that are carried in the name of a seemingly unrelated party are sometimes used to conceal self-dealing loans.

Technical Incompetence

Technical incompetence usually is manifested in management's inability to obtain and evaluate credit information or put together a well-conceived loan package.

Management weaknesses in this area are almost certain to lead to eventual loan losses. Problems can also develop when management, technically sound in some forms of lending, becomes involved in specialized types of credit in which it lacks expertise and experience.

Lack of Supervision

Loan problems encountered in this area normally arise for one of two reasons:

- Absence of effective active management supervision of loans which possessed reasonable soundness at inception. Ineffective supervision almost invariably results from lack of knowledge of a borrower's affairs over the life of the loan. It may well be coupled with one or more of the causes and sources of loan problems previously mentioned.
- Failure of the board and/or senior management to properly oversee subordinates to determine that sound policies are being carried out.

Lack of Attention to Changing Economic Conditions

Economic conditions, both national and local, are continuously changing, management must be responsive to these changes. This is not to suggest that lending policies should be in a constant state of flux, nor does it suggest that management should be able to forecast totally the results of economic changes. It does mean, however, that bankers should realistically evaluate lending policies and individual loans in light of changing conditions. Economic downturns can adversely affect borrowers' repayment potential and can lessen a bank's collateral protection. Reliance on previously existing conditions as well as optimistic hopes for economic improvement can, particularly when coupled with one or more of the causes and sources of loan problems previously mentioned, lead to serious loan portfolio deterioration.

Competition

Competition among financial institutions for growth, profitability, and community influence sometimes results in the compromise of sound credit principles and acquisition of unsound loans. The ultimate cost of unsound loans outweighs temporary gains in growth, income and influence.

Potential Problem Indicators by Document

The preceding discussions describe various practices or conditions which may serve as a source or cause of weak loans. Weak loans resulting from these practices or conditions may manifest themselves in a variety of ways. While it is impossible to provide a complete detailing of potential "trouble indicators", the following list, by document, may aid the examiner in identifying potential problem loans during the examination process.

- **Debt Instrument -** Delinquency; irregular payments or payments not in accordance with terms; unusual or frequently modified terms; numerous renewals with little or no principal reduction; renewals that include interest; and extremely high interest rate in relation to comparable loans granted by the bank or the going rate for such loans in the bank's market area.
- **Liability Ledger -** Depending on the type of debt, failure to amortize in a regular fashion over a reasonable period of time, e.g., on an annual basis, seasonally, etc.; and a large number of out-of-territory borrowers, particularly in cases where these types of loans have increased substantially since the previous examination.
- **Financial and Operating Statements -** Inadequate or declining working capital position; excessive volume or negative trend in receivables; unfavorable level or negative trend in inventory; no recent aging of receivables, or a marked slowing in receivables; drastic increase in volume of payables; repeated and increasing renewals of carry-over operating debt; unfavorable trends in sales and profits; rapidly expanding expenses; heavy debt-to-worth level and/or deterioration in this relationship; large dividend or other payments without adequate or reasonable earnings retention; and net worth enhancements resulting solely from reappraisal in the value of fixed assets.
- **Cash Flow Documentation -** Absence of cash flow statements or projections, particularly as related to newly established term borrowers; projections indicating an inability to meet required interest and principal payments; and statements reflecting that cash flow is being provided by the sale of fixed assets or nonrecurring situations.
- **Correspondence and Credit Files -** Missing and/or inadequate collateral or loan documentation, such as financial statements, security agreements, guarantees, assignments, hypothecation agreements, mortgages, appraisals, legal opinions and title insurance, property insurance, loan applications; evidence of borrower credit checks; corporate or partnership borrowing authorizations; letters indicating that a borrower has suffered financial difficulties or has been unable to meet established repayment programs; and documents

that reveal other unfavorable factors relative to a line of credit.
- **Collateral -** Collateral evidencing a speculative loan purpose or collateral with inferior marketability characteristics (single purpose real estate, restricted stock, etc.) which has not been compensated for by other reliable repayment sources; and collateral of questionable value acquired subsequent to the extension of the credit.

LOAN APPRAISAL AND CLASSIFICATION

Loan Appraisal

In order to properly analyze any credit, an examiner must acquire certain fundamental information about a borrower's financial condition, purpose and terms of the borrowing, and prospects for its orderly repayment. The process involved in acquiring the foregoing information will necessarily vary with the size of the bank under examination and the type and sophistication of records utilized by the bank.

Because of the sheer volume of loans, it is necessary to focus attention on the soundness of larger lines of credit. Relatively smaller loans that appear to be performing satisfactorily may ordinarily be omitted from individual appraisal. The minimum size of the loan to be appraised depends upon the characteristics of the individual bank. The cut-off point should be low enough to permit an accurate appraisal of the loan portfolio as a whole, yet not so high as to preclude a thorough analysis of a representative portion of total loans. This procedure does not prevent an examiner from analyzing smaller loans which do not show adequate amortization for long periods of time, are overdue, are deficient in collateral coverage, or otherwise possess characteristics which would cause them to be subject to further scrutiny. In most instances, there should be direct correlation between the cut-off point utilized, the percentage of loans lined, and the asset quality and management ratings assigned at the previous examination.

The following types of loans or lines of credit should be analyzed at each examination:

- Loans or lines of credit listed for Special Mention or adversely classified at the previous FDIC examination or State examination, if applicable as a result of an alternating examination program;
- Loans reflected on the bank's problem loan list, if such a list exists, or identified as problem loans by the bank's credit grading system;
- Significant overdue loans as determined from the bank's delinquency list;
- Other significant loans which exhibit a high degree of risk that have come to the examiner's attention in the review of minutes, audit reports or other sources; and
- Loans to the bank's insiders, and their related interests and insiders of other banks.

The degree of analysis and/or time devoted to the above loans may vary. For example, the time devoted to a previously classified loan which has been substantially reduced or otherwise improved may be significantly less than other loans. Watch list loans should initially be sampled to assess if management's ratings are accurate. The reworking of certain loan files, such as seasoned real estate mortgages, which are not subject to significant change, should be kept to a minimum or omitted. This does not mean that an examiner should not briefly review new file information (since the previous examination) to determine any adverse trends with respect to significant loans. In addition, the examiner should review a sufficient volume of different types of loans offered by the bank to determine that bank policies are adequate and being followed.

Review of Files and Records

Commercial loan liability ledgers or comparable subsidiary records vary greatly in quality and detail. Generally, they will provide the borrower's total commercial loan liability to the bank, and the postings thereto will depict a history of the debt. Collateral records should be scrutinized to acquire the necessary descriptive information and to ascertain that the collateral held to secure the notes is as transcribed.

Gathering credit information is an important process and should be done with care to obtain the essential information, which will enable the examiner to appraise the loans accurately and fairly. Failure to obtain and record pertinent information contained in the credit files can reflect unfavorably on examiners, and a good deal of examiner and loan officer time can be saved by carefully analyzing the files. Ideally, credit files will also contain important correspondence between the bank and the borrower. However, this is not universally the case; in some instances, important correspondence is deliberately lodged in separate files because of its sensitive character. Correspondence between the bank and the borrower can be especially valuable to the examiner in developing added insight into the status of problem credits.

Verification of loan proceeds is one of the most valuable and effective loan examining techniques available to the examiner and often one of the most ignored. This verification process can disclose fraudulent or fictitious notes, misapplication of funds, loans made for the benefit or accommodation of parties other than the borrower of record, or utilization of loans for purposes other than those reflected in the bank's files. Verification of the disbursement of a selected group of large or unusual loans, particularly those subject to classification or Special Mention and those granted under circumstances which appear illogical or incongruous is important. However, it is more important to carry the verification process one step further to the apparent utilization of loan proceeds as reflected by the customer's deposit account or other related bank records. The examiner should also determine the purpose of the credit and the expected source of repayment.

Examination Procedures regarding loan portfolio analysis are included in the Examination Documentation Modules.

Loan Discussion

The examiner must comprehensively review all data collected on the individual loans. In most banks, this review should allow the majority of loans to be passed without criticism, eliminating the need for discussing these lines with the appropriate bank officer(s). No matter how thoroughly the supporting loan files have been reviewed, there will invariably be a number of loans which will require additional information or discussion before an appropriate judgment can be made as to their credit quality, relationship to other loans, proper documentation, or other circumstances related to the overall examination of the loan portfolio. Such loans require discussion with the appropriate bank officer(s) as do other loans for which adequate information has been assembled to indicate that classification or Special Mention is warranted.

Proper preparation for the loan discussion is essential, and the following points should be given due consideration by the examiner. Loans which have been narrowed down for discussion should be reviewed in depth to insure a comprehensive grasp of all factual material. Careful advance preparation can save time for all concerned. Particularly with regard to large, complicated lines, undue reliance should not be placed on memory to cover important points in loan discussion. Important weaknesses and salient points to be covered in discussion, questions to be asked, and information to be sought should be noted. The loan discussion should not involve discussion of trivialities since the banker's time is valuable, and it is no place for antagonistic remarks and snide comments directed at loan officers. The examiner should listen carefully to what the banker has to say, and concisely and accurately note this information. Failure to do so can result in inaccuracies and make follow-up at the next examination more difficult.

Loan Analysis

In the appraisal of individual loans, the examiner should weigh carefully the information obtained and arrive at a judgment as to the credit quality of the loans under review. Each loan is appraised on the basis of its own characteristics. Consideration is given to the risk involved in the project being financed; the nature and degree of collateral security; the character, capacity, financial responsibility, and record of the borrower; and the feasibility and probability of its orderly liquidation in accordance with specified terms. The willingness and ability of a debtor to perform as agreed remains the primary measure of a loan’s risk. This implies that the borrower must have earnings or liquid assets sufficient to meet interest payments and provide for reduction or liquidation of principal as agreed at a reasonable and foreseeable date. However, it does not mean that borrowers must at all times be in a position to liquidate their loans, for that would defeat the original purpose of extending credit.

Following analysis of specific credits, it is important that the examiner ascertain whether troublesome loans result from inadequate lending and collection policies and practices or merely reflect exceptions to basically sound credit policies and practices. In instances where troublesome loans exist due to ineffective lending practices and/or inadequate supervision, it is quite possible that existing problems will go uncorrected and further loan quality deterioration may occur. Therefore, the examiner should not only identify problem loans, but also ascertain the cause(s) of these problems. Weaknesses in lending policies or practices should be stressed, along with possible corrective measures, in discussions with the bank's senior management and/or the directorate and in the Report of Examination.

Loan Classification

To quantify and communicate the results of the loan appraisal, the examiner must arrive at a decision as to which loans are to be subjected to criticism and/or comment in the examination report. Adversely classified loans are allocated on the basis of risk to three categories: Substandard; Doubtful; and Loss.

Other loans of questionable quality, but involving insufficient risk to warrant classification, are designated as Special Mention loans. Loans lacking technical or legal support, whether or not adversely classified, should be brought to the attention of the bank's management. If the deficiencies in documentation are severe in scope or volume, a schedule of such loans should be included in the Report of Examination.

Loan classifications are expressions of different degrees of a common factor, risk of nonpayment. All loans involve some risk, but the degree varies greatly. It is incumbent upon examiners to avoid classification of sound loans. The practice of lending to sound businesses or individuals for reasonable periods is a legitimate banking function. Adverse classifications should be confined to those loans which are unsafe for the investment of depositors' funds.

If the internal grading system is determined to be accurate and reliable, examiners can use the institution's data for preparing the applicable examination report pages and schedules, for determining the overall level of classifications, and for providing supporting comments regarding the quality of the loan portfolio. If the internal classifications are overly conservative, examiners should make appropriate adjustments and include explanations in the report's comments.

A uniform agreement on the classification of assets and appraisal of securities in bank examinations was issued jointly on June 15, 2004, by the Office of the Comptroller of the Currency, the FDIC, the Federal Reserve Board, and the Office of Thrift Supervision. This interagency statement provides definitions of Substandard, Doubtful, and Loss categories used for adversely classifying bank assets. Amounts classified Loss should be promptly eliminated from the bank's books.

Uniform guidelines have been established by the FDIC regarding the Report of Exam treatment of assets classified Doubtful. The general policy is not to require charge-off or similar action for Doubtful classifications. Examiners should make a statement calling for a bank to charge-off a portion of loans classified Doubtful only when State law or policy requires. Further, any such statement should be clear as to the intended purpose of bringing the bank into conformity with those State requirements. An exception is made for formal actions under Section 8 of the FDI Act.

A statement addressing the chargeoff of loans classified Loss is a required comment Report of Examination when the amount is material. Amounts classified Loss should be promptly eliminated from the bank's books.

Definitions

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

There is a close relationship between classifications, and no classification category should be viewed as more important than the other. The uncollectibility aspect of Doubtful and Loss classifications makes their segregation of obvious importance. The function of the Substandard classification is to indicate those loans which are unduly risky and, if unimproved, may be a future hazard.

A complete list of adversely classified loans is to be provided to management, either during or at the close of an examination.

Special Mention Assets

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

Use of Special Mention - The Special Mention category is not to be used as a means of avoiding a clear decision to classify a loan or pass it without criticism. Neither should it include loans listed merely "for the record" when uncertainties and complexities, perhaps coupled with large size, create some reservations about the loan. If weaknesses or evidence of imprudent handling cannot be identified, inclusion of such loans in Special Mention is not justified.

Ordinarily, Special Mention credits have characteristics which corrective management action would remedy. Often weak origination and/or servicing policies are the cause for the Special Mention designation. Examiners should not misconstrue the fact that most Special Mention loans contain management correctable deficiencies to mean that loans involving merely technical exceptions belong in this category. However, instances may be encountered where technical exceptions are a factor in scheduling loans for Special Mention.

Careful identification of loans which properly belong in this category is important in determining the extent of risk in the loan portfolio and providing constructive criticism for bank management. While Special Mention Assets should not be combined with adversely classified assets, their total should be considered in the analysis of asset quality and management, as appropriate.

The nature of this category precludes inclusion of smaller lines of credit unless those loans are part of a large grouping listed for related reasons. Comments on loans listed for Special Mention in the Report of Examination should be drafted in a fashion similar to those for adversely classified loans. There is no less of a requirement upon the examiner to record clearly the reasons why the loan is listed. The major thrust of the comments should be towards achieving correction of the deficiencies identified.

Troubled Commercial Real Estate Loan Classification Guidelines

Additional classification guidelines have been developed to aid the examiner in classifying troubled commercial real estate loans. These guidelines are intended to supplement the uniform guidelines discussed above. After performing an analysis of the project and its appraisal, the examiner must determine the classification of any exposure.

The following guidelines are to be applied in instances where the obligor is devoid of other reliable means of repayment, with support of the debt provided solely by the project. If other types of collateral or other sources of repayment exist, the project should be evaluated in light of these mitigating factors.

- **Substandard -** Any such troubled real estate loan or portion thereof should be classified Substandard when well-defined weaknesses are present which jeopardize the orderly liquidation of the debt. Well-defined weaknesses include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.
- **Doubtful -** Doubtful classifications have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable. A Doubtful classification may be appropriate in cases where significant risk exposures are perceived, but Loss cannot be determined because of specific reasonable pending factors which may strengthen the credit in the near term. Examiners should attempt to identify Loss in the credit where possible thereby limiting the excessive use of the Doubtful classification.
- **Loss -** Advances in excess of calculated current fair value which are considered uncollectible and do not warrant continuance as bankable assets. There is little or no prospect for near term improvement and no realistic strengthening action of significance pending.

Technical Exceptions

Deficiencies in documentation of loans should be brought to the attention of management for remedial action. Failure of management to effect corrections may lead to the development of greater credit risk in the future. Moreover, an excessive number of technical exceptions may be a reflection on management's quality and ability. Inclusion of the schedule "Assets With Credit Data or Collateral Documentation Exceptions" and various comments in the Report of Examination is appropriate in certain circumstances. Refer to the Report of Examination Instructions for further guidance.

Past Due and Nonaccrual

Overdue loans are not necessarily subject to adverse criticism. Nevertheless, a high volume of overdue loans almost always indicates liberal credit standards, weak servicing practices, or both. Because loan renewal and extension policies vary among banks, comparison of their delinquency ratios may be misleading. A more significant method of evaluating this factor lies in determination of the trend within the bank under examination, keeping in mind the distortion resulting from seasonal influences, economic conditions, or the timing of examinations. It is important for the examiner to carefully consider the makeup and reasons for the volume of overdue loans. Only then can it be determined whether the volume of past due paper is a significant factor reflecting adversely on the quality or soundness of the overall loan portfolio or the efficiency and quality of management. It is important that overdue loans be computed on a uniform basis. This allows for comparison of overdue totals between examinations and/or with other banks.

The Report of Examination includes information on overdue and nonaccrual loans. Loans which are still accruing interest but are past their maturity or on which either interest or principal is due and unpaid (including unplanned overdrafts) are separated by loan type into two distinct groupings: 30 to 89 days past due and 90 days or more past due. Nonaccrual loans may include both current and past due loans. In the case of installment credit, a loan will not be considered overdue until at least two monthly payments are delinquent. The same will apply to real estate mortgage loans, term loans or any other loans payable on regular monthly installments of principal and interest.

Some modification of the overdue criteria may be necessary because of applicable State law, joint examinations, or unusual circumstances surrounding certain kinds of loans or in individual loan situations. It will always be necessary for the examiner to ascertain the bank's renewal and extension policies and procedures for collecting interest prior to determining which loans are overdue, since such practices often vary considerably from bank to bank. This is important not only to validate which loans are actually overdue, but also to evaluate the soundness of such policies. Standards for renewal should be aimed at achieving an orderly liquidation of loans and not at maintaining a low ratio of past due paper through unwarranted extensions or renewals.

In larger departmentalized banks or banks with large branch systems, it may be informative to analyze delinquencies by determining the source of overdue loans by department or branch. This is particularly true if a large volume of overdue loans exist. The production of schedules delineating overdue loans by department or branch is encouraged if it will aid in pinpointing the source of a problem or be otherwise informative..

Continuing to accrue income on assets which are in default as to principal and interest overstates a bank's assets, earnings and capital. Call Report Instructions indicate that where the period of default of principal or interest equals or exceeds 90 days, the accruing of income should be discontinued unless the asset is well-secured and in process of collection. A debt is well-secured if collateralized by liens on or pledges of real or personal property, including securities that have a realizable value sufficient to discharge the debt in full; or by the guarantee of a financially responsible party. A debt is in process of collection if collection is proceeding in due course either through legal action, including judgment enforcement procedures, or, in appropriate circumstances, through collection efforts not involving legal action which are reasonably expected to result in repayment of the debt or its restoration to a current status. Banks are strongly encouraged to follow this guideline not only for reporting purposes but also bookkeeping purposes. There are several exceptions, modifications and clarifications to this general standard. First, consumer loans and real estate loans secured by one-to-four family residential properties are exempt from the nonaccrual guidelines. Nonetheless, these exempt loans should be subject to other alternative methods of evaluation to assure the bank's net income is not materially overstated. Second, any State statute, regulation or rule which imposes more stringent standards for nonaccrual of interest should take precedence over these instructions. Third, reversal of previously accrued but uncollected interest applicable to any asset placed in a nonaccrual status, and treatment of subsequent payments as either principal or interest, should be handled in accordance with generally accepted accounting principles. Acceptable accounting treatment includes reversal of all previously accrued but uncollected interest against appropriate income and balance sheet accounts.

Nonaccrual Loans That Have Demonstrated Sustained Contractual Performance

The following guidance applies to borrowers who have resumed paying the full amount of scheduled contractual interest and principal payments on loans that are past due and in nonaccrual status. Although a prior arrearage may not have been eliminated by payments from a borrower, the borrower may have demonstrated sustained performance over a period of time in accordance with the contractual terms. Such loans to be returned to accrual status, even though the loans have not been brought fully current, provided two criteria are met:

- All principal and interest amounts contractually due (including arrearage) are reasonably assured of repayment within a reasonable period, and
- There is a sustained period of repayment performance (generally a minimum of six months) by the borrower, in accordance with the contractual terms involving payments of cash or cash equivalents.

When the 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 the above criteria would continue to be disclosed as past due, as appropriate, until they have been brought fully current.

Troubled Debt Restructuring - Multiple Note Structure

The basic example of a trouble debt restructure (TDR) multiple note structure is a troubled loan that is restructured into two notes where the first or "A" note represents the portion of the original loan principal amount which is 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. In certain TDRs, the "B" note may be a contingent receivable that is payable only if certain conditions are met (e.g., sufficient cash flow from property). For other TDRs, the "B" note may be contingently forgiven (e.g., note "B" is forgiven if note "A" is paid in full). In other instances, an institution would have granted a concession (e.g., 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, for reporting purposes the "B" note could be viewed as a contingent receivable.

Institutions may return the "A" note to accrual status provided the following conditions are met:

- The restructuring qualifies as a TDR as defined by FAS 15 and there is economic substance to the restructuring.
- 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 credit 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.
- The "A" note is reasonably assured of repayment and of performance in accordance with the modified terms.
- 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. A sustained period of payment performance generally would be a minimum of six months and involve payments in the form of cash or cash equivalents.

Under existing reporting requirements, the "A" note would be disclosed as a TDR. In accordance with these requirements, if the "A" note yields a market rate of interest and performs in accordance with the restructured terms, such disclosures could be eliminated in the year following restructuring. To be considered a market rate of interest, the interest rate on the "A" note at the time of restructuring must be equal to or greater than the rate that the institution is willing to accept for a new receivable with comparable risk.

Interagency Retail Credit Classification Policy

The quality of consumer credit soundness is best indicated by the repayment performance demonstrated by the borrower. Because retail credit generally is comprised of a large number of relatively small balance loans, evaluating the quality of the retail credit portfolio on a loan-by-loan basis is burdensome for the institution being examined and examiners. To promote an efficient and consistent credit risk evaluation, the FDIC, the Comptroller of Currency, the Federal Reserve and the Office of Thrift Supervision adopted the Uniform Retail Credit Classification and Account Management Policy (Retail Classification Policy.)

Retail credit includes open-end and closed-end credit extended to individuals for household, family, and other personal expenditures. It includes consumer loans and credit cards. For purposes of the policy, retail credit also includes loans to individuals secured by their personal residence, including home equity and home improvement loans.

In general, retail credit should be classified based on the following criteria:

- Open-end and closed-end retail loans past due 90 cumulative days from the contractual due date should be classified Substandard.
- Closed-end retail loans that become past due 120 cumulative days and open-end retail loans that become past due 180 cumulative days from the contractual due date should be charged-off. The charge-off should be taken by the end of the month in which the 120-or 180-day time period elapses.
- Unless the institution can clearly demonstrate and document that repayment on accounts in bankruptcy is likely to occur, accounts in bankruptcy should be charged off within 60 days of receipt of notification of filing from the bankruptcy court or within the delinquency time frames specified in this classification policy, whichever is shorter. The charge-off should be taken by the end of the month in which the applicable

time period elapses. Any loan balance not charged-off should be classified Substandard until the borrower re-establishes the ability and willingness to repay (with demonstrated payment performance for six months at a minimum) or there is a receipt of proceeds from liquidation of collateral.

- Fraudulent loans should be charged off within 90 days of discovery or within the delinquency time frames specified in this classification policy, whichever is shorter. The charge-off should be taken by the end of the month in which the applicable time period elapses.
- Loans of deceased persons should be charged off when the loss is determined or within the delinquency time frames adopted in this classification policy, whichever is shorter. The charge-off should be taken by the end of the month in which the applicable time period elapses.
- One-to four-family residential real estate loans and home equity loans that are delinquent 90 days or more with loan-to-value ratios greater than 60 percent, should be classified Substandard.

When a residential or home equity loan is 120 days past due for closed-end credit and 180 days past due for open-end credit, a current assessment of value should be made and any outstanding loan balance in excess of the fair value of the property, less cost to sell, should be classified Loss. 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 should not be classified. However, home equity loans where the institution does not hold the senior mortgage, that are delinquent 90 days or more should be classified Substandard, even if the loan-to-value ratio is equal to, or less than, 60 percent.

If an institution can clearly document that the delinquent 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 estimated fair 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.

This policy does not preclude an institution from adopting an internal classification policy more conservative than the one detailed above. It also does not preclude a regulatory agency from using the Doubtful or Loss classification in certain situations if a rating more severe than Substandard is justified. Loss in retail credit should be recognized when the institution becomes aware of the loss, but in no case should the charge-off exceed the time frames stated in this policy.

Re-aging, Extensions, Deferrals, Renewals, or Rewrites

Re-aging is the practice of bringing a delinquent account current after the borrower has demonstrated a renewed willingness and ability to repay the loan by making some, but not all, past due payments. Re-aging of open-end accounts, or extensions, deferrals, renewals, or rewrites of closed-end accounts should only 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 of a policy is acceptable when it is based on recent, satisfactory performance and the true improvement in a borrower's other credit factors, and when it is structured in accordance with internal policies.

The decision to re-age 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 extended, deferred, renewed, or rewritten, including the number of times such action has been taken. Documentation normally shows that institution personnel communicated with the borrower, the borrower agreed to pay the loan in full, and the borrower shows the ability to repay the loan.

Institutions that re-age open-end accounts should establish a reasonable written policy and adhere to it. An account eligible for re-aging, extension, deferral, renewal, or rewrite should exhibit the following:

- The borrower should show a renewed willingness and ability to repay the loan.
- The account should exist for at least nine months before allowing a re-aging, extension, renewal, referral, or rewrite.
- The borrower should make at least three minimum consecutive monthly payments or the equivalent lump sum payment before an account is re-aged. Funds may not be advanced by the institution for this purpose.

- No loan should be re-aged, extended, deferred, renewed, or rewritten more than once within any twelve-month period; that is, at least twelve months must have elapsed since a prior re-aging. In addition, no loan should be re-aged, extended, deferred, renewed, or rewritten more than two times within any five-year period.
- For open-end credit, an over limit account may be re-aged at its outstanding balance (including the over limit balance, interest, and fees). No new credit may be extended to the borrower until the balance falls below the designated predelinquency credit limit.

Partial Payments on Open-End 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 delinquency. 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 loan would be $900, or three full months delinquent. An institution may use either or both methods in its portfolio, but may not use both methods simultaneously with a single loan.

Examination Considerations

Examiners should ensure that institutions adhere to the Retail Classification 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 regardless 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. Conversely, the Retail Classification Policy does not preclude examiners from reviewing and classifying individual large dollar retail credit loans that exhibit signs of credit weakness regardless of delinquency status.

In addition to reviewing loan classifications, the examiner should ensure that the ALLL provides adequate coverage for inherent losses. 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 lacking sound policies or failing to implement or effectively follow established policies will be subject to criticism.

Examination Treatment

Use of the formula classification approach can result in numerous small dollar adversely classified items. Although these classification details are not always included in the Report of Examination, an itemized list is to be left with management. A copy of the listing should also be retained in the examination work papers.

Examiner support packages are available which have built in parameters of the formula classification policy, and which generate a listing of delinquent consumer loans to be classified in accordance with the policy. Use of this package may expedite the examination in certain cases, especially in larger banks.

Losses are one of the costs of doing business in consumer installment credit departments. It is important for the examiner to give consideration to the amount and severity of installment loan charge-offs when examining the department. Excessive loan losses are the product of weak lending and collection policies and therefore provide a good indication of the soundness of the consumer installment loan operation. The examiner should be alert also to the absence of installment loan charge-offs, which may indicate that losses are being deferred or concealed through unwarranted rewrites or extensions.

Dealer lines should be scheduled in the report under the dealer's name regardless of whether the contracts are accepted with or without recourse. Any classification or totaling of the nonrecourse line can be separately identified from the direct or indirect liability of the dealer. Comments and format for scheduling the indirect contracts will be essentially the same as for direct paper. If there is direct debt, comments will necessarily have to be more extensive and probably will help form a basis for the indirect classification.

No general rule can be established as to the proper application of dealers' reserves to the examiner's classifications. Such a rule would be impractical because of the many methods used by banks in setting up such reserves and the various dealer agreements utilized. Generally, where the bank is handling a dealer who is not financially responsible, weak contracts warrant classification irrespective of any balance in the dealer's reserve. Fair and reasonable judgment on the part of the examiner will determine application of dealer reserves.

If the amount involved would have a material impact on capital, consumer loans should be classified net of unearned income. Large business-type loans placed in consumer installment loan departments should receive individual appraisal and, in all cases, the applicable unearned income discount should be deducted when such loans are classified.

Impaired Loans, Troubled Debt Restructurings, Foreclosures and Repossessions

Loan Impairment - A loan is impaired when, based on current information and events, it is likely that an institution will be unable to collect all amounts due according to the contractual terms of the loan agreement (i.e., principal and interest). The accounting standard for impaired loans is set forth in FAS 114, *Accounting by Creditors for Impairment of a Loan* as amended by FAS 118, *Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures*. FAS 114 applies to all loans, except large groups of smaller-balance homogenous loans that are collectively evaluated for impairment and loans that are measured at fair value or the lower of cost or fair value.
When a loan is impaired under FAS 114, the amount of impairment should be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate (i.e., the contractual interest rate adjusted for any net deferred loan fees or costs and premium or discount existing at the origination or acquisition of the loan). As a practical expedient, impairment may also be measured based on a loan's observable market price, or the fair value of the collateral, if the loan is collateral dependent. A loan is collateral dependent if repayment is expected to be provided solely by the underlying collateral and there are no other available and reliable sources of repayment.

If the measure of a loan calculated in accordance with FAS 114 is less than the book value of that loan, impairment should be recognized as a valuation allowance against the loan. For regulatory reporting and examination report purposes, this valuation allowance is included as part of the general allowance for loan and lease losses. In general, when the excess amount of the loan's book value is determined to be uncollectible, this excess amount should be promptly charged-off against the ALLL. When a loan is collateral dependent, any portion of the loan balance in excess of the fair value of the collateral (or fair value less cost to sell) should similarly be charged-off.

Troubled Debt Restructuring - Troubled debt restructuring takes placed when a bank grants a concession to a debtor in financial difficulty. The accounting standards for troubled debt restructurings are set forth in FAS 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, as amended by FAS 114. In certain situations FASB 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, also applies. It is the FDIC's policy that restructurings be reflected in examination reports in accordance with this accounting guidance. In addition, banks are expected to follow these principles when filing the Call Report.

Troubled debt restructurings may be divided into two broad groups: those where the borrower transfers assets to the creditor to satisfy the claim, which would include foreclosures; and those in which the terms of a debtor's obligation are modified, which may include reduction in the interest rate to an interest rate that is less than the current market rate for new obligations with similar risk , extension of the maturity date, or forgiveness of principal or interest. A third type of restructuring combines a receipt of assets and a modification of loan terms. A loan extended or renewed at an interest rate equal to the current interest rate for new debt with similar risk is not reported as a restructured loan for examination purposes.

Transfer of Assets to the Creditor - A bank that receives assets (except long-lived assets that will be sold) from a borrower in full satisfaction of the book value of a loan should record those assets at fair value. If the fair value of the assets received is less than the institution's recorded investment in the loan, a loss is charged to the ALLL. When property is received in full satisfaction of an asset other than a loan (e.g., a debt security), the loss should be reflected in a manner consistent with the balance sheet classification of the asset satisfied. When long-lived assets that will be sold, such as real estate, are received in full satisfaction of a loan, the real estate is recorded at its fair value less cost to sell. This fair value (less cost to sell) becomes the "cost" of the foreclosed asset.

To illustrate, assume a bank forecloses on a defaulted mortgage loan of $100,000 and takes title to the property. If the fair value of the realty at the time of foreclosure is $90,000 and costs to sell are estimated at $10,000, a $20,000 loss should be immediately recognized by a charge to the ALLL. The cost of the foreclosed asset becomes $80,000. If the bank is on an accrual basis of accounting, there may also be adjusting entries necessary to reduce both the accrued interest receivable and loan interest income accounts. Assume further that in order to effect sale of the realty to a third party, the bank is willing to offer a new mortgage loan (e.g., of $100,000) at a concessionary rate of interest (e.g., 10 percent while the market rate for new loans with similar risk is 20 percent). Before booking this new transaction, the bank must establish its "economic value". Pursuant to Accounting Principles Board Opinion No. 21 (APB 21, Interest on Receivables and Payables), the value is represented by the sum of the present value of the income stream to be received from the new loan, discounted at the current market rate for this type of credit, and the present value of the principal to be received, also discounted at the current market rate. This economic value is the proper carrying value for the asset at its origination date, and if less than the fair value less cost to sell at time of foreclosure (e.g., $78,000 vs. $80,000), an additional loss has been incurred and should be immediately recognized. This additional loss should be reflected in the allowance if a relatively brief period has elapsed between foreclosure and subsequent resale of the property. However, the loss should be treated as "other operating expenses" if the asset has been held for a longer period. The new loan would be placed on the books at its face value ($100,000) and the difference between the new loan amount and the "economic value" ($78,000) is treated as unearned discount ($22,000). For examination and Call Report purposes, the asset would be shown net of the unearned discount which is reduced periodically as it is earned over the life of the new loan. Interest income is earned on the restructured loan at the previously established market rate. This is computed by multiplying the carrying value (i.e., face amount of the loan reduced by any principal payments, less unearned discount) by that rate (20 percent).

The basis for this accounting approach is the assumption that financing the resale of the property at a concessionary rate exacts an opportunity cost which the bank must recognize. That is, unearned discount represents the present value of the "imputed" interest differential between the concessionary and market rates of interest. Present value accounting also assumes that both the bank and the third party who purchased the property are indifferent to a cash sales price at the "economic value" or a higher financed price repayable over time.

Modification of Terms - When the terms of a TDR provide for a reduction of interest or principal, the institution should measure any loss on the restructuring in accordance with the guidance for impaired loans as set forth in FAS 114 unless the loans are measured at fair value or the lower of cost or fair value. If the fair value of the restructured loan is less than the book value of that loan, FAS 114 requires impairment to be recognized as a valuation allowance against the loan. For regulatory reporting and examination report purposes, this valuation allowance should be included as part of ALLL. If the excess amount of the loan's book value is determined to be uncollectible, this excess amount should be promptly charged-off against the ALLL.

For example, in lieu of foreclosure, a bank chooses to restructure a $100,000 loan to a borrower which had originally been granted with an interest rate of 10 percent for 10 years. The bank and the borrower have agreed to capitalize the accrued interest ($10,000) into the note balance, but the restructured terms will permit the borrower to repay the debt over 10 years at a six percent interest rate. The bank does not believe the loan is collateral dependent. In this situation, the bank would record the restructured loan at the present value of the new note amount ($110,000) discounted at the 10 percent rate specified in the original contract. This amount becomes the loan's fair value. The difference between the calculated fair value and the book value of the bank's restructured loan (which includes accrued interest, net deferred loan fees or costs, and unamortized premium or discount) is recognized by creating a valuation allowance with a corresponding charge to the provision for loan and lease losses. As a result, the net book value of the restructured loan is reflected at fair value.

Combination Approach - In some instances, the bank may receive assets in partial rather than full satisfaction of a loan or security and may also agree to alter the original repayment terms. In these cases, the recorded investment should be reduced by the fair value of the assets received and the remaining investment accounted for as a restructuring involving only modification of terms.

Examination Report Treatment - Examiners should continue to classify troubled loans, including any troubled collateral dependent loans, based on the definitions of Loss, Doubtful, and Substandard. When a loan is collateral dependent, any portion of the loan balance which exceeds the fair value of the collateral should be promptly charged-off against the ALLL. For other loans that are impaired or have been restructured, the excess of the book value of the loan over its fair value (or fair value less cost to sell, as appropriate) is recognized by creating a valuation allowance which is included in the ALLL. However, when available information confirms that loans and leases (including any recorded accrued interest, net deferred loan fees or costs, and unamortized premium or discount) other than collateral dependent loans, or portions thereof, are uncollectible, these amounts should be promptly charged-off against the ALLL, regardless of whether an allowance was established to recognize impairment under FAS 114.

An examiner should not automatically require an additional allowance for credit losses of impaired loans over and above what is calculated in accordance with these standards. However, an additional allowance on impaired loans may be necessary based on consideration of institution-specific factors, 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 FAS 114 allowance.

Other Considerations - Examiners may encounter situations where impaired loans and restructured debts are identified, but the bank has not properly accounted for the transactions. Where incorrect accounting treatment resulted in an overstatement of earnings, capital and assets, it will be necessary to determine the proper carrying values for these assets, utilizing the best available information developed by the examiner after consultation with bank management. Nonetheless, proper accounting for impaired and restructured loans is the responsibility of bank management. Examiners should not spend a disproportionate amount of time developing the appropriate accounting entries, but instead discuss with and require corrective action by bank management when the bank's treatment is not in accordance with accepted accounting guidelines. It must also be emphasized that collectability and proper accounting and reporting are separate matters; restructuring a borrower's debt does not ensure collection of the loan or security. As with all other assets, adverse classification should be assigned if analysis indicates there is risk of loss present. Examiners should take care, however, not to discourage or be critical of bank management's legitimate and reasonable attempts to achieve debt settlements through concessionary terms. In many cases, restructurings offer the only realistic means for a bank to bring about collection of weak or nonearning assets. Finally, the volume of impaired loans and restructured debts having concessionary interest rates should be considered when evaluating the bank's earnings performance and assigning the earnings performance rating.

Examination procedures for reviewing TDRs are included in the ED Modules.

Report of Examination Treatment of Classified Loans

The Items Subject to Adverse Classification page allows an examiner to present pertinent and readily understandable comments related to loans which are adversely classified. In addition, the Analysis of Loans Subject to Adverse Classification page permits analysis of present and previous classifications from the standpoint of source and disposition. These loan schedules should be prepared in accordance with the Report of Examination Instructions.

An examiner must present, in writing, relevant and readily understandable comments related to criticized loans. Therefore, a thorough understanding of all factors surrounding the loan is required and only those germane to description, collectability, and management plans should be included in the comments. Comments should be concise, but brevity is not to be accomplished by omission of adequate information. Comments should be informative and factual data emphasized. The important weaknesses of the loan should not be overshadowed by extraneous information which might well have been omitted. An ineffective presentation of a classified loan weakens the value of a Report of Examination and frequently casts doubt on the accuracy of the classifications. The essential test of loan comments is whether they justify the classification.

Careful organization is an important ingredient of good loan comments. Generally, loan comments should include the following items:

- **Identification -** Indicate the name and occupation or type of business of the borrower. Cosigners, endorsers and guarantors should be identified and in the case of business loans, it should be clear whether the borrower is a corporation, partnership, or sole proprietorship.
- **Description -** The make-up of the debt should be concisely described as to type of loan, amount, origin and terms. The history, purpose, and source of repayment should also be indicated.
- **Collateral -** Describe and evaluate any collateral, indicating the marketability and/or condition thereof. If values are estimated, note the source.
- **Financial Data -** Current balance sheet information along with operating figures should be presented, if such data are considered necessary. The examiner must exercise judgment as to whether a statement should be detailed in its entirety. When the statement is relevant to the classification, it is generally more effective to summarize weaknesses with the entire statement presented. On the other hand, if the statement does not significantly support or detract from the loan, a very brief summarization of the statement is in order.
- **Summarize the Problem -** The examiner's comments should explicitly point out reasons for the classification. Where portions of the line are accorded different classifications or are not subject to classification, comments should clearly set forth the reasoning for the split treatment.

- **Management's Intentions -** Comments should include any corrective program contemplated by management.

Examiners should avoid arbitrary or penalty classifications, nor should "conceded" or "agreed" be given as the principal reason for adverse classifications. Management's opinions and ideas should not have to be emphasized; if a classification is well-founded, the facts will speak for themselves. If well-written, there is little need for long summary comments reemphasizing major points of the loan write-up.

When the volume of loan classifications reaches the point of causing supervisory concern, analysis of present and previous classifications from the standpoint of source and disposition becomes very important. For this reason, the Analysis of Loans Subject to Adverse Classification page should be completed in banks possessing characteristics which present special supervisory problems; when the volume or composition of adversely classified loans has changed significantly since the previous examination, including both upward and downward movements; and, in such other special or unusual situations as examiners deem appropriate. Generally, the page should not include consumer loans and overdrafts and it should be footnoted to indicate that these assets are not included.

Issuance of "Express Determination" Letters to Banks for Federal Income Tax Purposes

Tax Rules - The Internal Revenue Code and tax regulations allow a deduction for a loan that becomes wholly or partially worthless. All pertinent evidence is taken into account in determining worthlessness. Special tax rules permit a federally supervised depository institution to elect a method of accounting under which it conforms its tax accounting for bad debts to its regulatory accounting for loan charge-offs, provided certain conditions are satisfied. Under these rules, loans that are charged-off pursuant to specific orders of the institution's supervisory authority or that are classified by the institution as Loss assets under applicable regulatory standards are conclusively presumed to have become worthless in the taxable year of the charge-offs. These special tax rules are effective for taxable years ending on or after December 31, 1991.

To be eligible for this accounting method for tax purposes, an institution must file a conformity election with its Federal income tax return. The tax regulations also require the institution's primary Federal supervisory authority to expressly determine that the institution maintains and applies loan loss classification standards that are consistent with the regulatory standards of its supervisory authority.

For taxable years ending before the completion of the first examination of an institution's loan review process that is after October 1, 1992, transition rules allow an institution to make the conformity election without the determination letter from its primary supervisory authority. However, the letter must be obtained at the first examination involving the loan review process after October 1, 1992. If the letter is not issued by the supervisory authority at the examination, the election is revoked retroactively.

Once the first examination of the loan review process after October 1, 1992, has been performed by an institution's primary Federal supervisory authority, the transition rules no longer apply and the institution must have the "express determination" letter before making the election. To continue using the tax-book conformity method, the institution must request a new letter at each subsequent examination that covers the loan review process. If the examiner does not issue an "express determination" letter at the end of such an examination, the institution's election of the tax-book conformity method is revoked automatically as of the beginning of the taxable year that includes the date of examination. However, that examiner's decision not to issue an "express determination" letter does not invalidate an institution's election for any prior years. The supervisory authority is not required to rescind any previously issued "express determination" letters.

When an examiner does not issue an "express determination" letter, the institution is still allowed tax deductions for loans that are wholly or partially worthless. However, the burden of proof is placed on the institution to support its tax deductions for loan charge-offs.

Examination Guidelines - Banks are responsible for requesting "express determination" letters during examinations that cover their loan review process, i.e., during safety and soundness examinations. Examiners should not alter the scope or frequency of examinations merely to permit banks to use the tax-book conformity method.

When requested by a bank that has made or intends to make the election under Section 1.166-2(d)(3) of the tax regulations, the examiner-in-charge should issue an "express determination" letter, provided the bank does maintain and apply loan loss classification standards that are consistent with the FDIC's regulatory standards. The letter should only be issued at the completion of a safety and soundness examination at which the examiner-in-charge has concluded that the issuance of the letter is appropriate.

An "express determination" letter should be issued to a bank only if:

- The examination indicates that the bank maintains and applies loan loss classification standards that are

consistent with the FDIC's standards regarding the identification and charge-off of such loans; and
- There are no material deviations from the FDIC's standards.

Minor criticisms of the bank's loan review process as it relates to loan charge-offs or immaterial individual deviations from the FDIC's standards should not preclude the issuance of an "express determination" letter.

An "express determination" letter should not be issued if:

- The bank's loan review process relating to charge-offs is subject to significant criticism;
- Loan charge-offs reported in the Report of Condition and Income (Call Reports) are consistently overstated or understated; or

- There is a pattern of loan charge-offs not being recognized in the appropriate year.

When the issuance of an "express determination" letter is appropriate, it should be prepared on FDIC letterhead using the following format. The letter should be signed and dated by the examiner-in-charge and provided to the bank for its files. The letter is not part of the Report of Examination.

> Express Determination Letter for IRS Regulation 1.166-2(d)(3)
>
> "In connection with the most recent examination of [Name of Bank], by the Federal Deposit Insurance Corporation, as of [examination date], we reviewed the institution's loan review process as it relates to loan charge-offs. Based on our review, we concluded that the bank, as of that date, maintained and applied loan loss classification standards that were consistent with regulatory standards regarding loan charge-offs.
>
> This statement is made on the basis of a review that was conducted in accordance with our normal examination procedures and criteria. It does not in any way limit or preclude any formal or informal supervisory action (including enforcement actions) by this supervisory authority relating to the institution's loan review process or the level at which it maintains its allowance for loan and lease losses.
>
> *[signature]*
> Examiner-in-charge
> *[date signed]*

When an "express determination" letter is issued to a bank, a copy of the letter as well as documentation of the work performed by examiners in their review of the bank's loan loss classification standards should be maintained in the workpapers. A copy of the letter should also be forwarded to the Regional Office with the Report of Examination. The issuance of an "express determination" letter should be noted in the Report of Examination according to procedure in the Report of Examination Instructions.

When an examiner-in-charge concludes that the conditions for issuing a requested "express determination" letter have not been met, the examiner-in-charge should discuss the reasons for this conclusion with the Regional Office. The examiner-in-charge should then advise bank management that the letter cannot be issued and explain the basis for this conclusion. A comment indicating that a requested "express determination" letter could not be issued, together with a brief statement of the reasons for not issuing the letter are addressed in the Report of Examination Instructions.

CONCENTRATIONS

Generally a concentration is a significantly large volume of economically-related assets that an institution has advanced or committed to one person, entity, or affiliated group. These assets may in the aggregate present a substantial risk to the safety and soundness of the institution. Adequate diversification of risk allows the institution to avoid the excessive risks imposed by credit concentrations. It should also be recognized, however, that factors such as location and economic environment of the area limit some institutions' ability to diversify. Where reasonable diversification realistically cannot be achieved, the resultant concentration calls for capital levels higher than the regulatory minimums.

Concentrations generally are not inherently bad, but do add a dimension of risk which the management of the institution should consider when formulating plans and policies. In formulating these policies, management should, at a minimum, address goals for portfolio mix and limits within the loan and other asset categories. The institution's business strategy, management expertise and location should be considered when reviewing the policy. Management should also consider the need to track and monitor the economic and financial condition of specific geographic locations, industries and groups of borrowers in which the bank has invested heavily. All concentrations should be monitored closely by management and receive a more in-depth review than the diversified portions of the institution's assets. Failure to monitor concentrations can result in management being unaware how significant economic events might impact the overall portfolio. This will also allow management to consider areas where concentration reductions may be necessary. Management and the board can monitor any reduction program using accurate concentration reports. If management is not properly monitoring concentration levels and limits, examiners may consider criticizing management.

To establish a meaningful tracking system for concentrations of credit, financial institutions should be encouraged to consider the use of codes to track individual borrowers, related groups of borrowers, industries, and individual foreign countries. Financial institutions should also be encouraged to use the standard industrial classification (SIC) or similar code to track industry concentrations. Any monitoring program should be reported regularly to the board of directors.

Refer to the Report of Examination Instructions for guidance in identifying and listing concentrations in the examination report.

FEDERAL FUNDS SOLD AND REPURCHASE AGREEMENTS

Federal funds sold and securities purchased under agreement for resale represent convenient methods to employ excess funds to enhance earnings. Federal funds are excess reserve balances and take the form of a one-day transfer of funds between banks. These funds carry a specified rate of interest and are free of the risk of loss due to fluctuations in market prices entailed in buying and selling securities. However, these transactions are usually unsecured and therefore do entail potential credit risk. Securities purchased under agreement for resale represent an agreement between the buying and selling banks that stipulates the selling bank will buy back the securities sold at an agreed price at the expiration of a specified period of time.

Federal funds sold are not "risk free" as is often supposed, and the examiner will need to recognize the elements of risk involved in such transactions. While the selling of funds is on a one-day basis, these transactions may evolve into a continuing situation. This development is usually the result of liability management techniques whereby the buying bank attempts to utilize the acquired funds to support a rapid expansion of its loan-investment posture and as a means of enhancing profits. Of particular concern to the examiner is that, in many cases, the selling bank will automatically conclude that the buying bank's financial condition is above reproach without proper investigation and analysis. If this becomes the case, the selling bank may be taking an unacceptable risk unknowingly.

Another area of potential risk involves selling Federal funds to a bank which may be acting as an intermediary between the selling bank and the ultimate buying bank. In this instance, the intermediary bank is acting as agent with the true liability for repayment accruing to the third bank. Therefore, it is particularly important that the original selling bank be aware of this situation, ascertain the ultimate disposition of its funds, and be satisfied as to the creditworthiness of the ultimate buyer of the funds.

Clearly, the "risk free" philosophy regarding the sale of Federal funds is inappropriate. Selling banks must take the necessary steps to assure protection of their position. The examiner is charged with the responsibility of ascertaining that selling banks have implemented and adhered to policy directives in this regard to forestall any potentially hazardous situations.

Examiners should encourage management of banks engaged in selling Federal funds to implement a policy with respect to such activity. This policy should include consideration of such matters as the aggregate sum to be sold at any one time, the maximum amount to be sold to any one buyer, the maximum duration of time the bank will sell to any one buyer, a list of acceptable buyers, and the terms under which a sale will be made. As in any form of lending, thorough credit evaluation of the prospective purchaser, both before granting the credit extension and on a continuing basis, is a necessity. Such credit analysis should emphasize the borrower's ability to repay, the source of repayment, and alternative sources of repayment should the primary source fail to materialize. While sales of Federal funds are normally unsecured unless otherwise regulated by State statutes, and while collateral protection is no substitute for thorough credit review, the selling bank should consider the possibility of requiring security if sales agreements are entered into on a continuing basis for specific but extended periods of time, or for overnight transactions which have evolved into longer term sales. Where the decision is made to sell Federal funds on an unsecured basis, the selling bank should be able to present logical reasons for such action based on conclusions drawn from its credit analysis of the buyer and bearing in mind the potential risk involved.

A review of Federal funds sold between examinations may prompt examiners to broaden the scope of their analysis of such activity if the transactions are not being handled in accordance with sound practices as outlined above. Where the bank has not developed a formal policy regarding the sale of Federal funds or fails to conduct a credit analysis of the buyer prior to a sale and during a continuous sale of such funds, the matter should be discussed with management. In such discussion, it is incumbent upon examiners to inform management that their remarks are not intended to cast doubt upon the financial strength of any bank to whom Federal funds are sold. Rather, the intent is to advise the banker of the potential risks of such practices unless safeguards are developed. The need for policy formulation and credit review on all Federal funds sold should be reinforced via a comment in the Report of Examination. Also, if Federal funds sold to any one buyer equals or exceeds 100 percent of the selling bank's Tier 1 Capital, it should be listed on the Concentrations schedule unless secured by U.S. Government securities. Based on the circumstances, the examiner should determine the appropriateness of additional comments regarding risk diversification.

Securities purchased under an agreement to resell are generally purchased at prevailing market rates of interest. The purchasing bank must keep in mind that the transaction merely represents another form of lending. Therefore, considerations normally associated with granting secured credit should be made. Repayment or repurchases by the selling bank is a major consideration, and the buying bank should satisfy itself that the selling bank will be able to generate the necessary funds to repurchase the securities on the prescribed date. Policy guidelines should limit the amount of money extended to one seller. Collateral coverage arrangements should be controlled by procedures similar to the safeguards used to control any type of liquid collateral. Securities held under such an arrangement should not be included in the bank's investment portfolio but should be reflected in the Report of Examination under the caption Securities Purchased Under Agreements to Resell. Transactions of this nature do not require entries to the securities account of either bank with the selling bank continuing to collect all interest and transmit such payments to the buying bank.

FUNDAMENTAL LEGAL CONCEPTS AND DEFINITIONS

Laws and regulations that apply to credit extended by banks are more complicated and continually in a state of change. However, certain fundamental legal principles apply no matter how complex or innovative a lending transaction. To avoid needless litigation and ensure that each loan is a legally enforceable claim against the borrower or collateral, adherence to certain rules and prudent practices relating to loan transactions and documentation is essential. An important objective of the examiner's analysis of collateral and credit files is not only to obtain information about the loan, but also to determine if proper documentation procedures and practices are being utilized. While examiners are not expected to be experts on legal matters, it is important they be familiar with the Uniform Commercial Code (UCC) adopted by their respective states as well as other applicable State laws governing credit transactions. A good working knowledge of the various documents necessary to attain the desired collateral or secured position, and how those documents are to be used or handled in the jurisdiction relevant to the bank under examination, is also essential.

Uniform Commercial Code – Secured Transactions

Article 9 of the UCC governs secured transactions; i.e., those transactions which create a security interest in personal property or fixtures including goods, documents, instruments, general intangibles, chattel paper or accounts. Article 9 was significantly revised effective July 1, 2001, but each individual state must adopt the changes for it to become law. Because some states have enacted modified versions of the UCC and subsequent revisions, each applicable State statute should be consulted.

General Provisions

A Security Agreement is an agreement between a debtor and a secured party that creates or provides for a security interest. The Debtor is the person that has an interest in the collateral other than a security interest. The term Debtor also includes a seller of payment intangibles or promissory notes. The obligor is the person who owes on a secured transaction. The Secured Party is the lender, seller or other person in whose favor there is a security interest.

Grant of Security Interest

For a security interest to be enforceable against the debtor or third party with respect to the collateral, the collateral must be in the possession of the secured party pursuant to agreement, or the debtor must sign a security agreement which covers the description of the collateral.

Collateral

Any description of personal property or real estate is a sufficient description of the collateral whether or not it is specific if it reasonably identifies what is described. If the parties seek to include property acquired after the signing of the security agreement as collateral, additional requirements must be met.

Unless otherwise agreed a security agreement gives the secured party the rights to proceeds from the sale, exchange, collection or disposition of the collateral.

In some cases, the collateral that secures an obligation under one security agreement can be used to secure a new loan, too. This can be done by using a cross-collateralization clause in the security agreement.

Perfecting the Security Interest

Three terms basic to secured transactions are attachment, security agreement and security interest. Attachment refers to that point when the creditor's legal rights in the debtor's property come into existence or "attach." This does not mean the creditor necessarily takes physical possession of the property, or does it mean acquisition of ownership of the property. Rather, it means that before attachment, the borrower's property is free of any legal encumbrance, but after attachment, the property is legally bound by the creditor's security interest. In order for the creditor's security interest to attach, there must be a security agreement in which the debtor authenticates and provides a description of the collateral. A creditor's security interest can be possessory or nonpossessory, a secured party with possession pursuant to "agreement" means that the "agreement" for possession has to be an agreement that the person will have possession for purposes of security. The general rule is a bank must take possession of deposit accounts (proprietary), letter of credit rights, electronic chattel, paper, stocks and bonds to perfect a security interest therein. In a transaction involving a nonpossessory security interest, the debtor retains possession of the collateral. A security interest in collateral automatically attaches to the proceeds of the collateral and is automatically perfected in the proceeds if the credit was advanced to enable the purchase

A party's security interest in personal property is not protected against a debtor's other creditors unless it has been perfected. A security interest is perfected when it has attached and when all of the applicable steps required for perfection, such as the filing of a financing statement or possession of the collateral, have been taken. These provisions are designed to give notice to others of the secured party's interest in the collateral, and offer the secured party the first opportunity at the collateral if the need to foreclose should arise. If the security interest is not perfected, the secured party loses its secured status.

Right to Possess and Dispose of Collateral

Unless otherwise agreed, when a debtor defaults on a secured loan, a secured party has the right to take possession of the collateral without going to court if this can be done without breaching the peace. Alternatively, if the security agreement so provides, the secured party may require the debtor to assemble the collateral and make it available to the secured party at a place to be designated by the secured party which is reasonably convenient to both parties.

A secured party may then sell, lease or otherwise dispose of the collateral with the proceeds applied as follows: (a) foreclosure expenses, including reasonable attorneys' fees and legal expenses; (b) the satisfaction of indebtedness secured by the secured party's security interest in the collateral; and (c) the satisfaction of indebtedness secured by any subordinate security interest in the collateral if the secured party receives written notification of demand before the distribution of the proceeds is completed. If requested by the secured party, the holder of a subordinate security interest must furnish reasonable proof of his interest, and unless he does so, the secured party need not comply with his demand.

Examiners should determine bank policy concerning the verification of lien positions prior to advancing funds. Failure to perform this simple procedure may result in the bank unknowingly assuming a junior lien position and, thereby, greater potential loss exposure. Management may check filing records personally or a lien search may be performed by the filing authority or other responsible party. This is especially important when the bank grants new credit lines.

Agricultural Liens

An agricultural lien is generally defined as an interest, other than a security interest, in farm products that meets the following three conditions:

- The lien secures payment or performance of an obligation for goods or services furnished in connection with a debtor's farming operation or rent on real property leased by a debtor in connection with its farming operation.
- The lien is created by statute in favor of a person that in the ordinary course of its business furnished goods or services to a debtor in connection with a debtor's farming operation or leased property to a debtor in connection with the debtor's farming operation.
- The lien's effectiveness does not depend on the person's possession of the personal property.

An agricultural lien is therefore non-possessory. Law outside of UCC-9 governs creation of agricultural liens and their attachment to collateral. An agricultural lien cannot be created or attached under Article 9. Article 9, however, does govern perfection. In order to perfect an agricultural lien, a financing statement must be filed. A perfected agricultural lien on collateral has priority over a conflicting security interest in or agricultural lien on the same collateral if the statute creating the agricultural lien provides for such priority. Otherwise, the agricultural lien is subject to the same priority rules as security interests (for example, date of filing).

A distinction is made with respect to proceeds of collateral for security interests and agricultural liens. For security interests, collateral includes the proceeds under Article 9. For agricultural liens, the collateral does not include proceeds unless State law creating the agricultural lien gives the secured party a lien on proceeds of the collateral subject to the lien.

Special Filing Requirements – There is a national uniform Filing System form. Filers, however are not required to use them. If permitted by the filing office, parties may file and otherwise communicate by means of records communicated and stored in a media other than paper. A peculiarity common to all states is the filing of a lien on aircraft; the security agreement must be submitted to the Federal Aviation Administration in Oklahoma City, Oklahoma.

Default and Foreclosure - As a secured party, a bank's rights in collateral only come into play when the obligor is in default. What constitutes default varies according to the specific provisions of each promissory note, loan agreement, security agreement, or other related documents. After an obligor has defaulted, the creditor usually has the right to foreclose, which means the creditor seizes the security pledged to the loan, sells it and applies the proceeds to the unpaid balance of the loan. For consumer transactions, there are strict consumer notification requirements prior to disposition of the collateral. For consumer transactions, the lender must provide the debtor with certain information regarding the surplus or deficiency in the disposition of collateral. There may be more than one creditor claiming a right to the sale proceeds in foreclosure situations. When this occurs, priority is generally established as follows: (1) Creditors with a perfected security interest (in the order in which lien perfection was attained); (2) Creditors with an unperfected security interest; and (3) General creditors.

Under the UCC procedure for foreclosing security interests, four concepts are involved. First is repossession or taking physical possession of the collateral, which may be accomplished with judicial process or without judicial process (known as self-help repossession), so long as the creditor commits no breach of the peace. The former is usually initiated by a replevin action in which the sheriff seizes the collateral under court order. A second important concept of UCC foreclosure procedures is redemption or the debtor's right to redeem the security after it has been repossessed. Generally, the borrower must pay the entire balance of the debt plus all expenses incurred by the bank in repossessing and holding the collateral. The third concept is retention that allows the bank to retain the collateral in return for releasing the debtor from all further liability on the loan. The borrower must agree to this action, hence would likely be so motivated only when the value of the security is likely to be less than or about equal to the outstanding debt. Finally, if retention is not agreeable to both borrower and lender, the fourth concept, resale of the security, comes into play. Although sale of the collateral may be public or private, notice to the debtor and other secured parties must generally be given. The sale must be commercially reasonable in all respects. Debtors are entitled to any surplus resulting from sale price of the collateral less any unpaid debt. If a deficiency occurs (i.e., the proceeds from sale of the collateral were inadequate to fully extinguish the debt obligation), the bank has the right to sue the borrower for this shortfall. This is a right it does not have under the retention concept.

Exceptions to the Rule of Priority - There are three exceptions to the general rule that the creditor with the earliest perfected security interest has priority. The first concerns a specific secured transaction in which a creditor makes a loan to a dealer and takes a security interest in the dealer's inventory. Suppose such a creditor files a financing statement with the appropriate public official to perfect the security interest. While it might be possible for the dealer's customers to determine if an outstanding security interest already exists against the inventory, it would be impractical to do so. Therefore, an exception is made to the general rule and provides that a buyer in the ordinary course of business, i.e., an innocent purchaser for value who buys in the normal manner, cuts off a prior perfected security interest in the collateral.

The second exception to the rule of priority concerns the vulnerability of security interests perfected by doing nothing. While these interests are perfected automatically, with the date of perfection being the date of attachment, they are extremely vulnerable at the hands of subsequent bona fide purchasers. Suppose, for example, a dealer sells a television set on a secured basis to an ultimate consumer. Since the collateral is consumer goods, the security interest is perfected the moment if attaches. But if the original buyer sells the television set to another person who buys it in good faith and in ignorance of the outstanding security interest, the UCC provides that the subsequent purchase cuts off the dealer's security interest. This second exception is much the same as the first except for one important difference: the dealer (creditor) in this case can be protected against purchase of a customer's collateral by filing a financing statement with the appropriate public official.

The third exception regards the after-acquired property clause that protects the value of the collateral in which the creditor has a perfected security interest. The after-acquired property clause ordinarily gives the original creditor senior priority over creditors with later perfected interests. However, it is waived as regards the creditor who supplies replacements or additions to the collateral or the artisan who supplies materials and services that enhance the value of the collateral as long as a perfected security interest in the replacement or additions, or collateral is held.

Borrowing Authorization

Borrowing authorizations in essence permit one party to incur liability for another. In the context of lending, this usually concerns corporations. A corporation may enter into contracts within the scope of the powers authorized by its charter. In order to make binding contracts on behalf of the corporation, the officers must be authorized to do so either by the board of directors or by expressed or implied general powers. Usually a special resolution expressly gives certain officers the right to obligate the corporate entity, pledge assets as collateral, agree to other terms of the indebtedness and sign all necessary documentation on behalf of the corporate entity.

Although a general resolution is perhaps satisfactory for the short-term, unsecured borrowings of a corporation, a specific resolution of the corporation's board of directors is generally advisable to authorize such transactions as term loans, loans secured by security interests in the corporation's personal property, or mortgages on real estate. Further, mortgaging or pledging substantially all of the corporation's assets without prior approval of the shareholders of the corporation is often prohibited, therefore, a bank may need to seek advice of counsel to determine if shareholder consent is required for certain contemplated transactions.

Loans to corporations should indicate on their face that the corporation is the borrower. The corporate name should appear followed by the name, title and signature of the appropriate officer. If the writing is a negotiable instrument, the UCC states the party signing is personally liable as a general rule. To enforce payment against a corporation, the note or other writing should clearly show that the debtor is a corporation.

Bond and Stock Powers

As mentioned previously, a bank generally obtains a security interest in stocks and bonds by possession. The documents which allow the bank to sell the securities if the borrower defaults are called stock powers and bond powers. The examiner should ensure the bank has, for each borrower who has pledged stocks or bonds, one signed stock power for all stock certificates of a single issuer, and a separate signed bond power for each bond instrument. The signature must agree with the name on the actual stock certificate or bond instrument. Refer to Federal Reserve Board Regulations Part 221 (Reg U) for further information on loans secured by investment securities.

Comaker

Two or more persons who are parties to a contract or promise to pay are known as comakers. They are a unit to the performance of one act and are considered primarily liable. In the case of default on an unsecured loan, a judgment would be obtained against all. A release against one is a release against all because there is but one obligation and if that obligation is released as to one obligor, it is released as to all others.

Loan Guarantee

Since banks often condition credit advances upon the backup support provided by third party guarantees, examiners should understand the legal fundamentals governing guarantees. A guarantee may be a guarantee of payment or of collection. "Payment guaranteed" or equivalent words added to a signature means that if the instrument is not paid when due, the guarantor will pay it according to its terms without resort by the holder to any other party. "Collection guaranteed" or equivalent words added to a signature means that if the instrument is not paid when due, the guarantor will pay it, but only after the holder has reduced to judgment a claim against the maker and execution has been returned unsatisfied, or after the maker has become insolvent or it is otherwise useless to proceed against such a party.

Contracts of guarantee are further divided into a limited guarantee which relates to a specific note (often referred to as an "endorsement") or for a fixed period of time, or a continuing guarantee which, in contrast, is represented by a separate instrument and enforceable for future (duration depends upon State law) transactions between the bank and the borrower or until revoked. A well drawn continuing guarantee contains language substantially similar to the following: "This is an absolute and unconditional guarantee of payment, is unconditionally delivered, and is not subject to the procurement of a guarantee from any person other than the undersigned, or to the performance or happening of any other condition." The aforementioned unambiguous terms are necessary to the enforceability of contracts of guarantee, as they are frequently entered into solely as an accommodation for the borrower and without the guarantor's participation in the benefits of the loan. Thus, courts tend to construe contracts of guarantee strictly against the party claiming under the contract. Unless the guarantee is given prior to or at the time the initial loan is made, the guarantee may not be enforceable because of the difficulty of establishing that consideration was given. Banks should not disburse funds on such loans until they have the executed guarantee agreement in their possession. Banks should also require the guarantee be signed in the presence of the loan officer, or, alternatively, that the guarantor's signature be notarized. If the proposed guarantor is a partnership, joint venture, or corporation, the examiner should ensure the signing party has the legal authority to enter into the guarantee agreement. Whenever there is a question concerning a corporation's authority to guarantee a loan, counsel should be consulted and a special corporate resolution passed by the organization's board of directors.

Subordination Agreement

A bank extending credit to a closely held corporation may want to have the company's officers and shareholders subordinate to the bank's loan any indebtedness owed them by the corporation. This is accomplished by execution of a subordination agreement by the officers and shareholders. Subordination agreements are also commonly referred to as standby agreements. Their basic purpose is to prevent diversion of funds from reduction of bank debt to reduction of advances made by the firm's owners or officers.

Hypothecation Agreement

This is an agreement whereby the owner of property grants a security interest in collateral to the bank to secure the indebtedness of a third party. Banks often take possession of the stock certificates, plus stock powers endorsed in blank, in lieu of a hypothecation agreement. Caution, however, dictates that the bank take a hypothecation agreement setting forth the bank's rights in the event of default.

Real Estate Mortgage

A mortgage may be defined as a conveyance of realty given with the intention of providing security for the payment of debt. There are several different types of mortgage instruments but those commonly encountered are regular mortgages, deeds of trust, equitable mortgages, and deeds absolute given as security.

Regular Mortgages - The regular mortgage involves only two parties, the borrower and the lender. The mortgage document encountered in many states today is referred to as the regular mortgage. It is, in form, a deed or conveyance of realty by the borrower to the lender followed or preceded by a description of the debt and the property, and includes a provision to the effect that the mortgage be released upon full payment of the debt. Content of additional paragraphs and provisions varies considerably.

Deeds of Trust - In the trust deed, also known as the deed of trust, the borrower conveys the realty not to the lender but to a third party, a trustee, in trust for the benefit of the holder of the notes(s) that constitutes the mortgage debt. The deed of trust form of mortgage has certain advantages, the principle being that in a number of states it can be foreclosed by trustee's sale under the power of sale clause without court proceedings.

Equitable Mortgages - As a general rule, any instrument in writing by which the parties show their intention that realty be held as security for the payment of a debt, constitutes an equitable mortgage capable of being foreclosed in a court of equity.

Deeds Absolute Given as Security - Landowners who borrow money may give as security an absolute deed to the land. "Absolute deed" means a quitclaim or warranty deed such as is used in an ordinary realty sale. On its face, the transaction appears to be a sale of the realty; however, the courts treat such a deed as a mortgage where the evidence shows that the instrument was really intended only as security for a debt. If such proof is available, the borrower is entitled to pay the debt and demand reconveyance from the lender, as in the case of an ordinary mortgage. If the debt is not paid, the grantee must foreclose as if a regular mortgage had been made.

The examiner should ensure the bank has performed a title and lien search of the property prior to taking a mortgage or advancing funds. Proper procedure calls for an abstractor bringing the abstract up to date, and review of the abstract by an attorney or title insurance company. If an attorney performs the task, the abstract will be examined and an opinion prepared indicating with whom title rests, along with any defects and encumbrances disclosed by the abstract. Like an abstractor, an attorney is liable only for damages caused by negligence. If a title insurance company performs the task of reviewing the abstract, it does essentially the same thing; however, when title insurance is obtained, it represents a contract to make good, loss arising through defects in title to real estate or liens or encumbrances thereon. Title insurance covers various items not covered in an abstract and title opinion.

Some of the more common are errors by abstractors or attorneys include unauthorized corporate action, mistaken legal interpretations, and unintentional errors in public records by public officials. Once the bank determines title and lien status of the property, the mortgage can be prepared and funds advanced. The bank should record the mortgage immediately after closing the loan. Form, execution, and recording of mortgages vary from state to state and therefore must conform to the requirements of State law.

Collateral Assignment

An assignment is generally considered as the transfer of a legal right from one person to another. The rights acquired under a contract may be assigned if they relate to money or property, but personal services may not be assigned. Collateral assignments are used to establish the bank's rights as lender in the property or asset serving as collateral. It is generally used for loans secured by savings deposits, certificates of deposit or other cash accounts as well as loans backed by cash surrender value of life insurance. In some instances, it is used in financing accounts receivable and contracts. If a third party holder of the collateral is involved, such as life insurance company or the payor of an assigned contract, an acknowledgement should be obtained from that party as to the bank's assigned interest in the asset for collateral purposes.

CONSIDERATION OF BANKRUPTCY LAW AS IT RELATES TO COLLECTABILITY OF A DEBT

Introduction

Familiarity with the basic terms and concepts of the Federal bankruptcy law (formally known as the Bankruptcy Reform Act of 1978) is necessary in order for examiners to make informed judgments concerning the likelihood of collection of loans to bankrupt individuals or organizations. The following paragraphs present an overview of the subject. Complex situations may arise where more in-depth consideration of the bankruptcy provisions may be necessary and warrant consultation with the bank's attorney, Regional Counsel or other member of the Regional Office staff. For the most part, however, knowledge of the following information when coupled with review of credit file data and discussion with bank management should enable examiners to reach sound conclusions as to the eventual repayment of the bank's loans.

Forms of Bankruptcy Relief

Liquidation and rehabilitation are the two basic types of bankruptcy proceedings. Liquidation is pursued under Chapter 7 of the law and involves the bankruptcy trustee collecting all of the debtor's nonexempt property, converting it into cash and distributing the proceeds among the debtor's creditors. In return, the debtor obtains a discharge of all debts outstanding at the time the petition was filed which releases the debtor from all liability for those pre-bankruptcy debts.

Rehabilitation (sometimes known as reorganization) is effected through Chapter 11 or Chapter 13 of the law and in essence provides that creditors' claims are satisfied not via liquidation of the obligor's assets but rather from future earnings. That is, debtors are allowed to retain their assets but their obligations are restructured and a plan is implemented whereby creditors may be paid.

Chapter 11 bankruptcy is available to all debtors, whether individuals, corporations or partnerships. Chapter 13 (sometimes referred to as the "wage earner plan"), on the other hand, may be used only by individuals with regular incomes and when their unsecured debts are under $100,000 and secured debts less than $350,000. The aforementioned rehabilitation plan is essentially a contract between the debtor and the creditors. Before the plan may be confirmed, the bankruptcy court must find it has been proposed in good faith and that creditors will receive an amount at least equal to what would be received in a Chapter 7 proceeding. In Chapter 11 reorganization, all creditors are entitled to vote on whether or not to accept the repayment plan. In Chapter 13 proceedings, only secured creditors are so entitled. A majority vote binds the minority to the plan, provided the latter will receive pursuant to the plan at least the amount they would have received in a straight liquidation. The plan is fashioned so that it may be carried out in three years although the court may extend this to five years.

Most cases in bankruptcy courts are Chapter 7 proceedings, but reorganization cases are increasingly common. From the creditor's point of view, Chapter 11 or 13 filings generally result in greater debt recovery than do liquidation situations under Chapter 7. Nonetheless, the fact that reorganization plans are tailored to the facts and circumstances applicable to each bankrupt situation means that they vary considerably and the amount recovered by the creditor may similarly vary from nominal to virtually complete recovery.

Functions of Bankruptcy Trustees

Trustees are selected by the borrower's creditors and are responsible for administering the affairs of the bankrupt debtor's estate. The bankrupt's property may be viewed as a trust for the benefit of the creditors, consequently it follows the latter should, through their elected representatives, exercise substantial control over this property.

Voluntary and Involuntary Bankruptcy

When a debtor files a bankruptcy petition with the court, the case is described as a voluntary one. It is not necessary the individual or organization be insolvent in order to file a voluntary case. Creditors may also file a petition, in which case the proceeding is know as an involuntary bankruptcy. However, this alternative applies only to Chapter 7 cases and the debtor generally must be insolvent, i.e., unable to pay debts as they mature, in order for an involuntary bankruptcy to be filed.

Automatic Stay

Filing of the bankruptcy petition requires (with limited exceptions) creditors to stop or "stay" further action to collect their claims or enforce their liens or judgements. Actions to accelerate, set off or otherwise collect the debt are prohibited once the petition is filed, as are post-bankruptcy contacts with the obligor. The stay remains in effect until the debtor's property is released from the estate, the bankruptcy case is dismissed, the debtor obtains or is denied a discharge, or the bankruptcy court approves a creditor's request for termination of the stay. Two of the more important grounds applicable to secured creditors under which they may request termination are as follows: (1) The debtor has no equity in the encumbered property, and the property is not necessary to an effective rehabilitation plan; or (2) The creditor's interest in the secured property is not adequately protected. In the latter case, the law provides three methods by which the creditor's interests may be adequately protected: the creditor may receive periodic payments equal to the decrease in value of the creditor's interest in the collateral; an additional or substitute lien on other property may be obtained; or some other protection is arranged (e.g., a guarantee by a third party) to adequately safeguard the creditor's interests. If these alternatives result in the secured creditor being adequately protected, relief from the automatic stay will not be granted. If relief from the stay is obtained, creditors may continue to press their claims upon the bankrupt's property free from interference by the debtor or the bankruptcy court.

Property of the Estate

When a borrower files a bankruptcy petition, an "estate" is created and, under Chapter 7 of the law, the property of the estate is passed to the trustee for distribution to the creditors. Certain of the debtor's property is exempt from distribution under all provisions of the law (not just Chapter 7), as follows: homeowner's equity up to $7,500; automobile equity and household items up to $1,200; jewelry up to $500; cash surrender value of life insurance up to $4,000; Social Security benefits (unlimited); and miscellaneous items up to $400 plus any unused portion of the homeowner's equity. The bankruptcy code recognizes a greater amount of exemptions may be available under State law and, if State law is silent or unless it provides to the contrary, the debtor is given the option of electing either the Federal or State exemptions. Examiners should note that some liens on exempt property which would otherwise be enforceable are rendered unenforceable by the bankruptcy. A secured lender may thus become unsecured with respect to the exempt property. The basic rule in these situations is that the debtor can render unenforceable judicial liens on any exempt property and security interests that are both nonpurchase money and nonpossessory on certain household goods, tools of the trade and health aids.

Discharge and Objections to Discharge

The discharge, as mentioned previously, protects the debtor from further liability on the debts discharged. Sometimes, however, a debtor is not discharged at all (i.e., the creditor has successfully obtained an "objection to discharge") or is discharged only as regards to a specific creditor(s) and a specific debt(s) (an action known as "exception to discharge"). The borrower obviously remains liable for all obligations not discharged, and creditors may pursue customary collection procedures with respect thereto. Grounds for an "objection to discharge" include the following actions or inactions by the bankrupt debtor (this is not an all-inclusive list): fraudulent conveyance within 12 months of filing the petition; unjustifiable failure to keep or preserve financial records; false oath or account or presentation of a false claim in the bankruptcy case and estate, respectively; withholding of books or records from the trustee; failure to satisfactorily explain any loss or deficiency of assets; refusal to testify when legally required to do so; and receiving a discharge in bankruptcy within the last six full years. Some of the bases upon which creditors may file "exceptions to discharge" are: nonpayment of income taxes for the three years preceding the bankruptcy; money, property or services obtained through fraud, false pretenses or false representation; debts not scheduled on the bankruptcy petition and which the creditor had no notice; alimony or child support payments (this exception may be asserted only by the debtor's spouse or children, property settlements are dischargeable); and submission of false or incomplete financial statements. If a bank attempts to seek an exception on the basis of false financial information, it must prove the written financial statement was materially false, it reasonably relied on the statement, and the debtor intended to deceive the bank. These assertions can be difficult to prove. Discharges are unavailable to corporations or partnerships. Therefore, after a bankruptcy, corporations and partnerships often dissolve or become defunct.

Reaffirmation

Debtors sometimes promise their creditors after a bankruptcy discharge that they will repay a discharged debt. An example wherein a debtor may be so motivated involves the home mortgage. To keep the home and discourage the mortgagee from foreclosing, a debtor may reaffirm this obligation. This process of reaffirmation is an agreement enforceable through the judicial system. The law sets forth these basic limitations on reaffirmations: the agreement must be signed before the discharge is granted; a hearing is held and the bankruptcy judge informs the borrower there is no requirement to reaffirm; and the debtor has the right to rescind the reaffirmation if such action is taken within 30 days.

Classes of Creditors

The first class of creditors is known as priority creditors. As the name implies, these creditors are entitled to receive payment prior to any others. Priority payments include administrative expenses of the debtor's estate, unsecured claims for wages and salaries up to $2,000 per person, unsecured claims for employee benefit plans, unsecured claims of individuals up to $900 each for deposits in conjunction with rental or lease of property, unsecured claims of governmental units and certain tax liabilities. Secured creditors are only secured up to the extent of the value of their collateral. They become unsecured in the amount by which collateral is insufficient to satisfy the claim. Unsecured creditors are of course the last class in terms of priority.

Preferences

Certain actions taken by a creditor before or during bankruptcy proceedings may be invalidated by the trustee if they result in some creditors receiving more than their share of the debtor's estate. These actions are called "transfers" and fall into two categories. The first involves absolute transfers, such as payments received by a creditor; the trustee may invalidate this action and require the payment be returned and made the property of the bankrupt estate. A transfer of security, such as the granting of a mortgage, may also be invalidated by the trustee. Hence, the trustee may require previously encumbered property be made unencumbered, in which case the secured party becomes an unsecured creditor. This has obvious implications as regards loan collectability.

Preferences are a potentially troublesome area for banks and examiners should have an understanding of basic principles applicable to them. Some of the more important of these are listed here.

- A preference may be invalidated (also known as "avoided") if it has all of these elements: the transfer was to or for the benefit of a creditor; the transfer was made for or on account of a debt already outstanding; the transfer has the effect of increasing the amount a creditor would receive in Chapter 7 proceedings; the transfer was made within 90 days of the bankruptcy filing, or within one year if the transfer was to an insider who had reasonable cause to believe the debtor was insolvent at the time of transfer; and the debtor was insolvent at the time of the transfer. Under bankruptcy law, borrowers are presumed insolvent for 90 days prior to filing the bankruptcy petition.
- Payment to a fully secured creditor is not a preference because such a transfer would not have the effect of increasing the amount the creditor would otherwise receive in a Chapter 7 proceeding. Payment to a partially secured creditor does, however, have the effect of increasing the creditor's share and is thus deemed a preference which the trustee may avoid.
- Preference rules also apply to a transfer of a lien to secure past debts, if the transfer has all five elements set forth under the first point.
- There are certain situations wherein a debtor has given a preference to a creditor but the trustee is not permitted to invalidate it. A common example concerns floating liens on inventory under the Uniform Commercial Code. These matters are subject to complex rules, however, and consultation with the Regional Office may be advisable when this issue arises.

Setoffs

Setoffs occur when a party is both a creditor and a debtor of another; amounts which a party owes are netted against amounts which are owed to that party. If a bank exercises its right of setoff properly and before the bankruptcy filing, the action is generally upheld in the bankruptcy proceedings. Setoffs made after the bankruptcy may also be valid but certain requirements must be met of which the following are especially important: First, the debts must be between the same parties in the same right and capacity. For example, it would be improper for the bank to setoff the debtor's loan against a checking account of the estate of the obligor's father, of which the debtor is executor. Second, both the debt and the deposit must precede the bankruptcy petition filing. Third, the setoff may be disallowed if funds were deposited in the bank within 90 days of the bankruptcy filing and for the purpose of creating or increasing the amount to be set off.

Transfers Not Timely Perfected or Recorded

Under most circumstances, a bank which has not recorded its mortgage or otherwise fails to perfect its security interest in a proper timely manner runs great risk of losing its security. This is a complex area of the law but prudence clearly dictates that liens be properly obtained and promptly filed so that the possibility of losing the protection provided by collateral is eliminated.

SYNDICATED LENDING

Overview

Syndicated loans often represent a substantial portion of the commercial and industrial loan portfolios of large banks. A syndicated loan involves two or more banks contracting with a borrower, typically a large or middle market corporation, to provide funds at specified terms under the same credit facility. The average commercial syndicated credit is in excess of $100 million. Syndicated credits differ from participation loans in that lenders in a syndication participate jointly in the origination process, as opposed to one originator selling undivided participation interests to third parties. In a syndicated deal, each financial institution receives a pro rata share of the income based on the level of participation in the credit. Additionally, one or more lenders take on the role of lead or "agent" (co-agents in the case of more than one) of the credit and assume responsibility of administering the loan for the other lenders. The agent may retain varying percentages of the credit, which is commonly referred to as the "hold level."

The syndicated market formed to meet basic needs of lenders and borrowers, specifically:

- raising large amounts of money,
- enabling geographic diversification,
- satisfying relationship banking,
- obtaining working capital quickly and efficiently,
- spreading risk for large credits amongst banks, and
- gaining attractive pricing advantages.

The syndicated loan market has grown steadily, and growth in recent years has been extraordinary as greater market discipline has lead to uniformity in pricing. In recent years syndicated lending has come to resemble a capital market, and this trend is expected to continue as secondary market liquidity for these products continues to grow. The volume of syndicated credits is currently measured in trillions of dollars, and growth is expected to continue as pricing structures continue to appeal to lenders or "investors.”

In times of excess liquidity in the marketplace, spreads typically are quite narrow for investment-grade facilities, thus making it a borrower’s market. This may be accompanied by an easing of the structuring and covenants. In spite of tightening margins, commercial banks are motivated to compete regarding pricing in order to retain other business.

Relaxing covenants and pricing may result in lenders relying heavily on market valuations, or so-called "enterprise values" in arriving at credit decisions. These values are derived by applying a multiple to cash flow, which differs, by industry and other factors, to historical or projected cash flows of the borrower. This value represents the intangible business value of a company as a going concern, which often exceeds its underlying assets.

Many deals involve merger and acquisition financing. While the primary originators of the syndicated loans are commercial banks, most of the volume is sold and held by other investors.

A subset of syndicated lending is leveraged lending which refers to borrowers with an excessive level of debt and debt service compared with cash flow. By their very nature, these instruments are of higher risk.

Syndication Process

There are four phases in a loan syndication: Pre-Launch, Launch, Post-Launch, and Post-Closing.

The Pre-Launch Process - During this phase, the syndicators identify the borrower’s needs and perform their initial due diligence. Industry information is gathered and analyzed, and background checks may be performed. Potential pricing and structure of the transaction takes shape. Formal credit write-ups are sent to credit officers for review and to senior members of syndication group for pricing approval. Competitive bids are sent to the borrower. The group then prepares for the launch.

An information memorandum is prepared by the agent. This memorandum is a formal and confidential document that should address all principal credit issues relating to the borrower and to the project being financed. It should, at a minimum, contain an overview of the transaction including a term sheet, an overview of the borrower's business, and quarterly and annual certified financial statements. This documents acts as both the marketing tool and as the source of information for the syndication.

The Launch Phase - The transaction is launched into the market when banks are sent the information memoranda mentioned above. Legal counsel commences to prepare the documentation. Negotiations take place between the banks and the borrower over pricing, collateral, covenants, and other terms. Often there is a bank meeting so potential participants can discuss the company's business and industry both with the lead agent and with the company.

Post-Launch Phase - Typically there is a two-week period for potential participants to evaluate the transaction and to decide whether or not to participate in the syndication. During this period, banks do their due diligence and credit approval. Often this entails running projection models, including stress tests, doing business and industry research; and presenting the transaction for the approval process once the decision is made to commit to the transaction.

After the commitment due date, participating banks receive a draft credit agreement for their comments. Depending upon the complexity of the agreement, they usually have about a week to make comments. The final credit agreement is then negotiated based on the comments and the loan would then close two to five days after the credit agreement is finalized.

Post-Closing Phase - Post-Closing, there should be ongoing dialogue with the borrower about financial/operating performance as well as quarterly credit agreement covenant compliance checks. Annually, a full credit analysis should be done as well as annual meetings of the participants for updates on financial and operating performance. Both the agent bank and the participants need to assess the loan protection level by analyzing the business risk as well as the financial risk. Each industry has particular dominant risks that must be assessed.

Loan Covenants

Loan covenants are special or particular conditions that are included in a loan agreement and that the borrower is required to fulfill in order for the loan agreement to remain valid. Typically, covenants cover several domains but can broadly be divided into financial and non-financial categories. The former refers to respecting certain financial conditions that can be defined either in absolute amounts or ratios. Some examples are:

Net worth test: restricts the total amount of debt a borrower can incur, expressed as a percentage of net worth.

Current ratio/ Quick Ratio tests: measures liquidity.

Interest, Debt service or Fixed Charges Coverage test: assure that some level of cash flow is generated by a company above its operating expenses and other fixed obligations.

Profitability test: Particularly important for the nonrated company; some usual ratios include EBITDA (earnings before interest, taxes, depreciation, and amortization) divided by average capital, operating income as a percentage of sales and earnings on business segment assets.

Capital expenditure limitations: Should be set according to the company's business plan and then measured accordingly.

Borrowing Base Limitations: Ascertain that companies are not borrowing to overinvest in inventory and provide a first line of fallback for the lenders if a credit begins to deteriorate.

Cash Flow volatility: Actual leverage covenant levels vary by industry segment. Typical ratios that are used to measure cash flow adequacy include EBITDA divided by total debt and EBITDA divided by interest expense.

Non-financial covenants may include restrictions on other matters such as management changes, provisions of information, guarantees, disposal of assets, etc.

Credit Ratings

Over the past several years, large credit rating agencies have entered the syndicated loan market (Standard and Poors, Moody, Fitch Investor Services). Loan ratings differ from bond ratings in that bond ratings emphasize the probability of default of the bond; whereas loan ratings emphasize the probability of default as well as the likelihood of collection upon default. Loan ratings emphasize the loan's structural characteristics (covenants, cash flow, collateral, etc.) and the expected loss on the loan.

Overview of the Shared National Credit (SNC) Program

The Shared National Credit (SNC) Program is an interagency initiative administered jointly by the FDIC, Federal Reserve Board, and the Office of the Comptroller of the Currency. The program was established in the 1970's for the purpose of ensuring consistency among the three Federal banking regulators in the classification of large syndicated credits.

Each SNC is reviewed annually at its agent bank or a designated review bank and the quality rating assigned by examiners is reported to all participating banks. These ratings are subsequently used during all examinations of participating banks, thus avoiding duplicate reviews of the same loan and ensuring consistent treatment with regard to regulatory credit ratings. Examiners should not change SNC ratings during risk management examinations. Any material change in a SNC should be reported to the appropriate regional SNC coordinator so that a determination can be made as to the appropriate action, including inclusion in the credit re-review process.

Definition of a SNC

Any loan and/or formal loan commitment, including any asset such as other real estate, stocks, notes, bonds and debentures taken for debts previously contracted, extended to a borrower by a supervised institution, its subsidiaries, and affiliates which in original amount aggregates $20 million or more and, which is shared by three or more unaffiliated institutions under a formal lending agreement; or, a portion of which is sold to two or more unaffiliated institutions, with the purchasing institution(s) assuming its pro rata share of the credit risk.

SNC's Include:

- All international credits to borrowers in the private sector, regardless of currency denomination, which are administered by a domestic office.
- Assets taken for debts previously contracted such as other real estate, stocks, notes, bonds, and debentures.
- Credits or credit commitments which have been reduced to less than $20 million and were classified or criticized during the previous SNC review, provided they have not been reduced below $10 million.
- Any other large credit(s) designated by the supervisory agencies as meeting the general intent or purpose of the SNC program.
- Two or more credits to the same borrower that aggregate $20 million and each credit has the same participating lenders

SNCs Do Not Include:

- Credits shared solely between affiliated supervised institutions.
- Private sector credits that are 100 percent guaranteed by a sovereign entity.
- International credits or commitments administered in a foreign office.
- Direct credits to sovereign borrowers.
- Credits known as "club credits", which include related borrowings but are not extended under the same lending agreement.
- Credits with different maturity dates for different lenders.

For additional information regarding the SNC Program examiners can contact the regional SNC coordinator.

Glossary of Syndicated Lending Terms

Agent – Entity that assumes the lead role in originating and administering the credit facility.

Arranging Banks – The banks that arrange a financing on behalf of a corporate borrower. Usually the banks commit to underwriting the whole amount only if they are unable to place the deal fully. Typically, however, they place the bulk of the facility and retain a portion on their books. For their efforts in arranging a deal, these banks collect an arrangement fee.

Front-end costs – Commissions, fees or other payments that are taken at the outset of a loan. Some examples are: *lead management fees* – paid in recognition of the lead manager's organization; *management fees* – usually divided equally between the management group and is payable regardless of drawdown; *underwriting fees* – a percentage of the sum being underwritten; *participation fees* – expressed as a percentage of each bank's participation in the loan; and *agency fees* – levied on most loans and provide for the appointment of one or more agent banks. The fee may be a percentage of the whole facility or a pre-arranged fixed sum.

LIBOR – London Interbank Offered Rate – The interest rate at which major international banks in London lend to each other and the rate(s) frequently underlying loan interest calculations. LIBOR will vary according to market conditions and will of course depend upon the loan period as well as the currency in question.

Participating Banks – a bank that has lent a portion of the outstanding amount to the borrower.

Reference Bank – A bank that sets the lending rate (LIBOR) at the moment of each loan rollover period

Tranche – In a large syndicated loan, different portions of the facility may be made available at different time periods, and in different currencies. These separate components are known as "tranches" of the facility.

Underwriter - A bank that guarantees the lending of the funds to the borrower irrespective of successful syndication or not.

Zeta score - There are models which predict bankruptcy based on the analysis of certain financial ratios. Edward Altman of New York University developed a model in 1968 which is used by the regulatory agencies called Zeta. The Zeta score methodology is intended to forecast the probability of a company entering bankruptcy within a twelve month period. It uses five financial ratios from reported accounting information to produce an objective measure of financial strength of a company. The ratios included in the measurement are: working capital/total assets; retained earnings/total assets; earnings before interest and taxes/total assets; market value of common and preferred equity/total liabilities (in non-public organizations, the book value of common and preferred equity should be substituted); and sales/total assets (for non-manufacturing companies, this variable is eliminated).

CREDIT SCORING

Automated credit scoring systems allow institutions to underwrite and price loans more quickly than was possible in the past. This efficiency has enabled some banks to expand their lending into national markets and originate loan volumes once considered infeasible. Scoring also reduces unit-underwriting costs, while yielding a more consistent loan portfolio that is easily securitized. These benefits have been the primary motivation for the proliferation of credit scoring systems among both large and small institutions.

Credit scoring systems identify specific characteristics that help define predictive variables for acceptable performance (delinquency, amount owed on accounts, length of credit history, home ownership, occupation, income, etc.) and assign point values relative to their overall importance. These values are then totaled to calculate a credit score, which helps institutions to rank order risk for a given population. Generally, an individual with a higher score will perform better relative to an individual with a lower credit score.

Few, if any, institutions have an automated underwriting system where the credit score is used exclusively to make the credit decision. Some level of human review is usually present to provide the flexibility needed to address individual circumstances. Institutions typically establish a minimum cut-off score below which applicants are denied and a second cutoff score above which applicants are approved. However, there is usually a range, or "gray area," in between the two cut-off scores where credits are manually reviewed and credit decisions are judgmentally determined.

Most, if not all, systems also provide for overrides of established cut-off scores. If the institution's scoring system effectively predicts loss rates and reflects management's risk parameters, excessive overrides will negate the benefits of an automated scoring system. Therefore, it is critical for management to monitor and control overrides. Institutions should develop acceptable override limits and prepare monthly override reports that provide comparisons over time and against the institution's parameters. Override reports should also identify the approving officer and include the reason for the override.

Although banks often use more than one type of credit scoring methodology in their underwriting and account management practices, many systems incorporate credit bureau scores. Credit bureau scores are updated periodically and validated on an ongoing basis against performance in credit bureau files. Scores are designed to be comparable across the major credit bureaus; however, the ability of any score to estimate performance outcome probabilities depends on the quality, quantity, and timely submission of lender data to the various credit bureaus. Often, the depth and thoroughness of data available to each credit bureau varies, and as a consequence, the quality of scores varies.

As a precaution, institutions that rely on credit bureau scores should sample and compare credit bureau reports to determine which credit bureau most effectively captures data for the market(s) in which the institution does business. For institutions that acquire credit from multiple regions, use of multiple scorecards may be appropriate, depending on apparent regional credit bureau strength. In some instances, it may be worthwhile for institutions to pull scores from each of the major credit bureaus and establish rules for selecting an average value. By tracking credit bureau scores over time and capturing performance data to differentiate which score seems to best indicate probable performance outcome, institutions can select the best score for any given market. Efforts to differentiate and select the best credit bureau score should be documented.

Although some institutions develop their own scoring models, most are built by outside vendors and subsequently maintained by the institution. Vendors build scoring models based upon specific information and parameters provided by bank management. Therefore, management must clearly communicate with the vendor and ensure that the scorecard developer clearly understands the bank's objectives. Bank management should also adhere closely to vendor manual specifications for system maintenance and management, particularly those that provide guidance for periodically assessing performance of the system.

Scoring models generally become less predictive as time passes. Certain characteristics about an applicant, such as income, job stability, and age change over time, as do overall demographics. One-by-one, these changes will result in significant shifts in the profile of the population. Once a fundamental change in the profile occurs, the model is less able to identify potentially good and bad applicants. As these changes continue, the model loses its ability to rank order risk. Thus, institutions must periodically validate the system's predictability and refine scoring characteristics when necessary. These efforts should be documented.

Institutions initially used credit scoring for consumer lending applications such as credit card, auto, and mortgage lending. However, credit scoring eventually gained acceptance in the small business sector. Depending on the manner in which it is implemented, credit scoring for small business lending may represent a fundamental shift in underwriting philosophy if institutions view a small business loan as more of a high-end consumer loan and, thus, grant credit more on the strength of the principals' personal credit history and less on the fundamental strength of the business. While this may be appropriate in some cases, it is important to remember that the income from small business remains the primary source of repayment for most loans. Banks that do not analyze business financial statements or periodically review their lines of credit may lose an opportunity for early detection of credit problems.

The effectiveness of any scoring system directly depends on the policies and procedures established to guide and enforce proper use. Policies should include an overview of the institution's scoring objectives and operations; the establishment of authorities and responsibilities over scoring systems; the use of a chronology log to track internal and external events that affect the scoring system; the establishment of bank officials responsible for reporting, monitoring, and reviewing overrides; as well as the provision of a scoring system maintenance program to ensure that the system continues to rank risk and to predict default and loss under the original parameters.

Examiners should refer to the Credit Card Specialty Bank Examination Guidelines and the Credit Card Activities section of the Examination Modules for additional guidance on credit scoring systems.

SUBPRIME LENDING

Introduction

There is not a universal definition of a subprime loan in the industry, but subprime lending is generally characterized as a lending program or strategy that targets borrowers who pose a significantly higher risk of default than traditional retail banking customers. Institutions often refer to subprime lending by other names such as the nonprime, nonconforming, high coupon, or alternative lending market.

Well-managed subprime lending can be a profitable business line; however, it is a high-risk lending activity. Successful subprime lenders carefully control the elevated credit, operating, compliance, legal, market, and reputation risks as well as the higher overhead costs associated with more labor-intensive underwriting, servicing, and collections. Subprime lending should only be conducted by institutions that have a clear understanding of the business and its inherent risks, and have determined these risks to be acceptable and controllable given the institution's staff, financial condition, size, and level of capital support. In addition, subprime lending should only be conducted within a comprehensive lending program that employs strong risk management practices to identify, measure, monitor, and control the elevated risks that are inherent in this activity. Finally, subprime lenders should retain additional capital support consistent with the volume and nature of the additional risks assumed. If the risks associated with this activity are not properly controlled, subprime lending may be considered an unsafe and unsound banking practice.

The term, subprime, refers to the credit characteristics of the borrower at the loan's origination, rather than the type of credit or collateral considerations. Subprime borrowers typically have weakened credit histories that may include a combination of payment delinquencies, charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria. Generally, subprime borrowers will display a range of credit risk characteristics that may include one or more of the following:

- Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;
- Judgment, foreclosure, repossession, or charge-off in the prior 24 months;
- Bankruptcy in the last 5 years;
- Relatively high default probability as evidenced by, for example, a Fair Isaac and Co. risk score (FICO) of 660 or below (depending on the product/collateral), or other bureau or proprietary scores with an equivalent default probability likelihood; and/or
- Debt service-to-income ratio of 50 percent or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

This list is illustrative rather than exhaustive and is not meant to define specific parameters for all subprime borrowers. Additionally, this definition may not match all market or institution-specific subprime definitions, but should be viewed as a starting point from which examiners should expand their review of the bank's lending program.

Subprime lenders typically use the criteria above to segment prospects into subcategories such as, for example, A-, B, C, and D. However, subprime subcategories can vary significantly among lenders based on the credit grading criteria. What may be an "A" grade definition at one institution may be a "B" grade at another bank, but generally each grade represents a different level of credit risk.

While the industry often includes borrowers with limited or no credit histories in the subprime category, these borrowers can represent a substantially different risk profile than those with a derogatory credit history and are not inherently considered subprime. Rather, consideration should be given to underwriting criteria and portfolio performance when determining whether a portfolio of loans to borrowers with limited credit histories should be treated as subprime for examination purposes.

Subprime lending typically refers to a lending program that targets subprime borrowers. Institutions engaging in subprime lending generally have knowingly and purposefully focused on subprime lending through planned business strategies, tailored products, and explicit borrower targeting. An institution's underwriting guidelines and target markets should provide a basis for determining whether it should be considered a subprime lender. The average credit risk profile of subprime loan programs will exhibit the credit risk characteristics listed above, and will likely display significantly higher delinquency and/or loss rates than prime portfolios. High interest rates and fees are a common and relatively easily identifiable characteristic of subprime lending. However, high interest rates and fees by themselves do not constitute subprime lending.

Subprime lending does not include traditional consumer lending that has historically been the mainstay of community banking, nor does it include making loans to subprime borrowers as discretionary exceptions to the institution's prime retail lending policy. In addition, subprime lending does not refer to: prime loans that develop credit problems after acquisition; loans initially extended in subprime programs that are later upgraded, as a result of their performance, to programs targeted to prime borrowers; or community development loans as defined in the CRA regulations.

For supervisory purposes, a subprime lender is defined as an insured institution or institution subsidiary that has a subprime lending program with an aggregate credit exposure greater than or equal to 25 percent of Tier 1 capital. Aggregate exposure includes principal outstanding and committed, accrued and unpaid interest, and any retained residual assets relating to securitized subprime loans.

Capitalization

The FDIC's minimum capital requirements generally apply to portfolios that exhibit substantially lower risk profiles than exist in subprime loan programs. Therefore, these requirements may not be sufficient to reflect the risks associated with subprime portfolios. Each subprime lender is responsible for quantifying the amount of capital needed to offset the additional risk in subprime lending activities, and for fully documenting the methodology and analysis supporting the amount specified.

Examiners will evaluate the capital adequacy of subprime lenders on a case-by-case basis, considering, among other factors, the institution's own documented analysis of the capital needed to support its subprime lending activities. Examiners should expect capital levels to be risk sensitive, that is, allocated capital should reflect the level and variability of loss estimates within reasonably conservative parameters. Examiners should also expect institutions to specify a direct link between the estimated loss rates used to determine the required ALLL, and the unexpected loss estimates used to determine capital.

The sophistication of this analysis should be commensurate with the size, concentration level, and relative risk of the institution's subprime lending activities and should consider the following elements**:**

- Portfolio growth rates;
- Trends in the level and volatility of expected losses;
- The level of subprime loan losses incurred over one or more economic downturns, if such data/analyses are available;
- The impact of planned underwriting or marketing changes on the credit characteristics of the portfolio, including the relative levels of risk of default, loss in the event of default, and the level of classified assets;
- Any deterioration in the average credit quality over time due to adverse selection or retention;
- The amount, quality, and liquidity of collateral securing the individual loans;
- Any asset, income, or funding source concentrations;
- The degree of concentration of subprime credits;
- The extent to which current capitalization consists of residual assets or other potentially volatile components;
- The degree of legal and/or reputation risk associated with the subprime business line(s) pursued; and
- The amount of capital necessary to support the institution's other risks and activities.

Given the higher risk inherent in subprime lending programs, examiners should reasonably expect, as a starting point, that an institution would hold capital against such portfolios in an amount that is one and one half to three times greater than what is appropriate for non-subprime assets of a similar type. Refinements should depend on the factors analyzed above, with particular emphasis on the trends in the level and volatility of loss rates, and the amount, quality, and liquidity of collateral securing the loans. Institutions with subprime programs affected by this guidance should have capital ratios that are well above the averages for their traditional peer groups or other similarly situated institutions that are not engaged in subprime lending.

Some subprime asset pools warrant increased supervisory scrutiny and monitoring, but not necessarily additional capital. For example, well-secured loans to borrowers who are slightly below what is considered prime quality may entail minimal additional risks compared to prime loans, and may not require additional capital if adequate controls are in place to address the additional risks. On the other hand, institutions that underwrite higher-risk subprime pools, such as unsecured loans or high loan-to-value second mortgages, may need significantly higher levels of capital, perhaps as high as 100% of the loans outstanding depending on the level and volatility of risk. Because of the higher inherent risk levels and the increased impact that subprime portfolios may have on an institution's overall capital, examiners should document and reference each institution's subprime capital evaluation in their comments and conclusions regarding capital adequacy.

Stress Testing

An institution's capital adequacy analysis should include stress testing as a tool for estimating unexpected losses in its subprime lending pools. Institutions should project the performance of their subprime loan pools under conservative stress test scenarios, including an estimation of the portfolio's susceptibility to deteriorating economic, market, and business conditions. Portfolio stress testing should include "shock" testing of basic assumptions such as delinquency rates, loss rates, and recovery rates on collateral. It should also consider other potentially adverse scenarios, such as: changing attrition or prepayment rates; changing utilization rates for revolving products; changes in credit score distribution; and changes in the capital markets demand for whole loans, or asset-backed securities supported by subprime loans.

These are representative examples. Actual factors will vary by product, market segment, and the size and complexity of the portfolio relative to the institution's overall operations. Whether stress tests are performed manually, or through automated modeling techniques, the Regulatory Agencies will expect that:

- The process is clearly documented, rational, and easily understood by the board and senior management;
- The inputs are reliable and relate directly to the subject portfolios;
- Assumptions are well documented and conservative; and
- Any models are subject to a comprehensive validation process.

The results of the stress test exercises should be a documented factor in the analysis and determination of capital adequacy for the subprime portfolios.

Institutions that engage in subprime lending without adequate procedures to estimate and document the level of capital necessary to support their activities should be criticized. Where capital is deemed inadequate to support the risk in subprime lending activities, examiners should consult with their Regional Office to determine the appropriate course of action.

Risk Management

The following items are essential components of a risk management program for subprime lenders.

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, market, liquidity, reputation and legal risks.

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. Strategic plan performance analysis should be conducted frequently in order to detect adverse trends or circumstances and take appropriate action in a timely manner.

Management and Staff. Prior to engaging in subprime lending, the board should ensure that management and staff possess sufficient expertise to appropriately manage the risks in subprime lending and that staffing levels are adequate for the planned volume of activity. Subprime lending requires specialized knowledge and skills that many financial institutions do not possess. Marketing, account origination, and collections strategies and techniques often differ from those employed for prime credit; thus it is generally not sufficient to have the same staff responsible for both subprime and prime loans. Servicing and collecting subprime loans can be very labor intensive and requires a greater volume of staff with smaller caseloads. Lenders should monitor staffing levels, staff experience, and the need for additional training as performance is assessed over time. Compensation programs should not depend primarily on volume or growth targets. Any targets used should be weighted towards factors such as portfolio quality and risk-adjusted profitability.

Lending Policies and Procedures. Lenders should have comprehensive written policies and procedures, specific to each subprime lending product, that set limits on the amount of risk that will be assumed and address how the institution will control portfolio quality and avoid excessive exposure. Policies and procedures should be in place before initiating the activity. Institutions may originate subprime loans through a variety of channels, including dealers, brokers, correspondents, and marketing firms. Regardless of the source, it is critical that underwriting policies and procedures incorporate the risk tolerances established by the board and management and explicitly define underwriting criteria and exception processes. Subprime lending policies and procedures should, at a minimum, address the items outlined in the loan reference module of the Examination Documentation Modules for subprime lending. If the institution elects to use scoring systems for approvals or pricing, the model should be tailored to address the behavioral and credit characteristics of the subprime population targeted and the products offered. It is not acceptable to rely on models developed for standard risk borrowers or products. Furthermore, the models should be reviewed frequently and updated as necessary to ensure assumptions remain valid.

Given the higher credit risk associated with the subprime borrower, effective subprime lenders use mitigating underwriting guidelines and risk-based pricing to reduce the overall risk of the loan. These guidelines include lower loan-to-value ratio requirements and lower maximum loan amounts relative to each risk grade within the portfolio. Given the high-risk nature of subprime lending, the need for thorough analysis and documentation is heightened relative to prime lending. Compromises in analysis or documentation can substantially increase the risk and severity of loss. In addition, subprime lenders should develop criteria for limiting the risk profile of borrowers selected, giving consideration to factors such as the frequency, recency, and severity of delinquencies and derogatory items; length of time with re-established credit; and reason for the poor credit history.

While the past credit deficiencies of subprime borrowers reflect a higher risk profile, subprime loan programs must be based upon the borrowers' current reasonable ability to repay and a prudent debt amortization schedule. Loan repayment should not be based upon foreclosure proceedings or collateral repossession. Institutions must recognize the additional default risks and determine if these risks are acceptable and controllable without resorting to foreclosure or repossession that could have been predetermined by the loan structure at inception.

Profitability and Pricing. A key consideration for lenders in the subprime market is the ability to earn risk-adjusted yields that appropriately compensate the institution for the increased risk and costs assumed. The institution must have a comprehensive framework for pricing decisions and profitability analysis that considers all costs associated with each subprime product, including origination, administrative/servicing, expected charge-offs, funding, and capital. In addition, the pricing framework should allow for fluctuations in the economic cycle. Fees often comprise a significant portion of revenue in subprime lending. Consideration should be given to the portion of revenues derived from fees and the extent to which the fees are a recurring and viable source of revenue. Profitability projections should be incorporated into the business plan. Management should track actual performance against projections regularly and have a process for addressing variances.

Loan Review and Monitoring. Institutions must have comprehensive analysis and information systems that identify, measure, monitor and control the risks associated with subprime lending. Analysis must promote understanding of the portfolio and early identification of adverse quality/performance trends. Systems employed must posses the level of detail necessary to properly evaluate subprime activity. Recommended portfolio segmentation and trend analyses are fully discussed in the subprime lending loan reference module of the Examination Modules.

Analysis should take into consideration the effects of portfolio growth and seasoning, which can mask true performance by distorting delinquency and loss ratios. Vintage, lagged delinquency, and lagged loss analysis methods are sometimes used to account for growth, seasoning, and changes in underwriting. Analysis should also take into account the effect of cure programs on portfolio performance. Refer to the glossary of the Credit Card Specialty Bank Examination Guidelines for definitions of vintage, roll rate, and migration analysis.

Servicing and Collections. Defaults occur sooner and in greater volume than in prime lending; thus a well-developed servicing and collections function is essential for the effective management of subprime lending. Strong procedures and controls are necessary throughout the servicing process; however, particular attention is warranted in the areas of new loan setup and collections to ensure the early intervention necessary to properly manage higher risk borrowers. Lenders should also have well-defined written collection policies and procedures that address default management (e.g., cure programs and repossessions), collateral disposition, and strategies to minimize delinquencies and losses. This aspect of subprime lending is very labor intensive but critical to the program's success.

Cure programs include practices such as loan restructuring, re-aging, renewal, extension, or consumer credit counseling. Cure programs should be used only when the institution has substantiated the customer's renewed willingness and ability to pay. Management should ensure that its cure programs are neither masking poor initial credit risk selection nor deferring losses. Effective subprime lenders may use short-term loan restructure programs to assist borrowers in bringing loans current when warranted, but will often continue to report past due status on a contractual basis. Cure programs that alter the contractual past due status may mask actual portfolio performance and inhibit the ability of management to understand and monitor the true credit quality of the portfolio.

Repossession and resale programs are integral to the subprime business model. Policies and procedures for foreclosure and repossession activities should specifically address the types of cost/benefit analysis to be performed before pursuing collateral, including valuation methods employed; timing of foreclosure or repossession; and accounting and legal requirements. Policies should clearly outline whether the bank will finance the sale of the repossessed collateral, and if so, the limitations that apply. Banks should track the performance of such loans to assess the adequacy of these policies.

Compliance and Legal Risks. Subprime lenders generally run a greater risk of incurring legal action given the higher fees, interest rates, and profits; targeting customers who have little experience with credit or damaged credit records; and aggressive collection efforts. Because the risk is dependent, in part, upon the public perception of a lender's practices, the nature of these risks is inherently unpredictable. Institutions that engage in subprime lending must take special care to avoid violating consumer protection laws. An adequate compliance management program must identify, monitor and control the consumer protection hazards associated with subprime lending. The institution should have a process in place to handle the potential for heightened legal action. In addition, management should have a system in place to monitor consumer complaints for recurring issues and ensure appropriate action is taken to resolve legitimate disputes.

Audit. The institution's audit scope should provide for comprehensive independent reviews of subprime activities. Audit procedures should ensure, among other things, that a sufficient volume of accounts is sampled to verify the integrity of the records, particularly with respect to payments processing.

Third Parties. Subprime lenders may use third parties for a number of functions from origination to collections. In dealing with high credit-risk products, management must take steps to ensure that exposures from third-party practices or financial instability are minimized. Proper due diligence should be performed prior to contracting with a third party vendor and on an ongoing basis thereafter. Contracts negotiated should provide the institution with the ability to control and monitor third party activities (e.g. growth restrictions, underwriting guidelines, outside audits, etc.) and discontinue relationships that prove detrimental to the institution.

Special care must be taken when purchasing loans from third party originators. Some originators who sell subprime loans charge borrowers high up-front fees, which may be financed into the loan. These fees provide incentive for originators to produce a high volume of loans with little emphasis on quality, to the detriment of a potential purchaser. These fees also increase the likelihood that the originator will attempt to refinance the loans. Contracts should restrict the originator from the churning of customers. Further, subprime loans, especially those purchased from outside the institution's lending area, are at special risk for fraud or misrepresentation. Management must also ensure that third party conflicts of interest are avoided. For example, if a loan originator provides recourse for poorly performing loans purchased by the institution, the originator or related interest thereof should not also be responsible for processing and determining the past due status of the loans.

Securitizations. Securitizing subprime loans carries inherent risks, including interim credit, liquidity, interest rate, and reputation risk, that are potentially greater than those for securitizing prime loans. The subprime loan secondary market can be volatile, resulting in significant liquidity risk 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 may be forced to sell loan 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, whole loans, or the attendant servicing functions, alternate funding sources, and measures for raising additional capital. An institution’s liquidity and funding structure should not be overly dependent upon the sale of subprime loans.

Given some of the unique characteristics of subprime lending, accounting for the securitization process requires assumptions that can be difficult to quantify reliably, and erroneous assumptions can lead to the significant overstatement of an institution's assets. Institutions should take a conservative approach when accounting for these transactions and ensure compliance with existing regulatory guidance. Refer to outstanding memoranda and examination instructions for further information regarding securitizations.

Classification

The Uniform Retail Credit Classification and Account Management Policy (Retail Classification Policy) governs the evaluation of consumer loans. This policy establishes general classification thresholds based on delinquency, but also grants examiners the discretion to classify individual retail loans that exhibit signs of credit weakness regardless of delinquency status. 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. Given the high-risk nature of subprime portfolios and their greater potential for loan losses, the delinquency thresholds for classification set forth in the Retail Classification Policy should be considered minimums. Well-managed subprime lenders should recognize the heightened risk-of-loss characteristics in their portfolios and, if warranted, internally classify their delinquent accounts well before the timeframes outlined in the interagency policy. If examination classifications are more severe than the Retail Classification Policy suggests, the examination report should explain the weaknesses in the portfolio and fully document the methodology used to determine adverse classifications.

ALLL Analysis

The institution’s documented ALLL analysis should identify subprime loans as a specific risk exposure separate from the prime portfolio. In addition, the analysis should segment the subprime lending portfolios by risk exposure such as specific product, vintage, origination channel, risk grade, loan to value ratio, or other grouping deemed relevant.

Pools of adversely classified subprime loans (to include, at a minimum, all loans past due 90 days or more) should be reviewed for impairment, and an adequate allowance should be established consistent with existing interagency policy. For subprime loans that are not adversely classified, the ALLL should be sufficient to absorb at least all estimated credit losses on outstanding balances over the current operating cycle, typically 12 months. To the extent that the historical net charge-off rate is used to estimate expected credit losses, it should be adjusted for changes in trends, conditions, and other relevant factors, including business volume, underwriting, risk selection, account management practices, and current economic or business conditions that may alter such experience.

Subprime Auto Lending

Underwriting. Subprime auto lenders use risk-based pricing of loans in addition to more stringent advance rates, discounting, and dealer reserves than those typically used for prime auto loans to mitigate the increased credit risk. As credit risk increases, advance rates on collateral decrease while interest rates, dealer paper discounts, and dealer reserves increase. In addition to lower advance rates, collateral values are typically based on the wholesale value of the car. Lenders will typically treat a new dealer with greater caution, using higher discounts and/or purchasing the dealer's higher quality paper until a database and working relationship is developed.

Servicing and Collections. Repossession is quick, generally ranging between 30 to 60 days past due and sometimes earlier. The capacity of a repossession and resale operation operated by a prime lender could easily be overwhelmed if the lender begins targeting subprime borrowers, leaving the lender unable to dispose of cars quickly. Resale methods include wholesale auction, retail lot sale, and/or maintaining a database of retail contacts. While retail sale will command a greater price, subprime lenders should consider limiting the time allocated to retail sales before sending cars to auction in order to ensure adequate cash flow and avoid excessive inventory build-up. Refinancing resales should be limited and tightly controlled, as this practice can mask losses. Lenders typically implement a system for tracking the location of the collateral.

Subprime Residential Real Estate Lending

Underwriting. To mitigate the increased risk, subprime residential real estate lenders use risk-based pricing in addition to more conservative LTV ratio requirements and cash-out restrictions than those typically used for prime mortgage loans. As the credit risk of the borrower increases, the interest rate increases and the loan-to-value ratio and cash-out limit decreases. Prudent loan-to-value ratios are an essential risk mitigant in subprime real estate lending and generally range anywhere from 85 percent to 90 percent for A- loans, to 65 percent for lower grades. High loan-to-value (HLTV) loans are generally not considered prudent in subprime lending. HLTV loans should be targeted at individuals who warrant large unsecured debt, and then only in accordance with outstanding regulatory guidance. The appraisal process takes on increased importance given the greater emphasis on collateral. Prepayment penalties are sometimes used on subprime real estate loans, where allowed by law, given that prepayment rates are generally higher and more volatile for subprime real estate loans. Government Sponsored Agencies, Fannie Mae and Freddie Mac, participate in the subprime mortgage market to a limited degree through purchases of subprime loans and guarantees of subprime securitizations.

Servicing and Collections. Collection calls begin early, generally within the first 10 days of delinquency, within the framework of existing laws. Lenders generally send written correspondence of intent to foreclosure or initiate other legal action early, often as early as 31 days delinquent. The foreclosure process is generally initiated as soon as allowed by law. Updated collateral valuations are typically obtained early in the collections process to assist in determining appropriate collection efforts. Frequent collateral inspections are often used by lenders to monitor the condition of the collateral.

Subprime Credit Card Lending

Underwriting. Subprime credit card lenders use risk-based pricing as well as tightly controlled credit limits to mitigate the increased credit risk. In addition, lenders may require full or partial collateral coverage, typically in the form of a deposit account at the institution, for the higher-risk segments of the subprime market. Initial credit lines are set at low levels, such as $300 to $1,000, and subsequent line increases are typically smaller than for prime credit card accounts. Increases in credit lines should be subject to stringent underwriting criteria similar to that required at origination.

Underwriting for subprime credit cards is typically based upon credit scores generated by sophisticated scoring models. These scoring models use a substantial number of attributes, including the frequency, severity, and recency of previous delinquencies and major derogatory items, to determine the probability of loss for a potential borrower. Subprime lenders typically target particular subprime populations through prescreening models, such as individuals who have recently emerged from bankruptcy. Review of the attributes in these models often reveals the nature of the institution's target population.

Servicing and Collections. Lenders continually monitor customer behavior and credit quality and take proactive measures to avert potential problems, such as decreasing or freezing credit lines or providing consumer counseling, before the problems become severe or in some instances before the loans become delinquent. Lenders often use sophisticated scoring systems to assist in monitoring credit quality and frequently re-score customers. Collection calls on delinquent loans begin early, generally within the first 10 days delinquent, and sometimes as early as 1-day delinquent, within the framework of existing laws. Lenders generally send written correspondence within the first 30 days in addition to calling. Account suspensions occur early, generally within the first 45 days of delinquency or immediately upon a negative event such as refusal to pay. Accounts over 90 days past due are generally subject to account closure and charge-off. In addition, account closures based upon a borrower's action, such as repeated refusal to pay or broken promises to bring the account current within a specified time frame, may occur at any time in the collection process. Account closure practices are generally more aggressive for relatively new credit card accounts, such as those originated in the last six months.

Payday Lending

Payday lending is a particular type of subprime lending. Payday loans (also known as deferred deposit advances) are small dollar, short-term, unsecured loans that borrowers promise to repay out of their next paycheck or regular income payment (such as social security check). Payday loans are usually priced at a fixed dollar fee, which represents the finance charge. Because these loans have such short terms to maturity, the cost of borrowing, expressed as an annual percentage rate is very high.

In return for the loan, the borrower usually provides the lender with a check or debit authorization for the amount of the loan plus the fee. The check is either post-dated to the borrower's next payday or the lender agrees to defer presenting the check for payment until a future date, usually two weeks or less. When the loan is due, the lender expects to collect the loan by depositing the check or debiting the borrower's account or by having the borrower redeem the check with a cash payment. If the borrower informs the lender that he or she does not have the funds to repay the loan, the loan is often refinanced (payday lenders may use the terms "rollover," "same day advance," or "consecutive advance") through payment of an additional finance charge. If the borrower does not redeem the check in cash and the loan is not refinanced, the lender normally puts the check or debit authorization through the payment system. If the borrower's deposit account has insufficient funds, the borrower typically incurs a NSF charge on this account. If the check or the debit is returned to the lender unpaid, the lender also may impose a returned item fee plus collection charges on the loan.

Significant Risks

Credit Risk. Borrowers who obtain payday loans generally have cash flow difficulties and few, if any, lower-cost borrowing alternatives. In addition, some payday lenders perform minimal analysis of the borrower's ability to repay either at the loan's inception or upon refinancing; they may merely require a current pay stub or proof of a regular income source and evidence that the customer has a checking account. Other payday lenders use scoring models and consult nationwide databases that track bounced checks and persons with outstanding payday loans. However, payday lenders typically do not obtain or analyze information regarding the borrower's total level of indebtedness or information from the major national credit bureaus. The combination of the borrower's limited financial capacity, the unsecured nature of the credit, and the limited underwriting analysis of the borrower's ability to repay pose substantial credit risk for insured depository institutions.

Legal and Reputation Risk**.** Federal law authorizes Federal and state-chartered insured depository institutions making loans to out-of-state borrowers to "export" favorable interest rates provided under the laws of the State where the bank is located. That is, a state-chartered bank is allowed to charge interest on loans to out-of-state borrowers at rates authorized by the State where the bank is located, regardless of usury limitations imposed by the State laws of the borrower's residence. Nevertheless, institutions face increased reputation risk when they enter into certain arrangements with payday lenders, including arrangements to originate loans on terms that could not be offered directly by the payday lender.

Transaction Risk**.** Payday loans are a form of specialized lending not typically found in state nonmember institutions, and are most frequently originated by specialized nonbank firms subject to State regulation. Payday loans can be subject to high levels of transaction risk given the large volume of loans, the handling of documents, and the movement of loan funds between the institution and any third party originators. Because payday loans may be underwritten off-site, there also is the risk that agents or employees may misrepresent information about the loans or increase credit risk by failing to adhere to established underwriting guidelines.

Third-Party Risk**.** Insured depository institutions may have payday lending programs that they administer directly, using their own employees, or they may enter into arrangements with third parties. In the latter arrangements, the institution typically enters into an agreement in which the institution funds payday loans originated through the third party. These arrangements also may involve the sale to the third party of the loans or servicing rights to the loans. Institutions also may rely on the third party to provide additional services that the bank would normally provide, including collections, advertising and soliciting applications. The existence of third party arrangements may, when not properly managed, significantly increase institutions' transaction, legal, and reputation risks.

Arrangements with third parties should be guided by written contract and approved by the institution's board. At a minimum, the arrangement should:

- Describe the duties and responsibilities of each party, including the scope of the arrangement;
- Specify that the third party will comply with all applicable laws and regulations;
- Specify which party will provide consumer compliance related disclosures;
- Authorize the institution to monitor the third party and periodically review and verify that the third party and its 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 and conduct onsite transaction testing and operational reviews at the third party locations as necessary or appropriate to evaluate such compliance;
- Require the third party to indemnify the institution for potential liability resulting from action of the third party with regard to the payday lending program; and
- Address customer complaints, including any responsibility for third-party forwarding and responding to such complaints.

Bank management should sufficiently monitor the third party with respect to its activities and performance. Management should dedicate sufficient staff with the necessary expertise to oversee the third party. The bank's oversight program should monitor the third party's financial condition, its controls, and the quality of its service and support, including its resolution of consumer complaints if handled by the third party. Oversight programs should be documented sufficiently to facilitate the monitoring and management of the risks associated with third-party relationships.

Concentrations

Given the risk inherent in payday lending, concentrations of credit in this line of business pose a significant safety and soundness concern. In the context payday lending, a concentration would be defined as a volume of payday loans totaling 25 percent or more of a bank's Tier 1 capital. Where concentrations of payday lending are noted, bank management should be criticized for a failure to diversify risks. Appropriate supervisory action may be necessary to address concentrations, including directing the institution to reduce its loans to an appropriate level, raising additional capital, or submitting a plan to achieve compliance.

Capital Adequacy

Payday lending is among the highest risk subsets of subprime lending, and significantly higher levels of capital than the starting point for subprime loans - one and a half to three times what is appropriate for nonsubprime assets of a similar type - should be required. Institutions that underwrite payday loans may be required to maintain as high as one hundred percent of the loans outstanding (dollar-for-dollar capital), depending on the level and volatility of risk. Risks to consider when determining capital requirements include the unsecured nature of the credit, the relative levels of risk of default, loss in the event of default, and the level of classified assets. The degree of legal or reputation risk associated with payday lending should also be considered, especially as it relates to third party agreements.

Allowance for Loan and Lease Losses

Institutions should maintain an ALLL that is adequate to absorb estimated credit losses with the payday portfolio. Although the contractual term of each payday loan may be short, institutions' methodologies for estimating credit losses on these loans should take into account the fact that many payday loans remain continuously outstanding for longer periods because of renewals and rollovers. In addition, institutions should evaluate the collectibility of accrued fees and finance charges on payday loans and employ appropriate methods to ensure that income is accurately measured.

Classifications

The Retail Classification Policy establishes general classification thresholds for consumer loans based on delinquency, but also grants examiners the discretion to classify individual retail loans that exhibit signs of credit weakness regardless of delinquency status. Examiners also may 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.

Most payday loans have well-defined weaknesses that jeopardize the liquidation of the debt. Weaknesses include limited or no analysis of repayment capacity and the unsecured nature of the credit. In addition, payday loan portfolios are characterized by a marked proportion of obligors whose paying capacity is questionable. As a result of these weaknesses, payday loan portfolios should be classified Substandard.

Furthermore, payday loans that have been outstanding for extended periods of time evidence a high risk of loss. While such loans may have some recovery value, it is not practical or desirable to defer writing off these essentially worthless assets. Payday loans that are outstanding for greater than 60 days from origination generally meet the definition of Loss. In certain circumstances, earlier charge-off may be appropriate (i.e., the bank does not renew beyond the first payday and the borrower is unable to pay, the bank closes an account, etc.). The institution's policies regarding consecutive advances also should be considered when determining Loss classifications. Where the economic substance of consecutive advances is substantially similar to "rollovers" – without appropriate "cooling off" or waiting periods – examiners should treat these loans as continuous advances and classify accordingly.

When classifying payday loans, examiners should reference the Retail Classification Policy as the source document. Examiners would normally not classify loans for which the institution has documented adequate paying capacity of the obligors and/or sufficient collateral protection or credit enhancement.

Renewals/Rewrites

The Retail Classification Policy establishes guidelines for extensions, deferrals, renewals, or rewrites of closed-end accounts. Despite the short-term nature of payday loans, borrowers that request an extension, deferral, renewal, or rewrite should exhibit a renewed willingness and ability to repay the loan. Examiners should ensure that institutions adopt and adhere to the *Retail* Classification Policy standards that control the use of extensions, deferrals, renewals, or rewrites of payday loans. Under the Retail Classification Policy, institutions' standards should:

- Limit the number and frequency of extensions, deferrals, renewals, and rewrites;
- Prohibit additional advances to finance unpaid interest and fees and simultaneous loans to the same customer; and
- Ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained.

In addition to the above items, institutions also should:

- Establish appropriate "cooling off" or waiting periods between the time a payday loan is repaid and another application is made:
- Establish the maximum number of loans per customer that are allowed within one calendar year or other designated time period; and
- Provide that no more than one payday loan is outstanding with the bank at a time to any one borrower.

Accrued Fees and Finance Charges

Institutions should evaluate the collectibility of accrued fees and finance charges on payday loans because a portion of accrued interest and fees is generally not collectible. Although regulatory reporting instructions do not require payday loans to be placed on nonaccrual based on delinquency status, institutions should employ appropriate methods to ensure that income is accurately measured. Such methods may include providing loss allowances for uncollectible fees and finance charges or placing delinquent and impaired receivables on nonaccrual status. After a loan is placed on nonaccrual status, subsequent fees and finance charges imposed on the borrower would not be recognized in income and accrued, but unpaid fees and finance charges normally would be reversed from income.

INTRODUCTION

Overview

Securities and end-user derivatives (investment) activities can provide banks with earnings, liquidity, and capital appreciation. Carefully constructed positions can also reduce overall bank risk exposures. However, investment activities can also create considerable risk exposures, particularly:

- Market risk,
- Credit risk,
- Liquidity risk,
- Operating risk,
- Legal risk,
- Settlement risk, and
- Interconnection risk.

This section provides guidance, policy, and sound practices regarding:

- Policies, procedures and risk limits,
- Internal controls,
- Unsuitable investment activities,
- Risk Identification, measurement, and reporting,
- Board and senior management oversight,
- Compliance,
- Report of examination treatment, and
- Other guidance (trading, accounting, and information services).

Use this section to assess how effectively a bank's board and management identifies, measures, monitors, and controls investment activity risks. Incorporate findings into relevant examination assessments, including sensitivity to market risk, liquidity, asset quality, and management.

Refer to the Capital Markets Examination Handbook for reference information on a wide range of activities and instruments, including fixed income instruments, mutual funds, derivatives, sensitivity to market risk, portfolio management, and specialized examination procedures. That handbook's information focuses more closely on specific activities and instruments than this section's general guidance.

Policy Statement

The Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities (Policy Statement) was adopted by the FDIC, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Office of Thrift Supervision, and National Credit Union Administration, effective May 26, 1998. The Policy Statement provides guidance and sound principles to bankers for managing investment securities and derivatives risks. It makes clear the importance of board oversight and management supervision, and focuses on risk management. The Policy Statement covers all securities used for investment purposes and all end-user derivative instruments used for non-trading purposes. It applies to all federally-insured commercial banks, savings banks, and savings associations. Notably, the Policy Statement:

- Underscores the importance of board oversight and management supervision,
- Emphasizes effective risk management,
- Contains no specific constraints on holding "high risk" mortgage derivative products,
- Eliminates the requirement to obtain the former regulatory volatility test for mortgage derivative products, and
- Applies to all permissible investment securities and end-user derivatives.

The Policy Statement declares that banks should implement programs to manage the market, credit, liquidity, legal, operational, and other risks that result from investment activities. Adequate risk management programs identify, measure, monitor, and control these risks.

Failure to understand and adequately manage investment activity risks is an unsafe and unsound practice.

Risk Management Process Summary

This subsection provides guidance for evaluating a risk management program's effectiveness at identifying, measuring, monitoring, and controlling investment activity risks. It also includes guidance for assessing those risks relative to overall risk exposure.

Management should establish a risk management program that identifies, measures, monitors, and controls investment activity risks. Its intricacy and detail should be commensurate with the bank's size, complexity, and investment activities. Thus, the program should be tailored to the bank's needs and circumstances. Regardless, an effective risk management program will include the following processes:

- The board should adopt policies that establish clear goals and risk limits.
- The board should review and act upon management's reports.

- The board should establish an independent review function and review its reports.
- Management should develop investment strategies to achieve the board's goals.
- Management should analyze and select investments consistent with its strategies.
- Management should maintain an effective internal control program.
- Management should regularly measure the portfolio's risk levels and performance.
- Management should provide periodic reports to the board.
- The board and management should periodically evaluate and, when warranted, modify the program.

The following sections of the guidance cover each of the above steps in greater detail.

Management must determine, consistent with board policy, how investment activity risks will be managed. The Policy Statement provides considerable flexibility by permitting banks to manage risk on an individual instrument basis, on an aggregate portfolio basis, or on a whole bank basis.

Banks that engage in less complex activities may effectively manage investment activity risk on an individual instrument basis. That is, each instrument's risk and return is evaluated independently. An instrument's contribution to overall portfolio risk and return may only be considered in general terms. This approach requires rather specific individual instrument risk limits, but typically does not involve aggregate portfolio analysis.

Banks with complex or extensive investment activities should strongly consider the portfolio approach for managing investment activity risk. Under a portfolio approach, management evaluates an instrument's contribution to overall portfolio risk and return. It requires portfolio risk limits and a system for aggregating and measuring overall portfolio risk and return. More complex aggregate portfolio risk and return measurements should be incorporated into overall interest rate risk or asset/liability management programs.

In recommending that all banks *consider* portfolio or whole bank risk management, the Policy Statement notes that such approaches generally provide certain advantages over the individual instrument approach, including:

- Integrated management of risk and return
- Understanding of each instrument's contribution to overall risk and return
- Increased flexibility when selecting instruments

POLICIES, PROCEDURES, AND RISK LIMITS

Policies

The board is responsible for adopting comprehensive, written investment policies that clearly express the board's investment goals and risk tolerance. Policies should be tailored to the bank's needs and should address:

- The board's investment goals,
- Authorized activities and instruments,
- Internal controls and independent review,
- Selecting broker/dealers,
- Risk limits,
- Risk and performance measurement,
- Reporting, and
- Accounting and taxation.

At most banks, the investment portfolio serves as a secondary source of both earnings and liquidity. At some banks, the investment portfolio is a primary earnings component. The policies should articulate the investment portfolio's purpose, risk limits, and return goals. Return goals should express the board's earnings objectives for the investment portfolio. The board may also establish portfolio performance targets.

Policies should describe all authorized investment activities and set guidelines for new products or activities. Further, policies should delegate investment authority, including naming specific personnel. The board's approved policies should also provide management with general guidelines for selecting securities broker/dealers and limiting broker/dealer credit risk exposure.

The bank should have policies that ensure an understanding of the market risks associated with investment securities and derivative instruments before purchase. Accordingly, banks should have policies that define the characteristics of authorized instruments. The policy should sufficiently detail the characteristics of authorized instruments. For example, a policy that merely authorizes the purchase of agency securities would not be sufficiently detailed. The price sensitivities of agency pass-throughs, step-up structured notes, agency callable debt or leveraged inverse floaters are very different. Therefore, the policy should delineate the authorized types of agency securities that may be purchased. Management should analyze the risks in an instrument that has not been authorized and should seek the board's permission to alter the list of authorized instruments before purchase.

Banks should have policies that specify the analysis of the risk of an investment that must be conducted prior to purchase. The pre-purchase analysis is meant to discover and quantify all relevant risks in the investment. Not all investments will require pre-purchase analysis. Relatively simple or standardized instruments, the risks of which are well known to the bank, would likely require no or significantly less analysis than would more complex or volatile instruments. Policies should delineate which of the authorized investments do not require pre-purchase analysis.

The list of authorized instruments may include instruments of varying characteristics. Policies should divide the spectrum of authorized investments into segments of instruments of similar risk characteristics. Policies should also require appropriate pre-purchase analysis for each segment.

Risk Limits

To effectively oversee investment activities, the board must approve the bank's risk limits. Management should set these risk limits, consistent with the board's goals, objectives, and risk appetite. The risk limits should be formally approved and incorporated within the board's policies. Limits may be expressed in terms of bank-wide risk, investment portfolio risk, portfolio segment risk, or even individual instrument risk.

Risk limits should be consistent with the bank's strategic plans and overall asset/liability management objectives. Limits should be placed on:

- Market risk,
- Credit risk,
- Liquidity risk,
- Asset types, and
- Maturities.

At a minimum, risk limits should be expressed relative to meaningful standards, such as capital or earnings. More complex investment activities may require more detailed risk limits.

Market risk limits should at least quantify maximum permissible portfolio or individual instrument price sensitivity as percentage of capital or earnings. Capital-based risk limits clearly illustrate the potential threat to the bank's viability, while earnings-based limits reflect potential profitability effects. In addition, the board may choose to establish limits relative to earnings, total assets, total investment securities, or other standards.

Credit risk limits should generally restrict management to investment grade instruments. The board may permit management to acquire nonrated instruments; however, these instruments should be consistent with investment grade standards. For example, management may wish to purchase a nonrated bond issued by a local municipality. Regardless, the board should carefully monitor such activity.

Liquidity risk limits should restrict positions in less marketable instruments. These limits should apply to securities that management would have difficulty selling at or near fair value. Less marketable instruments may not meet the board's investment goals, and holdings should generally be small. Obscure issues, complex instruments, defaulted securities, and instruments with thin markets may all have limited liquidity.

Asset type limits should limit concentrations in specific issuers, market sectors, and instrument types. These limits will require management to diversify the portfolio. When properly diversified, a portfolio can have lower risk for a given yield or can earn a higher yield for a given risk level. For example, the board may limit total investment in a particular instrument type to a specific percentage of capital.

Maturity limits should place restrictions on the maximum stated maturity, weighted average maturity, or duration of instruments that management may purchase. Longer-term securities have greater interest rate risk, price risk, and cash flow uncertainty than shorter-term instruments possess. Therefore, maturity limits should complement market risk limits, liquidity risk limits, and the board's investment goals.

In addition, management should establish a standard risk measurement methodology. The measurement system must capture all material risks and accurately calculate risk exposures. Management should provide the board with consistent, accurate risk measurements in a format that directly illustrates compliance with the board's risk limits. Refer to the Risk and Performance Measurement subsection for additional guidance.

INTERNAL CONTROLS

Internal Control Program

Effective internal controls are the first line of defense in supervising investment activity operating risks. Ineffective controls can lead to bank failures. Consequently, examiners will carefully evaluate the internal control program. Examiners will emphasize separation of duties between the individuals who execute, settle, and account for transactions.

The internal control program should be commensurate with the volume and complexity of the investment activity conducted, and should be as independent as practical from related operations.

The board has responsibility for establishing general internal control guidelines, which management should translate into clear procedures that govern daily operations. Management's internal control program should include procedures for the following:

- Portfolio valuation,
- Personnel,
- Settlement,
- Physical control and documentation,
- Conflict of interest,
- Accounting,
- Reporting, and
- Independent review.

Internal controls should promote efficiency, reliable internal and regulatory reporting, and compliance with regulations and bank policies.

Portfolio valuation procedures should require independent portfolio pricing. The availability of independent pricing provides an effective gauge of the market depth for thinly traded instruments, allowing management to assess the potential liquidity of specific issues. For these and other illiquid or complex instruments, completely independent pricing may be difficult to obtain. In such cases, estimated or modeled values may be used. However, management should understand and agree with the methods and assumptions used to estimate value.

Personnel guidelines should require sufficient staffing resources and expertise for the bank's approved investment activities.

Settlement practices should be evaluated against the guidelines provided in the Settlement Practices, Confirmation and Delivery Requirements, and Delivery Documentation Addenda.

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Physical control and documentation requirements should include:

- Possessing and controlling purchased instruments,
- Saving and safeguarding important documents, and
- Invoice review.

Invoice review requirements should address standards for all securities and derivatives sold or purchased. Invoices and confirmations display each instrument's original purchase price, which provides a basis to establish book value and to identify reporting errors. Invoice reviews can also be used when determining if the bank is involved in any of the following inappropriate activities:

- Engaging one securities dealer or representative for virtually all transactions.
- Purchasing from or selling to the bank's trading department.
- Unsuitable investment practices (refer to following page.).
- Inaccurate reporting.

Conflict of interest guidelines should govern all employees authorized to purchase and sell securities for the bank. These guidelines should ensure that all directors, officers, and employees act in the bank's best interest. The board should adopt polices that address authorized employees' personal relationships, including securities transactions, with the bank's approved securities broker/dealers. The board may also adopt policies that address the circumstances under which directors, officers, and employees may accept gifts, gratuities, or travel expenses from securities broker/dealers and associated personnel.

Accounting practices should be evaluated against the standards, opinions, and interpretations listed in this section.

Reporting procedures should be evaluated against the guidelines discussed in the Risk Reporting subsection Risk Identification, Assessment and Reporting.

Independent review of the risk management program should be conducted at regular intervals to ensure the integrity, accuracy, and reasonableness of the program. Independent review may encompass external audits or an internal audit program. At many banks, however, evaluation by personnel independent of the portfolio management function will suffice. The independent review program's scope and formality should correspond to the size and complexity of the bank's investment activities. Independent review of investment activity should be at least commensurate with the independent review of other primary bank activities. It should assess:

- Adherence to the board's policies and risk limits,

- The risk measurement system's adequacy and accuracy,
- The reporting system's timeliness, accuracy, and usefulness,
- Personnel resources and capabilities,
- Compliance with regulatory standards,
- The internal control environment,
- Accounting and documentation practices, and
- Conflicts of interest.

Banks with complex investment activities should consider augmenting the independent review with internal or external auditors, while banks with less complex investment activities may rely on less formal review. Sophisticated risk measurement systems, particularly those developed in-house, should be independently tested and validated.

Independent review findings should be reported directly to the board at least annually. The board should carefully review the independent review reports and ensure that material exceptions are corrected.

Examiners will evaluate the independent review's scope and veracity, and will rely on sound independent review findings during examinations. However, when the independent review is unsatisfactory, examiners will perform review procedures to reach independent conclusions. When warranted, examiners will conduct a detailed review of all investment activities.

UNSUITABLE INVESTMENT ACTIVITIES

Trading activity within the held-to-maturity (HTM) or available-for-sale (AFS) portfolio is an unsuitable investment activity and may be considered unsafe and unsound. Each of the following activities are unsuitable within the HTM or AFS portfolio, and any resulting securities acquisitions should be reported as trading assets. The bank's internal control program should be designed to prevent the following unsuitable investment activities:

- Gains trading,
- When-issued securities,
- Pair-offs,
- Extended settlement,
- Repositioning repurchase agreement, and
- Adjusted trading.

Gains trading is the purchase and subsequent sale of a security at a profit after a short holding period, while securities acquired for this purpose that cannot be sold at a profit are retained in the AFS or HTM portfolio. Gains trading may be intended to defer loss recognition, as unrealized losses on debt securities in such categories do not directly affect regulatory capital and generally are not reported in income until the security is sold.

Examiners should scrutinize institutions with a pattern of reporting significant amounts of realized gains on sales of non-trading securities (typically, AFS securities) after short holding periods while continuing to hold other non-trading securities with significant amounts of unrealized losses. If, in the examiner's judgment, such a practice has occurred, the examiner should consult with the Regional Office for additional guidance on whether some or all of the securities reported outside of the trading category will be designated as trading assets.

When-issued securities trading is the buying and selling of securities in the period between the announcement of an offering and the issuance and payment date of the securities. A purchaser of a when-issued security acquires the risks and rewards of owning a security and may sell the when-issued security at a profit before having to take delivery and pay for it.

Pair-offs are security purchase transactions that are closed-out or sold at or before the settlement date. In a pair-off, an institution commits to purchase a security. Then, before the predetermined settlement date, the bank pairs-off the purchase with a sale of the same security. Pair-offs are settled net when one party to the transaction remits the difference between the purchase and sale price to the counterparty. Pair-offs may also involve the same sequence of events using swaps, options on swaps, forward commitments, options on forward commitments, or other off-balance sheet derivative contracts.

Extended Settlement is the use of a securities trade settlement period in excess of the regular-way settlement period. Regular-way settlement for U.S. Government and Federal agency securities (except mortgage-backed securities and derivative contracts) is one business day after the trade date. Regular-way settlement for corporate and municipal securities is three business days after the trade date, and for mortgage-backed securities it can be up to 60 days or more after the trade date. The use of a settlement period in excess of the regular-way settlement period to facilitate speculation is considered a trading activity.

A **repositioning repurchase agreement** is offered by a dealer to allow an institution that has entered into a when-issued trade or a pair-off (which may include an extended settlement) that cannot be closed out at a profit on the payment or settlement date to hold its **speculative** position until the security can be sold at a gain. The institution purchasing the security pays the dealer a small margin that approximates the actual loss in the security. The dealer then agrees to fund the purchase of the security by buying it back from the purchaser under a resale agreement. Any securities acquired through a dealer financing technique such as a repositioning repurchase agreement that is used to fund the speculative purchase of securities should be reported as trading assets.

A **short sale** is the sale of a security that is not owned. The purpose of a short sale generally is to speculate on a fall in the price of the security. Short sales should be conducted in the trading portfolio. A short sale that involves the delivery of the security sold short by borrowing it from the depository institution's AFS or HTM portfolio should not be reported as a short sale. Instead, it should be reported as a sale of the underlying security with gain or loss recognized in current earnings.

Adjusted trading involves the sale of a security to a broker or dealer at a price above the prevailing market value and the simultaneous purchase and booking of a different security, frequently a lower rated or quality issue or one with a longer maturity, at a price above its market value. Thus, the dealer is reimbursed for losses on the purchase from the institution and ensured a profit. Such transactions inappropriately defer the recognition of losses on the security sold and establish an excessive cost basis for the newly acquired security. Consequently, such transactions are prohibited and may be in violation of 18 U.S.C. Sections 1001-False Statements or Entries and 1005-False Entries.

RISK IDENTIFICATION, MEASUREMENT, AND REPORTING

Risk Identification

All investment activities create risk exposures, but the risk types and levels depend upon the activity conducted. The following guidance summarizes the major risk exposures. Refer to the Capital Markets Examination Handbook for additional guidance on specific instruments, markets, and strategies.

Market risk is the possibility that an instrument will lose value due to a change in the price of an underlying instrument, change in the value of an index of financial instruments, changes in various interest rates, or other factors. Frequently, an instrument will increase a bank's market risk due to price volatility, embedded options, leverage factors, or other structural factors. The three principal types of market risk are price risk, interest rate risk and basis risk.

<u>Price risk</u> is the possibility that an instrument's price fluctuation will unfavorably affect income, capital, or risk reduction strategies. Price risk is usually influenced by other risks. For example, a bond's price risk could be a function of rising interest rates, while a currency-linked note's price risk could be a function of devaluation in the linked currency.

<u>Interest rate risk</u> is the possibility that an instrument's value will fluctuate in response to current or expected market interest rate changes.

<u>Yield curve risk</u> is the possibility that an instrument's value will fluctuate in response to a nonparallel yield curve shift. Yield curve risk is a form of interest rate risk.

<u>Basis risk</u> is the possibility that an instrument's value will fluctuate at a rate that differs from the change in value of a related instrument. For example, three-month Eurodollar funding is not perfectly correlated with Treasury bill yields. This imperfect correlation between funding cost and asset yield creates basis risk.

Credit risk is the possibility of loss due to a counterparty's or issuer's default, or inability to meet contractual payment terms. The amount of credit risk equals the replacement cost (also referred to as *current exposure*) of an identical instrument. The replacement cost is established by assessing the instrument's current market value rather than its value at inception.

In addition, default exposes a bank to market risk. After default, losses on a now unhedged position may occur before the defaulted hedge instrument can be replaced. Such losses would have been largely (or completely) offset if the counterparty had not defaulted.

Exchange-traded derivatives (futures, options, and options on futures) contain minimal credit risk. These instruments are marked-to-market at the end of each trading day, or on an intra-day basis, by the exchange clearinghouse. Position value changes are settled on a cash basis at least daily. To reduce credit risk, all exchange participants must post a performance bond or maintain margin with the exchange. Many over-the-counter (OTC) transactions use collateral agreements. OTC transaction collateral agreements can be one- or two-sided (only one party is required to post collateral on out-of-the-money positions, or both are required to post such collateral). Netting and collateral agreements and their specific terms can materially reduce credit risk exposure. For additional explanation of the treatment of netting for capital calculations, refer to Part 325 of the FDIC Rules and Regulations.

In managing credit exposure, institutions should consider settlement and pre-settlement credit risk. The selection of dealers, investment bankers, and brokers is particularly important in effectively managing these risks. When selecting a dealer, investment banker, or broker, management should, at a minimum:

- Review each firm's most current financial statements, such as annual reports and credit reports, and evaluate its ability to honor its commitments.
- Inquire into the general reputation of the firm by contacting previous or current customers.
- Review information from State or Federal securities regulators and industry self-regulatory organizations such as NASD Regulation, Inc., concerning any formal enforcement actions against the dealer, its affiliates, or associated personnel.

Liquidity risk is the possibility that an instrument cannot be obtained, closed out, or sold at (or very close to) its economic value. As individual markets evolve, their liquidity will gradually change, but market liquidity can also fluctuate rapidly during stress periods. In some markets, liquidity can vary materially during a single day. Some markets are liquid for particular maturities or volumes, but are illiquid for others. For example, the Eurodollar futures market is liquid for contracts with maturities up to four years, but liquidity decreases for greater maturities (although maturities of up to 10 years are listed).

Many instruments trade in established secondary markets with a large number of participating counterparties. This ensures liquidity under normal market conditions. However, uniquely tailored or more thinly traded products may not have sufficient supply, demand, or willing counterparties in periods of market stress.

Operational risk is the possibility that inadequate internal controls or procedures, human error, system failure or fraud can cause losses. Operating risk can result in unanticipated open positions or risk exposures that exceed established limits.

Legal risk is the possibility that legal action will preclude a counterparty's contractual performance. Legal risk may occur when a contract or instrument violates laws or regulations. Legal risk may also occur when a law or regulation prohibits a counterparty from entering into a particular contract, or if an individual is not authorized to execute transactions on behalf of the counterparty. Banks should ensure that all agreements are enforceable and that counterparties can legally enter into specific transactions.

Settlement risk is the possibility of loss from a counterparty that does not perform after the investor has delivered funds or assets (before receiving the contractual proceeds). Settlement risk may result from time differences between foreign counterparties, delivery that is not synchronized with payment, or method of payment delays. Few transactions are settled on a real-time basis, and any delay in receiving funds or assets after delivering funds or assets will create settlement risk.

The most famous settlement risk example occurred in the foreign exchange markets. German regulators closed Bankhaus Herstatt after it had received deutschemarks on its foreign exchange trades, but before it had sent out its currency payments. Settlement risk is sometimes referred to as Herstatt risk.

Interconnection risk is the possibility of loss due to changes in interest rates, indices or other instrument values that may or may not be held by the investor. Cash flows associated with an instrument may be directly or indirectly tied to a number of other rates, indices or instrument values. These interconnections frequently involve cross-border and cross-market links and a wide range of individual financial instruments.

For example, a U.S. dollar denominated structured note may have a coupon formula linked to a currency exchange rate. Structured notes with coupon payments linked to the relationship between the Mexican peso and the U.S. dollar fell substantially in value when the peso fluctuated in the wake of the assassination of a Mexican presidential candidate.

Risk Measurement

Effective investment activity oversight requires accurate risk measurement. Without periodic assessments, management can not determine the success of its investment strategies. Further, the board can not determine if management has achieved the board's goals or complied with its policies.

Risk measurement should be tailored to the cash flow characteristics of each particular instrument type. For example, a mortgage derivative product should be given far more sophisticated analysis than a U.S. Treasury bill. Management's analysis should focus on risk, return, and compliance with risk limits.

Authorized investment instruments should be segregated into groups of like risk characteristics. There will likely be a group of relatively simple or standardized instruments, the risks of which are well known to the bank, which will require no pre-purchase analysis. All other authorized instruments will require pre-purchase analysis. It is important that these groups be well defined and that the pre-purchase analysis is tailored to capture the risks of the instruments. For example, it would not be appropriate to group dual-indexed structured notes with agency pass-throughs. The characteristics of these two types of instruments are different and each will require separate and distinct pre-purchase analysis. It would also not be appropriate to group simple agency pass-throughs with inverse floater collateralized mortgage obligations (CMOs). The inverse floaters are not only subject to similar prepayment optionality as the pass-throughs but also contain leverage and vastly different cash flow characteristics.

In addition to pre-purchase analysis, management should also periodically monitor investment portfolio risks. As with pre-purchase analysis, this periodic analysis should identify and measure the instrument's or the portfolio's risk characteristics. Management can perform this periodic analysis on an individual instrument basis or total portfolio (or bank) basis.

The market risk measurement system used to conduct pre-purchase analysis and periodic monitoring should be commensurate with the size and nature of the investment portfolio. For detailed comments regarding the types of risk measurement systems, refer to the Sensitivity to Market Risk section of this Manual. The risk measurement system should identify and measure all material risks. Management should translate its measurements into results that illustrate compliance with the board's risk limits. For example, to measure market risk the system should:

- Identify and measure the price sensitivity of embedded options (modified and Macaulay duration measures do not capture option risk).[1]
- Use interest rate shocks large enough to measure realistic potential market movements and risk (such as 100, 200, and 300 basis points).
- Include adjustments (for example, convexity) to accurately measure price changes when interest rate movements exceed 100 basis points.[2]
- Subject instruments to nonparallel interest rate shocks when those instruments are exposed to risk from changes in the yield curve's shape.

While management may measure risk and performance on an individual instrument basis, broader risk management should be considered. Management may aggregate individual instrument risk and return measurements to produce risk and return results for the entire investment portfolio. Portfolio results may then be aggregated into the bank's overall interest rate risk measurement system. Aggregation does not necessarily require complex systems. Management may simply combine individual instrument results to calculate portfolio analysis, or use portfolio results to compile whole bank analysis. Examiners should coordinate risk aggregation review with the staff completing the Sensitivity to Market Risk review.

Risk Reporting

To properly exercise its oversight responsibilities, the board must review periodic investment activity reports. The board should require management to periodically provide a complete investment activity report. Report frequency and substance should be commensurate with the portfolio's complexity and risk profile. Management's reports to the board should:

- Summarize all investment activity,
- Clearly illustrate investment portfolio risk and return,
- Evaluate management's compliance with the investment policy and all risk limits, and
- List exceptions to internal policy and regulatory requirements.

Management should receive reports that contain sufficient detail to comprehensively and frequently assess the portfolio.

Management should regularly ensure compliance with internal policies and regulatory requirements. In addition, management should periodically evaluate portfolio performance. The board should review and consider each policy exception. Management should present exceptions for approval before engaging in an unauthorized activity. Recurring exceptions should prompt close scrutiny from the board. When warranted, the board may consider changing its policies to permit an activity. The board should take strong action when management fails to seek prior approval for an unauthorized activity.

[1] Macaulay duration is the weighted average term to maturity of a security's cash flows. Modified duration is a measurement of the change in the value of an instrument in response to a change in interest rates. Refer to the Capital Markets Examination Handbook for additional information.

[2] Convexity is a measure of the way duration and price change when interest rates change. Refer to the Capital Markets Examination Handbook for additional information.

BOARD AND SENIOR MANAGEMENT OVERSIGHT

Board Oversight

Throughout this guidance, "board" references either the board or directors or a designated board committee. Board oversight is vital to effective investment risk management, and the board has very specific investment activity responsibilities. The board should adopt policies that establish guidelines for management and periodically review management's performance. The board should:

- Approve broad goals and risk limits,
- Adopt major investment and risk management policies,
- Understand the approved investment activities,
- Ensure competent investment management,
- Periodically review management's investment activity,
- Require management to demonstrate compliance with the board's goals and risk limits, and
- Mandate an independent review program and review its findings.

Senior Management Oversight

Management is responsible for daily oversight of all investment activity. Management should:

- Establish policies, procedures, and risk limits to achieve the board's goals,
- Implement operational policies that establish a strong internal control environment,
- Understand all approved investment activities and the related risks,
- Identify, measure, monitor, and control investment activity risks,
- Report investment activity and risks to the board;,
- Ensure that its staff is competent and adequately trained, and
- Adhere to securities broker/dealer selection policies.

Investment activity risk is not effectively managed if the board and management do not fulfill their responsibilities. Ineffective risk management can be an unsafe and unsound practice. While the board or management may obtain professional advice to supplement their understanding of investment activities and risks, their responsibilities can not be transferred to another party. The board and senior management should also periodically evaluate and, when warranted, modify the risk management process.

Investment Strategies

Management should employ reasonable investment strategies to achieve the board's portfolio objectives. A strategy is a set of plans that management uses to direct daily portfolio operations. In order to develop sound strategies, management must understand the board's goals, applicable risk limits, and related instruments and markets. Investment strategies should also be consistent with the following:

- Overall strategic goals,
- Capital position,
- Asset/liability structure,
- Earnings composition, and
- Competitive market position.

Strategies will vary widely between banks, ranging from simple to extremely complex. However, any strategy should be documented, reasonable, and supportable. Examiners will evaluate strategies to determine their effect on risk levels, earnings, capital, liquidity, asset quality, and overall safety and soundness. Additional guidance on investment strategies and market risk modification strategies is provided in this section under the headings Investment Strategies and the Market Risk Modification respectively.

Delegation of Investment Authority

Investment authority may be delegated to a third party, with specific board approval. Regardless of whether the board's policies permit management to delegate investment authority to a third party, management must understand every investment's risk, return, and cash flow characteristics. To conduct its independent analysis, management may rely on information and industry standard analysis tools provided by the broker/dealer, provided that:

- The analysis uses reasonable calculation methods and assumptions,
- Management understands the analysis and assumptions, and
- Management's investment decisions remain independent.

If management does not understand an investment's risk characteristics, then management should not engage in that activity until it possesses the necessary knowledge. Failure to adequately understand and manage investment activity risks constitutes an unsafe and unsound practice.

Before delegating investment authority to a third party, management should thoroughly evaluate the third party's reputation, performance, creditworthiness, and regulatory background. Any third party arrangement should be governed by a formal written agreement that specifies:

- Compensation,
- Approved broker/dealers,
- Investment goals,
- Approved activities and investments,
- Risk limits,
- Risk and performance measurement,
- Reporting requirements,
- Settlement practices, and
- Independent review.

In addition, written agreements should require that all trade invoices, safekeeping receipts, and investment analyses are readily available to the bank.

Program Evaluation

Periodically, the board and management should evaluate the risk management program to ensure that its investment activities reasonably meet the board's goals and the bank's strategic needs. Without such an assessment, the board and management cannot prudently oversee investment activities. The scope and detail of the evaluation should correspond to the bank's size, complexity, and investment activities. At most banks, annual evaluations should be sufficient. In larger or more complex banks, quarterly (or more frequent) evaluation may be necessary.

The board should review management's reports, including an investment activity summary, portfolio risk and performance measures, and independent review findings to identify broad weaknesses and determine if:

- Stated goals accurately represent the board's objectives,
- Risk limits properly reflect the board's risk tolerance,
- Risk limits reasonably protect the bank's safety and soundness,
- Management has appropriately pursued the board's goals,
- Internal controls remain adequate,
- Any new activities are warranted, and
- Policies provide sufficient guidance for management.

The board should first consider the bank's current and expected condition, competitive environment, and strategic plans. Then, the board should reassess its portfolio goals to ensure that they do not conflict with the overall strategic plan. When necessary, the board should adjust its portfolio goals.

After evaluating its goals, the board should then affirm that the existing risk limits accurately reflect the board's risk tolerance. When warranted, the board should consider either relaxing or tightening the risk limits placed on management. Before altering its risk limits, the board should discuss the effects of accepting increased or reduced risk. The board should consider if increased or diminished risk would produce satisfactory returns.

In addition, the board should evaluate management's performance. That review should encompass management's success at achieving the board's goals, adherence to policies and risk limits, and maintenance of an effective control environment. The board should determine the cause of any material deficiencies and obtain management's commitment to rectify those deficiencies.

Finally, the board should determine if any changes to its policies are warranted. For example, management may request authority to engage in new investment activities. The board should carefully consider such requests and determine if the proposed activity comports with its investment goals and risk tolerance.

Management should review the portfolio management program in more detail to identify both broad and specific weaknesses. Management's responsibilities include:

- Measuring portfolio risk and performance,
- Validating risk measurement systems' adequacy and accuracy,
- Reporting portfolio activity and performance to the board,
- Adjusting investment strategies to better achieve the board's goals, and
- Correcting policy and regulatory exceptions.

At many banks, the periodic evaluation will result in few program alterations. Less complex programs will naturally require fewer modifications than more complex programs. Successful programs will similarly need fewer changes than unsuccessful programs. Examiners will assess the periodic evaluations to determine if the board and management effectively oversee the portfolio management process.

COMPLIANCE

Permissible Activities

Part 362 of the FDIC's Rules and Regulations, "Activities and Investments of Insured State Banks," (Part 362) implements Section 24 of the Federal Deposit Insurance Act. Part 362 generally prohibits investment activities that are not permissible for national banks, with certain exceptions. National bank investment activities are governed by the National Bank Act (12 USC 21 et seq.) and Office of the Comptroller of the Currency (OCC) regulations (12 CFR Part 1). 12 CFR Part 1 outlines five general types of investments that are permissible for national banks. A copy of the updated rule may be found at the OCC's Internet site, http://www.occ.treas.gov/ftp/regs/part1a.txt.

In limited circumstances, the FDIC may grant an exception to Part 362, on a case-by-case basis, if the FDIC determines that:

- The activity presents no significant risk to the deposit insurance fund, and
- The bank complies with the FDIC's capital regulations.

While Part 362 contains investment type restrictions, it does not include the investment amount restrictions that apply to national banks.

REPORT OF EXAMINATION TREATMENT

Adverse Classification

Examiners may adversely classify subinvestment quality securities and off-balance sheet derivatives in the Report of Examination. Any classifications should be consistent with the Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts. This Agreement addresses the examination treatment for adversely classified assets and:

- Provides definitions of the Substandard, Doubtful, and Loss categories used for criticizing bank and thrift assets,
- Defines characteristics of investment quality and subinvestment quality securities.,
- Establishes specific guidance for the classification of subinvestment quality debt securities and other-than-temporary impairment on investment quality debt securities, and
- Provides examiners discretion in classifying debt securities beyond a ratings-based approach in certain cases.

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

Doubtful assets have all the weaknesses found in Substandard assets, with the added characteristic that the weaknesses make collection or liquidation in full (on the basis of currently existing facts, conditions, and values) highly questionable and improbable.

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

Investment quality debt securities are marketable obligations in which the investment characteristics are not distinctly or predominantly speculative. This group generally includes investment securities in the four highest rating categories provided by nationally recognized statistical rating organizations (NRSROs) and unrated debt securities of equivalent quality. The Securities and Exchange Commission (SEC) lists the following as NRSROs:

- Dominion Bond Rating Service Ltd.,
- Fitch, Inc.,
- Moody's Investors Service, and
- Standard & Poor's Division of the McGraw Hill Companies Inc.

(Check the SEC's website to find the most current list of NRSROs).

When two or more NRSROs list different credit ratings for the same instrument, examiners will generally base their assessments on the more recently issued ratings.

Since investment quality debt securities do not exhibit weaknesses that justify an adverse classification rating, examiners generally will not classify them. However, published credit ratings occasionally lag demonstrated changes in credit quality and examiners may, in limited cases, classify a security notwithstanding an investment grade rating.

Some debt securities may have investment quality ratings by one (or more) rating agencies and sub-investment quality ratings by others. Examiners will generally classify such securities, particularly when the most recently assigned rating is not investment quality. However, an examiner has discretion to "pass" a debt security with both investment and sub-investment quality ratings. The examiner may use that discretion if, for example, the institution has demonstrated through its documented credit analysis that the security is the credit equivalent of investment grade.

Some individual debt securities have ratings for principal, but not interest. The absence of a rating for interest typically reflects uncertainty regarding the source and amount of interest the investor will receive. Because of the speculative nature of the interest component, examiners will generally classify such securities, regardless of the rating for the principal.

Non-rated debt securities have no ratings from a NRSRO and the FDIC expects institutions holding individually large non-rated debt security exposures, or having significant aggregate exposures from small individual holdings, to demonstrate that they have made prudent pre-acquisition credit decisions and have effective, risk-based standards for the ongoing assessment of credit risk. Examiners will review the institution's program for monitoring and measuring the credit risk of such holdings and, if the assessment process is considered acceptable, generally will rely upon those assessments during the examination process. If an institution has not established independent risk-based standards and a satisfactory process to assess the quality of such exposures, examiners may classify such securities, including those of a credit quality deemed to be the equivalent of subinvestment grade, as appropriate.

Some non-rated debt securities held in investment portfolios represent small exposures relative to capital, both individually and in aggregate. While institutions generally have the same supervisory requirements (as applicable to large holdings) to show that these holdings are the credit equivalent of investment grade at purchase, comprehensive credit analysis subsequent to purchase may be impractical and not cost effective. For such small individual exposures, institutions should continue to obtain and review available financial information, and assign risk ratings. Examiners may rely upon the bank's internal ratings when evaluating such holdings.

Foreign debt securities are often assigned transfer risk ratings for cross border exposures from the Interagency Country Exposure Review Committee (ICERC). However, examiners should use the guidelines in the Uniform Agreement rather than ICERC transfer risk ratings in assigning security classifications, except when the ICERC ratings result in a more severe classification.

Subinvestment quality debt securities are those in which the investment characteristics are distinctly or predominantly speculative. This group generally includes debt securities, including hybrid equity instruments (i.e. trust preferred securities), in grades below the four highest rating categories, unrated debt securities of equivalent quality, and defaulted debt securities.

Other Types of Securities such as certain equity holdings or securities with equity-like risk and return profiles, have highly speculative performance characteristics. Examiners should generally classify such holdings based upon an assessment of the applicable facts and circumstances.

Treatment of Declines in Fair Value

Under generally accepted accounting principles (GAAP), an institution must assess whether a decline in fair value below the amortized cost of a security – that is, the depreciation on the security – is a "temporary" or "other-than-temporary" impairment. When the decline in fair value on an individual security represents other-than-temporary impairment, the cost basis of the security must be written down to fair value, thereby establishing a new cost basis for the security, and the amount of the write-down must be reflected in current period earnings. This new cost basis should not be adjusted through earnings for subsequent recoveries in fair value. If an institution's process for assessing impairment is considered acceptable, examiners may use those assessments in determining the appropriate classification of declines in fair value below amortized cost on individual debt securities.

Any decline in fair value below amortized cost on defaulted debt securities will be classified as indicated in the General Debt Security Classification Guidelines Table following. Apart from classification, for impairment write-downs or charge-offs on adversely classified debt securities, the existence of a payment default will generally be considered a presumptive indicator of other-than-temporary impairment.

The following table outlines the uniform classification approach the agencies will generally use when assessing credit quality in debt securities portfolios:

General Debt Security Classification Guidelines Table			
Security Type	**Classification**		
	Substandard	***Doubtful***	***Loss***
Investment quality debt securities with "temporary" impairment	----	----	----
Investment quality debt securities with "other than temporary" impairment	----	----	Impairment
Subinvestment quality debt securities with "temporary" impairment	Amortized Cost	----	----
Subinvestment quality debt securities with "other than temporary" impairment, including defaulted debt securities.	Fair Value	----	Impairment
NOTE: Impairment is the amount by which amortized cost exceeds fair value.			

The General Debt Security Classification Guidelines do not apply to private debt and equity holdings in a small business investment company or Edge Act Corporation. The Uniform Agreement does not apply to securities held in trading accounts, provided the institution demonstrates through its trading activity a short term holding period or holds the security as a hedge for a valid customer derivative contract.

Examiner Discretion in Classifying Securities

Examiners may assign a more or less severe classification for an individual debt security than would otherwise apply based on the security's rating depending upon a review of applicable facts and circumstances. However, examiners may not assign a Loss classification to the depreciation on an individual debt security when this impairment is determined to be temporary. Examiners have discretion to "pass" a debt security with both investment and sub-investment quality ratings. For an investment quality debt, examiners have the discretion to assign a more severe classification when justified by credit information the examiner believes is not reflected in the rating, to properly reflect the security's credit risk. As mentioned above, published credit ratings occasionally lag demonstrated changes in credit quality and examiners may, in limited cases, classify a security notwithstanding an investment grade rating.

Furthermore, examiners may in limited cases "pass" a debt security that is rated below investment quality. For example, when the institution has an accurate and robust credit risk management framework and has demonstrated, based on recent, materially positive, credit information, and properly documented credit analysis, that the security is the credit equivalent of investment grade, examiners have the discretion to "pass" the security, irrespective of the rating.

When an institution has developed an accurate, robust, and documented credit risk management framework to analyze its securities holdings, examiners can depart from the General Guidelines in favor of individual asset review in determining whether to classify those holdings. A robust credit risk management framework entails appropriate pre-acquisition credit due diligence by qualified staff that grades a security's credit risk based upon an analysis of the repayment capacity of the issuer and the structure and features of the security. It also involves the continual monitoring of holdings to ensure that risk ratings are reviewed regularly and updated in a timely fashion when significant new information is received.

The credit analysis of securities should vary based on the structural complexity of the security, the type of collateral and external ratings. The credit risk management framework should reflect the size, complexity, quality, and risk characteristics of the securities portfolio, the risk appetite and policies of the institution, and the quality of its credit risk management staff, and should reflect changes to these factors over time. Policies and procedures should identify the extent of credit analysis and documentation required to satisfy sound credit risk management standards.

Subinvestment Quality Available-for-Sale (AFS) Debt Securities

Consistent with Statement of Financial Accounting Standards (FAS) 115, AFS debt securities are "marked-to-market" and carried at their fair value on the balance sheet for regulatory reporting purposes. The unrealized holding gains (losses) on these securities, net of tax effects, are excluded from earnings and reported in a separate component of equity capital on the balance sheet. However, for purposes of determining a bank's regulatory capital under Part 325 of the FDIC's regulations, any unrealized holding gains (losses) on these AFS debt securities that are included in the separate equity capital component generally are ignored. As a result, any amortized cost amount in excess of fair value on an AFS debt security – that is, the amount of impairment or depreciation – normally is not deducted in determining regulatory capital.

However, in order to appropriately reflect in regulatory capital calculations the effect of any depreciation on a subinvestment quality AFS debt security, when the depreciation on such a security is deemed to be other than temporary and is therefore classified Loss, the depreciation should be deducted in determining Tier 1 capital. In addition, consistent with FAS 115 and Emerging Issues Task Force (EITF) Issue No. 03-1, when the depreciation represents an impairment that is other than temporary, the bank should recognize an impairment loss in current period earnings equal to the difference between the security's amortized cost and its fair value. This fair value then becomes the new cost basis for the AFS debt security and the new cost basis should not be adjusted through earnings for subsequent recoveries in value. Nevertheless, this AFS debt security must continue to be "marked-to-market" with the unrealized holding gains (losses) reported directly in equity capital.

For subinvestment quality AFS debt securities with temporary impairment, amortized cost rather than the lower amount at which these securities are carried on the balance sheet, i.e., fair value, is classified Substandard. This classification is consistent with the regulatory capital treatment of AFS debt securities. As mentioned above, under GAAP, unrealized holding gains (losses) on AFS debt securities are excluded from earnings and reported in a separate component of equity capital. In contrast, these unrealized holding gains (losses) are excluded from regulatory capital. Accordingly, the amount classified Substandard on these subinvestment quality AFS debt securities, i.e., amortized cost, also excludes the balance sheet adjustment for unrealized losses.

Subinvestment Quality AFS Equity Securities Equity securities may also be adversely classified if identified weaknesses warrant such treatment. Some investment advisory services issue rankings for equity instruments, which generally indicate projected investment performance rather than credit quality. Examiners should not rely on equity rankings to adversely classify equity investments. However, any AFS equity security whose cost is in excess of its fair value – that is, an equity security that has impairment or depreciation – must be evaluated to determine whether the impairment is temporary or other than temporary. When the impairment is determined to be other than temporary, the amount of the impairment should be classified Loss. In this situation, the equity security itself may be considered subinvestment quality, in which case examiners should also adversely classify the fair value of the equity security Substandard. Consistent with the treatment of AFS debt securities, when the impairment on an AFS equity security is determined to be other than temporary, the bank should recognize an impairment loss in current period earnings equal to the difference between the security's cost and its fair value. This fair value then becomes the new cost basis for the AFS equity security and the new cost basis should not be adjusted through earnings for subsequent recoveries in value. Nevertheless, this AFS equity security must continue to be "marked-to-market" with the unrealized holding gains (losses) reported directly in equity capital.

Securities with Substantial Prepayment Risks FAS 115, as amended by FAS 140, does not permit a debt security to be designated as held-to-maturity (HTM) if it can be prepaid or otherwise settled in such a way that the security holder would not recover substantially all of its recorded investment. Thus, those debt securities with a risk of substantial investment loss in the event of early prepayment, such as interest-only stripped mortgage backed securities and principal-linked structured notes, cannot be treated as HTM securities and carried at amortized cost. Rather, these securities should be categorized as either trading or AFS securities and reported at their fair value on the balance sheet for regulatory reporting purposes. The General Debt Security Classification Guidelines shown above should be applied to these securities when they have been categorized as AFS securities.

Determining Fair Value

As currently defined under GAAP, the fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices are the best evidence of fair value and must be used as the basis for measuring fair value, if available. If quoted market prices are not available, the estimate of fair value must be based on the best information available in the circumstances. The estimate of fair value must consider prices for similar assets and the results of valuation techniques to the extent available in the circumstances.

In order to properly classify a security or determine any necessary regulatory capital adjustment, examiners must determine its fair value. Examiners will review management's fair values for all adversely classified securities. When management's valuation for an adversely classified security appears reasonable, examiners will use that value to determine classification amounts. If management's valuation does not appear reasonable, examiners will discuss concerns with management and request that management provide a more reasonable valuation during the examination. When management cannot provide a reasonable valuation during the examination, examiners should use the information services provided by the Capital Markets Branch of the Division of Supervision and Consumer Protection in Washington, D.C.

Qualitative Capital Adequacy Considerations for Securities

Although unrealized holding gains (losses) on HTM and AFS debt securities normally are not recognized in calculating a bank's regulatory capital ratios, examiners should evaluate the extent of any unrealized appreciation or depreciation on these debt securities in making an overall qualitative assessment of the bank's capital adequacy and in evaluating whether the bank has an effective risk management system for securities. Such a risk management system should include:

- Policies, procedures, and limits,
- Risk identification, measurement, and reporting, and
- Internal controls.

Examiners should discuss any concerns that result from this assessment with management.

OTHER GUIDANCE

Trading

Trading activities involve strategies or transactions designed to profit from short term price changes. Trading activities almost always employ active strategies, which assume that the bank can consistently outperform the market. Trading programs can generate significant earnings, but also create unique risk exposures. The board and management have the responsibility to identify, measure, monitor, and control trading activity risks.

Failure to adequately understand and manage trading activity risks is an unsafe and unsound practice.

This section's investment activity guidance also applies to all trading activity. In addition, trading programs should include:

- Specific board approval and periodic review,
- Separate policies and procedures,
- Management that possesses sufficient expertise,
- Segregated accounting and reporting,
- A risk measurement system that quantifies potential trading loss,
- Performance measurement relative to established benchmarks,
- Strong conflict of interest guidelines, and
- Appropriately rigorous internal controls.

The trading program's risk measurement system should identify and measure all material risks, including potential trading loss for defined periods. For example, the system could measure potential one day trading loss for a given set of statistical assumptions. Management's assumptions should be reasonable, supported, and consistent. Results should be translated into terms that clearly illustrate compliance with the board's trading risk limits.

To measure the performance of the bank's trading activity, trading desks, or individual traders, management will generally seek to compare their results to established performance standards or to benchmarks. For example, a benchmark's return represents the return for simply adopting a passive investment strategy in a similar class of investments. Performance evaluation benchmarks commonly used are market indexes. Indexes frequently used as equity portfolio benchmarks include the Standard and Poor's 500 Index and the Russell 2000 Index. An index frequently used as a bond portfolio benchmark is the Lehman Brothers Aggregate Bond Index. Management should select benchmarks that provide realistic comparative value. When the trading portfolio consistently fails to achieve returns at least equivalent to reasonable benchmarks, management should assess whether the program achieves the board's objectives.

Whenever a bank reports or demonstrates trading activity, examiners should refer to Part 325 of the FDIC's Rules and Regulations and determine if the bank adheres to all trading-related requirements.

Accounting

Accurate accounting is essential to the evaluation of a bank's risk profile and the assessment of its financial condition and capital adequacy. Reporting treatment for securities and derivative holdings should be consistent with the bank's business objectives, generally accepted accounting principles (GAAP), and regulatory reporting standards. When necessary, examiners should consult regional accounting specialists for additional guidance. A listing of pertinent accounting guidance is included in the Accounting Guidance portion of this section.

FAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, must be adopted for Call Report purposes by all banks. It requires banks to divide their securities holdings among three categories: held-to-maturity (HTM), available-for-sale (AFS), and trading. Different accounting treatment applies to each category. Only debt securities which management has the positive intent and ability to hold to maturity may be designated as HTM and carried at amortized cost. AFS securities are those that management has not designated for trading or as HTM. AFS securities are reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate capital component. Securities held for trading must be reported at fair value, with unrealized gains and losses recognized in current earnings and regulatory capital. Proper categorization ensures that trading gains and losses are promptly recognized in earnings and regulatory capital. Refer to the Call Report Instructions for additional information.

Reporting trading assets as HTM or AFS is an unsafe and unsound practice. The substance of management's securities activities determines whether securities reported as HTM or AFS are, in fact, held for trading. While there are no standard benchmarks for identifying trading activity, trading generally reflects active and frequent buying and selling of securities for the purpose of generating profits on short-term fluctuations in price.

Examiners should also evaluate the extent of any unrealized gains and losses on both AFS and HTM securities when evaluating capital adequacy.

FAS 144, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and its predecessor amended FAS 115 and clarified that a debt security may not be classified HTM if it can contractually be prepaid or otherwise settled in such a way that the bank would not recover substantially all of its recorded investment. This provision is effective for financial assets held on or acquired after January 1, 1997 (no grandfather provision).

Premiums and discounts should be accounted for according to the Call Report Instructions. Inadequately amortized premium amounts should be adversely classified as Loss.

Trade date accounting is preferred (to settlement date accounting) for Call Report purposes to report HTM, AFS, and trading assets (other than derivatives). However, if the reported amounts under settlement date accounting would not be materially different from those under trade date accounting, settlement date accounting is acceptable.

Derivatives regulatory reporting instructions require that derivatives be reported in accordance with GAAP, and in particular FAS 133, *Accounting for Derivative Instruments and Hedging Activities*; FAS 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities-an amendment of FAS 133,* and FAS 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities.* In addition, the reporting should conform to the interpretive reporting guidance provided in the regulatory reporting instructions. These instructions state that derivatives generally should be marked to market, with resulting market value gains and losses recognized in current earnings. However, if certain criteria are met, banks may defer the recognition in income of gains and losses on derivative instruments used for hedging until they recognize in income the effects of related changes on the items hedged.

Market risk modification (including hedging) transactions accounting should be consistent with the board's risk management and accounting policies. Consistent with GAAP, derivatives and the hedged assets and liabilities must be designated when the hedging transaction is initiated. Management should retain adequate documentation to support deferrals of gains and losses, including the market risk modifications strategy and performance criteria.

Examiners having questions regarding the accounting for derivatives should consult with their regional accounting specialist.

Information Services

The Capital Markets Branch can help examiners identify a security's characteristics and risks. Capital Markets can provide a variety of security and derivative data to examiners, including prices, credit ratings, historical interest rates, mortgage prepayment forecasts, derivatives market summaries, and other information.

Prices and ratings should be requested through the Capital Markets Branch's Security Information Request System (SIRS). To use SIRS, examiners complete a computer data entry form and transmit it via electronic mail to a dedicated address. The Capital Markets Branch will enter all available data in the form and transmit it to the examiner within five business days of receipt. The data entry form is an automated Excel file that may be downloaded from the Capital Markets Branch's FDIC website.

Examiners should first submit a sample of a bank's securities and derivatives. When sampling results in material, unresolvable discrepancies, examiners may expand the sample and seek management's commitment to address any deficiencies. Prices provided by the Capital Markets Branch should not be substituted for management's prices, unless significant deficiencies are not resolved. Examiners should only submit requests to price an entire portfolio when a material safety and soundness concern exists.

The Capital Markets Branch obtains price and rating information from several sources. Prices are indications of value, but do not necessarily represent potential purchase or sale values. Whenever available, prices are drawn from market observations. However, many instruments do not trade on organized exchanges. In such circumstances, the Capital Markets Branch's sources provide estimated prices that have been derived from valuation models. These estimated prices are indications of value, not precise purchase or sale prices. Credit ratings are obtained from several of the NRSROs.

Historical interest rates are provided in the Market Index and Rate Application (MIRA). MIRA contains a ten-year database of rates, current forward rates, summary reports, yield curves, and an index comparison analysis feature. MIRA is an automated Excel template which examiners may download from the Capital Markets Branch's FDICnet site.

Mortgage prepayment forecasts and derivative market summaries are provided in a simple spreadsheet format and may be downloaded from the Capital Markets Branch's FDICnet site.

Other information, including detailed analytics and financial information for debt and equity issuers, may be requested on an individual basis. In addition, examiners may contact the Capital Markets Branch for guidance on examination procedures, supervisory policy, and Report of Examination treatment. Examiners should coordinate those requests with a Senior Capital Markets and Securities Specialist in their assigned regional office before contacting the Capital Markets Branch.

Settlement Practices, Confirmation and Delivery Requirements, and Delivery Documentation

Settlement Practices

Inadequate understanding of standard settlement practices coupled with poor internal controls can result in unnecessary costs or losses.

U.S. Treasury and Agency securities normally settle the next full business day after the trade date. Transactions involving U. S. Treasury and Agency obligations are typically in book-entry form, rather than in physical certificate form. Book-entry is an electronic registration, transfer, and settlement system that enables the rapid and accurate registration and transfer of securities with concurrent cash settlement. Book-entry reduces handling costs and quickens transaction completion. U. S. Treasury and Agency book-entry securities are delivered and cleared over the Federal Reserve Wire System (Fedwire) on a delivery versus payment basis. Acceptance of the security automatically debits the payment amount from the buyer's account and credits it to the seller's account. The payment and securities involved are transferred over the Fedwire system. The Federal Reserve Bank of New York maintains the book-entry custody system. All depository banks are eligible to maintain book-entry accounts at their local Reserve bank, provided that they also maintain a funds account with their Reserve bank.

Corporate and municipal bonds normally settle three full business days after the date of the transaction. The Municipal Securities Rulemaking Board Rule G-15 established guidelines for the settlement of municipal securities transactions. Corporate and municipal debt securities are available in book-entry and registered, definitive form. Book-entry corporate and municipal bonds settle through the Depository Trust Company (DTC). Members effect securities deliveries through DTC via computerized bookkeeping entries.

Mortgage securities settlement procedures are more complex than those for government, corporate, and municipal bonds. The Bond Market Association developed the "Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities" (Uniform Practices) to establish industry standards for mortgage securities settlements. Since the Uniform Practices are updated frequently, banks engaged in mortgage and asset-backed securities transactions should keep abreast of current settlement standards. The current Uniform Practices are summarized in the following paragraphs.

Government National Mortgage Association (GNMA) guaranteed mortgage pass-through securities are available in book-entry and definitive form. While most GNMA securities have been converted to book-entry, some physical certificates still exist. Book-entry GNMA securities settle through the Participants Trust Company (PTC) MBS Depository.

The Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) both issue Real Estate Mortgage Investment Conduits (REMICs) and mortgage pass-through securities. Since 1985, these securities have been issued in book-entry form only. Nearly all of the agency's securities that were issued in definitive, registered form before 1985 have been converted to book-entry. Book-entries are transferred, delivered, and settled through the Fedwire system.

Private label CMOs/REMICs (those issued by an entity other than FNMA and FHLMC) and asset backed securities (ABSs) are available in book-entry and registered, definitive form. Book-entry private label CMOs/REMICs and ABSs settle through the DTC. Private label pass-through securities are only available in physical form.

Confirmation and Delivery Requirements

Within one business day following the trade date, each party in a CMO/REMIC, stripped mortgage-backed security (SMBS), or ABS transaction should send a written confirmation of the transaction to the other party. Banks should have procedures established to issue, receive, and verify confirmations in a timely fashion. A bank is bound to a particular trade if it does not object to the written confirmation within 10 days of its receipt. Failure to exercise appropriate controls over confirmation procedures may result in the receipt or delivery of incorrect securities and improper payment amounts. The confirmation must contain the following information:

- Price,
- Trade date,
- Coupon rate,
- Maturity date,
- Settlement date,
- CUSIP number,
- Settlement amount,
- Original face amount,
- Security description,
- Confirming party's name and address, and
- Designation of "purchase from" and “sale to."

Confirmation procedures for mortgage pass-through securities differ from those for CMOs/REMICs, SMBSs, and ABSs, due to the manner in which mortgage pass-through securities typically trade. Most trades of mortgage pools occur on a To Be Announced (TBA) basis. In TBA transactions, information on the mortgage pools, such as pool numbers, is not known at trade time. Instead, the seller notifies the buyer of the pool numbers and original face values of the underlying securities at least 48 hours before delivery. No later than the second business day before the settlement date of each TBA transaction, the seller must transmit the following information to the buyer:

- Price
- Coupon rate and product
- Trade date and settlement date
- Pool, group, or other identification number
- Issue date and maturity date for new pools
- Identification of firm sending the information
- Original face amount for each pool or group number within the transaction

This information may be transmitted to the buyer verbally or by fax. If agreed to by both parties, the information may also be sent electronically. If the seller does not transmit the required information before the 48-hour deadline, the seller can not make delivery earlier than two business days after such information is transmitted. The seller must then promptly confirm in writing the following information:

- Price,
- Settlement date,
- Current face amount,
- Proceeds to be paid,
- Amount of accrued interest,
- Identification of the "contra party,"
- Designation of "purchase from" or "sale to,"
- Pool, group, or other identification number,
- Original face value for each pool or group number,
- Confirming party's name, address, and telephone number,
- Securities' description, settlement month, coupon rate, and product type, and
- Additional information as agreed to by the parties of the transaction.

The delivery variance permitted on TBA trades is plus or minus 2.50 percent of the dollar amount of the transaction agreed to by the parties. There is no variance permitted on transactions in which the seller provides the buyer with a specific pool number and a specific original face amount at the time of the trade. The 2.50 percent variance is applicable to each $1,000,000 within a TBA trade larger than $1,000,000. There are a maximum number of pools that may be delivered to satisfy a TBA trade. For securities with coupon rates below 12 percent, no more than three pools per $1,000,000 may be delivered. Up to four pools per $1,000,000 may be delivered for securities with coupons of 12 percent and above. TBA transactions that do not conform to these guidelines may result in "failed" trades.

The settlement amount (sum of the principal amount and accrued interest) is the amount payable by the buyer to the seller on the settlement date. Refer to the Capital Markets Examination Handbook for settlement amount formulas.

Delivery Documentation

Banks that purchase and sell mortgage-backed and other related securities in physical form must be aware of the documentation requirements contained in the Uniform Practices. Physical securities must have assignments for their registration in the name of the buyer on the books of the issuer or transfer agent. Each certificate must be accompanied by an assignment on the certificate or separate assignment for each certificate containing a signature that corresponds to the name written on the certificate. A detached assignment (standard corporate bond power) must provide for the irrevocable appointment of an attorney with power of substitution and must include a full description of the security, maturity date, series number, interest rate, and par amount. Each assignment, endorsement, alteration, and erasure must bear a guarantee acceptable to the issuer or transfer agent. A certificate registered in the name of a party other than a natural person will constitute good delivery only if it is accompanied by evidence of the authority of the assignor to transfer the securities.

If a trade has a settlement date between a record date and a payable date, delivery of the securities must be accompanied by a due bill. A due bill is a document delivered by a seller of a security to a buyer evidencing that any principal and interest received by the seller past the record date will be paid to the buyer by the seller upon submission of the due bill for redemption. The record date is the date set by the trustee for determining who will be paid principal and interest on a security. Book-entry messages are considered acceptable due bill substitutes for securities transferred over Fedwire, DTC, or PTC. Due bills and book-entry messages cease to be valid after 60 days from their issue date. A bank may experience considerable delays in attempting to recover payments without the use of a due bill, which can result in the accumulation of significant principal and interest receivable accounts. If delivery and payment on a trade occur after a record date and on or after a payable date, delivery of the securities must be accompanied by a check for the principal and interest due.

Examiners may review the bank's procedures for good delivery verification and interview bank personnel. The bank's policies for mortgage-backed and other related securities should conform to the Uniform Practices, and the operations staff should be thoroughly familiar with these standards. Failed trade frequency and costs will provide a general quality indicator for the overall settlement practices.

When a bank is on the sell side of a TBA trade, pools must be delivered to the buyer within good delivery guidelines. The process of assigning pools to a TBA transaction is known as allocation. While allocation is a critical part of the settlement process, relatively little effort is normally expended on this function by traders and senior management. Instead, the operations staff is usually responsible for performing allocations. The independent review should periodically confirm that the allocations meet good delivery guidelines. Prudent allocation controls will reduce the likelihood of costly "fails."

The operations department should also be aware of the Uniform Practices for reclamations. A reclamation is a claim for the right to return or the right to demand the return of a security that has been previously accepted as a result of bad delivery or other irregularities in the settlement process. Either party may make a reclamation if information is discovered after delivery, which if known at the time of delivery, would have caused the delivery not to constitute good delivery. Reclamation must be made within the stated time limits established by the Bond Market Association.

INVESTMENT STRATEGIES

Passive strategies generally do not require forecasting or complex analysis. Rather, management seeks to mirror a particular market segment’s performance or to retire predetermined liabilities. Adopting a passive investment strategy is a management decision to not attempt to outperform the market. Passive strategies typically incur lower expenses than do active strategies.

<u>Indexing</u> involves assembling a portfolio that closely resembles the risk and return characteristics of a preferred market index. For fixed-income portfolios, the portfolio may possess the same maturity, duration, credit quality characteristics, coupon, industrial classification, call or sinking fund features as the index. Advantages of passive bond portfolio management using indexing include low management and advisory fees, performance that mirrors the market, and low costs due to minimal turnover and no research. Disadvantages include performance that is no better than average, no immunization against interest rate risk, no guarantee that a specific liability stream can be funded from the portfolio, and the exclusion of many different types of bonds in the market. For example, zero-coupon U. S. Treasuries and most asset-backed securities are generally excluded from most conventional broad bond market indexes.

<u>Immunization</u> is a strategy that is employed to provide protection against the interest rate risk of a liability stream. The strategy requires that a bond portfolio be structured so that its interest rate risk characteristics (Macaulay duration) match those of the liability stream. The strategy, which is often referred to as "duration matching," requires advanced calculations and frequent re-balancing.

Active strategies involve detailed analysis, such as forecasting future events or interest rates, and selecting investments that will perform best under those conditions. Active strategies typically incur greater expenses than passive strategies, due to their higher transaction volume and complex analysis.

An interest-rate expectations strategy is an attempt to maximize return based on a forecast of future interest rate movements. An example of this strategy consists of adjusting the duration of a bond portfolio to take advantage of expected changes in interest rates. The success of this strategy depends on the accurate forecasting of future interest rates.

An individual security selection strategy is an attempt to identify individual instruments that will outperform other similarly rated instruments. The most common of this type of strategy identifies an issue as undervalued because its yield is higher that that of comparably rated issues or its yield is expected to decline because credit analysis indicates the issue's rating will change. The success of this strategy depends on superior skill in performing credit analysis. An active strategy assumes that the investor will attempt to outperform the market.

Many other investment strategies may be employed without measuring risk on a portfolio basis. Two commonly used active strategies include yield curve strategies and yield spread strategies.

Yield curve strategies involve the positioning of fixed-income portfolios to capitalize on or protect against expected changes in the shape of the Treasury yield curve. These strategies may be referred to as "riding the yield curve." Three common yield curve strategies are bullet strategies, ladder strategies, and barbell strategies.

A *bullet* portfolio is constructed so that the maturity of the securities is highly concentrated at one point on the yield curve. A *laddered* portfolio spreads instruments (and reinvestment risk) across the maturity spectrum and provides regular cash flows. A typical laddered portfolio is constructed with approximately equal percentages of the portfolio maturing at different segments of the yield curve. A *barbell* portfolio concentrates instruments at the short term and long term extremes of the maturity spectrum. Barbell strategies can be used to take advantage of, or compensate for, non-parallel shifts in the yield curve. These strategies are based on the theory that the value of long-term bonds will appreciate more when long-term market interest rates fall, than shorter-term bonds depreciate even if short-term market interest rates simultaneously rise (a non-parallel yield curve shift). The ability to reinvest the proceeds from maturing short-term bonds at higher short-term rates provides this value. The actual performance of a barbell strategy will depend upon both the type of non-parallel shift (e.g. steepening or flattening) and the magnitude of the shift. For example, barbell strategies will be disadvantageous if long-term market interest rates rise while short-term rates remain unchanged.

Yield spread[3] strategies involve the positioning of fixed-income portfolios to profit on expected changes in yield spreads between sectors of the bond market. These sectors can vary by type of issuer (such as Treasury, agencies, corporates, and mortgage-backed securities), quality or credit (such as Treasuries, triple A, double A), coupon (such as high-coupon/premium bonds, low coupon/discount bonds), and maturity (such as short, intermediate, or long term). Spreads can change for a variety of reasons. For example, the spread between top quality and lower quality bonds tends to narrow as business conditions improve, and widen when business conditions deteriorate. Making changes in the portfolio to take advantage of changes in spreads will often result in accepting additional credit risk or extension risk.

Cash flow matching strategies attempt to match the cash flow requirements of a bank's liabilities with the cash flows provided by specific investments. This approach is also known as dedicating a portfolio. Bonds are selected with maturities, principal amounts and coupon payments that match the bank's liability payment stream. Theoretically, this cash flow matching process can be continued until all liabilities have been matched by the cash flows from securities in the portfolio. Interest rate risk reduction is the primary advantage of this strategy, since a known amount of cash sufficient to fund the required payment schedule will be generated with certainty. The inability to reposition the securities being used to match liabilities, the possibility of bonds being called, and the possibility of bonds going into default are the primary disadvantages of this strategy. Cash flow matching strategies are becoming more popular in banks that use FHLB borrowings.

Using *total return* measurement in determining an investment strategy better incorporates the investor's interest rate expectations over time than either a simple yield to maturity or yield to call investment selection. The total return for an individual bond consists of the change in the market value over the measurement period; the coupon received; and the reinvestment interest on the cash flows received during the measurement period. For bond portfolios, the total return is the weighted average of the

[3] Yield spread is the yield premium of one bond over another. Traditional analysis of the yield premium for a non-U.S. Treasury bond involves calculating the difference between the yield-to-maturity of the bond in question and the yield-to-maturity of a U.S. Treasury security with a comparable maturity.

returns of the bonds in the portfolio. Selecting investments based solely on their yield to maturity assumes holding those bonds to maturity and ignores the reinvestment return on interim coupon payments.

Modern portfolio theory (MPT) refers to a variety of portfolio construction, asset valuation, and risk measurement concepts and models that rely on the application of statistical and quantitative techniques. MPT is an approach used for managing investment risk. The theory states that by creating an efficient portfolio, an investor can increase portfolio return without a commensurate risk increase, or reduce portfolio risk without a commensurate return reduction.

First, an investor should determine the required portfolio risk and return levels. By diversifying risk through prudent investment choices, an investor can reduce portfolio risk. Risk averse investors (such as most banks) require a greater expected return in exchange for assuming increased risk. Diversifying the portfolio among different asset classes, maturities, and other characteristics can provide a greater expected return without a commensurate risk increase.

The investor adds or removes assets from the portfolio in order to maintain or alter overall portfolio risk and return characteristics. The investor focuses on the entire portfolio's cash flow characteristics, risk, and return. An individual instrument may be extremely risky if evaluated independently. However, its cash flow characteristics may improve the overall portfolio's risk and return performance.

For example, an interest-only strip may be very price sensitive (market risk) under declining rate scenarios. However, that instrument may offset some or all of a portfolio's price sensitivity under rising interest rate scenarios. Each instrument's individual cash flow characteristics are analyzed to determine the instrument's incremental effect on the overall portfolio's cash flow characteristics.

This approach also demands periodic performance measurement. The investor must accurately measure both risk and return for the overall portfolio and for major portfolio segments. That is, the investor must determine if the portfolio earned a return that adequately compensated the investor for the risk level assumed. Such measurements require accurate pricing information, detailed accounting systems, and a sophisticated risk measurement system.

No particular investment strategy is superior to any other. Management must determine reasonable strategies that effectively achieve the board's goals. Refer to the Capital Markets Handbook for additional information.

MARKET RISK MODIFICATION STRATEGIES

Market risk modification strategies involve using financial instruments whose cash flow fluctuations partially or completely offset the cash flow variability of an asset, liability, or balance sheet segment. Any financial instrument with the desired cash flow characteristics may be used to modify market risk, including off-balance sheet derivatives, mortgage-backed securities, and structured notes. For many banks, market risk modification is an integral part of asset/liability management. This section provides summary guidance for market risk modification strategies. Refer to the Capital Markets Examination Handbook for more detailed information.

Bank earnings result primarily from the spread between earning asset yields and funding costs. Market interest rate changes can narrow the net interest margin and can reduce the economic value of equity. In response, management may attempt to modify the bank's market risk profile to reduce risk or improve performance.

Risk Management Process

Management must evaluate many factors before implementing a market risk modification strategy, including:

- Market risk exposure,
- The board's risk tolerance,
- Current and expected interest rate volatility,
- Cash flow forecasts,
- Strategy time horizon,
- Specific instruments and cost, and
- Potential effectiveness.

To devise a successful strategy (or simply determine if a strategy is needed), management must first quantify the bank's market risk and identify the positions whose market risk should be modified. Then, management must devise a strategy to modify those positions' market risk.

This process requires thorough understanding of the bank's market risk and cash flow characteristics for all on and off-balance sheet positions. For most banks, market risk results primarily from repricing imbalances between earning assets and funding. When developing strategy, therefore, management should typically evaluate the repricing and cash flow characteristics for all on and off-balance sheet positions. If management uses a market risk modification strategy without assessing its effects on overall bank market risk, then management may actually worsen the bank's market risk profile. Failure to understand and adequately manage those risks is an unsafe and unsound practice.

Next, management must determine the strategy's intended time horizon (the length of time the strategy must remain in place) and number of periods needed. Horizon length is an important factor, since many long-term derivatives and some securities have limited liquidity. The number of periods can be an equally important factor. For example, a strategy that involves the value of a single cash position to be liquidated or acquired on a single future date may be described as a single-period strategy. However, a multi-period strategy involves liquidation or acquisition of a cash position over successive periods. Offsetting such positions can involve a sequence of instruments that mature in corresponding periods.

Prior to implementing any market risk modification strategy, management should evaluate all related costs, including transaction costs, analysis and monitoring expense, and foregone interest income on funds paid to mark positions to market (for example, margin maintenance).

Once a strategy has been implemented, management must regularly monitor the strategy's effectiveness. However, careful development and monitoring can not guarantee a strategy will achieve the intended market risk objectives. Management should periodically evaluate instrument performance to determine if the strategy remains appropriate and effective. When warranted, management should adjust the strategy.

The examination of this area should focus on evaluating management's understanding and reporting of the instruments used in any risk modification strategies. This understanding will be reflected in a program for reviewing and documenting financial contracts and counterparty information. Determining the effectiveness of risk modification strategies should be conducted as part of the rate sensitivity module. The interest rate risk review should be able to rely on the individual investment findings of the securities and derivatives review.

Board and Management Oversight

The board and management must understand and regularly evaluate the risks and benefits from all market risk modification strategies used. Market risk modification strategies can involve complex transactions and instruments, which may include significant risk. In addition, market risk modification strategies may require enhanced management expertise and internal controls.

The board maintains oversight responsibility for all market risk modification strategies. In that role, the board should adopt policies that establish management's responsibility for developing, implementing, and monitoring the process. Those policies should specify:

- Risk limits,
- Specific exposures needing modification,
- Accounting treatment,
- Reporting,
- Monitoring,
- Permissible strategies and instruments,
- Counterparty credit risk guidelines,
- Activity limits, and
- Analysis and documentation standards.

ACCOUNTING GUIDANCE

AICPA Audit and Accounting Guide: Banks and Savings Institutions
Chapter 5 – Investments in Debt and Equity Securities
Chapter 8 – Mortgage Banking Activities and Loan Sales
Chapter 15 – Futures, Forwards, Options, Swaps, and Similar Financial Instruments

APB - Accounting Principles Board Opinions
EITF - Consensus Positions of the Emerging Issues Task Force
FAS - FASB Statements
FIN - FASB Interpretations
FTB - FASB Technical Bulletins
PB - AICPA Practices Bulletins
SOP - AICPA Statements of Position

APB 18
The Equity Method of Accounting for Investments in Common Stock

EITF 00-9
Classification of a Gain or Loss from a Hedge of Debt That is Extinguished

EITF 98-15
Structured Notes Acquired for a Specified Investment Strategy

EITF 96-12
Recognition of Interest Income and Balance Sheet Classification of Structured Notes

EITF 96-11
Accounting for Forward Contracts and Purchased Options to Acquire Securities Covered by FAS No. 115

EITF 95-11
Accounting for Derivative Instruments Containing Both a Written Option-Based Component and a Forward-Based Component

EITF 93-18
Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate

EITF 90-19
Convertible Bonds with Issuer Option to Settle for Cash Upon Conversion

EITF 90-17
Hedging Foreign Currency Risks with Purchased Options

EITF 89-4
Accounting for Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate

EITF 89-18
Divestitures of Certain Investment Securities to an Unregulated Common Controlled Entity Under FIRREA

EITF 88-9
Put Warrants

EITF 88-8
Mortgage Swaps

EITF 87-20
Offsetting Certificates of Deposit Against High-Coupon Debt

EITF 87-1
Deferral Accounting for Cash Securities That Are Used to Hedge Rate or Price Risk

EITF 86-40
Investments in Open-End Mutual Funds That Invest in U.S. Government Securities

EITF 86-28
Accounting Implications of Indexed Debt Instruments

EITF 86-25
Offsetting Foreign Currency Swaps

EITF 86-15
Increasing-Rate Debt

EITF 85-29
Convertible Bonds with a “Premium Put”

EITF 85-20
Recognition of Fees for Guaranteeing a Loan

EITF 85-17
Accrued Interest Upon Conversion of Convertible Debt

EITF 84-7
Termination of Interest Rate Swaps

FAS 149
Amendment of Statement 133 on Derivative Instruments and Hedging Activities

FAS 140
Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities (Effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001)

FAS 138
Accounting for Certain Derivative Instruments and Certain Hedging Activities-an amendment of FASB Statement No. 133

FAS 134
Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise

FAS 115
Accounting for Certain Investments in Debt and Equity Securities

FAS 107
Disclosures About Fair Value of Financial Instruments

FAS 65
Accounting for Certain Mortgage Banking Activities

FAS 91
Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases

FAS 52
Foreign Currency Translation

FIN-41
Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements

FIN-39
Offsetting of Amounts Related to Certain Contracts

FTB 94-1
Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring

FTB 87-3
Accounting for Mortgage Servicing Fees and Rights

FTB 79-19
Investor's Accounting for Unrealized Losses on Marketable Securities Owned by an Equity Method Investee

PB 4
Accounting for Foreign Debt/Equity Swaps

SOP 90-3
Definition of the Term "Substantially the Same" for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position

CASH AND DUE FROM BANKS

OVERVIEW

Financial institutions maintain cash on hand and at correspondent banks to comply with statutory reserve requirements and to meet customer demands. Cash accounts include U.S. and foreign coin and currency on hand and transit, clearing, and cash items. Demand and time deposits maintained at correspondent banks are often known as due from accounts, or correspondent balances. Banks maintain correspondent accounts to facilitate the transfer of funds.

Cash

Every bank must maintain a certain amount of U.S. and/or foreign coin and currency on hand. To avoid having excess nonearning assets and to minimize exposure to misappropriation and robbery, each bank should establish a policy to maintain cash balances at the minimum levels necessary to meet reserve requirements and customer demands. Federal Reserve Regulation D governs the level of required reserves. Part 326 of the FDIC Rules and Regulations requires banks to adopt appropriate security procedures to discourage robberies and to assist in apprehending persons who commit such acts.

Clearings

The term clearing is used to describe the activities involved with processing financial transactions from the time a transaction is made until it is settled. Clearing items include checks, drafts, notes, and other items that represent instructions for processing financial transactions. Financial institutions accept, collect, and process a variety of payment instruments and can participate in a variety of clearing and settlement systems.

For decades, many communities with two or more banks organized local clearinghouse associations which adopted rules governing the exchange of checks. Clearings were also processed through regional associations, correspondent banks, or the Federal Reserve. Physical items such as checks (typically submitted in batches) were often processed on proof and sorting machines that facilitated an institution's ability to verify the accuracy of individual documents, separate items by pre-identified categories, provide balance verifications for transaction types (proof), and send cash items drawn on other banks for collection (transit). Proof machines had paper handling mechanisms that fed checks, deposit slips, and other items into the system. As each item went into the system, a proof operator read and entered the courtesy amount of the check (the face value of the check). The proof machine then printed the face value on the bottom of the item in Magnetic Ink Character Recognition (MICR) ink so the transaction information could be processed electronically. Most proof machines also had a MICR reader that allowed them to read the bank and item number from pre-encoded MICR information.

Legislative changes and advances in technology now allow banks to process clearing items, or have items processed by a servicer, on equipment that captures images of items, reads the information, including MICR data, and stores images and data in a computerized file. The file can then be transmitted electronically for settlement. Similarly, institutions are now able to use remote deposit capture systems. With remote deposit capture, instead of physically transporting checks to a banking facility, customers are able to scan checks on devices maintained in their own offices and transmit information electronically to a financial institution or its service provider.

Although institutions can process clearing items such as checks quickly and efficiently using modern technologies, in many situations, checks are no longer the most convenient payment instruments for consumers. Often consumers use checks merely for person-to-person transactions that are not conducive to electronic payments. Many consumers have shifted to using fully electronic payments through Automated Teller Machine, Point-of-Sale, and on-line bill payment systems.

No matter how transactions are initiated or processed, a bank's objective remains the same: to forward items for collection quickly so funds are available as soon as possible; to distribute checks and deposits efficiently to their destinations; to establish that deposit totals balance with the totals shown on deposit tickets; to prove subsidiary and general ledger entries and other transactions; to collect data for computing customer's service charges and available funds; and to accomplish the functions accurately, securely, and efficiently.

Cash Items

Cash items are checks or other items in process of collection payable in cash upon presentation. A separate control account of all such items is generally maintained on the bank's general ledger and supported by a subsidiary record of individual amounts and other pertinent data. Cash items and related records usually are in the custody of one employee at each banking office who is designated as the collection, or exchange, teller.

In normal daily operations, all banks have items which are charged to demand deposits but which cannot be charged to individual accounts because of insufficient funds, a lack of information, unknown accounts, etc. Such items include return items, rejects, or unposted debits and may consist of checks, loan payments, or other debit memos. In some banks, such items are separated and an entry is made reclassifying them to a separate asset account. Other banks include the items in a subsidiary control account in the individual demand deposit ledgers. In that case, the account would have a debit balance that would be credited when the bank returns the checks to their sources.

Cash items not in process of collection should be carried in a noncash account and reported as other assets. These include items payable upon presentation that a bank has elected to accumulate until forwarding to payers on a periodic basis. Items not immediately payable in cash upon presentation, or items that were not paid when presented and require further collection efforts should also be included in an appropriate account, such as suspense, and shown under other assets. Many banks establish a three-day limit, after which all items not collected must be automatically transferred from cash items to a suspense account. Refer to the Other Assets section of this Manual for additional comments on cash items not in process of collection.

Due From Banks

As noted above, due from accounts enable the transfer of funds between banks. The accounts are used to facilitate the collection of cash items and cash letters, the transfer and settlement of security transactions, the transfer of participation-loan funds, the purchase or sale of Federal funds, and for many other purposes.

Due from accounts may also exist when a bank utilizes the services of another bank and maintains a minimum or compensating balance in full or partial payment for the services received. Such services may involve processing cash letters, packaging loan agreements, performing information technology or payroll services, collecting out-of-area items, or exchanging foreign currency.

Balances due from institutions cover all interest-bearing and noninterest-bearing balances whether in the form of demand, savings, or time balances, but excludes certificates of deposit held for trading.

Reciprocal balances arise when two depository institutions maintain deposit accounts with each other, i.e., when a reporting bank has both a due from and a due to balance with another depository institution. Reciprocal balances between the reporting bank and other depository institutions may be reported on a net basis when a right of set off exists. Net due from balances should be reported as deposit assets. Net due to balances should be reported as deposit liabilities.

DEPOSIT NOTES

Some banks have purchased deposit notes as investments. These instruments are a form of deposit liability somewhat similar to negotiable time certificates of deposit (CD). "Deposit notes" have been structured like corporate bonds by having a five-day corporate settlement period for purchases and semiannual interest payments calculated on a 30/360-day basis. Although maturities vary from nine months to 15 years, most "deposit notes mature in four to seven years. While the foregoing contract terms could be incorporated into a CD, certain banks, for marketing purposes, prefer to use the "deposit note" format.

Bank purchases of such notes should be made in accordance with established investment and asset/liability management policies. While these note issues tend to be rated, banks considering the purchase of a deposit note should nonetheless obtain the offering circular or other similar information to ensure that they understand the nature of such notes (including possible deposit insurance coverage) before investing. A bank's investment in a deposit note should generally be included on the balance sheet in the interest-bearing balances due from depository institutions asset category. However, if the offering circular or note instrument for a particular deposit note is available for review and it does not contain a statement to the effect that the liability represented by the note is a deposit liability of the issuing bank, the bank's investment in the note should be treated as a security or a loan based on the characteristics of the note.

Structured CDs

Structured CDs are similar to structured note investment securities in that they have customized features typically containing embedded options or having cash flows linked to various indices.

The uncertainty of the cash flows, caused by movements in interest rates or other indices, may expose banks that invest in the CDs to heightened market risk, liquidity risk, or other such risks traditionally experienced in the context of investment securities. As a result, investments in structured CDs warrant heightened supervisory attention to ensure that management understands, and has the ability to adequately monitor and manage these risks.

The risk profile of structured CDs can be very similar to that of structured notes. Certificates may include step-up features with call options, inverse floating or dual indices, or other such terms. These types of terms, in addition to severe early withdrawal penalties and the lack of an established secondary market, may result in cash flow behavior similar to that of structured notes. Proper controls for these investments include effective senior management supervision, board oversight, periodic reporting, and appropriate policies and procedures. The degree and complexity of an institution's monitoring and reporting systems should be commensurate with the volume and complexity of their investment in structured certificates.

Classification of structured CDs should be consistent with the adverse classification guidelines outline in the Securities and Derivatives section of this Manual.

EXAMINATION OBJECTIVES

When reviewing activities related to cash and due from bank accounts, examiners should consider the issues discussed below.

Primary Reserves

Cash and balances due from other banks generally represent an institution's primary liquidity reserves, except to the extent they include required reserves. Excessive cash or due from balances can have an adverse impact on earnings because they generate little or no income, while insufficient balances can contribute to a weak overall liquidity position. Examiners should review the level of primary reserves as part of the Earnings and Liquidity reviews. Some assistance in making this assessment may be obtained by referring to the UBPR. If a bank's level of cash and due from bank accounts appears considerably out of line with those of the peer group (after considering reserve requirements), or if the level changed significantly from the previous examination, or over a period of time, further investigation may be warranted.

Interbank Liabilities

All insured institutions are required to establish and maintain written policies and procedures to prevent excessive exposure to any individual correspondent, in accordance with Federal Reserve Regulation F (12 CFR Part 206), Limitations on Interbank Liabilities. This rule covers all exposure to a correspondent, including credit and liquidity risks and operational risks related to intraday and interday transactions. The regulation requires banks to establish prudent standards that consider credit, liquidity, and operational risks when selecting correspondents and terminating relationships. Where exposure is considered significant, banks must periodically review their correspondents' financial condition.

Policy standards should include exposure limits when a correspondent's financial condition, or the general level of exposure to a correspondent, creates a significant risk to a bank. Exposure limits may be fixed by amount or flexible, but should be based on the financial condition of the correspondent and the type and level of identified exposure. Regulation F provides that when exposure limits are required, banks should limit interday credit exposure to a correspondent to 25 percent of a bank's capital, unless the bank can demonstrate that its correspondent is at least adequately capitalized. When a correspondent is not at least adequately capitalized, banks should reduce their credit exposure to the 25 percent level within 120 days after the date when the current Call Report or other relevant report would be available.

Compensating Balances

Banks may be exposed to insider abuse if their officers, directors, or principal shareholders have loans at correspondent banks. For example, a correspondent bank may provide a bank insider a below-market rate loan if that officer establishes a below-market rate deposit account at the correspondent bank (in the name of their bank). In this situation the officer would be abusing their position by receiving personal gain (the below-market rate loan), and harming the bank by establishing an account at the correspondent that receives below-market returns. Therefore examiners should be alert to potential abusive relationship between executive officers, directors, and principal shareholders of a bank and that bank's correspondent banks.

Such arrangements may constitute a breach of a bank official's fiduciary obligations to the depositing bank and thus to its depositors, creditors and shareholders. In some cases, the arrangements may also involve a criminal offense.

Accordingly, if the bank maintains a correspondent account with another bank which has extended credit to any of the above persons or anyone associated with them and where there is evidence that the depositing bank may have suffered a detriment because of the loan/deposit arrangement, the situation should be thoroughly investigated. This is also the case when the bank holds a deposit from another bank and has outstanding extensions of credit to such persons in the other bank or their associates. Refer to the Bank Fraud and Insider Abuse section for further information.

Correspondent Concentration Risks

The FFIEC issued guidance (FIL-18-2010) detailing the expectation that financial institutions take actions beyond the minimum requirements established in Regulation F. The guidance clarifies that risk management practices relating to correspondent concentrations should encompasses all credit and funding exposures. In addition, management should be aware of its affiliates' exposures to individual correspondents and their affiliated entities.

A financial institution’s relationship with a correspondent can result in credit (asset) and funding (liability) concentrations. Asset concentrations may be present when an institution maintains significant due from balances; or advances, or commits to advancing, significant funds to a correspondent or their related entities. Liability concentrations may exist when an institution maintains significant due to balances; or depends on a correspondent or their related entities for a disproportionate share of its total funding.

Some correspondent concentrations may involve legitimate business purposes, such as concentrations arising when an institution maintains large due from accounts to facilitate clearing activities. However, correspondent concentrations represent diversification risks that management should consider when formulating strategic plans and risk limits. Examiners should ensure management performs appropriate due diligence procedures and adequately identifies, monitors, and manages all credit and funding concentrations.

Due Diligence

Financial institutions that maintain, or contemplate entering into, credit or funding arrangements with other financial institutions should establish correspondent risk management programs. The programs should include written investment, lending, and funding policies that incorporate appropriate risk limits. In addition, the programs should ensure institutions conduct analysis of credit transactions prior to committing to, or engaging in, the transactions. The terms of all credit and funding transactions should avoid conflicts of interest and conform to sound investment, lending, and funding practices.

Identifying Credit Concentrations

Credit concentrations involve a variety of assets and activities. For example, an institution could have due from bank accounts, Federal funds sold on a principal basis, and direct or indirect loans to or investments in a correspondent bank. When calculating credit concentration levels, institutions should aggregate all exposures, including, but not limited to:

- Due from demand and time accounts,
- Federal funds sold on a principal basis,
- Over-collateralized amounts on repurchase agreements,
- Under-collateralized portions of reverse repurchase agreements,
- Net credit exposures on derivatives contracts,
- Unrealized gains on unsettled security transactions,
- Direct or indirect loans to or for the benefit of the correspondent, and
- Investments in the correspondent, such as stocks, subordinated debts, or trust preferred securities.

Identifying Funding Concentrations

The primary risk relating to funding concentrations is that an institution may need to replace the advances on short notice or on unfavorable terms. The risks may be more pronounced if funds are credit sensitive or the party advancing the funds has a weakened financial condition. Additionally, the level of risk relating to a funding concentration is likely to vary depending on the type and maturity of the funds and the structure of the recipient's overall sources of funds. For example, a concentration in overnight unsecured funding would raise different concerns than a concentration in secured long-term funding. Also, the risks of a concentration from a particular correspondent would be more significant if the level of funds constituted a high percentage of an institution's overall funding sources.

Calculating Credit and Funding Concentrations

When identifying credit and funding concentrations, institutions should calculate both gross and net exposures to individual correspondents and to groups of affiliated correspondents. Exposures are reduced to net positions to the extent the transactions are secured by the net realizable proceeds from readily marketable collateral or are covered by valid and enforceable netting agreements.

Monitoring Correspondent Relationships

Management should maintain written policies and procedures designed to prevent excessive exposure to correspondents in relation to the correspondent's financial condition. The depth and frequency of monitoring procedures may be more or less aggressive depending on the type and level of risk exposures. Institutions should implement procedures that ensure ongoing, timely reviews of correspondent relationships, include documentation requirements, and specify when risks that meet internal criteria are to be brought to the attention of the board of directors.

In monitoring correspondent relationships, institutions should specify internal parameters relative to information, ratios, or trends that will be reviewed for each correspondent on an ongoing basis such as:

- Deteriorating trends in capital, asset quality, or earnings,
- Increasing levels of other real estate owned,
- Significant use of volatile funding sources such as large CDs or brokered deposits,
- Downgrades in its credit ratings, if publicly traded, and
- Public enforcement actions.

Managing Correspondent Concentrations

Institutions should establish prudent internal concentration limits for each correspondent, as well as ranges or tolerances for each factor being monitored. Institutions should also develop contingency plans for managing risks when internal limits, ranges, or tolerances are met, either on an individual or collective basis. However, contingency plans should not rely on temporary deposit insurance programs for mitigating concentration risks.

Contingency plans should provide for the orderly reduction of identified concentrations over reasonable timeframes. Such actions may include, but are not limited to:

- Reducing the volume of uncollateralized/uninsured funds,
- Transferring excess funds to other correspondents,
- Requiring a correspondent to serve as an agent rather than as principal for Federal funds sold,
- Modifying credit and funding limits to a correspondent, and
- Specifying timeframes to meet targeted reductions for different types of exposures.

EXAMINATION PROCEDURES

Examiners should review correspondent relationships to ascertain whether an institution’s policies and procedures appropriately manage correspondent concentrations. Examiners should also review the adequacy and reasonableness of an institution's contingency plans for managing correspondent concentrations. The Examination Documentation Modules include examination procedures regarding the evaluation of the internal controls for cash, cash items, and correspondent bank accounts. Refer to the Other Assets and Liabilities and the Internal Routine and Controls sections for additional details.

PREMISES AND EQUIPMENT

DEFINITIONS

Banks have historically relied on a reasonable investment in premises and equipment to successfully conduct business. A financial institution's physical presence in a community can bolster its public image and competitive position, and enhance convenience for customers. Bank offices can provide a platform for gathering deposits, originating credit, and serving the financial needs of its community. However, overinvestment in facilities may tie up capital and hinder earnings. Therefore, similar to other balance sheet assets, premises and equipment can pose risks to the institution and present a range of accounting issues that require appropriate oversight.

Premises include the cost, less accumulated depreciation, of land and buildings actually owned and occupied (or to be occupied) by the bank, its branches, and consolidated subsidiaries. This includes vaults, fixed machinery, equipment, parking lots, and real estate acquired for future expansion. Interest costs associated with the construction of a building should be capitalized as part of the cost of the building. Bank premises also include leasehold improvements. Leasehold improvements comprise two types of accounts:

- Buildings constructed on leased property, and
- Capitalized disbursements directly related to leased quarters such as vaults, renovations, or fixed equipment.

Equipment includes all movable furniture, fixtures, and equipment of the bank, its branches, and consolidated subsidiaries, including automobiles and other vehicles, and any liens on the above. The institution's ownership interest in premises or equipment of non-majority-owned corporations is also included.

FIXED ASSETS ACCOUNTING

Fixed Assets - Owned

Fixed assets are reported at original cost and are depreciated over their estimated useful life, except for land which is not a depreciable asset.

Interest may be capitalized as part of the historical cost of acquiring assets that need a period of time to be brought to the condition and location necessary for their intended use. FASB Accounting Standards Codification (ASC) 835-20, Capitalization of Interest (formerly Statement of Financial Accounting Standards (FAS) 34, *Capitalization of Interest Cost*), calls for capitalization of interest costs associated with the construction of a building, if material. Such interest costs include both the actual interest incurred when the construction funds are borrowed and the interest costs imputed to internal financing of a construction project. The rate used to capitalize interest on internally financed projects in a reporting period shall be the rate(s) applicable to the bank's borrowings outstanding during the period. For this purpose, a bank's borrowings include interest-bearing deposits and other interest-bearing liabilities. The interest capitalized shall not exceed the total amount of interest cost incurred by the bank during the reporting period.

Fixed Assets - Leased

Premises and equipment are often leased. Lease obligations can represent commitments that have or will have a significant effect on bank earnings. ASC 840, Leases (formerly FAS 13, *Accounting for Leases*), establishes generally accepted accounting principles regarding lease transactions. Any lease entered into by a Lessee bank, which at its inception meets one or more of the four following criteria must be accounted for as a property acquisition financed with a debt obligation (i.e., as a capitalized lease). The criteria are:

- Ownership of the property is transferred to the lessee at the end of the lease term.
- The lease contains a bargain purchase option.
- The lease term represents at least 75 percent of the estimated economic life of the leased property.
- The present value of the minimum lease payments at the beginning of the lease term is 90 percent or more of the fair value of the leased property to the lessor at the inception date, less any related investment tax credit retained by or expected to be realized by the lessor.

If none of the above criteria is met, the lease should be accounted for as an operating lease. Normally, rental payments should be charged to expense over the term of the operating lease as they become payable.

Capitalized leases are to be reported in the Premises and Fixed Assets category in the Call Report. The amount capitalized equals the present value of the minimum required payments over the noncancellable term as defined by the lease plus the present value of the payment required under the bargain purchase option, if any, less any portion of the payments representing administrative expenses such as insurance, maintenance, and taxes to be paid by the lessor. The property shall be amortized according to the bank's normal depreciation policy (except, if appropriate, the amortization period shall be the lease term) unless the lease involves land only.

If a lease is not being correctly reported, appropriate comments should be included in the Report of Examination. The comments should remind management of the responsibility for accurate reporting and include the recommendation that competent outside assistance be obtained if the bank lacks satisfactory accounting expertise. In addition, if the amount incorrectly reported is significant, amended Call Reports may be necessary. Decisions on how to report a lease should be fully supported and documented.

Sale-Leaseback Transactions

Sale-leaseback transactions involve the sale of property by the owner and a lease of the property back to the seller. If a bank sells premises or fixed assets and leases back the property, the lease shall be treated as a capital lease if it meets any one of the four criteria above for capitalization. Otherwise, the lease shall be accounted for as an operating lease. ASC 840-40, Leases – Sale-Leaseback Transactions (formerly FAS 28, *Accounting for Sales with Leasebacks*) provides guidance on the treatment of any gain or loss. A loss must be recognized immediately for any excess of net book value over fair value at the time of sale. In the event a bank sells a property for an amount less than its fair value, (for example, in order to obtain more favorable lease terms), the difference between the sale proceeds and fair value represents an additional loss that must be deferred and amortized over the life of the lease. Any gain resulting from a sale-leaseback transaction is generally deferred and amortized over the life of the lease. Accordingly, the general rule on deferral does not permit the recognition of all or a part of the gain in income, at the time of sale. Exceptions to the general rule do permit full or partial recognition of a gain at the time of the sale if the leaseback covers less than substantially all of the property that was sold or if the total gain exceeds the minimum lease payments.

Banks may provide seller-financing to the purchaser in conjunction with a sale-leaseback transaction, ASC 360-20, Property, Plant, and Equipment - Real Estate Sales (formerly FAS 66, *Accounting for Sales of Real Estate*, as amended by FAS 98, *Accounting for Leases*), applies to all transactions in which the seller provides financing to the buyer of the real estate.

The requirements of accounting for leases and sales of real estate are complex and examiners who have questions on lease capitalizations or sale-leaseback transactions should refer to appropriate accounting resources or contact their regional accounting specialist.

ANALYSIS OF FIXED ASSETS

From an accounting standpoint, an investment in fixed assets is an essential cost of doing business. Attention should be focused on the adequacy of depreciation, the reasonableness of the overall commitment, and the current and prospective utilization of fixed assets in serving the present and future anticipated banking needs. Only under exceptional circumstances, such as the contemplated abandonment of bank premises, gross under-utilization due to obsolescence, closed bank situations, or other extreme circumstances, do market value considerations assume any significance in the analysis of fixed assets.

Depreciation Costs

Depreciation is an overhead cost of doing business as the item being depreciated will have to be replaced when it ceases to have utility. An acceptable depreciation program allocates the original cost of the fixed asset over its estimated useful life. Failure to follow a realistic schedule of fixed asset depreciation distorts both the balance sheet and income statement.

Banks carry premises and equipment at cost less accumulated depreciation, and adjust the carrying amount for permanent impairments of value. Any method of depreciation or amortization conforming to accounting principles that are generally acceptable for financial reporting purposes may be used. However, depreciation for premises and fixed assets may be based on a method used for federal income tax purposes if the results would not be materially different from depreciation based on the asset's estimated useful life. Under normal circumstances, examiners should not need to prepare detailed depreciation schedules in accordance with the generally accepted accounting principles. In instances where tax depreciation and book depreciation are the same, and depreciation is accelerated for tax purposes only, detailed analysis of book values may be necessary to determine whether fixed assets are being appropriately depreciated.

Depreciation can result in a taxable temporary difference if a bank uses the straight-line method to determine the amount of depreciation expense to be reported for book purposes but uses an accelerated method for tax purposes. In the early years, tax depreciation under the accelerated method will typically be larger than book depreciation under the straight-line method. During this period, a taxable temporary difference originates. Tax depreciation will be less than book depreciation in the later years when the temporary difference reverses. Therefore, in any given year, the depreciation reported on the books will differ from that reported in the bank's tax returns. However, total depreciation taken over the useful life of the asset will be the same under either method.

Overinvestment

An overcommitment in equipment and facilities can adversely impact earnings. A review of pertinent Uniform Bank Performance Report (UBPR) schedules will reveal how an institution compares to its peers in terms of total assets invested in premises and equipment, and percent of operating income absorbed by occupancy expense. This information, though not in itself conclusive, can be a useful starting point in the analysis. However, as long as commitments conform to State banking regulations and aggregate direct and indirect investments, including lease obligations, appear reasonable in relation to the institution's earnings performance and capacity, the decision as to what constitutes an appropriate fixed asset commitment should generally be left to management's discretion.

Fixed Asset Investments

A reasonable investment in premises and equipment is essential to conducting bank business. However, overinvestment in facilities or equipment may weaken depositor protection, encumber capital, and burden earnings. Consequently, many states impose limits on fixed asset investments. Reluctance on the part of banks to keep their investments within statutory limits has resulted in a variety of alternative arrangements, such as the organization of subsidiary or affiliate realty corporations, sale-leaseback transactions, and lease-purchase contracts. These arrangements are most common in connection with bank buildings, but in some instances are also used in connection with equipment.

The realty corporation arrangement typically calls for investment in a subsidiary corporation and capitalization by the bank of an amount within State limitations, with the subsidiary corporation financing the additional cost of banking facilities in the mortgage market. The facilities are then leased to the bank by the subsidiary corporation at a rent rate that usually coincides with the mortgage payments. In one type of affiliate setup, a group of the bank's directors may form a corporation to hold title to the property and lease it to the bank.

Lease-purchase contracts or sale-leaseback arrangements should enable a bank, at its option, to acquire title to the fixed assets either during, or at the expiration of, the lease period.

Examiners should determine whether any arrangements or transactions concerning fixed assets involve "insiders" and, if so, that the transactions are made on substantially the same terms as those prevailing at the time for comparable transactions with non-insiders and do not involve more than normal risk or present other unfavorable features to the bank. In addition, examiners should consider whether insiders' use of bank owned/leased facilities and equipment (including vehicles) is prudent and in accordance with banking laws and employment agreements.

FIXED ASSET INSURANCE

Historically, banks purchased property insurance to cover damage caused by fire or lightning. Coverage to protect against other risks, such as windstorms, hail, explosions, riots or civil commotion, aircraft damage, vehicle damage, etc., was obtained by purchasing extended coverage policies or endorsements.

Modern property insurance is generally designated as providing basic, broad, or special (a.k.a. all-risk) coverage. The primary difference between these types of policies is that basic and broad coverage policies only provide coverage for items specifically included in a policy. Special coverage policies provide coverage for other risks not specifically excluded by a policy.

Basic policies typically provide coverage of risks caused by fire, lightning, explosion, windstorm, hail, civil unrest, aircraft or vehicle damage, etc. Broad form property insurance includes coverage for the risks identified in basic policies and adds additional coverage for falling objects, weight of ice, sleet, or snow, and accidental water damage.

The most common form of property insurance is special coverage, or "all risk" insurance. As mentioned above, special coverage policies provide protection against all risks not specifically identified in a policy. Special coverage policies normally provide the best overall risk protection; however, the number and type of items excluded from coverage can be numerous. Typical exclusions include damage caused by government action, nuclear hazard, wars, floods, fungus, and pollution.

Regardless of the type of property insurance policies a bank carries, management must thoroughly understand, periodically review, and document their analysis of the adequacy of their institution's insurance coverage.

EXAMINATION PROCEDURES

The Examination Documentation Modules include examination procedures regarding the evaluation of the reasonableness of investment in premises and equipment.

OTHER REAL ESTATE

Other real estate (ORE) consists of real property held for reasons other than to conduct bank business. Banks usually acquire ORE through foreclosure after a borrower defaults on a loan secured by real estate. Most states have laws governing the acquisition and retention of such assets.

Examiners should ensure management establishes appropriate policies and procedures for acquiring, holding, and disposing of ORE. Management should establish policies and procedures that:

- Protect a bank's interests in ORE while mitigating the impact on surrounding property values,
- Ensure ORE is accounted for in conformance with generally accepted accounting principles and Call Report Instructions, and
- Assure the institution's compliance with federal and state laws pertaining to holding ORE.

For regulatory reporting purposes, ORE includes:

- All real estate, other than bank premises, actually owned or controlled by the bank and its consolidated subsidiaries, including real estate acquired through foreclosure or deed in lieu of foreclosure, even if the bank has not yet received title to the property;
- Real estate collateral in a bank's possession, regardless of whether formal foreclosure proceedings have been initiated;
- Property originally acquired for future expansion but no longer intended for that purpose; and
- Foreclosed real estate sold under contract and accounted for under the deposit method of accounting.

Maintaining Other Real Estate

Part 364, Appendix A of the FDIC Rules and Regulations, Interagency Guidelines Establishing Standards for Safety and Soundness, requires institutions to identify problem assets and prevent deterioration in those assets. Institutions should maintain and protect ORE from deterioration to maximize recovery values. Typical expenses incurred during the ORE holding period relate to maintenance, tax, insurance, and miscellaneous costs.

Management should maintain ORE in a manner that complies with local property and fire codes. Other requirements, such as homeowner association covenants, may also require careful attention. Efforts to ensure an ORE property is maintained in a marketable condition not only improve an institution's ability to obtain the best price for the property, but also minimize liability and reputation risks.

Real estate taxes on ORE should be paid in a timely manner to avoid unnecessary penalties and interest.

Management should periodically review general insurance policies to determine if adequate hazard and liability coverage for ORE exists. If adequate general coverage is not in place, management should consider obtaining policies on each parcel of ORE. If an institution decides to self-insure, the decision should be board approved and appropriately documented.

Management should implement reasonable procedures for managing other miscellaneous expenses the institution may incur during the ORE holding period. These expenses could include, but are not limited to, sewer and water fees, utility charges, property management fees, and interest on prior liens.

OTHER REAL ESTATE ACCOUNTING

The accounting and reporting standards for foreclosed real estate are set forth in ASC 310-40, Receivables – Troubled Debt Restructurings by Creditors (formerly FAS 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*), and ASC 360, Property, Plant, and Equipment (formerly FAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*). The disposition of ORE is addressed in ASC 360-20, Property, Plant, and Equipment – Real Estate Sales (formerly FAS 66, *Accounting for Sales of Real Estate*). For regulatory reporting purposes, certain provisions of former AICPA Statement of Position (SOP) No. 92-3, *Accounting for Foreclosed Assets*, have been incorporated into the Call Report Instructions even though SOP 92-3 was rescinded subsequent to the issuance of FAS 144. Institutions must follow these provisions of SOP 92-3 when preparing their Call Reports.

Carrying Value

Call Report Instructions provide that foreclosed real estate received in full or partial satisfaction of a loan be recorded at the fair value less cost to sell the property. This fair value (less cost to sell) becomes the "cost" of the foreclosed real estate. If the recorded amount of the loan exceeds the "cost" of the property, the difference is a loss which must be charged to the Allowance for Loan and Lease Losses (ALLL) at the time of foreclosure or repossession. However, if an asset is sold shortly after it is received in a foreclosure or repossession, it may be appropriate to substitute the value received in the sale (net of the cost to sell the property) for the fair value, with any adjustments made to losses previously charged against the ALLL.

The recorded amount of a loan at the time of foreclosure is the loan balance adjusted for any unamortized premium or discount and unamortized loan fees or costs, less any amount previously charged off, plus recorded accrued interest. An asset received in partial satisfaction of a loan should be accounted for at its fair value less cost to sell, and the recorded amount of the loan should be reduced by the fair value (less cost to sell) of the asset at the time of foreclosure. Legal fees and other direct costs incurred by the bank in a foreclosure should be expensed as incurred.

After foreclosure, each foreclosed real estate parcel must be carried at the lower of (1) the fair value of the real estate minus the estimated costs to sell the real estate or (2) the “cost” of the real estate. If the real estate’s fair value minus the estimated costs to sell the real estate is less than its “cost,” the deficiency must be recognized as a valuation allowance against the real estate which is created through a charge to expense. The valuation allowance should thereafter be increased or decreased (but not below zero) for changes in the real estate’s fair value or estimated selling costs.

FINANCED SALES OF ORE

ASC 360-20, which applies to all transactions in which the seller provides financing to the buyer of real estate, establishes five different methods of accounting for dispositions of real estate. Failure to apply the correct method may result in misstating ORE and earning assets (i.e., loans). The deposit method is the only one of five methods where disposition of ORE and financing by the seller of real estate does not result in a sale and corresponding recognition of a loan. Brief descriptions of the five accounting methods for seller-financed dispositions of ORE are listed below. Refer to ASC 360-20 for more detailed definitions.

Full Accrual Method

Under this method, the disposition is recorded as a sale. Any resulting profit is recognized in full and the seller-financed asset is reported as a loan. The following conditions must be met in order to utilize this method.

- A sale has been consummated,
- The receivable is not subject to future subordination,
- The usual risks and rewards of ownership have been transferred, and
- The buyer's initial investment (down payment) and continuing investment (periodic payments) are adequate to demonstrate a commitment to pay for the property.

Guidelines for meeting the minimum down payment are set forth in Appendix A to ASC 360-20. These vary from five to 25 percent of the property sales value. These guideline percentages vary by type of property and are primarily based on the inherent risk assumed for the type and characteristics of the property. To meet the continuing investment criteria, the contractual loan payments must be sufficient to repay the loan over the customary loan term for the type of property involved. For instance, the customary repayment term for a loan secured by a single-family residential property could range up to 30 years.

Installment Method

This method recognizes a sale and corresponding loan. Profits are recognized as the bank receives payments. Interest income is recognized on an accrual basis, when appropriate.

The installment method is used when the down payment is not adequate to allow for use of the full accrual method, but recovery of the cost of the property is reasonably assured in the event of buyer default. Reasonable assurance of cost recovery may be achieved despite a small down payment if there is recourse to borrowers who have verifiable net worth, liquidity, and income levels, or if there is additional collateral pledged.

Cost Recovery Method

This method also recognizes a sale and corresponding loan and may apply when dispositions do not qualify under the full accrual or installment methods. No profit or interest income is recognized until either the aggregate payments exceed the recorded amount of the loan or a change to another accounting method is appropriate. The loan is maintained on nonaccrual status while this method is used.

Reduced-Profit Method

This method is appropriate in those situations where the bank receives an adequate down payment, but the loan amortization schedule does not meet the requirements of the full accrual method. Like the installment method, any profit is recognized as payments are received. However, profit recognition is based on the present value of the lowest level of periodic payments required under the loan agreement. This method is seldom used in practice because sales with adequate down payments are generally not structured with inadequate loan amortization requirements.

Deposit Method

The deposit method is used in situations where a sale of the real estate has not been consummated. It may also be used for dispositions that could be accounted for under the cost recovery method. Under this method a sale is not recorded and the asset continues to be reported as ORE. Furthermore, no profit or interest income is recognized. Payments received from the borrower are reported as a liability until sufficient payments or other events have occurred which allow the use of one of the other methods.

VALUATIONS AND CLASSIFICATION

Many states require institutions to obtain ORE appraisals or valuations when acquiring, holding, and/or disposing of real estate. Management should obtain ORE appraisals or valuations as required to ensure assets are reported at appropriate values and any material change in market conditions or physical property aspects is periodically recognized. If an institution is selling and financing the sale of an ORE parcel, Part 323 of the FDIC Rules and Regulations, Appraisals, and some state laws require updated appraisals or evaluations.

Examiners can test the general validity of appraised values by comparing the sale prices and appraised values of properties previously held. The fact of foreclosure is presumptive, but not conclusive, evidence that takeover value exceeds market or appraised value. Therefore, each parcel of ORE is to be reviewed and classified on its own merits.

Often a reliable appraisal may not be available or the appraisal on file may be suspect for various reasons. Nevertheless, a careful evaluation of all the relevant factors should enable the examiner to make an accurate and reliable judgment about a property's fair value less cost to sell with regard to classification. Any portion of the carrying value in excess of fair value less cost to sell should be classified Loss. The remaining carrying value should then be evaluated and adversely classified, if appropriate. Regulatory definitions of Substandard, Doubtful, and Loss (as discussed in the Loans section) should be utilized in the analysis of ORE holdings.

ORE VALUATION ALLOWANCE

As previously mentioned, a valuation allowance is established for each parcel of ORE during the holding period when the real estate's fair value minus the estimated costs to sell the real estate is less than the real estate's "cost." Call Report Instructions clarify that valuation allowances must be determined on an asset-by-asset basis. As a result, the individual valuation allowance should be subtracted from the related asset's "cost" to determine the property's carrying value, which is the amount subject to classification.

Valuation allowances on foreclosed properties being held for sale are not recognized as a component of regulatory capital. The risk-based capital standards permit only the "allowance for loan and lease losses" to be included in Tier 2 capital up to a maximum of 1.25% of risk-weighted assets.

OTHER ASSETS AND LIABILITIES

INTRODUCTION

Assets and liabilities that are not reported in major balance sheet categories are generally reported in other asset or other liability categories. Although these items are listed in "other" categories, it does not mean the accounts are of less significance than items detailed in major categories. Intangible assets lack physical substance and are also reported separately on the balance sheet. The following pages include descriptions of common other assets, intangible assets, and other liabilities. Additional guidance and information is included in the Call Report Instructions and the Examination Documentation (ED) Module - Other Assets and Liabilities.

OTHER ASSETS

Accrued Income

All banks, regardless of size, shall prepare the Call Report on an accrual basis. Accrued income represents the amount of interest earned or accrued on earning assets and applicable to current or prior periods that has not yet been collected. Examples include accrued interest receivable on loans and investments. When income is accrued but not yet collected, a bank debits a receivable account and credits an applicable income account. When funds are collected, cash or an equivalent is debited, and the receivable account is credited.

The degree to which accrual accounts and practices are reviewed during an examination should be governed by the examination scope. When scoping examination procedures, examiners should consider the adequacy of a bank’s internal control structure and the extent to which accrual accounting procedures are analyzed during audits.

When reviewing accrual accounts and practices, examiners should assess the general accuracy of the accrual accounting system and determine if accruals relate to items in default or to items where collection is doubtful. If accrued income accounts are materially overstated, examiners should consider the impact to overall profitability levels, classify overstated amounts as Loss, and recommend management amend Call Reports.

Tax Assets

Banks must estimate the amount of the current income tax liability (or receivable) to be reported on its tax returns. Estimating this liability (or receivable) may involve consultation with the bank's tax advisers, a review of the previous year's tax returns, the identification of significant expected differences between items of income and expense reflected on the Call Report and on the tax returns, and the identification of expected tax credits.

Deferred tax assets and liabilities represent the amount by which taxes receivable (or payable) are expected to increase or decrease in the future as a result of temporary differences and net operating losses or tax credit carryforwards that exist at the reporting date. When determining the current and deferred income tax assets and liabilities to be reported in any period, a bank’s income tax calculation will contain an inherent degree of uncertainty surrounding the realizability of the tax positions included in the calculation.

A net deferred tax asset is reported if a debit balance results after offsetting deferred tax assets (net of valuation allowance) and deferred tax liabilities measured at the report date for a particular tax jurisdiction. If the result for a particular tax jurisdiction is a net credit balance, then a net deferred tax liability is reported. A bank may report a net deferred tax debit, or asset, for one tax jurisdiction, such as for federal income tax purposes, and also report at the same time a net deferred tax credit, or liability, for another tax jurisdiction, such as for state or local income tax purposes.

Temporary differences arise when an institution recognizes income or expense items on the books during one period, but records them for tax purposes in another period. For example a deductible temporary difference is created when a provision for loan and lease losses is expensed in one period for financial reporting purposes, but deferred for tax purposes until the loans are charged off in a subsequent period.

A bank sustains an operating loss when deductions exceed income for federal income tax purposes. An operating loss in a year following periods when the bank had taxable income may be carried back to recover income taxes previously paid. Banks may carry back operating losses for two years. Generally, an operating loss that occurs when loss carrybacks are not available (e.g., when losses occur in a year following periods of losses) becomes an operating loss carryforward. Banks may carry operating losses forward 20 years.

Tax credit carryforwards are tax credits that cannot be used for tax purposes in the current year, but which can be carried forward to reduce taxes payable in a future period.

Deferred tax assets are recognized for operating loss and tax credit carryforwards just as they are for deductable temporary differences. However, a bank can only recognize the benefit of a net operating loss, or a tax credit carryforward, to the extent the bank determines that a valuation allowance is not necessary. A valuation allowance must be recorded, if needed, to reduce the amount of deferred tax assets to an amount that is more likely than not to be realized. Examiners should obtain management's analysis and support for any deferred tax asset and valuation allowance reported for financial reporting purposes. Examiners should refer to the Call Report Glossary for guidance on income taxes and may contact the regional accounting specialist for further guidance in cases involving significant amounts of net deferred tax assets.

Part 325 of the FDIC Rules and Regulations, Capital Maintenance (Part 325), establishes limitations on the amount of deferred tax assets that can be included in Tier 1 capital. The maximum allowable amount is limited to the lesser of: the amount of deferred tax assets dependent upon future taxable income expected to be realized within one year of the calendar quarter-end date, based on projected future taxable income for that year; or ten percent of the amount of Tier 1 capital that exists before certain deductions. Refer to Part 325 for more details.

Interest-Only Strips

Accounting standards for interest-only strips receivable are set forth in ASC 860, Transfers and Servicing (formerly FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, as amended by FAS 156, Accounting for Servicing of Financial Assets, FAS 166, Accounting for Transfers of Financial Assets, and certain other standards). ASC 860 defines interest-only strips receivable as the contractual right to receive some or all of the interest due on a bond, mortgage loan, collateralized mortgage obligation, or other interest-bearing financial asset.

Financial assets such as interest-only strips receivable, that can contractually be prepaid or otherwise settled in such a way that the holder of the financial asset would not recover substantially all of its recorded investment do not qualify to be accounted for at amortized cost. Interest-only strips subsequently measured at fair value like available-for-sale securities are reported as other assets. Alternatively, interest-only strips may be reported as trading securities. Refer to the Call Report Instructions for additional details.

Equities without Readily Determinable Fair Values

An equity security does not have a readily determinable fair value if sales or bid-and-asked quotations are not currently available on a securities exchange registered with the Securities and Exchange Commission and are not publicly reported by the National Association of Securities Dealers Automated Quotations or the National Quotation Bureau. Equity securities that do not have readily determinable fair values may have been purchased by a bank or acquired for debts previously contracted, and may include items such as paid-in stock of a Federal Reserve Bank, stock of a Federal Home Loan Bank, and stock of a bankers' bank. Refer to the Call Report Instructions for additional details.

Bank-Owned Life Insurance Policies

The purchase of bank-owned life insurance (BOLI) can be an effective way for institutions to manage exposures arising from commitments to provide employee compensation and pre- and post-retirement benefits, and to protect against the loss of key persons.

Consistent with safe and sound banking practices, institutions must understand the risks associated with BOLI and implement a risk management process that provides for the identification and control of such risks. A sound pre-purchase analysis, meaningful ongoing monitoring program, reliable accounting process and accurate assessment of risk-based capital requirements are all components of a comprehensive risk management process.
The ability of state chartered banks to purchase life insurance is governed by state law. The safe and sound use of BOLI depends on effective senior management and board oversight. An institution's board of directors must understand the complex risk characteristics of the institution's insurance holdings and the role this asset plays in the institution's overall business strategy.

Each institution should establish internal policies and procedures governing its BOLI holdings, including guidelines that limit the aggregate cash surrender value (CSV) of policies from, any one insurance company, as well as the aggregate CSV of policies from all insurance companies. In general, it is not prudent for an institution to hold BOLI with an aggregate CSV that exceeds 25 percent of its Tier 1 capital. Therefore, an institution that plans to acquire BOLI in an amount that results in an aggregate CSV in excess of this concentration limit, or any lower internal limit, should gain prior approval from its board of directors or the appropriate board committee. In this situation, management is expected to justify that any increase in BOLI resulting in an aggregate CSV above 25 percent of Tier 1 capital does not constitute an imprudent capital concentration.

Management should conduct a thorough pre-purchase analysis to help ensure that the institution understands the risks, rewards, and unique characteristics of BOLI. The nature and extent of this analysis should be commensurate with the size and complexity of the potential BOLI purchases and should take into account existing BOLI holdings.

A comprehensive assessment of BOLI risks on an ongoing basis is especially important for an institution whose aggregate BOLI holdings represent a capital concentration. Management should analyze the financial condition of BOLI insurance carriers, review the performance of BOLI products, and report their findings to the board at least annually. More frequent reviews may be necessary if management anticipates additional BOLI purchases, a decline in an insurance carrier's financial condition, policy surrenders, or changes in tax laws that could affect BOLI products or performance.

Examiners should review the Interagency Statement on the Purchase and Risk Management of Life Insurance (Interagency Statement) when assessing an institution's BOLI program. Examiners should closely scrutinize risk management policies and controls associated with BOLI assets when an institution holds BOLI in an amount that approaches or exceeds 25 percent of Tier 1 capital. An institution holding life insurance in a manner inconsistent with safe and sound banking practices is subject to supervisory action. Where ineffective controls over BOLI risks exist, or the exposure poses a safety and soundness concern, supervisory action against the institution, may include requiring the institution to divest affected policies, irrespective of potential tax consequences.

ASC 325-30, Investments-Other – Investments in Insurance Contracts (formerly FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance, and Emerging Issues Task Force Issue No. 06-5, Accounting for Purchases of Life Insurance – Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4) addresses the accounting for BOLI. Only the amount that could be realized under an insurance contract as of the balance sheet date (that is, the CSV reported by the carrier, less any applicable surrender charges not reflected in the CSV) is reported as an asset. If a bank records amounts in excess of the net CSV of the policy, then the excess should be classified Loss.

For risk-based capital purposes, an institution that owns general account permanent insurance should apply a 100 percent risk weight to its claim on the insurance company. If an institution owns a separate account policy and can demonstrate that it meets certain requirements, it may choose to apply a look-through approach to the underlying assets to determine the risk weight. Refer to Call Report Instructions, the ED Module - Bank-Owned Life Insurance (BOLI), and the Interagency Statement for further details.

MISCELLANEOUS ASSETS

Miscellaneous assets that are not reported in major Balance Sheet or Other Asset categories should be reported separately under all other assets in the Call Report. Examples include derivative instruments held for purposes other than trading that have a positive fair value, computer software, and bullion. Some of the more common miscellaneous assets are described below.

Prepaid Expenses

Prepaid expenses are the costs that are paid for goods and services prior to the periods in which the goods or services are consumed or received. When the cost is prepaid, the payment is recorded as an asset because it represents a future benefit to the bank. In subsequent periods the asset is reduced (expensed) as the goods or services are used or rendered. At the end of each accounting period, the bank makes adjusting entries to reflect the portion of the cost that has expired during that period. The prepayment is often for a service for which the benefit is spread evenly throughout the year. As the service is provided, the prepaid expense is amortized to match the cost to the period it benefits. Examples of prepaid expenses include premiums paid for insurance, advance payments for leases or asset rentals, payments for stationery or other supplies that will be used over several months, and retainer fees paid for legal services to be provided over a specified period.

Examiners should ensure management accurately adjusts prepaid expenses to reflect exhausted purchased goods or services. Prepaid expenses that are recorded and amortized in accordance with generally accepted accounting principles should not be adversely classified. However, any prepaid expense that is overstated should be classified Loss.

Repossessed Personal Property

Repossessed personal property such as automobiles, boats, equipment, and appliances, represents assets acquired for debts previously contracted. A bank that receives assets from a borrower in full satisfaction of a loan, such as a receivable from a third party, an equity interest in the borrower, or another type of asset (except a long-lived asset that will be sold), will account for the asset at its fair value. An asset received in partial satisfaction of a loan should be accounted for as described above and the recorded amount of the loan should be reduced by the asset's fair value less the cost to sell. .Examiners should assess repossessed assets individually for possible adverse classification.

Suspense Accounts

Suspense accounts, also known as interoffice or clearing accounts, are temporary holding accounts in which items are carried until they can be identified and their disposition to the proper account is made. For example, items are included in suspense accounts when a transaction is coded incorrectly and cannot be processed immediately, when an account number is missing on a loan or deposit transaction, or when a check drawn on a deposit account at the bank is not properly endorsed. Most suspense items are researched and cleared the following day. The balances of suspense accounts as of the report date should not automatically be reported as Other Assets or Other Liabilities. Rather, the items included in these accounts should be reviewed and material amounts should be reported appropriately in the Call Report. Moreover, banks should regularly reconcile suspense accounts. Stale suspense items should be charged off when it is determined that they are uncollectible and should be classified Loss in the report of examination.

Cash Items Not In Process Of Collection

In contrast to those cash items that are in process of collection, cash items that are not paid when presented are referred to as cash items that are not in the process of collection. In general, cash items that are not in the process of collection occur when the paying bank has refused payment after being presented with the cash item. Once payment has been refused, the cash item immediately becomes not in process of collection and is reclassified as an Other Asset. Cash items not in the process of collection are frequently kept in a suspense account. Although collection efforts will continue, when it becomes clear that the cash item will not be paid, the bank should promptly charge off the cash item. It is common for the payee bank to refuse payment if the customer's deposit account had insufficient funds, the check was improperly endorsed, the checking account on which the check is drawn has been closed, or for some other acceptable reason.

Other Accrued Interest Receivables

Accrued interest on securities purchased (if accounted for separately from accrued interest receivable in the bank's records) and retained interests in accrued interest receivable related to securitized credit cards is reported in all other assets in the Call Report. Accrued interest receivable amounts that are overstated should be classified Loss.

In a typical credit card securitization, an institution transfers a pool of receivables and the right to receive the future collections of principal (credit card purchases and cash advances), finance charges, and fees on the receivables to a trust. If a securitization transaction qualifies as a sale, then the selling institution removes the receivables that were sold from its reported assets and continues to carry any retained interests in the transferred receivables on its balance sheet. An institution should treat this accrued interest receivable asset as a retained (subordinated) beneficial interest. Accordingly, it should be reported in all other assets in the Call Report and not as a loan receivable.

For further guidance refer to the Interagency Advisory on the Accounting Treatment of Accrued Interest Receivable Related to Credit Card Securitizations and the Call Report Instructions.

Indemnification Assets

Indemnification assets represent the carrying amount of the right to receive payments from the FDIC for losses incurred on specified assets acquired from failed insured depository institutions or otherwise purchased from the FDIC that are covered by loss-sharing agreements. Despite the linkage between them, the acquired covered assets and the indemnification asset, are treated as separate units of account. Each covered asset is reported in the appropriate category on the balance sheet. The indemnification asset is recorded at its acquisition-date fair value and is reported in all other assets in the Call Report.

Examiners should ensure the acquiring institution's financial and regulatory reporting is appropriate for the covered assets and the indemnification asset. Refer to the Call Report Instructions for further details.

INTANGIBLE ASSETS

Goodwill and Other Intangible Assets

Goodwill is an intangible asset that is commonly recognized as a result of a business combination. .Other intangible assets resulting from a business combination, such as core deposit intangibles, purchased credit card relationships, servicing assets, favorable leasehold rights, trademarks, trade names, internet domain names, and non-compete agreements, should be recognized as an asset separately from goodwill. This discussion will focus on intangible assets acquired through business combinations.

Goodwill represents the excess of the cost of a company over the sum of the fair values of the tangible and identifiable intangible assets acquired less the fair value of liabilities assumed in a business combination accounted for in accordance with ASC 805, Business Combinations (formerly FAS 141 (revised 2007), Business Combinations).

Push down accounting is the establishment of a new accounting basis for a bank in its separate financial statements as a result of it becoming substantially wholly owned via a purchase transaction or a series of purchase transactions. When push down accounting is applied, any goodwill is reflected in the separate financial statements of the acquired bank as well as in any consolidated financial statements of the bank's parent.

When measuring Tier 1 capital for regulatory capital purposes, institutions generally must deduct goodwill and other intangible assets (other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships eligible for inclusion in core capital). Refer to Part 325 for further information on the regulatory capital treatment of goodwill and intangible assets.

Accounting for Goodwill

After initial recognition, goodwill must be accounted for in accordance with ASC 350, Intangibles-Goodwill and Other (formerly FAS 142, Goodwill and Other Intangible Assets), which requires that goodwill be tested for impairment at least annually.

Goodwill is considered impaired when the amount of goodwill exceeds its implied fair value at the reporting unit level. An impairment loss must be recognized in earnings. After a goodwill impairment loss is recognized, the adjusted carrying amount of goodwill shall be its new accounting basis. Subsequent reversal of a previously recognized goodwill impairment loss is prohibited once the measurement of that loss is completed. Goodwill of a reporting unit must be tested for impairment annually and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Examples of such events or circumstances include a significant adverse change in the business climate, unanticipated competition, a loss of key personnel, and an expectation that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed. In addition, goodwill must be tested for impairment after a portion of goodwill has been allocated to a business to be disposed.

A bank may not remove goodwill from its balance sheet, for example, by selling or upstreaming this asset to its parent holding company or another affiliate.

Other intangible assets that have indefinite useful lives should not be amortized but must be tested at least annually for impairment. Intangible assets that have finite useful lives must be amortized over their useful lives and must be reviewed for impairment.

Refer to the Call Report Instructions for further details.

Servicing Assets

The right to service assets is represented by the contractual obligations undertaken by one party to provide servicing for mortgage loans, credit card receivables, or other financial assets for another. Servicing includes, but is not limited to, processing principal and interest payments, maintaining escrow accounts for the payment of taxes and insurance, monitoring delinquencies, and accounting for and remitting principal and interest payments to the holders of beneficial interests in the financial assets. Servicers typically receive certain benefits from the servicing contract and incur the costs of servicing the assets.

Servicing is inherent in all financial assets; however, it becomes a distinct asset or liability only when contractually separated from the underlying financial assets by sale or securitization with servicing retained or by a separate purchase or assumption of the servicing rights and responsibilities. Whenever an institution undertakes an obligation to service financial assets, a servicing asset or liability must be recognized unless the institution securitizes the assets, retains all of the resulting securities, and classifies the securities as held-to-maturity.

Accounting

Accounting and reporting standards for asset and liability servicing rights are set forth in ASC 860-50, Transfers and Servicing – Servicing Assets and Liabilities (formerly FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, as amended by FAS 156, Accounting for Servicing of Financial Assets, and FAS 166, Accounting for Transfers of Financial Assets), and ASC 948, Financial Services-Mortgage Banking (formerly FAS 65, Accounting for Certain Mortgage Banking Activities, as amended by FAS 140).. Servicing assets result from contracts to service financial assets for which the servicing benefits (revenues from contractually specified servicing fees, late charges, and other ancillary sources) are expected to more than adequately compensate the servicer. Contractually specified servicing fees are all amounts that, per contract, are due to a servicer in exchange for servicing the financial assets and which would no longer be received by a servicer if the contract for servicing were shifted to another servicer.

A bank must recognize and initially measure at fair value a servicing asset or a servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in either of the following situations:

- The bank's transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset that meets the requirements for sale accounting; or
- An acquisition or assumption of a servicing obligation that does not relate to financial assets of the bank or its consolidated affiliates included in the Call Report.

If a bank sells a participating interest in an entire financial asset, it only recognizes a servicing asset or servicing liability related to the participating interest sold.

A bank should subsequently measure each class of servicing assets and servicing liabilities using either the amortization method or the fair value measurement method. Once a bank elects the fair value measurement method for a class of servicing, that election must not be reversed.

Under the amortization method, all servicing assets or servicing liabilities in the class should be amortized in proportion to, and over the period of, estimated net servicing income for assets (servicing revenues in excess of servicing costs) or net servicing loss for liabilities (servicing costs in excess of servicing revenues). The servicing assets or servicing liabilities should be assessed for impairment or increased obligation based on fair value at each quarter-end Call Report date. The servicing assets within a class should be stratified into groups based on one or more of the predominant risk characteristics of the underlying financial assets. If the carrying amount of a stratum of servicing assets exceeds its fair value, the bank should separately recognize impairment for that stratum by reducing the carrying amount to fair value through a valuation allowance for that stratum. The valuation allowance should be adjusted to reflect changes in the measurement of impairment subsequent to the initial measurement of impairment. For the servicing liabilities within a class, if subsequent events have increased the fair value of the liability above the carrying amount of the servicing liabilities, the bank should recognize the increased obligation as a loss in current earnings.

Under the fair value measurement method, all servicing assets or servicing liabilities in a class should be measured at fair value at each quarter-end report date. Changes in the fair value of these servicing assets and servicing liabilities should be reported in earnings in the period in which the changes occur.

Institutions that sell only a limited number of financial assets with servicing retained and do not otherwise actively purchase or sell servicing rights may determine that the servicing activity is immaterial. Typically, these institutions will have a relatively low volume of financial assets serviced for others and the value of any servicing assets and liabilities would likewise be immaterial. Management must provide a reasonable basis for not reporting servicing activity. Refer to the Servicing Liabilities section below and the Call Report Instructions for further details.

Valuation

The fair value of servicing assets and liabilities is determined in accordance with ASC 820, Fair Value Measurements and Disclosures (formerly FAS 157, Fair Value Measurements) that defines fair value and establishes a framework for measuring fair value. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the asset's or liability's principal (or most advantageous) market at the measurement date. This value is often referred to as an exit price. ASC 820 establishes a three level fair value hierarchy that prioritizes inputs used to measure fair value based on observability. The highest priority is given to Level 1 (observable, unadjusted) and the lowest priority to Level 3 (unobservable).

Valuation techniques consistent with the market approach, income approach, and/or cost approach should be used to measure fair value, as follows:

The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. Valuation techniques consistent with the market approach include matrix pricing and often use market multiples derived from a set of comparables.

The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Valuation techniques consistent with the income approach include present value techniques, option-pricing models, and the multi period excess earnings method.

The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). Fair value is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.

When the discounted cash flow approach is used to measure the fair value of servicing assets, a number of factors and assumptions are considered when projecting the potential income stream (net of servicing costs) generated by the servicing rights. This income stream is present valued using appropriate market discount rates to determine the estimated fair value of the servicing rights. These factors and assumptions, which should be adequately documented, include:

- Average loan balance and coupon rate,
- Average portfolio age and remaining maturity,
- Contractual servicing fees,
- Estimated income from escrow balances,
- Expected late charges and other possible ancillary income,
- Anticipated loan balance repayment rate (including estimated prepayment speeds),
- Direct servicing costs and appropriate allocations of other costs, as well as the inflation rate effect, and
- Delinquency rate and estimated out-of-pocket foreclosure and collection costs that will not be recovered.

Regulatory Capital

Part 325 provides information on the regulatory capital treatment of mortgage servicing assets and nonmortgage servicing assets.

For purposes of calculating Tier 1 capital, the balance sheet assets for mortgage servicing assets and nonmortgage servicing assets will each be reduced to an amount equal to the lesser of:

- 90 percent of the fair value of these assets; or
- 100 percent of the remaining unamortized book value of these assets (net of any related valuation allowances).

The total amount of mortgage servicing assets, nonmortgage servicing assets, along with purchased credit card relationships recognized for regulatory purposes (i.e., not deducted from assets and capital) is limited to no more than 100 percent of Tier 1 capital. In addition to the aggregate limitation on such assets, the maximum allowable amount of purchased credit card relationships and nonmortgage servicing assets, when combined, is limited to 25 percent of Tier 1 capital. These limitations are calculated before the deduction of any disallowed servicing assets, disallowed purchased credit card relationships, disallowed credit-enhancing interest-only strips, disallowed deferred tax assets, and any nonfinancial equity investments. In addition, banks may elect to deduct disallowed servicing assets on a basis that is net of any associated deferred tax liability.

Servicing Risk

Examiners should be aware of the risks that can affect an institution from the failure to follow the servicing rules related to securitized assets. While credit risk may appear to be of little or no concern, the mishandling of procedures in these transactions can affect a holder's ability to collect. Financial institutions perform roles as sellers, buyers, servicers, trustees, etc., in these types of transactions. Examiners should evaluate the potential risks that might arise from one or more of these roles. In most cases, the government agency that provided the guarantee or insurance against ultimate default will also impose guidelines and regulations for the servicer to follow. If the servicer or others involved in the servicing function fail to follow these rules and guidelines, then the government agency that is providing the guarantee or insurance may refuse to honor its commitment to insure all parties against loss due to default. It is necessary for the financial institution to have adequate policies and procedures in place to control and limit the institution's liability and exposure in this regard.

Examination Procedures

When assessing asset quality during onsite examinations and when reviewing merger applications, examiners and supervisory personnel should review the valuation and accounting treatment of servicing assets. The ED Module - Mortgage Banking contains various examination procedures and references for reviewing mortgage servicing assets.

OTHER LIABILITIES

Other Borrowed Money

Mortgages, liens, and other encumbrances on premises and other real estate owned, and obligations under capitalized leases, which the bank is legally obligated to pay, are reported as other borrowed money in the Call Report. Regardless of the mortgage amount outstanding on bank premises, the asset should be carried on the general ledger at historical cost net of accumulated depreciation. ASC 840 establishes generally accepted accounting principles regarding lease transactions that must be accounted for as a property acquisition financed with a debt obligation

Additional information on premises and leases is included in the Premises and Equipment section of this Manual.

Accrued Expenses

Expenses are also reported in the Call Report on the accrual basis of accounting that records revenues when realized or realizable and earned, and expenses when incurred. This attempt to match expenses incurred during a period to the revenues that they helped generate is known as the matching principle. At the end of each reporting period, but no less frequently than quarterly, bank management needs to make appropriate entries to record accrued expenses. Interest on deposits accrued through charges to expense during the current or prior periods, but not yet paid or credited to a deposit account, are reported as other liabilities in the Call Report. Likewise, the amount of income taxes, interest on nondeposit liabilities, and other expenses accrued through charges to expense during the current or prior periods, but not yet paid, are reported as other liabilities.

Servicing Liabilities

As noted under Servicing Assets, servicers typically receive certain benefits from a servicing contract and incur costs of servicing the assets. The accounting and reporting standards addressing servicing rights (i.e., assets and liabilities) are set forth in ASC 860-50. Servicing liabilities result from contracts to service financial assets for which the benefits of servicing are not expected to adequately compensate the servicer. Banks must initially measure a servicing liability at fair value and subsequently measure each class of servicing liabilities using either the amortization method or the fair value measurement method. The election of the subsequent measurement method should be made separately for each class of servicing liabilities. Refer to the Call Report Instructions for further details.

Deferred Tax Liabilities

As noted under Tax Assets, a net deferred tax liability is reported if a net credit balance results after offsetting deferred tax assets (net of valuation allowance) and deferred tax liabilities measured at the report date for a particular tax jurisdiction. A bank may report a net deferred tax debit, or asset, for one tax jurisdiction, and also report at the same time a net deferred tax credit or liability, for another tax jurisdiction.

Deferred tax liabilities are recognized for taxable temporary differences. For example, depreciation can result in a taxable temporary difference if a bank uses the straight-line method to determine the amount of depreciation expense to be reported in the Call Report but uses an accelerated method for tax purposes. In the early years, tax depreciation under the accelerated method will typically be larger than book depreciation under the straight-line method. During this period, a taxable temporary difference originates. Tax depreciation will be less than book depreciation in the later years when the temporary difference reverses. Other taxable temporary differences include the undistributed earnings of unconsolidated subsidiaries and associated companies and amounts funded to pension plans that exceed the recorded expense.

Allowance for Off-Balance Sheet Exposures

Each bank should maintain, as a separate liability account, an allowance at a level that is appropriate to cover estimated credit losses associated with off-balance sheet credit instruments such as loan commitments, standby letters of credit, and guarantees. This separate allowance should be reported as an other liability, not as part of the allowance for loan and lease losses. The allowance for credit losses on off-balance sheet exposures should meet the criteria for accrual of a loss contingency set forth in generally accepted accounting principles.

All Other Miscellaneous Liabilities

Examiners will encounter other miscellaneous liabilities not reported in major Balance Sheet or Other Liability categories that should be reported separately in all other liabilities in the Call Report. Examples include accounts payable, deferred compensation payable, dividends declared but not yet paid, and derivative instruments held for purposes other than trading that have a negative fair value.

INTRODUCTION

Off-balance sheet activities encompass a variety of items including certain loan commitments, certain letters of credit, and revolving underwriting facilities. Additionally, swaps, futures, forwards, and option contracts are derivative instruments whose notional values are carried off-balance sheet, but whose fair values are recorded on the balance sheet. Examiners reviewing off-balance sheet derivative contracts will find resources such as the Capital Markets Handbook, the Consolidated Reports of Condition and Income (Call Report) Instructions, Senior Capital Markets Specialists, and capital markets and accounting subject matter experts helpful.

Off-balance sheet fee producing activities can improve earnings ratios, at a faster pace than on-balance sheet fee producing activities. Earnings ratios typically use assets as a component. Since earnings generated from these activities are included in income, while total asset balances are not affected, ratios appear higher than they would if the income was derived from on-balance sheet activities. Because these types of activities remain off the balance sheet, capital to asset ratios (with the exception of risk-based capital ratios) are not adversely affected regardless of the volume of business conducted. But, the volume and risk of the off-balance sheet activities needs to be considered by the examiner in the evaluation of capital adequacy. Regulatory concern with off-balance sheet activities arises since they subject a bank to certain risks, including credit risk. Many of the risks involved in these off-balance sheet activities are indeterminable on an offsite-monitoring basis.

OFF-BALANCE SHEET ITEMS AND DERIVATIVES

Accounting treatment for derivatives activities is largely governed by Statement of Financial Accounting Standard No. (FAS) 133, *Accounting for Derivative Instruments and Hedging* Activities, and FAS 149, *Amendment of Statement 133*. In general terms, FAS 133 provides that derivative contracts must be reported at fair value on the balance sheet. Prior to the issuance of FAS 133, accounting standards generally allowed derivative contracts to be carried off-balance sheet.

General guidance regarding the risks involved with derivatives instruments and the proper recording and accounting are outlined below. Expanded guidance is delineated in the Capital Markets Handbook and the Call Report Glossary and the instructions for RC-L – Derivatives and Off-Balance Sheet Items.

OFF-BALANCE SHEET LENDING ACTIVITIES

An evaluation of off-balance sheet lending activities should apply the same general examination techniques that are used in the evaluation of a direct loan portfolio. For example, banks with a material level of contingent liabilities should have written policies addressing such activities adopted and approved by their board of directors. The policies should cover credit underwriting standards, documentation and file maintenance requirements, collection and review procedures, officer and customer borrowing and lending limits, exposures requiring committee or board approval, and periodic reports to the board of directors. Overall limits on these contingent liabilities and specific sub-limits on the various types of off-balance sheet lending activities, either as a dollar amount or as a relative percentage (such as a percent of total assets or capital), should also be considered.

In reviewing individual credit lines, all of a customer's borrowing arrangements with the bank (e.g., direct loans, letters of credit, and loan commitments) should be considered. Additionally, many of the factors analyzed in evaluating a direct loan (e.g., financial performance, ability and willingness to pay, collateral protection, future prospects) are also applicable to the review of such contingent liabilities as letters of credit and loan commitments. When analyzing these off-balance sheet lending activities, examiners should evaluate the probability of draws under the arrangements and whether an allowance adequately reflects the risks inherent in off-balance sheet lending activities. (Such allowances should not be included in the allowance for loan and lease losses (ALLL) since off-balance sheet items are not included within the scope of FAS 5 and 114.) Allowances for off-balance sheet items should be made to "Other liabilities." Consideration should also be given to legal lending limits, including the provision of Part 337 of the FDIC Rules and Regulations, which generally requires standby letters of credit to be included when determining any legal limitation on loans to one borrower.

Letters of Credit

A letter of credit is a document issued by a bank on behalf of its customer authorizing a third party to draw drafts on the bank up to a stipulated amount and with specified terms and conditions. The letter of credit is a conditional commitment (except when prepaid by the account party) on the bank's part to provide payment on drafts drawn in accordance with the document terms. There are four basic types of letters of credit: travelers, those sold for cash, commercial, and standby.

Travelers – A travelers letter of credit is addressed by the bank to its correspondents authorizing drafts by the person named in accordance with specified terms. These letters are generally sold for cash.

Sold for Cash – When a letter of credit is sold for cash, the bank receives funds from the account party at the time of issuance. This letter is not reported as a contingent liability, but rather as a demand deposit.

Commercial – A commercial letter of credit is issued specifically to facilitate trade or commerce. Generally, drafts will be drawn when the underlying transaction is consummated as intended. Commercial letters of credit not sold for cash do, however, represent contingent liabilities and should be accorded examination treatment as such. Refer to the International Banking section of this Manual for further details on commercial letters of credit.

Standby – A standby letter of credit (SBLC) is an irrevocable commitment on the part of the issuing bank to make payment to a designated beneficiary. It obligates the bank to guarantee or stand as surety for the benefit of a third party. SBLCs can be either financial-oriented, where the account party is to make payment to the beneficiary, or performance-oriented, where a service is to be performed by the account party. SBLCs are issued for a variety of purposes, such as to improve the credit ratings for issuers of industrial development revenue bonds and commercial paper; to provide back-up facilities for loans granted by third parties; to assure performance under construction and employment contracts; and to ensure the account party satisfies financial obligations payable to major suppliers or under tax shelter programs.

FASB Interpretation No. (FIN) 45, *Guarantor's Accounting and Disclosure Requirements of Guarantees, Including Indirect Guarantees of Indebtedness of Others*, clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. FIN 45 applies to standby letters of credit, both financial and performance. Commercial letters of credit are not considered guarantees, and therefore, are not subject to FIN 45.

An SBLC differs from a commercial letter of credit in that the latter facilitates the sale of goods and is expected to be drawn upon by the beneficiary in the normal course of business, whereas the SBLC is not, generally, expected to be used unless the account party defaults in meeting an obligation to the beneficiary.

While no particular form is required for a SBLC, it should contain certain descriptive information. First, there should be a separate binding agreement wherein the account party agrees to reimburse the bank for any payments made under the SBLC. The actual letter should be labeled as a "standby letter of credit," be limited in amount, cover a specific time period, and indicate the relevant information that must be presented to the bank before any draws will be honored due to the account party's failure to perform. Since the bank is not a party to the contract between the account party and the beneficiary, the SBLC should not be worded so as to involve the bank in making determinations of fact or law at issue between the parties.

The two primary areas of risk relative to SBLCs are credit risk (the possibility of default on the part of the account party), and funding risk (the potential inability of the bank to fund a large draw from normal sources). An SBLC is a potential extension of credit and should be evaluated in a manner similar to evaluating a direct loan. The risk could be significant under an SBLC given its irrevocable nature, especially if the SBLC is written for an extended time period. Deterioration in the financial position of a customer could allow for a direct loan commitment to be rescinded if the commitment contained a "material adverse change" clause; however, such would not be applicable with an SBLC since it is an irrevocable agreement between the bank and the beneficiary. Some SBLCs may have an automatic renewal provision and will roll over until notice of cancellation is given by either the bank or beneficiary prior to a maturity date. However, notice given by the bank usually allows the beneficiary to draw under the letter irrespective of whether the account party is performing.

SBLCs, like loans, can be participated and syndicated. Unlike loans, however, the sale of SBLC participations does not diminish the total contingent liability of the originating bank. The name of the originating bank is on the actual letter of credit, and it must therefore honor all drafts whether or not the participants are willing or able to disburse their pro rata share. Syndications, on the other hand, represent legal apportionments of liability. If one of the banks fails to fulfill its obligation under the SBLC, the remaining banks are not liable for that bank's share.

Section 337.2(d) of the FDIC Rules and Regulations requires banks to maintain adequate controls and subsidiary records of SBLCs comparable to records maintained on direct loans so that a bank's total liability may be determined at all times. Banks are also required to adequately reflect all SBLCs on published financial statements. Credit files should be kept current as to the status of SBLCs, and reports should be provided on a regular basis to the directors on the volume of standby letters, with a breakdown by type, as well as by industry.

This report will enable any concentrations to be monitored so that steps can be taken to reduce any undue exposure should economic or financial trends so dictate.

It may be appropriate to adversely classify or Special Mention an SBLC if draws under the SBLC are probable and credit weaknesses exist. For example, deterioration in the account party's financial standing could jeopardize performance under the letter of credit and result in a draw by the beneficiary. If a draw under an SBLC were to occur, the offsetting loan to the account party could then become a collection problem, especially if it was unsecured.

Loan Commitments

A formal loan commitment is a written agreement, signed by the borrower and lender, detailing terms and conditions under which a loan of up to a specified amount will be made. The commitment will have an expiration date and, for agreeing to make the accommodation, the bank may require a fee to be paid and/or require the maintenance of a stipulated compensating balance by the customer. A commitment can be irrevocable, like an SBLC facility, operating as an unconditional guarantee by the bank to lend when called upon to do so by the customer. In many instances, however, commitments are conditioned on the maintenance of a satisfactory financial standing by the customer and the absence of default in other covenants. A bank may also enter into an agreement to purchase loans from another institution, which should be reflected as off-balance sheet items, until the sale is consummated. Loan commitments intended for sale are covered under Mortgage Banking later in this Section.

Some commitments are expected to be used, such as a revolving working capital line for operating purposes or a term loan facility wherein the proceeds will be used for such purposes as equipment purchases, construction and development of property, or acquisitions of other companies. Other commitments serve as backup facilities, such as for a commercial paper issue, whereby usage would not be anticipated unless the customer was unable to retire or roll over the issue at maturity.

Less detailed than a formal loan commitment, is a line of credit, which expresses to the customer, usually by letter, a willingness to lend up to a certain amount over a specified time frame, frequently one-year in duration. These lines of credit are disclosed to the customer and are referred to as "advised" or "confirmed" lines, in contrast to "guidance" lines, which are not made known to the customer, but are merely used by the bank as lending guidelines for internal control and operational purposes. Many lines of credit are cancelable if the customer's financial condition deteriorates, while others are simply subject to cancellation at the bank's option.

Disagreements can arise as to what constitutes a legally binding commitment on the part of the bank. Descriptive terminology alone, as used by the bank, might not always be the best guideline. For example, a credit arrangement could be referred to as a revocable line of credit, but at the same time may be a legally binding commitment to lend, especially if consideration has been given by the customer and if the terms of the agreement between the parties result in a contract. It is important to identify the extent of the bank's legally binding and revocable commitments to ensure that obligations are properly documented and legally defensible should the bank contemplate canceling a loan commitment.

Credit documentation frequently contains a "material adverse change" (MAC) clause, which is intended to allow the bank to terminate the commitment or line of credit arrangement if the customer's financial condition deteriorates. The extent to which MAC clauses are enforceable depends on whether a legally binding relationship continues to exist when specific financial covenants are violated. Although the enforceability of MAC clauses may be subject to some uncertainty, such clauses may provide the bank with leverage in negotiations with the customer over such issues as requests for additional collateral or personal endorsements.

Whether funding of a commitment or line of credit will be required cannot always be determined in a routine manner and careful analysis will frequently be necessary. A MAC clause could allow the bank to refuse funding to a financially troubled borrower, or a covenant default might also be a means of canceling the commitment or line of credit. Some banks might refuse funding if any covenant is broken, whereas others might take a more accommodating approach and make advances short of a bankruptcy situation. The procedure followed by the bank in acceding to or denying take down requests where adverse conditions have arisen is an important consideration in the examiner's overall evaluation of credit risk.

In assessing the adequacy of a bank's asset/liability management program, it is important to evaluate the anticipated funding of loan commitments and lines of credit relative to anticipated funding sources. At each examination, the amount of funding that is anticipated for unused commitments and disclosed lines of credit should be estimated. If the amount is large relative to the bank's liquidity position, completion of the Cash Flow Projection workpaper may be useful to give an indication of cash availability and whether borrowings will be needed to meet anticipated draws. For further information, refer to the Liquidity and Funds Management section of this Manual.

OFF-BALANCE SHEET ASSET TRANSFERS

Mortgage Banking

Under FAS 149, *Amendment of Statement 133*, loan commitments that relate to the origination or purchase of mortgage loans that will be *held for sale*, commonly referred to as interest rate lock commitments, must be accounted for as derivatives by the issuers of the commitment. Interest rate lock commitments include floating and fixed rate commitments to fund loans intended for sale. Since they are derivatives, interest rate lock commitments must be fair valued and accounted for on the general ledger. Mortgage loan commitments (both floating and fixed rate) that must be accounted for as derivative instruments are considered over-the-counter written interest rate options. The total notional amount of loan commitments *held for sale* is typically reported in RC-L Derivatives and Off-Balance Sheet Items within the category for Gross Amounts of Derivatives.

Many times the bank will originate a forward contract to sell loans (which could be mandatory delivery, best efforts, or private-label securitization) with investors. In addition to the held for sale loan commitment that is accounted for as a derivative, the bank must account for the forward contract to sell loans. Institutions cannot offset derivatives with negative fair values against those with positive fair values, unless the criteria for “netting” under generally accepted accounting procedures (GAAP) have been satisfied.

Commitments to originate mortgage loans that will be *held for investment* purposes and commitments to originate other types of loans are **not** considered derivatives. Unused portions of loan commitments that are not considered derivatives should continue to be reported as off-balance sheet items.

Assets Sold Without Recourse

Assets (including loans) sold without recourse are generally not a contingent liability. In the case of participations, the bank should reflect on the general ledger only that portion of participated loans it retained. However, some banks may follow the practice of repurchasing loan participations and absorbing any loss on such loans even when no legal responsibility exists. It is necessary to determine management's attitude toward repurchasing these assets in order to evaluate the degree of risk involved. Contingent liabilities may result if the bank, as seller of a loan participation without recourse, does not comply with participation and/or loan agreement provisions. Noncompliance may result from a number of factors, including failure on the part of the selling institution to receive collateral and/or security agreements, obtain required guarantees, or notify the purchasing party of default or adverse financial performance on the part of the borrower. The purchaser of the participation may also assert claims against the bank on the basis that the financial information relied upon when acquiring the loan was inaccurate, misleading, or fraudulent and that the bank as a seller was aware of this fact. Therefore, a certain degree of risk may in fact be evident in participation loans sold without recourse. Examiners need to be mindful of this possibility and the financial consequences it may have on the bank. Further discussion of loan participations is contained in the Loans section of this Manual.

Assets Sold With Recourse

Assets transferred in transactions that **do not** qualify as sales under GAAP remain as balance sheet assets. For example, loan transfers that do not qualify for sale treatment would remain on the balance sheet and the proceeds raised from transfer are reflected as a secured borrowing with pledge of collateral.

Assets (including loans) sold with recourse **may qualify** for sale treatment under FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, if certain criteria are met. Under FAS 140, a transfer of financial assets is accounted for as a sale if the transferor surrenders control over those assets and receives consideration other than an interest in the transferred assets. Control is evaluated using three criteria: legal isolation of the financial assets from the transferor (purported seller); the ability of the transferee (investor) to pledge or sell the assets; and the absence of a right or obligation of the transferor to repurchase the financial assets.

If the asset transfer (e.g., a loan sale) qualifies as a sale under FAS 140, the asset may be removed from the general ledger. However, if an asset transfer, which qualifies for sale treatment under GAAP, contains certain recourse provisions, the transaction would be treated as an asset sale with recourse for purposes of reporting risk-based capital information in Schedules RC-R and RC-S within the Call Report. In those circumstances, examiners need to consider the recourse attributes when calculating risk-based capital. When reviewing assets sold with recourse, examiners should refer to the Call Report Glossary under

Sales of Assets for Risk-Based Capital Purposes, FAS 140, and Part 325 of the FDIC Rules and Regulations.

Recourse and Direct Credit Substitutes

A recourse obligation or direct credit substitute typically arises when an institution transfers assets in a sale and retains an obligation to repurchase the assets or absorb losses due to a default of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may also exist implicitly where a bank provides credit enhancement beyond any contractual obligation to support assets it sold.

When an examiner encounters recourse arrangements or direct credit substitutes (commonly found in securitization and mortgage banking operations), they should refer to the outstanding Financial Institution Letters, Call Report guidance, Part 325 of the FDIC Rules and Regulations, and FAS 133 and 140.

OFF-BALANCE SHEET CONTINGENT LIABILITIES

Asset-Backed Commercial Paper Programs

Asset-backed commercial paper programs are usually carried out through a bankruptcy-remote, special-purpose entity, which generally is sponsored and administered by a bank to provide funding to its corporate customers. Some programs will qualify for consolidation onto a bank's general ledger. For programs that are not consolidated, a bank should report the credit enhancements and liquidity facilities it provides to the programs as off-balance sheet liabilities.

Bankers Acceptances

The following discussion refers to the roles of accepting and endorsing banks in bankers acceptances. It does not apply to banks purchasing other banks' acceptances for investment purposes, which is described in the Other Assets and Liabilities section of this Manual. Bankers acceptances may represent either a direct or contingent liability of the bank. If the bank creates the acceptance, it constitutes a direct liability that must be paid on a specified future date. If a bank participates in the funding risk of an acceptance created by another bank, the liability resulting from such endorsement is only contingent in nature. In analyzing the degree of risk associated with these contingent liabilities, the financial strength and repayment ability of the accepting bank should be taken into consideration. Further discussion of bankers acceptances is contained in the International Banking section of this Manual under the heading Forms of International Lending.

Revolving Underwriting Facilities

A revolving underwriting facility (RUF) (also referred to as a note issuance facility) is a commitment by a group of banks to purchase at a fixed spread over some interest rate index, the short-term notes that the issuer/borrower is unable to sell in the Euromarket at or below this predetermined rate. In effect, the borrower anticipates selling the notes as funds are needed at money market rates, but if unable to do so, has the assurance that credit will be available under the RUF at a maximum spread over the stipulated index. A lead bank generally arranges the facility and receives a one-time fee, and the RUF banks receive an annual commitment or underwriting fee. When the borrower elects to draw down funds, placement agents arrange for a sale of the notes and normally receive compensation based on the amount of notes placed. The notes usually have a maturity range of 90 days to one-year and the purchasers bear the risk of any default on the part of the borrower. There are also standby RUFs, which are commitments under which Euronotes are not expected to be sold in the normal course of the borrower's business.

Inability to sell notes in the Euromarket could be the result of a financial deterioration on the part of the borrower, but it could also be due to volatile short-term market conditions, which precipitate a call by the borrower on the participating banks for funding under the RUF arrangement. The evaluation of RUFs by the examiner will follow the same procedures used for the review of loan commitments. An adverse classification should be accorded if it is determined that a loan of inferior quality will have to be funded under a RUF.

ADVERSELY CLASSIFIED CONTINGENT LIABILITIES

For examination purposes, Category I contingent liabilities are defined as those which will give rise to a concomitant increase in bank assets if the contingencies convert into actual liabilities. Such contingencies should be evaluated for credit risk and if appropriate, listed for Special Mention or subjected to adverse classification. This examination treatment does not apply to Category II contingent liabilities where there will be no equivalent increase in assets if a contingency becomes a direct liability. Examination treatment of Category II contingencies is covered under Contingent Liabilities in the Capital section of this Manual.

Classification of Category I contingencies is dependent upon two factors: the likelihood of the liability becoming direct and the credit risk of the potential acquired asset. Examiners should refer to the Report of Examination Instructions and the Bank of Anytown contained in this Manual for Report of Examination treatment when adversely classifying or special mentioning contingent liabilities.

Adverse classification and Special Mention definitions for direct loans are set forth in the Loans section of this Manual. The following adverse classification and Special Mention criteria should be viewed as a supplement to those definitions and considered when evaluating contingent liability credit risk.

Special Mention – The chance of the contingency becoming an actual liability is at least reasonably possible, and the potentially acquired assets are considered worthy of Special Mention. An example would be the undrawn portion of a poorly supervised accounts receivable line where the drawn portion is listed for Special Mention.

Substandard – The chance of the contingency becoming an actual liability is at least reasonably possible, and the potentially acquired assets are considered no better than Substandard quality. Undisbursed loan funds in a speculative real estate venture in which the disbursed portion is classified Substandard and the probability of the bank acquiring the underlying property is high, would be an example of a Substandard contingency.

Doubtful – The chance of the contingency becoming an actual liability is probable, and the potentially acquired assets are considered of Doubtful quality. Undisbursed loan funds on an incomplete construction project wherein cost overruns or diversion of funds will likely result in the bank sustaining significant loss from disposing the underlying property could be an example of a Doubtful contingency.

Loss – The chance of the contingency becoming an actual liability is probable, and the potentially acquired assets are not considered of bankable quality. A letter of credit on which the bank will probably be forced to honor draws that are considered uncollectible is an example of a Loss contingency. A Loss classification normally indicates that a balance sheet liability (specific reserve) should be established to cover the estimated loss. For further information as to when a contingency should be reflected as a direct liability on the balance sheet, refer to FAS 5, *Accounting for Contingencies*.

INTRODUCTION

The quality of management is probably the single most important element in the successful operation of a bank. For purposes of this section, management includes both the board of directors, which is elected by the shareholders, and executive officers, who are appointed to their positions by the board. In the complex, competitive, and rapidly changing environment of financial institutions, it is extremely important for all members of bank management to be aware of their responsibilities and to discharge those responsibilities in a manner which will ensure stability and soundness of the institution, so that it may continue to provide to the community the financial services for which it was created.

The extreme importance of a bank director's position is clearly emphasized by the fact that bank directors can, in certain instances, be held personally liable. Also, Congress has placed great emphasis on the role of bank management by passing legislation which allows regulatory authorities to utilize "cease and desist" actions against individuals (instead of solely against the institution) to assess civil money penalties (CMPs), and even remove an officer, director, or other person participating in the affairs of the bank when their gross negligence or disregard for safety and soundness considerations threatens the financial safety of the bank.

The board of directors is the source of all authority and responsibility. In the broadest sense, the board is responsible for formulation of sound policies and objectives of the bank, effective supervision of its affairs, and promotion of its welfare. On the other hand, the primary responsibility of executive management is implementation of the board's policies and objectives in the bank's day-to-day operations. While selection of competent executive management is critical to the successful operation of any bank, the continuing health, viability, and vigor of the bank are dependent upon an interested, informed and vigilant board of directors. Therefore, the main thrust of this section is devoted to the powers, responsibilities, and duties vested in bank directors.

MANAGEMENT/DIRECTORS

Selection and Qualifications of Directors

Being selected to serve as a bank director is generally regarded as an honor, for it often denotes an individual's reputation as being successful in business or professional endeavors, public spirited, and entitled to public trust and confidence. It is this latter attribute and the public accountability implicit therein that distinguishes the office of bank director from directorships in most other corporate enterprises. Bank directors are not only responsible to the stockholders who elected them, but must also be concerned with the safety of depositors' funds and the influence the bank exercises on the community it serves.

Various laws governing the election of board members emphasize the importance of a director’s position. Statutory or regulatory qualifications usually include taking an oath of office, unencumbered ownership of a specific amount of the bank's capital stock, and residential and citizenship requirements. Other laws also pertain to the qualification and selection of directors. There are, for example, certain restrictions, prohibitions, and penalties relating to: interlocking directorates; purchases of assets from or sales of assets to directors; commissions and gifts for procuring loans; and criminal activities such as embezzlement, abstraction, willful misapplication, making false entries, and improper political contributions. These qualifications and restrictions have no counterpart in general corporate law and both illustrate and emphasize the quasi-public nature of banking, the unique role of the bank director, and the grave responsibilities of that office. The position of bank director is one, therefore, not to be offered or entered into lightly.

Aside from the legal qualifications, each director should bring to the position particular skills and experience which will contribute to the composite judgment of the group. Directors should have ideas of their own and the courage to express them, sufficient time available to fulfill their responsibilities, and be free of financial difficulties which might tend to embarrass the bank. The one fundamental and essential attribute, which all bank directors must possess without exception, is personal integrity. Its presence usually gives assurance of a well-intentioned, interested and responsible director capable of assuming the important fiduciary responsibilities of the office and representing fairly and equitably the diverse interests of stockholders, depositors and the general public. The Statement Concerning the Responsibilities of Bank Directors and Officers states that the duties of loyalty (to administer the affairs of the bank with candor, personal honesty and integrity) and care (to act as prudent and diligent business persons in conducting the affairs of the bank) are among the most important responsibilities of bank directors. Other desirable personal characteristics include: knowledge of the duties and responsibilities of the office; genuine interest in performing those duties and responsibilities to the best of their ability; capability to recognize and avoid potential conflicts of interest, or the appearance of same, which might impair their objectivity; sound business judgment and experience to facilitate understanding of banking and banking problems; familiarity with the community and trade area the bank serves and general economic conditions; and an independence in their approach to problem solving and decision making.

Powers, Duties and Responsibilities of Directors

The powers, duties and responsibilities of the board of directors are usually set forth in the applicable banking statutes and the bank's charter and bylaws. Generally speaking, the powers and responsibilities of bank directors include but are not limited to those discussed below.

Regulating the Manner in Which All Business of the Bank is Conducted

Directors must provide a clear framework of objectives and policies within which executive officers operate and administer the bank's affairs. These objectives and policies should, at a minimum, cover investments, loans, asset/liability and funds management, profit planning and budgeting, capital planning, internal routine and controls, audit programs, conflicts of interest, code of ethics, and personnel. Specialty areas, such as the Bank Secrecy Act (BSA), Information Technology (IT), Trust Department activities, and consumer compliance should also be subject to similar appropriate oversight and internal guidelines. Objectives and policies in most instances should be written and reviewed periodically to determine that they remain applicable. Examiners may encounter situations (often in smaller banks with control vested in one or a few individuals) where written policies have not been developed for these operational functions, and management is reluctant to do so on the grounds that such written guidelines are unnecessary. To a considerable degree, the necessity for written policies may be inferred from the results achieved by management. That is, if the examiner's assessment of the bank reflects that it is sound and healthy in virtually every important respect, it may be difficult to convince management of the need for formalized written policies. However, when deficiencies are noted in one or more aspects of a bank's operations, it is nearly always the case that absence of written and clearly defined objectives, goals, performance standards, and limits of authority is an important contributing factor. There are few better means of ensuring that directors are properly supervising the bank's affairs than by their direct participation in devising, enforcing, and modifying the institution's written guidelines on such matters as investments, loans, marketing, capital and profit planning. Moreover, it is recognized that the depth and detail of written policies may properly vary among banks, depending on the nature, scope and complexity of their operations. Therefore, it remains the FDIC's strongly held belief that all banks should have written policies which are readily understood by all affected parties, kept up-to-date, and relevant to the institution's needs and circumstances. While it is acceptable for a bank to obtain written policies from an outside source, it is the responsibility of management to ensure that the policies are suited to their bank and that the policies accurately describe the bank's practices. The board of directors should give final approval of the substantial content of policies.

The policies and objectives of the directorate should include provisions for adherence to the Interagency Guidelines Establishing Standards for Safety and Soundness set forth in Part 364, Appendix A, of the FDIC Rules and Regulations. These standards set specific guidelines for the safe operation of banks in the following areas: internal controls and information systems; internal audit system; loan documentation; credit underwriting; interest rate exposure; asset growth; asset quality; earnings; and compensation, fees, and benefits. The specific provisions for each area are discussed in further detail within the appropriate sections of this DSC Risk Management Manual of Examination Policies (Manual). Conformance to these standards may help identify emerging problems and correct deficiencies before capital becomes impaired. The standards, which should be viewed as minimum requirements, establish the objectives of proper operations and management, but leave specific methods of achieving these objectives to each institution.

Examiners should review the bank’s conformance to the safety and soundness standards at each examination. The nature, scope and risk of the institution’s activities should be considered when evaluating the adequacy of controls in each of the respective areas. Material deficiencies should be documented in appropriate sections of the Report of Examination.

Corporate Planning

A vital part of the responsibilities of directors is to set the future direction of the bank. Planning, organizing, and controlling are three fundamental dimensions of management. Planning, however, had not been a priority concern for a large part of the banking industry. This may have been due in part to the fact that the industry has historically been highly regulated and somewhat insulated from competitive pressures and sudden change. Dramatic changes in the structure, volatility and technology associated with the financial services market altered this situation and led to an emphasis on deregulating financial institutions. Increased competition and innovation consequently produced an environment characterized by uncertainty.

Sound planning is indispensable in dealing with this uncertainty and rapid change. In order to be effective, planning must be dynamic, carefully attended to, and well supported. Projections must be revised periodically as circumstances change and new strategies devised to meet stated objectives. An increasingly competitive marketplace suggests that an inadequate or ill-conceived planning process may be as much the cause of bank failure as poor loans.

The adequacy of a bank's planning process may be judged by considering questions such as:

- How formal is the bank's planning process?
- Who is involved? The board? Middle management?
- Is the plan based on realistic assumptions regarding the bank's present and future market area(s) and nontraditional competitive factors?
- Does the bank monitor actual performance against its plan?
- Does the bank consider alternative plans in response to changing conditions?

Although the focus must be on an evaluation of the process, the plan itself cannot be ignored if, in the examiner's judgment, the plan is predicated on assumptions which are inappropriate or unrealistic. This assessment must take into account the personnel and financial resources and operating circumstances and conditions unique to the bank being examined. It is emphasized that plotting the future direction of the institution is, properly, the responsibility of the board of directors and not examiners. However, when the goals and objectives chosen by directors are likely to result in significant financial harm to the bank, examiners must identify the deficiencies in the plan and attempt to effect necessary changes.

Absence of a satisfactory planning process or glaring weaknesses in the plan itself must be considered in the appraisal of bank management.

Appointing, Dismissing at Pleasure, and Defining the Duties of Officers

It is a primary duty of a board of directors to select and appoint executive officers who are qualified to administer the bank's affairs effectively and soundly. It is also the responsibility of the board to dispense with the services of officers who prove unable to meet reasonable standards of executive ability and efficiency.

Personnel Administration

Recruiting, training, and personnel activities are vital to the development and continuity of a quality staff. Some features of good personnel administration are a designated organization structure, detailed position descriptions, carefully planned recruiting, appropriate training and developmental activities, a performance appraisal system, quality salary administration, and an effective communications network.

Honestly and Diligently Administering the Affairs of the Bank

The board of directors is charged with the responsibility of conducting the affairs of the bank. It is not expected to directly carry out details of the bank's business; these may be delegated to senior officers. But they may not be delegated and forgotten. The power to manage and administer carries with it the duty to supervise; therefore, directors must periodically examine the system of administration they have established to see that it functions properly. Should it become obsolete, it should be modernized, or should the bank's officers fail to function as intended, the cause(s) should be determined and corrections made.

Observance of Applicable Laws

It is important for directors to ensure that executive management is cognizant of applicable laws and regulations; develop a system to effect and monitor compliance, which will likely include provisions for training and retraining personnel in these matters; and, when violations do occur, make correction as quickly as possible. Board members cannot be expected to be personally knowledgeable of all laws and regulations, but they should make certain that compliance with all laws and regulations receives high priority and violations are not knowingly committed by themselves or anyone the bank employs.

Avoiding Self-Serving Practices

Although somewhat independent from the responsibility to provide effective direction and supervision, the need for directors to avoid self-serving practices and conflicts of interest is of no less importance. Bank directors must place performance of their duties above personal concerns. Wherever there is a personal interest of a director that is adverse to that of the bank, the situation clearly calls for the utmost fairness and good faith in guarding the interests of the bank. Accordingly, directors must never abuse their influence with bank management for personal advantage, nor wrongfully employ confidential information concerning the bank's clients. The same principles with respect to self-serving practices and conflicts of interest apply to the executive management of the bank.

Paying Such Dividends as May Properly Be Paid

The board of directors has the responsibility of maintaining an adequately capitalized bank, and once this responsibility has been satisfied, the payment of dividends can and should receive consideration. Dividends represent the distribution of bank earnings to owners. Establishing the medium, rate, and date of payment must be based on the directors' overall assessment of the bank's financial condition.

Appropriate Internal Control System and Adequate Auditing Program

A sound framework of internal controls and a reliable and objective audit function are essential tools for bank directors. The existence of such enable directors to remain well informed of the adequacy, effectiveness, and efficiency of accounting, operating, and administrative controls and provide an assessment of the quality of ongoing operations. Establishment and oversight of such controls is the responsibility of the board of directors. Refer to the Internal Routines and Controls section for a complete discussion of these vital areas.

Management Information System (MIS)

The critical need for and dependence on information involves a concern and responsibility for the integrity of not only the specific information furnished, but the system that supplies it as well. Advances in technology have helped banks improve both information availability and models for analysis and decision making. Regardless of the technology employed, management is responsible for developing and implementing an information system that facilitates managerial activities. Review of these reports should be undertaken during onsite examinations to ascertain the accuracy of the information being provided.

An effective MIS is comprised of information from a number of sources, and the information must serve a number of users, each having various needs. The MIS must selectively update information and coordinate it into meaningful and clear formats. One possible approach would be to combine information from the bank's accounting system with other internal sources, such as personnel records, and include information from external sources regarding economic conditions, characteristics of the marketplace and competition, technology, and legal regulatory requirements. Quality, quantity and timeliness are factors that determine the effectiveness of management information systems.

Supervision by Directors

Supervision by directors does not necessarily indicate a board should be performing management tasks, but rather ensuring that its policies are being implemented and adhered to and its objectives achieved. It is the failure to discharge these supervisory duties, which has led to bank failures and personal liability of directors for losses incurred.

Directors' supervisory responsibilities can best be discharged by establishing procedures calculated to bring to their attention relevant and accurate information about the bank in a consistent format and at regular intervals. From this critical point, the remainder of a director's job unfolds. Directors who keep abreast of basic facts and statistics such as resource growth, capital growth, loan-to-deposit ratios, deposit mix, liquidity position, general portfolio composition, loan limits, loan losses and recoveries, delinquencies, etc., have taken a first, indispensable step in discharging their responsibilities. It is essential, therefore, that directors insist on receiving pertinent information about the bank in concise, meaningful and written form, and it is one of executive management's most important responsibilities to make certain directors are kept fully informed on all important matters and that the record clearly reflects this.

Directors' meetings that are conducted in a businesslike and orderly manner are a significant aid to fulfillment of the board's supervisory responsibilities. This requires, among other things, regular attendance (whether by actual or audio, video or other remote access). Absence without just cause is, like ignorance, not a valid defense. Moreover, a director's attendance should be an informed and intelligent one, and the record should reflect this. If directors dissent from the majority, they should, for their own protection, insist upon their negative vote being recorded along with reasons for their action.

Careful and consistent preparation of an agenda for each board meeting not only assists in the conduct of such meetings, but also provides board members reasonable assurance that all important matters are brought to their attention. Agenda items will vary from bank to bank depending on asset size, type of business conducted, loan volume, trust activities and so forth. In general, the agenda should include reports on income and expense; new, overdue, renewed, insider, charged-off and recovered loans; investment activity; personnel; and individual committee actions.

To carry out its functions, the board of directors may appoint and authorize committees to perform specific tasks and supervise certain phases of operations. In most instances, the name of the committee, such as loan, investment, examination, and, if applicable, trust, identifies its duties. Of course, utilization of the committee process does not relieve the board of its fundamental responsibilities for actions taken by those groups. Review of the minutes of these committees' meetings should be a standard part of the board meeting agenda.

Communication of facts to a board of directors is essential to sound and effective supervision. However, with the ever-broadening scope of modern banking and the increased complexity of banking operations, the ability of a board of directors to effectively supervise is becoming more difficult. Because of this, the use of outside personnel to provide management supervision is relatively common. While this does not release the board from its legal and implied responsibilities, it does provide an opportunity for management improvement through the use of these external sources. The bank holding company can play a very large role in the supervision of its individual banks. Bank holding companies which control a number of banks may be able to provide individual banks' boards with lending and investment counseling, audit and internal control programs or services, profit planning and forecasting, personnel efficiency reports, electronic data processing services, marketing strategy and asset appraisal reports. Banks that do not operate within a holding company organization are also able to obtain management assistance from various firms offering the above services. In the interest of quality supervision by a bank's board of directors, the use of outside advisors, while not releasing the board from its responsibilities, can be a valuable management tool.

Legal Liabilities of Directors

In general, directors and other corporate officers of a bank may be held personally liable for: a breach of trust; negligence which is the proximate cause of loss to the bank; ultra vires acts, or acts in excess of their powers; fraud; and misappropriation or conversion of the bank's assets. From the standpoint of imposing directors' liability where the facts evidence that fraud, misappropriation, conversion, breach of trust or commission of ultra vires acts is clearly shown, a relatively simple situation presents itself. Difficulties usually arise, however, in cases involving negligence (or breach of duty) which fall short of breach of trust or fraud.

Directors' liability for negligent acts is premised on common law for failure to exercise the degree of care prudent individuals would exercise under similar circumstances, and/or noncompliance with applicable statutory law, either or both of which cause loss or injury to the bank. Statutory liability is reasonably well defined and precise. Common law liability is somewhat imprecise since failure to exercise due care on the part of a director depends on the facts and circumstances of the particular case.

A director's duty to exercise due care and diligence extends to the management, administration and supervision of the affairs of the bank and to the use and preservation of its assets. Perhaps the most common dereliction of duty by bank directors is the failure to maintain reasonable supervision over the activities and affairs of the bank, its officers and employees. The actions and inactions listed below have been found to constitute negligence on the part of directors.

- An attitude of general indifference to the affairs of the bank, such as failing to hold meetings as required by the bylaws, obtain a statement of the financial condition of the bank, or examine and audit the books and records of the bank to determine its condition.
- Failure to heed warnings of mismanagement or defalcations by officers and employees and take appropriate action.
- Failure to adopt practices and follow procedures generally expected of bank directors.
- Turning over virtually unsupervised control of the bank to officers and employees relying upon their supposed fidelity and skill.
- Failure to acquaint themselves with examination reports showing the financial condition of a company to which excessive loans had been made.
- Assenting to loans in excess of applicable statutory limitations.
- Permitting large overdrafts in violation of the bank’s internal policies or permitting overdrafts to insiders in violation of law.
- Representing certain assets as good in a Report of Condition when such assets were called to the directors' attention as Loss by the primary regulator and directions were given for their immediate collection or removal from the bank.

In the final analysis, liability of bank directors for acts of negligence rests upon their betrayal of those who placed trust and confidence in them to perform the duties of their office honestly, diligently and carefully. While applicable principles involving directors' negligence (or breach of duty) are easy enough to state, their application to factual situations presents difficulties. In essence, the courts have judged the conduct of directors "not by the event, but by the circumstance under which they acted" (Briggs v. Spaulding, 141 U.S. 132, 155(1890), 35L. Ed. 662, 672). Courts also have generally followed what may be called the rule of reason in imposing liability on bank directors, "lest they should, by severity in their rulings, make directorships repulsive to the class of men whose services are most needed; or, by laxity in dealing with glaring negligences, render worthless the supervision of director's over...banks and leave these institutions a prey to dishonest executive officers" (Robinson v. Hall, 63 Fed. 222, 225-226 (4th Cir. 1894)).

The following quotation represents a brief recapitulation of the law on the subject (Rankin v. Cooper, 149 Fed. 1010, 1013 (C.C.W.D. Ark. 1907) :

> "(1) Directors are charged with the duty of reasonable supervision over the affairs of the bank. It is their duty to use ordinary diligence in ascertaining the condition of its business, and to exercise reasonable control and supervision over its affairs. (2) They are not insurers or guarantors of the fidelity and proper conduct of the executive officers of the bank, and they are not responsible for lossses resulting from their wrongful acts or omissions, provided they have exercised ordinary care in the discharge of their own duties as directors. (3) Ordinary care in this matter as in other departments of the law, means that degree of care which ordinarily prudent and diligent men would exercise under similar circumstances. (4) The degree of care required further depends upon the subject to which it is to be applied and in each case must be determined in view of all circumstances. (5) If nothing has come to their knowledge to awaken suspicion that something is going wrong, ordinary attention to the affairs of the institution is sufficient. If, upon the other hand, directors know, or by the exercise of ordinary care should have known, any facts which would awaken suspicion and put a prudent man on his guard, then a degree of care commensurate with the evil to be avoided is required, and a want of that care makes them responsible. Directors cannot, in justice to those who deal with the bank, shut their eyes to what is going on around them. (6) Directors are not expected to watch the routine of every day's business, but they ought to have a general knowledge of the manner in which the bank's business is conducted, and upon what securities its larger lines of credit are given, and generally to know of and give direction to the important and general affairs of the bank. (7) It is incumbent upon bank directors in the exercise of ordinary prudence, and as a part of their duty of general supervision, to cause an examination of the condition and resource of the bank to be made with reasonable frequency."

FEDERAL BANKING LAWS AND REGULATIONS PRIMARILY PERTAINING TO BANK DIRECTORS

Section 18(k) of the Federal Deposit Insurance Act (FDI Act) - Authority to Regulate or Prohibit Certain Forms of Benefits to Institution Affiliated Parties

Part 359 of the FDIC Rules and Regulations - Golden Parachutes and Indemnification Payments

Part 359, pursuant to Section 18(k), permits the FDIC to prohibit or limit, by regulation or order, golden parachute payments or indemnification payments. Refer to “Other Issues” within this section for additional information.

Section 39(c) of the FDI Act - Compensation Standards

This statute requires the FDIC to prohibit excessive compensation to executive officers, employees, directors, and principal shareholders as an unsafe and unsound practice. The definition of excessive compensation, as well as the specific prohibition required by Section 39(c), is found in Section III of Appendix A to Part 364, Standards for Safety and Soundness. Refer to “Other Issues” within this section for further information.

Section 32 of the FDI Act - Agency Disapproval of Directors and Senior Executive Officers of Insured Depository Institutions or Depository Institution Holding Companies

A troubled insured depository institution or troubled depository institution holding company may not add any individual to the board of directors or employ any individual as a senior executive officer if the appropriate Federal banking agency issues a notice of disapproval of such addition or employment before the end of the 90-day period beginning on the date the agency receives the required notice.

Section 19 of the FDI Act - Penalty for Unauthorized Participation by Convicted Individual

Section 19 of the FDI Act prohibits, without the prior written consent of the FDIC, a person convicted of any criminal offenses involving dishonesty or breach of trust or money laundering, or who has entered into a pretrial diversion or similar program in connection with a prosecution for such offense, from becoming or continuing as an institution-affiliated party (IAP), owning or controlling, directly or indirectly, an insured institution, or otherwise participating, directly or indirectly, in the conduct of the affairs of an insured institution.

The intent of Section 19 is not punitive. Rather, the purpose is to provide the applicant an opportunity to demonstrate that a person is fit to participate in the conduct of the affairs of an institution without posing a risk to its safety and soundness or impairing public confidence in that institution. The FDIC's policy is to approve applications in which this risk is absent. For additional guidance, refer to the FDIC Statement of Policy for Section 19 of the FDI Act.

Part 349 of the FDIC Rules and Regulations - Reports and Public Disclosure of Indebtedness of Executive Officers and Principal Shareholders to a State Nonmember Bank and its Correspondent Banks

This regulation implements Section 7(k) if the FDI Act and Section 106(b)(2)(G)(ii) of Bank Holding Company Act Amendments of 1970 (BHCA Amendments). The BHCA Amendments prohibit (1) preferential lending by a bank to executive officers, directors, or principal shareholders of another bank, when there is a correspondent account relationship between the banks; or (2) the opening of a correspondent account relationship between banks when there is a preferential extension of credit by one of the banks to an executive officer, director or principal shareholders of the other bank. The BHCA Amendments also impose reporting and disclosure requirements with respect to certain insiders.

Section 22(g) and 22(h) of the Federal Reserve Act - Loans to Executive Officers of Banks and Extensions of Credit to Executive Officers, Directors and Principal Shareholders of Member Banks

The Federal Reserve Board's Regulation O – Loans to Executive Officers, Directors and Principal Shareholders of Member Banks

Section 337.3 of the FDIC Rules and Regulations – Limits on Extensions of Credit to Executive Officers, Directors and Principal Shareholders of Insured Nonmember Banks

Sections 22(g) and 22(h) are incorporated into the FDI Act via Section 18(j)(2) and pertain to loans and extensions of credit by both member and nonmember banks to their executive officers, directors, principal shareholders and their related interests. Section 18(j)(2) does not apply to any foreign bank in the United States but does apply to the insured branch itself. It is a very important statute in the examination and supervisory process because it is aimed at prevention and detection of insider abuse, a common characteristic of failed or failing banks.

Part 215 of the Federal Reserve Board's Regulation O was issued pursuant to Sections 22(g) and 22(h) of the Federal Reserve Act. It requires that extensions of credit to executive officers, directors, principal shareholders or their related interests be made on substantially the same terms and follow credit underwriting procedures that are not less stringent than those prevailing at the time for comparable transactions with persons not covered by the regulation. Aggregate lending limits and prior approval requirements are also imposed by Regulation O. Moreover, payment of overdrafts of directors or executive officers is generally prohibited unless part of a written, preauthorized interest bearing, extension of credit plan or by transfer of funds from another account at the bank. The requirements, prohibitions and restrictions of Regulation O are important and examiners should be fully familiar with them. The complete text of the regulation is contained in the FDIC Rules and Regulations.

Section 337.3 of the FDIC Rules and Regulations makes Regulation O applicable to state nonmember banks and sets forth requirements for approval of extensions of credit to insiders. Specifically, prior approval of the bank's board of directors is necessary if an extension of credit or line of credit to any of the bank's executive officers, directors, principal shareholders, or to any related interest of any such person, exceeds the amount specified in the regulation when aggregated with the amount of all other extensions of credit or lines of credit to that person. This approval must be granted by a majority of the bank's directors and the interested party(ies) must abstain from participating directly or indirectly in the voting.

Any nonmember insured bank which violates or any officer, director, employee, agent or other person participating in the conduct of the affairs of a nonmember insured bank who violates any provision of Section 22(g) or 22(h) of the Federal Reserve Act may be subject to a CMP. In determining the amount of the penalty, the FDIC takes into account the financial resources and good faith of the bank or person charged, gravity of the violation, history if any of previous violations, and such other matters as justice may require. Examiners are reminded violations of Regulation O must be evaluated in accordance with the 13 factors specified in the Interagency Policy Regarding the Assessment of Civil Money Penalties by the Federal Financial Institutions Regulatory Agencies.

Part 348 of the FDIC Rules and Regulations - Management Official Interlocks

This act is contained in 12 U.S.C. 1823(k) and its general purpose is to foster competition. It prohibits a management official of one depository institution or depository holding company from also serving in a similar function in another depository institution or depository holding company if the two organizations are not affiliated and are located in the same area or if the two organizations are not affiliated and are very large, as defined in the regulation.

A number of exceptions allowing interlocking relationships for certain organizations and their affiliates are detailed in Part 348 of the Rules and Regulations. Under Section 8(e) of the FDI Act, the FDIC may serve written notice of intention to remove a director or officer from office whenever, in its opinion, such director or officer of an insured bank has violated the Depository Institution Management Interlocks Act.

Section 7(j) of the FDI Act and the Change in Bank Control Act of 1978

Section 7(j) of the FDI Act prohibits any person, acting directly or indirectly or through or in concert with one or more other persons, from acquiring control of any insured depository institution through a purchase, assignment, transfer, pledge, or other disposition of voting stock of the insured bank unless the appropriate Federal banking agency has been given 60-days prior written notice of the proposed acquisition. An acquisition may be made prior to the expiration of the disapproval period if the agency issues written notice of its intent not to disapprove the action. The term "insured depository institution" includes any bank holding company or any other company which has control of any insured bank. The term "control" is defined as the power, directly or indirectly, to direct the management or policies of an insured bank or to vote 25% or more of any class of voting securities of an insured bank. Willful violations of this statute are subject to civil money penalties of up to $1 million per day. This statute gives the FDIC important supervisory powers to prevent or minimize the adverse consequences that almost invariably occur when incompetent or dishonest individuals obtain positions of authority and influence in banks.

Section 737 of the Gramm-Leach-Bliley Act – Bank Officers and Directors as Officers and Directors of Public Utilities

This section of the Gramm-Leach-Bliley Act amends the Federal Power Act to preclude persons from serving both as an officer or director of a public utility and a bank except in certain circumstances. Dual service is permissible when the individual does not participate in any deliberations involved in choosing a bank to underwrite or market the securities of the utility, when the bank is chosen by competitive procedures, or when the issuance of securities by the public utility have been approved by all appropriate regulatory agencies.

Section 8 of the FDI Act

Among other things, Section 8 of the FDI Act provides the Federal banking agencies with the authority to take action to remove from office or prohibit an IAP from any further participation in the conduct of the affairs of any depository institution. Specifically, Section 8(e) and Section 8(g) are utilized in such proceedings. Actions taken under this authority represent serious charges with significant potential consequences. Therefore, outstanding guidelines should be closely followed during the examination process. For additional guidance, refer to Section 8 the FDI Act and the Formal Administrative Actions section of this Manual.

OTHER ISSUES

Indebtedness of Directors, Officers and Their Interests

The position of director or officer gives no license to special credit advantages or increased borrowing privileges. Loans to directors, officers and their interests must be made on substantially the same terms as those prevailing at the time for comparable transactions with regular bank customers. Therefore, management loans should be evaluated on their own merits. Their business operations will, in many instances, necessitate bank loans, and these will ordinarily be among a bank's better assets. Since directors usually maintain a deposit relationship with their bank, this carries with it an obligation to meet their reasonable and prudent credit requirements.

On the other hand, there have been many instances where improper loans to officers, directors, and their interests resulted in serious losses. Unfortunately, when the soundness of a management loan becomes questionable, an embarrassing situation usually results. That is, management loans frequently may not be subject to the same frank discussion accorded other loans. Bank directors may assent to such loans, despite knowledge that they are unwarranted, rather than oppose a personal or business friend or associate. Moreover, directors who serve on the board in order to increase their opportunities for obtaining bank credit are reluctant to object to credit extensions to their colleagues. Problems that occur with management loans have received considerable legislative attention and laws have been passed to curb abuses associated with the position of director or officer (i.e. Regulation O). However, while steps have been taken to reduce the potential for problems in this area, a review of the board's policies and actual practices regarding insider loans remains an important part of the examination process.

Conflicts of Interest

Examiners should be especially alert to any insider involvement in real estate projects, loans or other business activities that pose or could pose a conflict of interest with their fiduciary duties of care and loyalty to the bank. On occasion, loans are advanced to business associates involved in apparently unrelated projects where an insider nevertheless benefited. The involvement of bank insiders in these projects is sometimes not apparent since ownership is held in the form of "business trusts" or other entities without disclosure of the identity or personal guarantees of the principals. In order to help uncover these types of situations, examiners should routinely inquire of senior management, through incorporation in the "first day" letter or request, whether any of the following situations exist:

- Loans or other transactions existing at the bank in which an officer, director or principal stockholder (or immediate family member of each) of the bank holds a beneficial interest.
- Loans or other transactions in which an officer, director or principal stockholder (or immediate family member of each) of another depository institution holds a beneficial interest.
- Loans or other transactions at any other depository institution in which a bank officer, director, or principal stockholder (or immediate family member of each) holds a beneficial interest, either direct or indirect.
- Loans or other transactions in which an officer, director or principal stockholder (or immediate family member of each) has no direct interest but which involve parties with whom an insider has other partnership or business associations.
- Loans extended personally by officers, directors or principal stockholders (or immediate family member of each) to parties who are also borrowers from the bank or loans extended personally by any borrowing customers to an officer, director or principal stockholder of the bank.

If any of this information is not readily available, management should be requested to survey their officers, directors and principal stockholders, as necessary, to obtain it.

Examiners are also reminded to inquire into bank policies and procedures designed to bring conflicts of interest to the attention of the board of directors when they are asked to approve loans or other transactions in which an officer, director or principal stockholder may be involved. Where such policies and procedures are lacking or insufficient to reveal insider involvement before action is taken by the board, the bank should be strongly encouraged to remedy the deficiency. The board should also be encouraged to act specifically on any loan or other transaction in which insiders or their associates may be involved, either directly or indirectly, or because of business associations outside the loan or transaction in question. Moreover, the results of board deliberations on any matter involving a potential conflict of interest should be noted clearly in the minutes.

Examiners are also reminded to carefully scrutinize any loan or other transaction in which an officer, director or principal stockholder is involved. Such loans or other transactions should be sound in every respect and be in full compliance with applicable laws and regulations and the bank's own policies. Any deficiencies in credit quality or other aspects of the transaction should receive critical comment not only from an asset quality perspective but from a management perspective as well. More specifically, if a director has a personal financial interest in a loan or other transaction subject to adverse classification, the board should be urged to require that director to strengthen the credit sufficiently to remove the adverse classification within a reasonable time frame or resign from the board. In the event a principal stockholder or an officer who is not a director is involved in an adversely classified loan or other transaction, the board should be urged to assume special oversight over the loan or activity, either directly or through a committee of outside directors, with a view towards limiting any further exposure and moving aggressively to secure or collect any exposed balances as the circumstances may permit. There should be concern that these types of situations not only tend to compromise the credit standards of the lending institution and eventually may lead to losses, but that they can also lead to violations of civil and criminal laws.

Nonbanking Activities Conducted on Bank Premises

Many banks conduct nonbanking activities on bank premises by selling insurance (e.g. credit life, accident and health) in conjunction with loan transactions of the bank. When these nontraditional banking activities take the form of establishment of a new department or subsidiary of the bank, the benefit and profit is directly realized by the bank and its shareholders. However, when these activities are conducted on bank premises for the benefit of others, a bank may be deprived of corporate opportunity and profit. The FDIC has long taken the position that when nonbanking activities are conducted on bank premises either by bank personnel or others and when the benefit and profit do not flow directly to the bank, certain disclosures, approvals, and reimbursements must be made.

In all cases, the bank's directors and shareholders should be fully informed regarding the nonbanking activity conducted on bank premises. The operation should be approved by the bank's shareholders, and expenses incurred by the bank in connection with these operations formally approved by the board of directors annually. The bank should be adequately compensated for any expenses it incurs in furnishing personnel, equipment, space, etc. to this activity. It is recommended that bank management disclose completely to its bonding company any such nonbanking activity conducted on its premises. Management would also be well advised to obtain acknowledgement from the bonding company that such activities do not impair coverage under the fidelity bond. Finally, the conduct of nonbanking activity must be in conformance with applicable State statutes and regulations.

Situations where the bank is being deprived of corporate opportunity through the diversion of opportunity or profit, or inadequately compensated for the utilization of its resources should be discussed with bank management and commented upon in the Risk Management Assessment and the Examination Conclusions and Comments pages, if appropriate. Additionally, the absence of disclosure and approval to the bank's directors, shareholders, and bonding company should be discussed with management and covered in the aforementioned schedule(s). Finally, in those instances where the examiner believes, based on known facts, that a violation of applicable statutes or regulations has occurred, or where there is no question that a criminal violation has been committed, the matter should be handled in accordance with guidelines prescribed in other sections of this Manual.

Directors of "One Man Banks" and Advisory Directors

Directors of “One Man Banks”

Supervisory authorities are properly concerned about the "One Man Bank" wherein the institution's principal officer and stockholder dominates virtually all phases of the bank's policies and operations. Often this situation stems from the personality make-up of the principal officer or ownership control, and it is usually abetted by an apathetic board of directors. Many bank directors when first elected have little or no technical knowledge of banking and feel dependent upon others more knowledgeable in banking matters. When this feeling becomes deep-seated and widespread, a managerial vacuum is created which an overly aggressive officer may fill and thus achieve a position of dominance. This development is facilitated by the fact that directors are very often nominated by bank officers to whom they feel indebted for the honor, even though stockholders elect them. Over the years, an officer can influence the election of a sufficient number of directors so that the officer is ultimately able to dominate the board and the affairs of the bank.

There are at least two potential dangers inherent in a "One Man Bank" situation. First, incapacitation of the dominant officer may deprive the bank of competent management, and because of the immediate need to fill the managerial void, may render the bank vulnerable to dishonest or incompetent replacement leadership. Second, problem situations resulting from mismanagement are more difficult to solve through normal supervisory efforts because the bank’s problems are often attributed to the one individual that dominates the bank.

In “One Man Bank” situations, it is extremely important that examiners assess the bank’s control environment and, when applicable, recommend necessary changes to the control structure. When examiners review the risk profile and control environment of a bank that is controlled by a dominant official, examiners should consider and assess whether:

- An appropriate segregation of duties and responsibilities is achieved or alternative actions are taken to mitigate the level of control exercised by the one individual.
- Director involvement in the oversight of policies and objectives of the bank is at an appropriate level.
- A diverse board membership provides the bank with an assortment of knowledge and expertise, including, but not limited to, banking, accounting, and the major lending areas of the bank’s target markets.
- There are a sufficient number of outside and independent directors.
- Committees of major risk areas exert a proper level of function, responsibility, and influence, and the value of the committees is exhibited in the decision-making process.
- A proper level of independence has been achieved for board committees of major risk areas, including, but not limited to, audit committees.

- An adequate audit committee has been established with only, or at least a majority of, outside directors.
- A need exists for the performance of annual financial audits by an independent certified public accounting firm.
- A qualified, experienced, and independent internal auditor is in place at the bank.
- A proper segregation of the internal audit function is achieved from operational activities.
- An appropriate rationale was established regarding changing a bank's external auditors, independent of oral discussions with bank management, including, but not limited to, a review of the audit committee minutes or a review of auditor notifications.
- An adequate written code of conduct and ethics and conflicts of interest policies have been established.
- A need exists for the bank's board to perform and report on an annual conflicts of interest and ethics review.
- A need exists for a bank to engage outside consultants to conduct an external loan review.
- A proper segregation of the internal loan review process is established.

The above serve as potential controls to mitigate the risk posed by a dominant official. In situations where appropriate segregation of duties, director independence and involvement, audit functions, code of conduct/ethics/conflict of interest policies and practices, and internal loan review function are lacking, deficiencies should be emphasized in the Report of Examination. When such weaknesses are evident, internal policies and practices should be sufficiently strengthened in order to mitigate the level of risk presented by the existence of such a dominant official. Recommendations, including provisions for supervisory action, when warranted, should be considered. Refer to the Formal Administrative Actions section for a discussion of possible supervisory actions in dealing with an overly dominant management official.

Advisory Directors

A naturally sensitive situation develops where the value of a director diminishes due to extensive outside commitments, illness, etc. Often such individuals do not wish to relinquish their position and the bank may be hesitant to request they do so. Some banks have met this situation by establishing a position of honorary director (or similar title) for persons who are no longer able to effectively fulfill the demanding duties of bank director. Generally, the honorary director attends board meetings as desired and offers advice on a limited participation basis, but has no formal voice or vote in proceedings, nor the responsibilities or liabilities of the office, except where there may be a continuing connection with a previous breach of duty as an official director.

Restrictions on Golden Parachute Payments and Indemnification Payments

Golden Parachute Payments

- The rule (Part 359) limits and/or prohibits, in certain circumstances, insured depository institutions, their subsidiaries, and their affiliated depository institution holding companies from agreeing to make or making golden parachute payments when the entity making the payment is "troubled," as defined in Section 303.101 of the FDIC Rules and Regulations.
- The rule does not restrict the payment of golden parachutes by healthy institutions, except that depository institution holding companies (including healthy ones) are prohibited from making golden parachute payments to IAPs of troubled subsidiary banks and savings associations.
- Several exceptions to the prohibition are included in the regulation; some are required by statute, others have been added by the FDIC. These exceptions are as follows:

    - Bona-fide deferred compensation plans.
    - Nondiscriminatory severance payment plans (for personnel reductions in force).
    - Qualified pension or retirement plans.
    - Payments pursuant to employee welfare benefit plans.
    - Payments made by reason of termination caused by death or disability.
    - Payments required by State statute or foreign law.

  The final three listed exceptions require the approval of both the appropriate Federal banking agency and the FDIC.

    - A troubled institution hiring new management ("White Knight").
    - Severance payment in the event of an unassisted change in control.
    - Any others on a case-by-case basis with the regulators' approval.

Indemnification Payments

- With regard to indemnification payments, Part 359 limits the circumstances under which an insured depository institution, its subsidiary, or affiliated depository institution holding company may indemnify institution affiliated parties IAPs for expenses incurred in administrative or civil enforcement actions brought by bank regulators. The circumstances where indemnification may be permitted are as follows:

1. The institution’s board of directors determines in writing that these four criteria are satisfied:

   - The IAP acted in good faith and in a manner believed to be in the best interests of the institution.
   - The payment will not materially adversely affect the safety and soundness of the institution.
   - The payment is limited to expenses incurred in an administrative proceeding or civil action instituted by a Federal financial institution's regulator.
   - The IAP agrees to reimburse the institution if he/she is found to have violated a law, regulation, or other fiduciary duty.

2. An insurance policy or fidelity bond may pay the cost of defending an administrative proceeding or civil action. It may not pay a penalty or judgement.

- Under no circumstances may an institution or an insurance policy of the institution indemnify an IAP for any judgment or civil money penalty imposed in an action where the IAP is assessed a civil money penalty, is removed from office or prohibited from participating in the affairs of the institution, or is required to cease and desist from or take any affirmative action pursuant to section 8(b) of the FDI Act. However, partial indemnification is allowed for charges that are found in the IAP’s favor as explained below under “Issues.”

Issues

Generally speaking, the essence of Part 359 lies in its definitions of terms such as: golden parachute payment, bona fide deferred compensation plan, and prohibited indemnification payment, as well as certain significant exceptions to the general prohibitions.

The following are additional discussions on several issues encompassed in the regulation.

- The rule does not apply to contracts and agreements entered into prior to the effective date of the rule (April 1, 1996). However, the FDIC put institutions and their IAPs on notice in the proposed rule (March 29, 1995) that the FDIC will look unfavorably upon any golden parachute agreement which was entered into after the proposal, but before the date of the final rule, that attempts to circumvent the regulation. Appropriate orders should be pursued in such cases.

- With regard to indemnification payments, the majority of administrative or civil enforcement cases end in a settlement and no indemnification payment will be permitted unless charges are dropped. The parties concerned will have to factor in this cost of no indemnification in their decisions to settle or not.

  However, there are situations when an individual has been charged with several significant items of misconduct, etc., and then during the process a settlement is reached where only some of the infractions are admitted. The rule permits partial indemnification in those cases. There is a special case-by-case exception to allocate costs to the sets of charges with indemnification permitted for those that are dropped.

  Partial indemnification is not permitted in cases where an IAP is removed from office and/or prohibited from participating in the affairs of the institution.

  It is recognized that in many cases the appropriate amount of any partial indemnification will be difficult to ascertain with certainty. Although no prior regulatory consent is required, obviously the regulators are part of the settlement process. The process provides the opportunity for the regulators to give “non-objections” at the time of settlement, prior to the indemnification being made. As part of the settlement process, the bank should be required to provide from the attorney a statement containing a description of specifically attributable expenses. Concern should focus on the reasonableness of the allocations.

- If a golden parachute is prohibited to an individual leaving the institution, it is prohibited forever, even if the institution returns to health (after the individual has left the institution). There are ample exceptions and procedures for an individual who is leaving a troubled institution to avoid the prohibition if that individual has not contributed significantly to the demise of the institution. If an individual does not qualify for one of these exceptions, that individual should not benefit due to the institution reversing its course and returning to health after that individual has left the institution.

- Troubled institutions cannot apply for an exception to offer "white knight" parachutes to their current officers to not leave the institution. Rather it is to entice new management to join the institution by compensating for the uncertainty of joining a troubled institution. It is considered illogical for the FDIC to provide an exception to permit a troubled institution to offer a buyout to current management to get them to stay. The regulation does not prohibit an institution from offering golden parachutes to their current officers. It only prohibits the payment of a golden parachute if the individual leaves while the institution is troubled. On the contrary, it is believed to be of greater incentive that the only way the current officers' golden parachutes will be of value is if they stay and work to return the institution to health.

- Approval is required for a severance payment in the event of an unassisted change in control. A maximum payment of 12 months salary is permitted under this exception. Any requests for payments in excess of this amount (12 months salary) would have to be considered for approval under the general case-by-case exception.

  This exception is provided in recognition of the need for current management to be motivated to seek out acquirers. This exception is believed appropriate for cases where the IAP may not clearly demonstrate that all the factors for the general exception are evident, yet an acquisition of the troubled institution has been arranged and the acquirer is willing to make the otherwise prohibited golden parachute payment. On the other hand, if after consideration of the factors for the general case-by-case exception, the appropriate Federal banking agency and/or the FDIC determines it inappropriate to make the severance payment, an exception should not be approved.

Excessive Compensation

Section III of Part 364, Appendix A, prohibits the payment of excessive compensation, as well as compensation that could lead to material financial loss to an institution, as an unsafe and unsound practice. Furthermore, Section II of Part 364, Appendix A, urges institutions to maintain safeguards that prevent excessive compensation or compensation that could subject the institution to material financial loss. Excessive compensation is defined as when amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director, or principal shareholder. The following items should be considered when determining whether compensation is excessive:

- The combined value of all cash and noncash benefits provided to an individual;
- The compensation history of the individual and other individuals with comparable expertise;
- The financial condition of the institution;
- Compensation practices at comparable institutions, based on such factors as asset size, location, and the complexity of the loan portfolio or other assets;
- For post-employment benefits, the projected total cost and benefit to the institution;
- Any connection between the individual and any instance of fraud or insider abuse occurring at the institution; and
- Any other factors determined to be relevant.

The FDIC does not seek to dictate specific salary levels or ranges for directors, officers, or employees. In fact, Section 39 of the FDI Act prohibits establishing guidelines that set a specific level or range of compensation for bank insiders. The criteria listed above are designed to be qualitative rather than quantitative in order to grant an institution's directors reasonable discretion when structuring a compensation program.

Examiners should review the information used by the board to establish the compensation structure of the institution. The information should adequately explain the rationale for the system in place and should enable the board to consider the above items that determine whether compensation is excessive.

Gaining Access to Bank Records and Employees

Section 10(b)(6) of the FDI Act provides authority for examiners to make a thorough examination of any insured depository institution and to complete a full and detailed report of the institution's condition. In most instances, the executive officers of insured depository institutions cooperate with the requests of examiners. However, there are rare occasions when executive officers are extremely uncooperative, or refuse to provide access to bank records and employees that are essential to the evaluation of the condition of the institution. In such cases, this pattern of behavior by executive officers may be indicative of serious problems in the bank, including fraud, mismanagement, or insolvency. The Regional Office should be consulted when executive officers restrict access to bank records or employees.

Bank Owned Life Insurance (BOLI)

A number of banks use BOLI as a means of protecting against the loss of key employees or hedging employee compensation and benefit plans. However, the purchase of life insurance is subject to supervisory considerations and life insurance holdings must be consistent with safe and sound banking practices. Bankers should complete a thorough analysis before purchasing BOLI. Associated risks, minimum standards for pre-purchase analysis and basic guidelines are detailed in the Other Assets and Liabilities section of this Manual.

EVALUATION OF MANAGEMENT

A bank's performance with respect to asset quality and diversification, capital adequacy, earnings performance and trends, liquidity and funds management, and sensitivity to fluctuations in market interest rates is, to a very significant extent, a result of decisions made by the bank's directors and officers. Consequently, findings and conclusions in regard to the other five elements of the CAMELS rating system are often major determinants of the management rating. More specific considerations are detailed in the Basic Examination Concepts and Guidelines section of this Manual. However, while a bank's overall present condition can be an indicator of management's past effectiveness, it should not be the sole factor relied upon in rating management. This is particularly true when there is new management or when the bank's condition has been significantly affected by external factors versus internal decisions.

When significant problems exist in a bank's overall condition, consideration must be given to management's degree of responsibility. However, appropriate recognition should also be given to the extent to which weaknesses are caused by external problems (such as a severely depressed local economy). A distinction should be made between problems caused by bank management and those largely due to outside influences. Management of a bank whose problems are related to the economy would warrant a higher rating than management believed substantially responsible for a bank's problems, provided that prudent planning and policies are in place and management is pursuing realistic resolution of the problems. Management's ability becomes more critical in problem situations, and it is important to note management's policies and acts of omission or commission in addressing problems.

The extent to which mismanagement has contributed to areas of weakness is particularly relevant to the management evaluation. Similarly, positive economic conditions may serve to enhance a bank's condition despite weak or undocumented policies and practices. At a minimum, the assessment of management should include the following considerations:

- Whether or not insider abuse is in evidence;
- Existing management's past record of performance in guiding the bank;
- Whether loan losses and other weaknesses are recognized in a timely manner;
- Past compliance with supervisory agreements, commitments, orders, etc.; and
- Capability of management to develop and implement acceptable plans for problem resolution.

Assessment of new management, especially in a problem situation, is difficult. Performance by individuals at their former employment, if known to the examiner, may be helpful, but the examiner should assess each situation based on its particular circumstances. The management rating should generally be consistent with any recommended supervisory actions. A narrative statement supporting the management rating and reconciling any apparent discrepancies between the assigned rating and any recommended supervisory actions (or lack of recommended actions) should be included on the confidential pages of the examination report.

Examination procedures regarding the evaluation of management are included in the Examination Documentation Modules.

RATING THE MANAGEMENT FACTOR

Uniform Financial Institutions Rating System

The Federal Deposit Insurance Corporation and the other Federal Financial Institutions Examination Council (FFIEC) member agencies adopted a uniform interagency system for rating the condition and soundness of the nation's banks. The Uniform Financial Institutions Rating System involves an assessment of six critical aspects of a bank's condition and operations. Management and administration is one of those critical dimensions.

The capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution’s activities and to ensure a financial institution’s safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in this rating. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures, and practices have been established. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives, and risk limits into prudent operating standards.

Depending on the nature and scope of an institution's activities, management practices may need to address some or all of the following risks: credit, market, operating or transaction, reputation, strategic, compliance, legal, liquidity, and other risks. Sound management practices are demonstrated by active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls taking into consideration the size and sophistication of the institution; maintenance of an appropriate audit program and internal control environment; and effective risk monitoring and management information systems. This rating should reflect the board's and management's ability as it applies to all aspects of banking operations as well as other financial service activities in which the institution is involved.

The capability and performance of management and the board of directors is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The level and quality of oversight and support of all institution activities by the board of directors and management.
- The ability of the board of directors and management, in their respective roles, to plan for, and respond to, risks that may arise from changing business conditions or the initiation of new activities or products.
- The adequacies of, and conformance with, appropriate internal policies and controls addressing the operations and risks of significant activities.
- The accuracy, timeliness, and effectiveness of management information and risk monitoring systems appropriate for the institution's size, complexity, and risk profile.
- The adequacy of audits and internal controls to: promote effective operations and reliable financial and regulatory reporting; safeguard assets; and ensure compliance with laws, regulations, and internal policies.
- Compliance with laws and regulations.
- Responsiveness to recommendations from auditors and supervisory authorities.
- Management depth and succession.
- The extent that the board of directors and management is affected by, or susceptible to, dominant influence or concentration of authority.
- Reasonableness of compensation policies and avoidance of self-dealing.
- Demonstrated willingness to serve the legitimate banking needs of the community.
- The overall performance and risk profile of the institution.

Ratings

A rating of 1 indicates strong performance by management and the board of directors and strong risk management practices relative to the institution's size, complexity, and risk profile. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

A rating of 2 indicates satisfactory management and board performance and risk management practices relative to the institution's size, complexity, and risk profile. Minor weaknesses may exist, but are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

A rating of 3 indicates management and board performance that need improvement or risk management practices that are less than satisfactory given the nature of the institution's activities. The capabilities of management or the board of directors may be insufficient for the type, size, or condition of the institution. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

A rating of 4 indicates deficient management and board performance or risk management practices that are inadequate considering the nature of an institution's activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to preserve the soundness of the institution. Replacing or strengthening management or the board may be necessary.

A rating of 5 indicates critically deficient management and board performance or risk management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution. Replacing or strengthening management or the board of directors is necessary.

INTRODUCTION

The board of directors is responsible for ensuring the proper and profitable conduct of banking activities; the safety of the bank's assets; and the accuracy and adequacy of periodic reports to shareholders, regulatory bodies, and in some instances, the general public. As a result, the primary responsibility for creating, implementing, and monitoring a system of internal control rests with the directorate. Rarely, if ever, can the board personally discharge the many duties stemming from these responsibilities. The workload usually demands delegation to the management team and other employees. Increases in asset size and complexity and business lines result in the need for a continually growing and changing series of interrelated operating procedures intended to establish and maintain control over delegated duties. These continual changes require that the internal control system be periodically reviewed and updated in order for it to be effective.

Internal control is a process 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, which is brought about by an institution's board of directors, management, and other personnel, is essential to achieving the internal control objectives. This description of internal control is consistent with the Committee of Sponsoring Organizations of the Treadway Commission (COSO) report entitled *Internal Control-Integrated Framework*. Institutions are encouraged to evaluate their internal control against the COSO internal control framework if they are not already doing so.

BASIC ELEMENTS OF AN INTERNAL CONTROL SYSTEM

Internal accounting controls are the techniques employed to prevent and detect errors in the processing of data and to safeguard assets and the reliability of financial records. Many internal control techniques are built into the operating system so that they appear to be part of the normal processing of a given task. Any attempt to identify and evaluate the overall system of controls requires that individual activities be considered in concert with other activities. The relative importance of an individual control, or lack thereof, must be viewed in the context of other control procedures that are in place. Every bank is unique, and one set of internal procedures, or for that matter, even a few sets of alternative procedures, cannot be prescribed for all cases. There are, however, certain basic principles and procedures that must be present in any bank to ensure the adequacy of internal controls. These include: development of an effective organizational structure; establishment of appropriate accounting procedures; provisions for the protection of assets; and development and use of an effective audit program.

Organizational Structure

The control environment begins with the bank's board of directors, which is responsible for the development of objectives and policies and for monitoring adherence to such. The policies established should ensure that decision-making authority is vested at the proper management level and that management decisions and policies are properly implemented throughout the organization. An effective directors' audit committee, made up of or including outside directors, is desirable to accomplish that responsibility.

The organization plan must have the complete support of the board of directors and must establish clear lines of authority and responsibility. The plan must segregate the operating and recording functions and provide for employees who are qualified to perform their assignments. From an organizational viewpoint, an internal control system, at a minimum, should provide for the items listed below.

Directors' Approvals

Limitations imposed by the board of directors with regard to authority levels, such as lending and investment authority and responsibilities, should be clearly detailed in (preferably) written job descriptions and policies. Actions taken by officers should be subject to periodic review by the board or a committee thereof. This control feature should provide for a reporting system that keeps the directors informed of such items as new loans, overdue loans, overdrafts, securities transactions, the statements of condition and income, and expense and audit reports.

Segregation of Duties

The participation of two or more persons or departments in a transaction causes the work of one to serve as proof for the accuracy of another. Additionally, when two or more persons are involved in a transaction, the possibility of fraud diminishes considerably. Ideally, duties should be arranged so that no one person dominates any transaction from inception to termination. For example, a loan officer should not be allowed to disburse loan proceeds; those having authority to sign checks should not be assigned to reconcile correspondent bank accounts; records should be reconciled to the general ledger by someone other than the one originating the entries; and IT service center personnel should not initiate transactions or correct data except when such activity may be required to complete processing in a reasonable period of time (if this unusual situation arises, transactions should be approved by appropriate levels of management at the data center and at the serviced institution).

Rotation of Personnel

Planned and unannounced rotation of duties is an important principle of internal control. The rotation should be of sufficient duration to be effective. Rotation of personnel, besides being an effective internal check, can be a valuable aid in the overall training program.

Sound Personnel Policies

Sound personnel policies are conducive to establishing an effective control environment. Such policies should include hiring employees for positions commensurate with their skills, effective training before assignment to more responsible positions, and evaluating and reviewing job performance with each employee.

Vacation Policies

All banks should have a vacation policy, which provides that officers and employees be absent from their duties for an uninterrupted period of not less than two consecutive weeks. Such a policy is considered an important internal safeguard largely because perpetration of an embezzlement of any substantial size usually requires the constant presence of the embezzler in order to manipulate records, respond to inquiries from customers or other employees, and otherwise prevent detection. Examiners and bank management should recognize that the benefits of this policy may be substantially, if not totally, eroded if the duties performed by an absent individual are not assumed by someone else. Where the bank's policy does not conform to the two-week recommended absence period, examiners should encourage the board of directors to annually review and approve the policy actually followed and the exceptions allowed. In such cases it is important that adequate compensating controls be devised and strictly enforced. If after consideration of all relevant facts and circumstances it is determined that the vacation policies are deficient, the matter should be discussed with the chief executive officer and the board of directors. Comments and recommendations on the supplemental Internal Routine and Controls schedule may be appropriate.

Accounting Procedures

The adoption of an accounting system that is flexible in capacity and rigid in controls and standards promotes accuracy and efficiency and holds costs to a minimum. Such a system is considered basic to any system of internal controls.

An efficient banking operation cannot be conducted without a recordkeeping system capable of generating a wide variety of internal information and reports. Such a system is necessary if the board of directors is to be kept well-informed and maximum managerial effectiveness is to be achieved. Furthermore, the needs of customers, supervisory agencies, and tax authorities must be met. Banks are often called upon to produce certain records in court.

While it is expected that forms, records, and systems will differ from bank to bank in varying degrees, the books of every bank should be kept in accordance with well-established accounting and banking principles. In each instance, a bank's records and accounts should reflect the actual financial condition and accurate results of operations. The following characteristics should be found in a bank's accounting procedures.

Operating Responsibilities

The accounting system should be designed to facilitate preparation of internal reports that correspond with the responsibilities of individual supervisors and key employees.

Current Records

Records should be updated daily, reflecting each day's activities separately and distinctly from that of another day. The records should show the bank's financial condition as of the given date.

Subsidiary Control Accounts

Subsidiary records, such as those pertaining to deposits, loans, and securities should be kept in balance with general ledger control figures.

Audit Trail

The records and systems should be designed to enable tracing any given item as it passes through the books. The following recordkeeping deficiencies are some of the more prevalent encountered during examinations:

- General ledger entries fail to contain an adequate transaction description,
- Customer loan records are incorrect, inadequate, or nonexistent,
- Permanent and satisfactory records pertaining to cash items, overdrafts, and other types of suspense or holding items are lacking,
- Tellers' cash records do not contain adequate details,
- Securities registers, whether processed electronically or manually, fail to list all necessary information,
- Reconcilement records of correspondent bank accounts are not kept current and/or fail to reflect the description and disposition of outstanding items,
- Details concerning debits and credits to the over and short accounts are inadequate,
- Accounts and records are not posted on a current basis,
- Control and subsidiary records of outstanding letters of credit or other contingent liabilities are inadequate, and
- Interbranch or interoffice accounts are not properly controlled and monitored.

Prenumbered Documents

Sequentially numbered instruments should be used wherever possible. Prenumbered documents aid in proving, reconciling, and controlling used and unused items. Number controls, including printer's confirmation, should be monitored by a person who is detached from that particular operation. Unissued, prenumbered instruments that could be used to obtain funds should be maintained under dual control or joint custody.

Accounting Manual

The uniform handling of like transactions is essential to the production of reliable reports. Accordingly, it is essential that instructions be established for processing routine transactions. In smaller banks where some or all records are manually produced, it may be advisable to reduce instructions to writing, possibly in the form of an accounting manual.

In banks where some or all records are computer generated, there should be an understandable user's guide for each application readily available for reference by user departments and personnel. Manuals for each application normally consist of a guide provided by the servicer and supplemented by procedures written by the user. Manuals normally delineate preparation and control source documents and certain practices pertaining to control over the movement of documents from the user to the servicer and their return, the daily reconcilement of subsystem totals to the general ledger, and changes to master files.

Protection of Physical Assets

A principal method of safeguarding assets is to limit access by authorized personnel. Protection of assets can be accomplished by various procedures, including those listed below.

Cash Control

Tellers should be provided with their own funds to which they have sole access. Common cash funds should not be utilized. Inability to fix responsibility in the event of a difference could be embarrassing and is unfair to all concerned.

Joint Custody or Dual Control

These two terms are not synonymous, but are often discussed in tandem. Joint custody refers to a procedure whereby two or more persons are equally accountable for the physical protection of certain items or records. An example consists of two keys or combinations, under the separate control of two individuals, which must be used in order to obtain access to vaults, files or other storage devices. These custodial responsibilities should be clearly assigned and communicated to all employees. For this system to be effective, persons exercising control must guard their key or combination carefully. If this is done, only collusion can bypass the important control feature. Reserve cash, negotiable collateral, investment securities, trust assets, safekeeping items, reserve supply of official checks, unissued electronic debit or credit cards, unissued traveler's checks, unissued Series E Bonds, the night depository, electronic banking terminals, dormant deposit accounts, safe deposit spare locks and keys, and spare keys to tellers' cash boxes are examples of items that should be under effective joint custody.

Dual control is a related, but slightly different concept in which the work of one person is verified or approved by another. The purposes of involving the second individual are to ensure that proper authority for the transaction or activity is given, that the transaction or activity is properly recorded, and that proper settlement is made. Dual control in automated systems should be used in the same manner as in manual systems. Supervisory holds should be placed on customer accounts requiring special attention. For example, dormant accounts, collateral accounts, and accounts with large uncollected funds normally have holds that require the action of two people to remove. In addition, certain types of transactions (e.g., master file changes) should require special codes or terminal keys from two people before they can be completed. When a hold on an account is added/removed or when a transaction requiring supervisory approval is completed on an automated system, exception reports will be printed and should be reviewed by a designated person not involved with the transaction. Used conscientiously, automated dual control methods are superior to the manual procedures.

Employee Hiring Procedures

The credit and previous employment references of prospective employees should be checked by management. The facilities of the FBI are available to check the fingerprints of employees and prospective employees of banks and to supply such institutions with criminal records, if any, of those whose fingerprints are submitted. Pursuant to Section 19 of the FDI Act, written consent of the FDIC is needed in order for persons to serve in an insured bank as a director, officer, or employee if they have been convicted of a criminal offense involving dishonesty, breach of trust, or money laundering. Some insurance companies that write bankers' blanket bonds also offer assistance to banks in screening officers and employees.

Emergency Preparedness Plans

Written emergency preparedness plans and off-premise storage of backup files for all critical records should be maintained in the event of natural disaster or physical damage to premises.

Reporting Shortages

Procedures should be developed for the prompt reporting and investigation of shortages when they become known. The results of an investigation should be reported to supervisory personnel within the bank and to fidelity insurers, regulators, and law enforcement agencies, when appropriate.

AUDIT

All banks should adopt an adequate audit program. Ideally, such a program would consist of a full-time, continuous program of internal audit coupled with a well-planned external auditing program. Such a system would substantially lessen the risk that a bank would not detect potentially serious problems.

Internal Audit

The board of directors and senior management of an institution are responsible for ensuring that the system of internal control operates effectively. Their responsibility cannot be delegated to others within the institution or to outside parties. An important element in assessing the effectiveness of the 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 so that management can take prompt, remedial action. Examiners should review an institution's internal audit function and recommend improvements, if needed.

The FDIC adopted minimum standards for an internal audit program, which can be found in Part 364, Standards for Safety and Soundness, of the FDIC Rules and Regulations. The regulation requires each institution to provide the following elements within the internal audit program:

- Adequate monitoring of the institution's internal control system,
- Independence and objectivity,
- Qualified personnel,
- Adequate testing and review of information systems,
- Adequate documentation of tests and findings of any corrective actions,
- Verification and review of management's actions to address material weaknesses, and
- Review by the audit committee or board of directors of the internal audit systems' effectiveness.

Each institution should have an internal audit function that is appropriate to its size and the nature and scope of its activities. The Interagency Policy Statement on the Internal Audit Function and Its Outsourcing sets forth the internal audit function's key characteristics, sound vendor outsourcing practices, and outsourcing arrangements effect on external auditor independence. Although the board of directors and senior management cannot delegate the responsibility for having an effective system of internal control and an effective internal audit function, they may delegate the design, implementation, and monitoring of specific internal controls to lower-level management and the testing and assessment of internal controls to others. Directors and senior management should have reasonable assurance that the system of internal control prevents or detects significant inaccurate, incomplete, or unauthorized transactions; deficiencies in the safeguarding of assets; unreliable financial reporting (which includes regulatory reporting); and deviations from laws, regulations, and the institution's policies. In order to be confident that the internal audit function addresses the risks and meets the demands posed by the institution's current and planned activities, directors should consider whether their institution's internal audit activities are conducted in accordance with professional standards, such as the Institute of Internal Auditors' (IIA) *Standards for the Professional Practice of Internal Auditing*. These standards address independence, professional proficiency, scope of work, performance of audit work, management of internal audit, and quality assurance reviews. Furthermore, directors and senior management should ensure that the following key characteristics regarding structure, management, staffing and audit quality, scope, communications, and contingency planning are reflected in the internal audit function.

Structure - The internal audit function should be positioned so that the board has confidence that internal audit will perform its duties with impartiality and not be unduly influenced by managers of day-to-day operations. The audit committee should oversee the internal audit function, evaluate performance, and assign responsibility for the internal audit function to a member of management or the internal audit manager. The internal audit manager should understand the internal audit function and have no responsibility for operating the system of internal control. Ideally, the internal audit manager should report directly and solely to the audit committee regarding both audit issues and administrative matters, e.g., resources, budget, appraisals, and compensation. If the internal audit manager is placed under a dual reporting structure, the board should weigh the risk of diminished independence against the benefit of reduced administrative burden, and the audit committee should document its consideration of this risk and mitigating controls.

Management, staffing, and audit quality - The internal audit manager is responsible for control risk assessments, audit plans, audit programs, and audit reports. Control risk assessments document the internal auditor's understanding of significant business activities and associated risks. These assessments typically analyze the risks inherent in a given business line, the mitigating control processes, and the resulting residual risk exposure of the institution. An internal audit plan is based on the control risk assessments and typically includes the key internal controls summaries within each significant business activity, the timing and frequency of planned internal audit work, and the resource budget. An internal audit program describes the audit objectives and lists the procedures that will be performed during each internal audit review. An audit report generally presents the purpose, scope, and results of the audit including findings, conclusions, and recommendations. Workpapers that document the work performed and support the audit report should be maintained.

Ideally, the internal audit function's only role should be to independently and objectively evaluate and report on the effectiveness of an institution's risk management, control, and governance processes. The role should not include a business-line management role over control activities, such as approving or implementing operating policies or procedures. The audit committee should ensure that any consulting work performed (e.g. mergers, acquisitions, advice on new products or services, etc.) by the internal auditor(s) does not interfere or conflict with the objectivity of monitoring the internal control system.

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. Internal audit policies and procedures should be consistent with the size and complexity of the department and the institution.

Scope - An effective system of internal control and an independent internal audit function form the foundation for safe and sound operations, regardless of an institution’s size. 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.

It is the responsibility of the audit committee and management to carefully consider the extent of auditing that will effectively monitor the internal control system after taking into account the internal audit function’s cost and benefits. For institutions that are large or have complex operations, the benefits derived from a full-time manager of internal audit or an auditing staff likely outweighs the cost. For small institutions with few employees and less complex operations, however, these costs may outweigh the benefits. Nevertheless, a small institution without an internal auditor can ensure that it maintains an objective internal audit function by implementing a comprehensive set of independent reviews of significant internal controls. The key characteristic of such reviews is that the person(s) directing and or performing the review of internal controls is not also responsible for managing or operating those controls. A person who is competent in evaluating a system of internal control should design the review procedures and arrange for their implementation. The person for reviewing the system of internal control should report findings directly to the audit committee. The audit committee should evaluate the findings and ensure that senior management has or will take appropriate action to correct the control deficiencies.

At least annually, the audit committee should review and approve internal audit's control risk assessment and the audit plan scope, including how much the manager relies on the work of an outsourcing vendor. The audit committee should also periodically review the internal audit's adherence to the audit plan and 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.

Communication - Directors and senior management should foster forthright communications including critical issues to better understand the importance and severity of internal control weaknesses identified by the internal auditor and operating management's solutions to these weaknesses. Internal auditors should immediately report internal control deficiencies to the appropriate level of management and significant matters should be promptly reported directly to the board of directors (or its audit committee) and senior management. Moreover, the audit committee should give the manager of internal audit the opportunity to discuss his or her findings without management being present. Furthermore, each audit committee should establish and maintain procedures for employees of their institution to submit (confidentially and anonymously) concerns to the committee about questionable accounting, internal accounting control, or auditing matters.

Contingency Planning – Whether using an internal audit staff and/or outsourcing arrangement, the institution should have a contingency plan to mitigate any significant discontinuity in audit coverage, particularly for high-risk areas. Operational risk may increase when an institution enters into an outsourcing arrangement because the arrangement may be terminated suddenly.

Internal Audit Outsourcing Arrangements

An outsourcing arrangement is a contract between an institution and an outsourcing vendor to provide internal audit services. Some institutions consider entering into these arrangements to enhance the quality of their control environment by obtaining the services of a vendor with the knowledge and skills to critically assess, and recommend improvements to, their internal control systems. Outsourcing may be beneficial to an institution if it is properly structured, carefully conducted, and prudently managed. The structure, scope, and management of some internal audit outsourcing arrangements should contribute to the institution's safety and soundness as directors and senior management are still responsible for maintaining an effective system of internal control and for overseeing the internal audit function.

Even when outsourcing vendors provide internal audit services, the board of directors and senior management of an institution are responsible for ensuring that both the system of internal control and the internal audit function operate effectively and must maintain ownership of the internal audit function and provide active oversight of outsourced activities. When negotiating the outsourcing arrangement with an outsourcing vendor, an institution should carefully consider its current and anticipated business risks in setting each party's internal audit responsibilities. The outsourcing arrangement should not increase the risk that a breakdown of internal control will go undetected.

To clearly distinguish its duties from those of the outsourcing vendor, the institution should have a written contract that typically includes: a definition of both parties expectations and responsibilities; the scope, frequency, fees for the vendor’s work; the responsibilities for providing and receiving information about the contract work status; the process for changing service contract terms; the internal audit reports are the institution’s property and specified employees will have reasonable and timely access to the vendor prepared workpapers; the locations of internal audit reports and the related workpapers; the time period that vendors must maintain the workpapers; the vendor audits are subject to regulatory review and examiners will be granted full and timely access to the internal audit reports and related workpapers; a process (arbitration, mediation, or other means) for resolving disputes and for determining who bears the cost of consequential damages arising from errors, omissions, and negligence; and the vendor will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of a member of management or an employee and, if applicable, will comply with AICPA, U.S. Securities and Exchange Commission (SEC), Public Company Accounting Oversight Board (PCAOB), or regulatory independence guidance.

Before entering an outsourcing arrangement, the institution should perform due diligence to satisfy itself that the outsourcing vendor has sufficient staff qualified to perform the contracted work. Throughout the outsourcing arrangement, management should ensure that the outsourcing vendor maintains sufficient expertise to effectively perform its contractual obligations. Directors and senior management should ensure that the outsourced internal audit function is competently managed with proper vendor oversight. Communication between the internal audit function and the audit committee and senior management should not diminish because the institution engages an outsourcing vendor. Rather, the entire vendor's work should be well-documented and all findings of control weaknesses should be promptly reported to the institution's manager of internal audit. Decisions not to report the outsourcing vendor's findings to directors and senior management should be the mutual decision of the internal audit manager and the outsourcing vendor. In deciding what issues should be brought to the board's attention, the concept of "materiality," as the term is used in financial statement audits, is generally not a good indicator of which control weakness to report. For example, when evaluating an institution's compliance with laws and regulations, any exception may be important.

Independence of the Independent Public Accountant

When one accounting firm performs both the external audit and the outsourced internal audit function, the firm risks compromising its independence. While the Sarbanes-Oxley Act of 2002 prohibits an accounting firm from acting as the external auditor of a public company during the same period that the firm provides internal audit outsourcing services, non-publicly traded institutions are also encouraged to consider the risks associated with compromising independence versus potential audit cost savings. Refer to the Corporate Governance portion of this section for further details on applicability.

External Audit

An external auditing program is designed to determine whether a bank's financial statements have been properly prepared in accordance with GAAP and to alert management to any significant deficiencies in internal controls over financial reporting.

Part 363 of the FDIC Rules and Regulations establishes specific audit and reporting requirements for insured depository institutions with total assets of $500 million or more which are discussed later in this section. In addition, the FDIC adopted the Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations which is applicable to all institutions. The examination reports for banks that are not in general compliance with the policy statement regarding external audits should indicate the status of implementation efforts. When warranted, the examiner's comments and recommendations with respect to the adequacy of a bank's external auditing program should also be presented.

Audit Committees

All banks are strongly encouraged to establish an audit committee consisting, if possible, entirely of outside directors and, in appropriate circumstances, should be criticized for not doing so. Although a committee of outside directors may not appear possible in a small closely held bank where there are, in effect, no outside directors on the board, all banks should be encouraged to add outside directors to their board and to appoint them to the audit committee. The audit committee or board should annually analyze the extent of external auditing coverage needed by the bank.

The board or audit committee, when evaluating the institution's external auditing needs should consider the size of the institution and the nature, scope, and complexity of its operations. It should also consider the potential benefits of an audit of the institution's financial statements or an examination of the institution's internal control structure over financial reporting, or both. In addition, the board or audit committee may determine that additional or specific external auditing procedures are warranted for a particular year or several years to cover areas of particularly high risk or special concern. The reasons supporting these decisions should be recorded in the committee's or board's minutes. If, in the judgment of the examiner, unique risks of the bank need additional external audit procedures, specific recommendations for addressing these areas should be made for audit committee and/or board consideration.

External Audit of the Financial Statements

Each bank is strongly encouraged to adopt an external auditing program that includes an annual audit of its financial statements by an independent public accountant (unless its financial statements are included in the audit of its holding company's consolidated financial statements). A bank that does so would generally be considered to have satisfied the objectives of the Interagency Policy Statement. An external audit of the financial statements benefits management by assisting in the establishment of the accounting and operating policies, internal controls, internal auditing programs, and management information systems necessary to ensure the fair presentation of these statements. An audit also assists the board of directors in fulfilling its fiduciary responsibilities and provides greater assurances that financial reports are accurate and provide adequate disclosure.

Nevertheless, examiners should not automatically comment negatively on a bank with an otherwise satisfactory external auditing program merely because an independent public accountant is not engaged to perform an audit of its financial statements.

Alternative External Auditing Programs

Alternatives to a financial statement audit by an independent public accountant include:

- *Reporting by an Independent Public Accountant on an Institution's Internal Control Structure Over Financial Reporting* – This is an independent public accountant's examination and report on management's assertion on the effectiveness of the institution's internal control over financial reporting. For a smaller institution with less complex operations, this type of engagement is likely to be less costly than a financial statement or balance sheet audit. It would specifically provide recommendations for improving internal control, including suggestions for compensating controls, to mitigate the risks due to staffing and resource limitations. Since the lending and investment securities activities generally present the most significant risks that affect an institution's financial reporting, management's assertion and the accountant's attestation generally should cover those regulatory report schedules.

- *Balance Sheet Audit Performed by an Independent Public Accountant* – This is where the institution engages an independent public accountant to examine and report only on the balance sheet. As with the financial statement audit, this audit is performed in accordance with Generally Accepted Auditing Standards (GAAS). The cost of a balance sheet audit is likely to be less than a financial statement audit. However, under this type of program, the accountant does not examine or report on the fairness of the presentation of the institution's income statement, statement of changes in equity capital, or statement of cash flows.

- *Agreed-Upon Procedures State-Required Examinations* - Some state-chartered depository institutions are required by State statute or regulation to have specified procedures performed annually by their directors or independent persons. Depending upon the engagement's scope, the cost of agreed-upon procedures or a State-required examination may be less than the cost of an audit. However, under this type of program, the independent auditor does not report on the fairness of the institution's financial statements or attest to the effectiveness of the internal control structure over financial reporting. The procedures' findings or results are usually presented to the board or the audit committee so that they may draw their own conclusions about the quality of the financial reporting or the sufficiency of internal control. When choosing this type of external auditing program, the board or audit committee is responsible for determining whether these procedures meet the external auditing needs of the institution, considering its size and the nature, scope, and complexity of its business activities.

If the audit committee or board, after due consideration, determines not to engage an independent public accountant to conduct an annual audit of the financial statements, the reason(s) for the conclusion to use one of the acceptable alternatives or to have no external auditing program should be documented in the written meeting minutes. Generally, the board or audit committee should consider not only the cost of an annual audit, but also the potential benefits. The examiner should determine whether the alternative selected by the bank adequately covers the bank's high-risk areas and is performed by a qualified auditor who is independent of the bank. As with deficiencies in an internal auditing program, any scope weaknesses in the bank's external auditing program should be commented on in the examination report.

If a bank chooses not to have a financial statement external audit by an independent public accountant, the examiner should strongly encourage the bank, at a minimum, to engage an independent auditor to perform an external auditing program for the bank. However, if high-risk areas are not adequately covered, the examiner should recommend that the additional procedures be performed in the future and that any other deficiencies in the auditing program be corrected to ensure that there is adequate independent external auditing coverage of operational risk areas.

If a bank has no external auditing program, the examiner should review the minutes to determine the reasons for this choice. A strong internal audit program is fundamental to the safety and soundness of a bank, but it is usually not a sufficient reason for the lack of an external auditing program. One should complement the other, and typically the external program tests and proves (or disproves) the strength of the internal audit program. In such situations, the bank should be strongly urged to reconsider its decision.

External Auditors' Reports

Each state nonmember bank that undergoes any external auditing work, regardless of the scope, is requested to furnish a copy of any reports by the public accountant or other external auditor, including any management letters, to the appropriate FDIC Regional Office, as soon as possible after receipt by the bank. A bank whose external auditing program combines State-mandated requirements with additional procedures may submit a copy of the auditors' report on its State-mandated procedures that is supplemented by a report on the additional procedures. In addition, the FDIC requests each bank to notify promptly the appropriate Regional Office when any public accountant or other external auditor is initially engaged to perform external audit procedures and when a change in its accountant or auditor occurs.

The auditors' reports submitted to the FDIC by a financial institution that chooses an alternative external auditing program rather than an annual audit of the financial statements should include a description of the procedures performed. If the auditor's report states that the "procedures agreed upon with management" have been performed, the bank should be requested to supply a copy of the engagement letter or other document that outlines the agreed-upon procedures so that the FDIC can determine the scope of the external auditing program.

Troubled Banks

When examining banks that have not had audits performed by an independent public accountant and at which any of the following conditions exist:

- Internal controls and internal auditing procedures are inadequate;
- The directorate is generally uninformed in the area of internal controls;
- There is evidence of insider abuse;
- There are known or suspected defalcations;
- There is known or suspected criminal activity;
- It is probable that director liability for losses exists;
- Direct verification is warranted; and/or
- Questionable transactions with affiliates have occurred.

The examiner and Regional Office staff should consider adding to any contemplated administrative order a condition directing the bank to obtain an audit or, if more appropriate, to have specified audit procedures performed by a public accountant or other independent party. Since each situation differs, the examiner and Regional Office must evaluate the type of external audit program that would be most suitable for each troubled bank and, in conjunction with the Regional Counsel, ascertain that the inclusion of such an external audit program as a condition in the order is appropriate. Whenever a condition requiring an audit or specified audit procedures is included in an order, it should include requirements that the bank promptly submit copies of the auditor's reports to the Regional Office and notify the Regional Office in advance of any meeting between the bank and its auditors at which audit findings are to be presented.

FDIC Rules and Regulations for Institutions over $500 Million

Although the described audit programs are recommended for all depository institutions in accordance with general prudent banking practices, certain institutions are specifically required by law to have external audit programs. Part 363 of the FDIC Rules and Regulations establishes audit and report requirements for insured depository institutions with total assets of $500 million or more and their independent public accountants.

Management of each institution covered by this regulation must:

- Engage an independent public accountant,
- Prepare annual financial statements in accordance with GAAP, and
- Produce annual reports.

The annual management reports must contain a statement of management's responsibilities for preparing the financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with laws and regulations relating to loans to insiders and dividend restrictions. The reports must also contain an evaluation by management of the effectiveness of the internal control structure and procedures for financial reporting and an assessment of the institution's compliance with designated laws and regulations.

The independent public accountant engaged by the institution is responsible for:

- Auditing and reporting on the institution's annual financial statements in accordance with GAAS; and
- Examining, attesting to, and reporting separately on the assertions of management concerning the institution's internal control structure and procedures for financial reporting.

Reporting Requirements

Part 363 requires that insured depository institutions submit the following reports and notifications to the FDIC, the appropriate Federal banking agency, and the appropriate State bank supervisor.

- Within 90 days after fiscal year end, an annual report must be filed. The annual report must contain audited annual financial statements, the independent public accountant's audit report, management's statements and assessments, and the independent public accountant's attestation concerning the institution's internal control structure and procedures for financial reporting.

- Within 15 days after receipt, the institution must submit any management letter; the audit report and any qualification to the audit report; and any other report, including attestation reports, from the independent public accountant.
- Within 15 days of occurrence, the institution must provide written notice of the engagement of an independent public accountant, the resignation or dismissal of a previously engaged accountant, and the reasons for such an event.

Part 363 requires certain filings from independent public accountants. The accountants must notify the FDIC and the appropriate Federal banking supervisor when it ceases to be the accountant for an insured depository institution. The notification must be in writing, must be filed within 15 days after the relationship is terminated, and must contain the reasons for the termination. The accountant must also file a peer review report with the FDIC within 15 days of receiving the report or before commencing any audit under Part 363.

Audit Committee

Each insured depository institution subject to Part 363 must establish an independent audit committee of its board of directors. The members of this committee must be outside directors who are independent of management. Their duties include overseeing the internal audit function, selecting the accountant, and reviewing with management and the accountant the audit's scope and conclusions, and the various management assertions and accountant attestations. Part 363 establishes the following additional requirements for audit committees of insured depository institutions with total assets of more than $3 billion: two members of the audit committee must have banking or related financial management expertise; large customers of the institution are excluded from the audit committee; and the audit committee must have access to its own outside counsel.

Holding Company Subsidiary Institutions

Subsidiaries of holding companies, regardless of asset size, may file the audited, consolidated financial statements of the holding company in lieu of separate audited financial statements covering only the institution. In addition, subsidiary institutions with less than $5 billion in total assets may elect to comply with the other requirements of Part 363 at the holding company level, provided that the holding company performs services and functions comparable to those required of the institution. If the holding company performs comparable functions and services, the institution may elect to rely on the holding company's audit committee and may file a management report and accountant's attestations that have been prepared for the holding company. Subsidiary institutions with $5 billion or more in total assets may elect to comply with these other requirements of Part 363 at the holding company level only if the holding company performs services and functions comparable to those required by the institution, and the institution has a composite CAMELS rating of 1 or 2.

The institution's audit committee may be composed of the same persons as the holding company's audit committee only if such persons are outside directors of both the holding company and the subsidiary and are independent of management of both. A separate set of minutes must be maintained.

If the institution being examined is not the lead bank in the holding company, the examiner need only confirm that the institution qualified for, and has invoked the holding company exemption and review the holding company reports to determine if any pertinent information about the institution is disclosed.

Mergers

Institutions subject to Part 363 that cease to exist at fiscal year-end have no responsibility under this rule. If a covered institution no longer exists as a separate entity as a result of its merger into another institution after the end of the fiscal year, but before its annual and other reports must be filed under this rule, reports should still be submitted to the FDIC and appropriate Federal and State banking agencies. An institution should consult with the DSC Accounting and Securities Disclosure Section in Washington, DC, and its primary Federal regulator, if other than the FDIC, concerning the statements and reports that would be appropriate to submit under the circumstances.

Review of Part 363

Examination procedures regarding the review of the bank's audit program and Part 363 are included in the Examination Documentation (ED) Modules under the Management and Internal Control Evaluation section.

When reviewing the audit report, particular note should be taken of any qualifications in the independent accountant's opinion and any unusual transactions. In reviewing management's report and the accountant's attestation, special attention should be given to any assessment that indicates less than reasonable assurance that internal controls over financial reporting are effective or less than material compliance with the designated laws and regulations exists. Notices referencing a change in accountants should be reviewed for possible "opinion shopping" and any other issues that may be related to safety and soundness.

The board's annual determination that all members of the committee are "independent of the management of the institution" should also be reviewed. For institutions exceeding $3 billion in total assets, the examiner should review board determinations and minutes documenting that at least two members of the audit committee have banking or related financial management expertise and that no member is a large customer of the institution. Appropriate recommendations should be made in the examination report if any determination is judged as unreasonable.

At the first examination of each institution subject to Part 363, examiners should describe and discuss any apparent violations, but based on their judgment of the institution's situation, should focus on education and making recommendations about compliance. The examination report should indicate the status of the institution's implementation efforts if not yet in full compliance with the rule.

Problems or concerns with the accountant's or firm's auditing, attestation, or accounting policies and procedures that may represent a basis for a suggested review of its peer review workpapers should be referred to the Regional Accountant. If the Regional Accountant considers a peer review workpaper review warranted, the Regional Accountant will confer with the DSC Accounting and Securities Disclosure Section about conducting the review. This referral does not preclude the Regional Office from filing a complaint, or taking any other enforcement action, against the accountant. Peer review workpaper reviews would generally be appropriate only in unusual or egregious circumstances; therefore, they are expected to be relatively rare.

Examiners, if requested, are not to provide any written representations concerning Part 363 to institutions or their independent outside auditors. Examination staff should continue to respond orally to inquiries of external auditors in accordance with outstanding guidelines on these communications.

Communication with External Auditors

The Interagency Policy Statement on Coordination and Communication Between External Auditors and Examiners includes guidelines regarding meetings between external auditors and examiners.

The FDIC encourages communication between its examiners and external auditors with the permission of institution management. Permission has been given once an institution notifies the FDIC of the accountant's name or the accounting firm that it engaged as external auditor (by letter or by submitting a copy of the auditor's report to an FDIC Regional Office). Permission continues until the institution notifies the FDIC that its relationship with the external auditor has been terminated or that another auditor has been engaged.

The FDIC encourages external auditors to attend exit conferences and other meetings at which examination findings are discussed between an institution's management and its examiners. In addition, auditors may request a meeting to discuss relevant supervisory matters with any of the regulatory agencies involved in the institution's supervision. An auditor who determines that communication with the FDIC is warranted concerning a recent examination should contact the appropriate Regional Office. A Regional Office staff member, the examiner, or the field supervisor may discuss any of the examiner's findings with the external auditor. The regulatory agencies will usually request that institution management be represented at the meeting. However, an external auditor may request a meeting without the representation of the institution's management.

Requests for meetings and information can also originate with the regulatory agencies. If questions arise concerning matters pertaining to the institution on which the external auditor is knowledgeable, examiners may request meetings, including confidential meetings, with an institution's external auditor. FDIC staff may also inquire of the external auditor whether any problems were encountered during the audit of which the FDIC should be aware. Furthermore, copies of workpapers relating to services performed by the external auditor may be solicited. In some instances, an FDIC examiner, field supervisor, or Regional Office staff member may determine that attending the meeting between an institution's auditors and its management or board of directors (or an appropriate committee) at which the audit report is discussed would be useful. The institution should be advised and asked to present the request to the auditor.

The Policy Statement suggests that the institution provide its external auditor a copy of certain regulatory reports and supervisory documents including, but not limited to, reports of condition, examination reports and correspondence from regulators, any memorandum of understanding or written agreement, and a report on any actions initiated under Section 8 of the FDI Act or similar action taken by a State banking supervisor. Similarly, the AICPA's Audit and Accounting Guide for Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies (Guide) provides auditors with guidance regarding communicating with examiners during audits of financial institutions. Chapter 5 of the Guide stresses communication between auditors and examiners. For example, the Guide recommends that auditors endeavor to be responsive to any requests from examiners to attend meetings with an institution's management at which audit reports are reviewed. According to the Guide, a refusal by bank management to allow the auditor to review such material or to communicate with the examiner would ordinarily be an audit scope limitation sufficient to prevent the auditor from rendering an opinion.

Workpaper Review Procedures

Examiners, in consultation with the Regional Accountant, may review the workpapers of the independent public accountant. Workpapers of the holding company audit may be examined with regard to the examination of a subsidiary institution. However, before any workpaper review is undertaken, the primary Federal regulator, if other than the FDIC, and any State bank supervisors of the institution or other holding company subsidiaries should be contacted to arrange a coordinated review. No set of workpapers should be reviewed more than once by all concerned agencies combined.

A workpaper review is not expected to be performed for every institution; however, examiners should review workpapers before or during an examination, (unless the workpapers of the institution for that fiscal year have been previously reviewed) in the following instances: each insured institution subject to Part 363 that has been or is expected to be assigned a CAMELS rating of 4 or 5; each state nonmember bank not subject to Part 363 that has been or is expected to be a assigned a CAMELS rating of 4 or 5; and where an institution, regardless of size, is not expected to be assigned a rating of 4 or 5, but significant concerns exist regarding other matters that would have been covered in the audit. A workpaper review may assist with the examination scope by identifying those areas where sufficient audit work was performed by the independent public accountant so examination procedures could be limited and by identifying those higher-risk areas where examination procedures should be expanded. A workpaper review may be especially useful before or during an examination if the institution has asset quality problems, aggressive accounting practices, mortgage servicing activities, or large deferred tax assets.

Requests by the Regional Director to independent public accountants for access to workpapers should be in writing and specify the institution to be reviewed, indicate that the accountant's related policies and procedures should be available for review, and request that a staff member knowledgeable about the institution be available for any questions. Since workpapers are often voluminous, examiners are expected to view them where they are located. Since these workpapers are highly confidential, examiners are encouraged to take notes of needed information, and should request copies of only those workpapers that are needed for their records. No requests for copies of all workpapers should be made.

Complaints Against Accountants

An examiner encountering evidence of possible violations of professional standards by a CPA or licensed public accountant should, if practicable, initially discuss the matter with the accountant in an attempt to resolve the concern. If the concern is not resolved in this manner, the examiner should send a memorandum to the Regional Director, with a copy to the Regional Accountant, summarizing the evidence of possible violations of professional standards and the inability to resolve the matter with the accountant. As part of the discussion, the accountant should be made aware that a complaint to the AICPA and/or the State board of accountancy is under consideration. Documentary evidence should be attached to support comments. Where notification of apparent violation of professional standards appears appropriate, letters should be concurrently forwarded by the Regional Director to the State board of accountancy in the institution's home state, the Professional Ethics Division of the AICPA (in the case of certified public accountants), the subject accountant or firm, and the DSC Accounting and Securities Disclosure Section.

In addition to violations of professional standards, complaints should also include substandard auditing work or lack of independence.

Institutions Contracting With A Third Party To Perform Specific Work at the FDIC's Request

Examiners sometimes find that an institution is involved in unique activities or complex transactions that are not within management's range of expertise. For example, the institution may carry certain complex financial instruments or other unusual assets on its financial statements at values that management cannot adequately support and that the examiner cannot confirm. Additionally, the institution may have certain internal control problems that require the expertise of an independent consultant to properly resolve.

In situations such as these, after receiving appropriate approval, examiners may request that an institution contract with an independent public accountant or other professional to perform specific work to address the identified concern. Such an assignment normally would not be included in the scope of the work performed in the usual external auditing programs, i.e., an audit, balance sheet audit, or attestation on internal control over financial reporting. This additional work, when performed by an independent public accountant, may be considered an engagement to perform "agreed-upon procedures," to issue a "special report," or "to report on the application of accounting principles" under applicable professional standards. These latter two engagements are performed by an independent public accountant under GAAS, while "agreed-upon procedures," are performed under Generally Accepted Standards for Attestation Engagements (GASAE). If another type of professional is contracted to perform services for an institution, the professional may be subject to a different set of professional standards. Nevertheless, the important elements for the examiner to consider when evaluating the adequacy of the institution's contract with the professional are similar in all cases.

When requiring or recommending that an institution contract with an independent public accountant or other outside professional for specific additional work, the examiner should advise the institution to provide the FDIC with a copy of the contract for review before the contract is signed. The contract should be reviewed to ascertain whether it describes the work that needs to be performed in sufficient detail so that the outside professional understands exactly what the FDIC's expectations are and can be responsive to any requirements established by the FDIC concerning the work to be performed. The contract or engagement letter should, at a minimum, include:

- A description of the work to be performed,
- The responsibilities of the accountant or other professional,
- An identification of, or a reference to, the specific financial statement elements, accounts, or items on which the work is to be performed, if applicable; the party responsible for recording them in the financial statements; and the basis of accounting of the specific elements, accounts, or items on which the work is to be performed,
- A reference to the applicable professional standards covering the work, if any. Examples include, auditing standards, attestation standards, and appraisal standards,
- An enumeration of, or a reference to, the specific procedures to be performed,
- The types of sources to be used to obtain the relevant information, if applicable,
- The qualifications of the employees who are to perform the work,
- The time frame for completing the work,
- Any restrictions on the use of the reported findings, and
- A provision for examiner access to workpapers.

The contract or engagement letter covering the specific work should include language assuring examiner access to the accountant's or other professional's workpapers. An example of the type of language that should be included in the engagement letter or other contract between the institution and the independent public accountant or other professional is:

> The workpapers for this (specify type of engagement, e.g., agreed-upon procedures, special report) are the property of (name of firm) and constitute confidential information. However, (name of firm) agrees to make the workpapers supporting this engagement available to the FDIC and other Federal and State banking regulators. In addition to the workpapers, (name of firm) agrees to make any or all of the following available to the FDIC and other Federal and State banking regulators:
>
> - the work plan, or similar planning document relating to this engagement,
> - the process used for the selection of samples used in the specific work, if applicable, and
> - other pertinent information on the firm's policies and procedures that may affect this work plan..
>
> Access to the workpapers will be provided at (name of firm) local office under the supervision of our personnel. Furthermore, upon the request of the FDIC or other Federal and State banking regulators, we agree to provide photocopies of selected workpapers to them.

CORPORATE GOVERNANCE

The provisions of the Sarbanes-Oxley Act of 2002 are primarily directed toward those companies, including depository institutions, that have a class of securities registered with the Securities and Exchange Commission (SEC) or the appropriate Federal banking agency under Section 12 of the Securities Exchange Act of 1934, i.e., public companies. Applicability of the Sarbanes-Oxley Act to insured depository institutions depends, in large part, on an institution's size and whether it is a public company or a subsidiary of a public company.

FDIC- Supervised Banks That Are Public Companies or Subsidiaries of Public Companies

Some FDIC-supervised banks have registered their securities pursuant to Part 335 of the FDIC's regulations and are, therefore, public companies. Other FDIC-supervised banks are subsidiaries of bank holding companies that are public companies. These public companies and their independent public accountants must comply with the Sarbanes-Oxley Act – including those provisions governing auditor independence, corporate responsibility and enhanced financial disclosures.

Non-public FDIC-Supervised Banks With Less Than $500 Million in Total Assets

Non-public, FDIC-supervised banks that have less than $500 million generally do **not** fall within the scope of the Act. Nevertheless, certain provisions of the Act mirror existing policy guidance related to corporate governance issued by the FDIC and other banking agencies. Other provisions of the Act represent sound corporate governance practices; and although such practices are not mandatory for smaller, non-public institutions, the FDIC recommends that each institution consider implementation to the extent possible, given the institution's size, complexity and risk profile.

Insured Depository Institutions With $500 Million or More in Total Assets

Institutions that have $500 million or more in total assets as of the beginning of their fiscal year are subject to the annual audit and reporting requirements of Section 36 of the FDI Act as implemented by Part 363 of the FDIC's Rules and Regulations. Some large institutions are also public companies or subsidiaries of public companies, and some institutions subject to Part 363 satisfy the requirements of the Act on a holding company basis. There are selected provisions of the Act that are applicable to FDIC-supervised banks with $500 million or more in total assets. For example, the auditor independence requirements, management's responsibility for financial reporting and controls, and management's assessment of internal controls and accountant's attestation on this assessment are applicable for FDIC-supervised banks with $500 million or more in total assets.

When performing a review of the Act and its applicability to the institution being examined, examiners should refer to outstanding guidance and, when necessary, should consult with the Regional Accountant.

THE EXAMINER'S RESPONSIBILITIES

Examinations are not undertaken for the detection of fraud, nor are their sole or primary purpose to assure the complete correctness or appropriateness of records. The overall assessment of a bank's system of internal control is, however, an important examination function. In most cases, such an appraisal can be accomplished by an overall evaluation of the internal control system, a specific review of audit systems and reports, performance of standard examination procedures, and recommendations to management. In some instances, all or a portion of a bank's system of internal control may be deficient, or management or the condition of a particular institution may be such that more intensive audit tests, suited to the particular circumstances and needs of the bank under examination, should be undertaken. These matters are discussed in a following section on possible audit techniques.

These techniques may lead to an indication of possible fraud or insider abuse. Such situations should be thoroughly investigated by the examiner. Please refer to the Bank Fraud and Insider Abuse section of this Manual for further information.

Overall Evaluation of Internal Controls

The examiner's principal efforts should be focused on the detection, exposure and correction of important weaknesses in the bank's records, operating systems, and auditing procedures. Information should be developed through discussions with management and employees and examiner observation of performance and procedures. Each bank presents specific situations to which common sense and technical knowledge must be applied. The institution's size, the number of employees, and the character of the bank's operations must be considered in any meaningful evaluation.

Specific Review of Audit Systems and Reports

The examiner's evaluation of internal/external audit procedures and reports plays a key role in the overall assessment of a bank's internal controls system. The following is a listing of functions and procedures that should be encompassed by the audit program. The list is not all-inclusive and performance lacking in any one area should not necessarily be viewed as a major deficiency. The list may, however, serve as a framework to assist in the evaluation of a bank's audit program.

Cash Accounts

Verify cash on hand; review cash items, cutbacks, or any other assets or liabilities held in suspense accounts to determine proper and timely disposition; and verify clearings.

Due From Banks

Test and review bank prepared reconcilements with particular emphasis on old or recurring outstanding items; obtain cut-off bank statements as of audit date and an appropriate date subsequent thereto for use in testing bank reconcilements; review all return items for an appropriate period subsequent to the audit date; and confirm balances due from banks to include time accounts with the banks holding the deposits.

Investments

Prove subsidiary records to the general ledger; verify securities on hand or held by others for safekeeping; check the gain and loss entries on securities sold or matured since the previous audit; review accrued interest accounts and test check computations and disposition of interest income. Review premium amortization procedures, especially for securities that have principal reductions to determine that premiums are being amortized appropriately.

Loans

Prove subsidiary records to general ledger; verify a sampling of loan balances on a positive or negative basis; verify the existence of negotiable collateral; review accrued interest accounts and test the computation and disposition of interest income; verify leases and related balance sheet accounts; verify unearned discount account; and test rebate amounts for loans that have been prepaid. Verify that Rules of 78 loans and loans with unearned discounts have decreased and that only those loans booked prior to January 1, 1999, remain on the books. Installment loans booked thereafter should be booked using the simple interest method for accounting.

Allowance For Loan and Lease Losses (ALLL)

Verify loan balances for loans charged-off since the previous audit and the debit entries to the ALLL account; check supporting documentation for loans charged-off; and review loan recoveries and check the credit entries in the allowance account; and review ALLL methodology to determine compliance with GAAP.

Bank Premises and Equipment

Examine entries and documentation relative to purchases and sales since the previous audit; check computation of depreciation expense; and check computation of gain or loss on property sold and trace sales proceeds.

Other Assets

Verify the appropriateness of all other asset categories.

Deposits

Reconcile subsidiary records to general ledger accounts; verify account balances on a test basis; review closed accounts and determine they were properly closed; review account activity in dormant accounts and in the accounts of bank insiders; review overdrafts; check computation of service charges and trace postings to appropriate income accounts; review accrued interest accounts and check computation of interest expense; account for numerical sequence of prenumbered certificates of deposit and official checks; reconcile outstanding official checks; determine the validity of outstanding official checks; examine documentation supporting paid official checks; and test certified checks to customers' collected funds balances.

Borrowed Funds

Verify borrowed fund balances; verify changes in capital notes outstanding; and review the accrued interest accounts and check interest expense computation.

Other Liabilities

Check the appropriateness of all other liabilities.

Capital Accounts and Dividends

Account for all unissued stock certificates; review capital account changes since the previous audit; check computations for dividends paid or accrued; and review minutes to determine propriety of dividend payments and accruals.

Consigned Items and Other Non-Ledger Control Accounts

Test rental income for safe deposit boxes; examine and confirm safekeeping items; and reconcile consigned items on hand.

Income and Expenses

Test income and expenses by examining supporting documentation for authenticity and proper approval; and test accruals by either recomputing amounts or examining documents supporting such accruals.

Direct Verification

Direct verification is universally recognized as one of the most effective methods of confirming the correctness and validity of certain accounts, primarily loan and deposit balances and collateral. Direct verification should be an important part of any internal and/or external audit program, and may be employed alone as an internal control separate from regularly scheduled audits.

There are two well-recognized types of direct verification, positive and negative. When the positive method is used, the customer is asked to confirm whether or not the balance, as shown, is correct. When the negative method is used, a reply is not requested unless an exception is noted.

The positive method has obvious advantages from an audit standpoint as it provides considerable assurance the customer has carefully checked the confirmation form. The negative method is less costly and provides a measure of protection in those institutions having a strong program of internal control. The positive method is recommended for loan accounts and preferred for deposit accounts, but because of the high volume and cost factor in the latter, the negative method is often employed. It is suggested that at least large accounts, public accounts, dormant accounts and accounts with high and usual volumes of activity be positively verified.

Direct verification may be conducted in whole or in part. The necessity for a complete verification of loans and deposits is rare. A partial verification of representative accounts is usually satisfactory. Overdue loans should be included in the verification as well as charged-off loans. It should be noted that direct verification may be accomplished internally, as well as externally. To be effective, the verification procedure (including follow-ups) must be completely controlled by someone not having responsibility for the accounts or records being verified.

Examination Procedures

The Examination Documentation (ED) Modules include examination procedures regarding control activities and monitoring. Procedures are provided both for institutions with formal internal audit departments and for institutions with either no audit functions or limited audit activity. Refer to the Management and Internal Control Evaluation ED Module for details.

Recommendations to Management or the Board of Directors

Serious or numerous internal routine and controls deficiencies detected during an examination should be brought to management's and the board's attention and appropriate action urged. In making recommendations and criticisms, examiners should consider the following points.

- The advantage and profitability of the suggestion to the bank should be stressed, not the advantage to the examiner.
- The suggestion or criticism must have substance and merit; criticisms that might be regarded as petty or reflect personal preference of the examiner will not be well-received.
- The recommendation or criticism should be discussed with operating management prior to bringing it to the attention of the board of directors. The record or procedure being criticized may have been devised by the banker who may have considerable pride in it and, conceivably, can offer a persuasive reason for its continuance.
- Recommending records or accounting forms supplied by a particular vendor is to be avoided. These decisions are within the purview of bank management, not examiners.
- It is possible to overdo criticisms. The goal of obtaining correction of major deficiencies, as opposed to listing a volume of relatively minor criticisms, is more desirable.
- The best results are achieved when criticisms are based on specific negative findings, rather than generalities, and accompanied by recommended remedial action consistent with the seriousness of the deficiencies and the bank's capacity and needs. However, the relative importance of an individual control or lack thereof must be viewed in the context of the other offsetting control procedures that may be in place. When deficiencies are considered to be of sufficient importance, appropriate comments should be set forth in the examination report.

Fraud and Insider Abuse

As noted previously, while examinations are not undertaken for the purpose of uncovering fraud, the examiner must be alert to its possible existence. Bank personnel at every level have committed fraud and experienced officers and employees have perpetrated large defalcations over a period of years. The following represent some of the most frequently used methods of manipulation, as applied to those accounts that normally offer the greatest risk and vulnerability. In addition, the Fraud section of this Manual contains a surveillance module for detecting bank fraud and insider abuse.

Loans

Forged or fictitious notes; accommodation loans; loans to insider-related shell companies; embezzlement of principal and interest payments; failure to cancel paid notes; use of blank, signed notes; embezzlement of escrow and collection accounts; commissions and kickbacks on loans; fraudulent loans to cover cash items and overdrafts; and diverted recoveries of charged-off loans.

Loan Collateral

Loans secured by phony collateral such as altered, stolen, or counterfeit securities; or certificates of deposit issued by illegitimate offshore banks; and brokered loans and link-financing arrangements where underlying collateral is not properly pledged or is prematurely released.

Deposits

Unauthorized withdrawals from dormant accounts; fictitious charges to customer accounts; unauthorized overdrafts; payment of bank personnel checks against customer accounts or against fictitious accounts, manipulation of bookkeepers' throw-out items, computer rejects or other items needed to reconcile deposit trial balances; unauthorized withdrawals from accounts where the employee is acting as an agent or in some other fiduciary capacity; withholding and destroying deposit tickets and checks; misappropriation of service charges; kiting; and manipulation of certificates of deposit, official checks, and money orders.

Correspondent Bank Accounts

Lapping of cash letters; delayed remittance of cash letters; fictitious credits and debits; issuing of drafts without corresponding recordation on the bank's books or credit to the account; overstatement of cash letters and return items; and false collection items.

Tellers and Cash

Lapping deposits; theft of cash; excessive over and short activity; fraudulent checks drawn on customers' accounts; fictitious cash items; manipulation of cash items; and intentional failure to report large currency transactions or suspicious activity.

Income and Expense

Embezzlement of income; fraudulent rebates on loan interest; fictitious expense charges; overstated expense; and misapplication of credit life insurance premiums.

Bond Trading

Adjusted trading, which usually involves collusion between a bank employee and a securities dealer to trade securities at inflated prices; concealing trading losses from bank management and examiners; and unauthorized purchases and sales of securities, futures, or GNMA forward contracts with benefit accruing to a bank employee. Improper securities trading practices include:

- Placing personal trades through bank accounts, thereby obtaining the advantage of the bank's volume discounts on commissions,
- Purchasing or selling an issue of securities prior to executing bank or trust account trades which could be expected to change the price of the security, thereby obtaining a personal price advantage ("**front-running**"),
- Purchasing and selling the same securities issue on the same day, with the trader pocketing any price increases and assigning transactions to trust accounts in the event of any price decreases, and
- Buying or selling based on nonpublic material inside information, which might affect the price of securities, thereby enabling the trader to benefit personally from the transaction.

The different types of manipulations employed in defalcations appear to be limited only by human ingenuity and inventiveness. The schemes and methods devised to cheat banks are virtually unlimited and pose a continuing problem to banks and examiners alike. While no bank is exempt from the threat of defalcations by management, employees or outsiders, certain institutions are more vulnerable than others. Any one or more of the following conditions or situations may be indicative of the need to utilize more comprehensive and intensive audit techniques:

- The one-person dominated or operated institution wherein one officer has complete control over a bank's operations;
- Lack of audit program;

- Weak internal controls such as deficient vacation policies or lack of separation of duties;
- Records are poorly maintained and carelessly handled;
- Close supervision by the board of directors and/or senior management is lacking, especially where rapid growth has occurred with concomitant accession of inexperienced management;
- Banks that recorded substantial growth in a short time period. This may reflect the employment of "hot" money or brokered funds, combined with fraudulent or poor quality loans, resulting in dishonest acts to conceal the bank's true condition;
- Banks that recorded little growth or a steady decline in deposits despite general economic prosperity in their operating area and continued growth by competing institutions;
- Earnings and yields are below average and expenses are high in comparison with past operating periods with no apparent explanation for the change; and
- Abnormal fluctuations in individual revenue or expense accounts either in terms of dollar amounts or in relation to all other operating accounts.

Possible Audit Techniques

Because of the virtually limitless opportunities for perpetrating and concealing bank fraud, even a complete and comprehensive audit may not expose the commission of deceptive practices. Time constraints and optimum resource utilization do not permit a complete audit during bank examinations, nor would the benefits derived from such efforts generally be warranted. Nevertheless, in those cases where the examiner perceives the need, the examination may be expanded to include the use of more audit techniques and procedures. The following is a listing of certain audit techniques available to examiners. The list is not all-inclusive, nor is it intended that any or all of these procedures be utilized at every examination.

General

Examiner-prepared reconcilements of all asset and liability items can ensure that individual subsidiary records balance to general ledger controls. Performance of any or all of the checks, tests, and reviews listed in this section of the Manual under Specific Review of Audit System and Reports may also be helpful.

Direct Verification

Except for securities, correspondent bank accounts and loan participations, direct verification is an audit procedure not often employed by examiners. However, the examiner may in certain circumstances, after obtaining the Regional Director's approval, conduct a direct verification of loans and/or deposits. The following basic procedures or guidelines are utilized in direct verification.

- Addressing, stuffing, sealing, and mailing of envelopes should be done by examination personnel only.
- Franked envelopes furnished for reply should be preaddressed to a post office box rented for that purpose, the Field Office, or the Regional Office.
- A duplicate record of all items verified should be maintained for control purposes.
- Watch for borrowers with common addresses or post office box numbers and for accounts having the same addresses as bank officers and employees.
- Loan verification should include charged-off notes; separate notices should be sent to primary obligors, comakers, endorsers, or guarantors.
- Third party guarantees on lines of credit or individual notes should be verified directly with guarantors and not through primary obligors.
- Deposit verification of recently closed dormant accounts, overdrawn accounts, and pledged accounts should be included.
- All replies should be compared against retained duplicate records. Exceptions should be further investigated against bank records or through follow-up correspondence with customers until discrepancies are satisfactorily resolved.
- Undelivered and returned tracers, unacknowledged verifications, and unexplained differences should be discussed with the entire board, not just with officers.

Loans

The techniques suggested below may be valuable when examiners have cause to suspect possible irregularities involving the loan portfolio.

- Compare the signature on a note with other notes or documents signed by the maker.
- Determine by review of bank records who actually pays the interest and principal on large lines of continuous credit, and the sources of funds.
- Regarding weak lines of a continuous nature, investigate the possibility that directors or management are actually the interested party although the bank's records may fail to indicate such information.
- If a large number and amount of out-of-territory loans are carried, spot check a cross-section of these items as to disbursement of loan proceeds and sources of payment of principal and interest.
- Audit the interest collected on a sampling of loans. Test check the loan interest account for several days

and compare the total with journal figures and amount credited to the general ledger.

- Compare collateral records to loans secured by such collateral, and compare the collateral receipt date with the date the loan was granted.
- In banks having large or numerous loan charge-offs, compare actual charge-offs to those approved by the appropriate authority; confirm that the amount charged-off was the actual balance due on the loan; determine who prepares the list of charge-offs, who collects recoveries, and the accuracy of the reporting of these items; and compare the actual instrument with the bank's records to confirm balances and signatures. Tracing the proceeds of loans charged off should also be considered. Where sizeable loan losses have occurred, it may be advisable to analyze the lines of credit involved by tracing disbursement of loan proceeds and reviewing the borrower's deposit account for possible payments of commissions or fees to a bank officer.
- In investigating installment and account receivable (A/R) financing departments, the following possible activities should be considered: the "lapping" of payments (use of prior payments which have been withheld to-make current payments on a specific loan(s)) is sometimes encountered. Check installment A/R records for an unusually large number of advance payments and/or a sizeable number of overdue loans. In suspect cases, spot check payments made or due to borrowers' checking accounts. Also, where the volume of total outstanding installment loans has increased substantially between examinations for no apparent reason and overdue loans are unusually low or high, spot check a cross-section of loans as to disposition of proceeds, signatures, collateral and sources of payment. In cases of fraudulent credits, loan payments may be traced directly to proceeds of other loans. Be watchful for multiple payments made on the same date on a particular note and compare the total of these payments with new loans granted on the same date. In addition, poorly handled indirect dealer paper lines should be investigated. Test checks should be made for possible lapping of payments, creation of fraudulent notes to cover delinquent payments, and unauthorized use of the dealer reserve accounts.

Deposits

The following suggestions may be useful in the investigation of improper activities in the bank's deposit accounts.

- In those banks manually posting deposit records, scan ledgers for perfect alignment of figures and similar ink density. This may indicate the sheet was prepared in one operation to conceal a shortage. Check any changes made in handwriting or by typewriter. Comparison of the balances of transferred sheets with end-of-month statements and pick-up balances on carry forward sheets may prove helpful in suspect situations.
- Be alert for possible kiting in accounts. The characteristics of this type of account usually include large, even checks, deposits of a like or similar amount, and small average balances. The important facts to determine in such cases are the amount of "float", sources of funds, other banks involved and to what extent, and how, when, and under what circumstances the activity began. Computer generated kiting suspect reports or uncollected funds reports can be helpful and should be reviewed. Examiners should determine who reviews the printouts and how often they are reviewed. The printouts should be marked up by whoever is reviewing them.
- Note any unusual withdrawals from inactive or dormant accounts.
- Take note of packages of unposted checks and undelivered or returned customer statements.
- In connection with savings accounts, various methods are available to determine the presence or disposition of accounts to which interest was credited on the last interest payment date.
- Particularly in small banks that lack adequate separation and rotation of duties, the transferring of a shortage between individual deposit accounts is always a possibility. In a bank where deposit transactions are computer posted, such a situation may be reflected in a machine reject of a continuous and constant amount. In banks with a manual posting system, a comparison of ledger sheets to customer statements for consistency of entries may prove helpful.
- Cash items, machine rejects and cutbacks should be compared to individual account records to determine if the accounts have been closed, do not exist, or balances are insufficient.
- Interest paid on certificates of deposit can be cross-checked to the interest expense account as to date, amount due, and amount actually paid.
- Gain control of incoming cash letters and local clearings. Sight-post items to demand account records to determine if there is an account for each item. If the cash letter has been opened prior to taking control, compare the number of items listed on the tape accompanying the letter with actual items to ascertain whether any items have been removed.

Correspondent Bank Accounts

The following audit steps are available relative to these accounts:

- A comparison of the daily total for several days of paid and cancelled drafts drawn on correspondent banks with the general ledger entries for the same days may reveal discrepancies. In particular, this test should be made for the date of the last examination and for the following several days.
- Review of past reconcilements should emphasize large outstanding items, unusual activity, forced balancing, and continuous unreasonable delays in crediting correspondents for their charges.
- Cross entries on the same day between correspondent accounts may indicate possible "kiting" or shortages between correspondent accounts.
- Delays in remitting for cash letters can be used to cover defalcations.
- Coin and currency transactions reflected on correspondent accounts should be compared to a bank's increase or decrease in the cash account on those particular days.

Tellers and Cash

Tellers' daily cash records can be inspected for possible discrepancies such as forced balancing, unusual charges or an excessive total and number of cash items. Items drawn on or by bank personnel should always be verified as to final payment or disposition. All work can be checked for prior endorsements and dates that may indicate a teller has been carrying these items for a long period.

Suspense Accounts

In many banks, asset and/or liability suspense accounts are used as "catch-alls." These accounts should be reviewed for large or unusual items. In some instances, suspense accounts have been used for concealment of shortages, worthless assets, and deposit diversions.

Income and Expense Accounts

Test check interest computations on a sampling of loans and securities. Large, regular or unusual debits to income accounts should be verified and interest rebates on loans and monthly service charges on demand deposits may be tested. Finally, interest paid on time and savings deposits can be compared to the amount credited to the respective controls.

General Ledger Accounts

Determine the reason for any unusual or abnormal variations between the various general ledger accounts. Check the validity of any reversing or correcting entries, particularly for a few days immediately following the previous examination. Trace all income closing entries to the undivided profits account.

Other

Be watchful for any major change, particularly growth, in assets or liabilities. In cases of rapid loan expansion, check for the possibility of out-of-territory loans to insiders. If both loans and certificates of deposit have increased beyond normal expectations check the source of certificates of deposit; check for tie-ins between new notes and new certificates of deposit as to common names, common amounts and/or common dates; trace the proceeds of new loans; and determine the source of principal and interest payments on new loans.

Secretary of State Websites

Many states have websites that can provide valuable information on an entity's corporate structure, principal shareholders, or officers and directors. In addition, a search can usually be completed to ascertain the principals other business relationships.

OTHER RELATED MATTERS

Information Technology

With respect to internal controls in information systems, Part 364 of the FDIC Rules and Regulations requires institutions to have systems that provide for the following elements commensurate with the size of the institution and the nature, scope and risk of its activities:

- An organizational structure that establishes clear lines of authority and responsibility for monitoring adherence to established policies;
- Effective risk assessment;
- Timely and accurate financial, operational, and regulatory reports;
- Adequate procedures to safeguard and manage assets; and
- Compliance with applicable laws and regulations.

If an institution's internal control systems do not meet the above standards, the deficiencies should be described in the Report of Examination or Information Technology Report of Examination, as appropriate.

Rapid changes in information technology have vastly altered the methods by which financial institutions process data. There may be any number of mediums incorporated within the institution to accomplish data processing needs. Networks are increasingly prevalent in the present multi-location banking environment. As with any other function in banking, operation of information systems presents certain risks and may ultimately impact safety and soundness of the institution. For this reason, the operation and control over information technology should be identified and reviewed at every examination.

Protecting or securing information and facilities that process and maintain information is vital to the continuity of operations. It is essential that information be accurate, safeguarded and provided without interruption. In order to maintain continuity and reliability of information, institutions should, at a minimum, formulate a comprehensive security plan to ensure that operations and data are not vulnerable to undue risks and exposures. The plan should, at a minimum, address: physical security; data security; and backup and contingency planning.

The FFIEC Information Technology Systems Examination Handbook is comprised of several booklets, each on a different topic, serves as a reference for the examination of these systems. The Handbook contains information technology examination procedures, examination report format, workprograms and related laws, regulations and examination policies. It also provides the examiner with fundamental principles of internal controls in all information processing environments. The FFIEC procedures, workprograms, and examination report format are the primary tools for the examination of large, complex data centers in financial institutions and independent technology service providers.

Information Technology Maximum Efficiency, Risk-Focused, Institution Targeted (IT-MERIT) procedures and the IT General Workprogram are the primary tools for evaluating information technology in financial institutions with non-complex information technology functions.

Management Information Systems

A management information system (MIS) is a system or process that provides the information necessary to effectively manage an organization. MIS is essential in all institutions, but becomes increasingly important in larger more departmentalized organizations. MIS is considered a feedback device and as such is a method for managing risks. The board of directors and management determine what information is needed for them to make informed decisions and monitor activities of the institution. Staff correspondingly develops the systems to ensure that the desired information is usable as a performance measurement. There are five essential elements that must be addressed before any MIS can be considered usable. They are timeliness; accuracy; consistency; completeness, and relevance. Management decisions and strategies may be rendered invalid or, in fact, detrimental should any one of these components be compromised.

In order to evaluate MISs, and ultimately the foundation upon which management's decisions are based, examiners must scrutinize each of the five essential components. First, information must be current and available to all appropriate users to facilitate timely decisions. This necessitates prompt collection and editing of data. Secondly, a sound system of internal controls must be in place to ensure the accuracy of data. Information should be properly edited and reconciled, with the appropriate control mechanisms in place. A comprehensive internal and external audit program would greatly facilitate this endeavor. Strategies and decisions can not be adequately monitored or measured unless information provided is consistent. Variations in how data is collected or reported can distort trend analysis. Any change in collection or reporting procedures should be clearly defined, documented, and communicated to all users. Information provided by MIS mechanisms must be complete. Lastly, information provided must be relevant. Details that are inappropriate, unnecessary, or unsuitable are of no value in effective decision-making. Decision-makers can not fulfill their responsibilities unless all pertinent information is provided in a comprehensive, yet concise format. Care should be taken to ensure that senior management and the board of directors receive relevant information in order to identify and measure potential risks to the institution. Sound MIS is a key component of management effectiveness and should be evaluated in relation to the size, structure and decision-making process of each individual institution.

Electronic Funds Transfer Services

Electronic fund transfer services can be grouped broadly into wholesale and retail systems. Wholesale systems generally are thought of as large dollar systems. Whereas, retail systems might include automated clearing houses, automated teller machines, point-of-sale systems, telephone bill paying, home banking systems and debit cards. Procedures for review of retail systems are comprehensive and are covered in the FFIEC Information Technology Examination Handbooks on Retail Payment Systems and Wholesale Payment Systems. Information systems procedures do not cover wholesale wire transfer systems.

Access to wholesale or large dollar transfers is most often provided through the FEDWIRE and CHIPS (Clearing

House Interbank Payment System). The latter of which is an international payments clearing system for transactions between domestic and foreign banks. Services available through FEDWIRE include transfers of funds between member institutions; transfers of U.S. Government and Federal agency securities; data transfers such as Automated Clearing House payment files; and administrative and research information. Member institutions may access FEDWIRE by three methods: off-line via telephone with Federal Reserve Bank; dial up access via a PC based system; or direct computer interface.

Although there is no settlement risk in the FEDWIRE system, there may be exposure due to errors and omissions and fraud. Because of these risks, a review of credit risks and control systems for wholesale wire transfer systems should be conducted at each safety and soundness examination. A separate examination procedures module on electronic funds transfer risk assessment is included in the ED Modules.

Lost and Stolen Securities Program (SEC Rule 17f-1)

Banks may receive securities certificates through transactions for their own investment, as collateral for loans, as trust assets, or through transfer agent activities. In each situation, a bank may possess a securities certificate that has been reported as lost, stolen, counterfeit, or missing. In 1979, the Securities and Exchange Commission (SEC) implemented Rule 17f-1 to require reporting and recordkeeping of such securities, so that the certificates are not later used erroneously or fraudulently. The regulation authorized the SEC to delegate the recordkeeping function and named Securities Information Center (SIC) as the central repository. SIC may be contacted at the Securities Information Center, Inc., P.O. Box 55151, Boston, MA 02205-5151 or via the Internet at www.secic.com.

Registration

All banks that possess or plan to possess securities certificates should be registered as either a direct or indirect inquirer. For direct inquirers, the bank has direct access to the SIC. For indirect inquirers, the bank submits information through another bank, most likely a correspondent bank, to inquire on the bank's behalf. In either event, institutions may inquire of the SIC whether a certificate has been reported as lost, stolen, counterfeit, or missing.

For the purposes of the rule, the following definitions are applicable:

- Securities are defined as corporate securities (those with a CUSIP number), municipal securities, and bearer U.S. Government and Agency securities that have actual certificates (not book-entry securities).
- Missing is defined as any certificate that cannot be located, but which is not believed to be lost or stolen, or that the transfer agent believes was destroyed, but was not destroyed according to the certificate destruction procedures required by SEC Rule 17AD-19.

For the purposes of this rule, the following types of securities are not subject to the inquiry and reporting requirements: registered securities of the U.S. Government, any agency or instrumentality of the U.S. Government, the International Bank for Reconstruction and Development, the InterAmerican Development Bank, or the Asian Development Bank, and counterfeit securities of such entities; security issues not assigned CUSIP numbers; and bond coupons. In addition, the SEC commented that the rule does not include bond coupons, or escheated, called, or restricted securities, issues in litigation, and bankrupt issues.

Banks must make an inquiry to the SIC by the end of the fifth business day after a certificate comes into its possession, unless the security is received directly from the issuer or issuing agent at the time of issue; received from another reporting institution or Federal Reserve bank or branch, or a securities drop that is affiliated with a reporting institution; received from a customer of the bank, and the security is registered in the name of the customer or its nominee or was previously sold to the customer, as verified by the internal records of the bank; or part of a transaction involving bonds of less than $10,000 face value and stocks of less that $10,000 market value. The limit applies to the aggregate transaction amount, not to the individual security. However, the recent amendment to the rule also provides that inquiries shall be made before the certificate is sold, used as collateral, or sent to another institution, if occurring sooner than the fifth business day.

All securities certificates identified as lost, stolen, counterfeit or missing, which are or were in the bank's possession or control must be reported to the SIC on Form X17FIA. The transfer agent for the certificate should receive a copy of the report, also. For each report submitted, the bank shall maintain and preserve copies of the forms for three years, along with other information received from the SIC as a result of the inquiry. Banks that are registered as indirect inquirers should maintain evidence of the inquiries made via the direct inquirer to the same extent required of the direct inquirers.

Counterfeit securities certificates and stolen certificates involving suspected criminal activity must also be promptly reported to the FBI if there is a "substantial basis" for believing that criminal activity was involved. All counterfeit securities must also be reported to the FBI. If a report has been filed with the SIC or the FBI has been notified, a report to the FDIC is not required. Refer to FDIC Rules and Regulations Part 353 regarding suspicious activity reports. A Suspicious Activity Report (SAR) is required for:

- Insider abuse involving any amount;
- Transactions aggregating $5,000 or more where a suspect can be identified;
- Transactions aggregating $25,000 or more regardless of potential suspects..

A Suspicious Activity Report must be filed within 30 days of discovery with the Financial Crimes Enforcement Network.

Examination Considerations

Examiners should consider reviewing the requirements of Rule 17f-1 with bank personnel to ascertain their knowledge and understanding of the rule. Bank procedures may be reviewed to determine adherence to the provisions of the rule. The examiner should consider the bank's audit procedures covering the lost and stolen securities program and ascertain whether documentation is adequate to determine compliance with the rule.

Test checks of the bank's inquiry procedures can be effectively integrated into the examination process. Inquiry will most likely be required for securities coming into the bank's possession as collateral for loans or as assets received by the bank's trust department. A subsequent check of the bank's inquiry records can determine compliance with Rule 17f-1. Noncompliance should be reported as an apparent violation of SEC Rule 240.17f-1 on the violations page of either the commercial or trust report of examination. Various aspects of SEC Rule 17f-1 are also discussed in the Trust Manual.

Improper and Illegal Payments by Banks and Bank Holding Companies

The Foreign Corrupt Practices Act and the Federal Election Campaign Act cover improper and illegal payments by banks and bank holding companies.

The devices used by banking organizations to make political payments include compensatory bonuses to employees, improperly designated expense accounts, excessive fees or salaries paid to officers, and low to zero interest rate loans. In addition, political contributions have been made by providing equipment and services without charge to candidates for office. Many of these devices involve clear departures from acceptable accounting practices. Consequent lack of corporate accountability raises serious questions regarding the effectiveness of an organization's own internal audit procedures. For banking organizations to engage in illegal or unethical activities and to attempt to conceal those activities by the use of irregular accounting practices only serves to undermine public confidence in the banking system.

The following items may be considered to detect violations of these two laws, and to evaluate the effectiveness of an individual institution's control in detecting such violations.

1. Determine whether the bank has a policy prohibiting improper or illegal payments, bribes, kickbacks, loans, and the like covered by statutes. If the bank has a policy, review and analyze it for adequacy.

2. Determine how the policy, if any, has been communicated to officers, employees or agents of the bank.

3. Review any investigative study performed by or on behalf of the board of directors evaluating the bank's policies and operations concerning the advance of funds in possible violation of the statutes. In addition, ascertain whether the bank was investigated by any other government agency with respect to a possible violation of the statutes and, if so and available, review the materials generated by such an investigation.

4. Review and analyze any internal and external audit program employed by the bank to determine whether the internal and external auditors have established appropriate routines to discover improper and illegal payments under the statutes. To determine the adequacy of any audit programs, the examiner should complete the following procedures:

    - During the review of audit programs, determine whether the programs remind the auditors to be alert to any unusual entries or charges which might be improper or illegal payments to persons or organizations covered by the aforementioned statutes;

    - Determine whether the auditor is aware of the provisions of the Foreign Corrupt Practices Act and the Federal Election Law and whether audit programs have been developed to check compliance with those laws; and

- Review such programs and the results of any audits.

5. Analyze the general level of internal control to determine whether there is sufficient protection against improper or illegal payments under the aforementioned statutes being inaccurately recorded on the bank's books.

6. If the review and analysis under paragraphs 4 and 5 indicate that either the audit program or the internal controls or both are inadequate, then the examiner should perform the following verification techniques:

   - Randomly select charged off loan files and determine whether any charged off loans are to foreign government officials or other persons or organizations covered by the Foreign Corrupt Practices Act or are to persons covered by the Federal Election Law;
   - Review bank controlled accounts on a random sample basis, such as dealer reserves and cash/collateral accounts, to determine the validity of entries and notification procedures to the customer of activity. With respect to official bank checks, review copies of the checks and supporting documentation on a random sample basis for unusual items or any checks to persons or organizations which may be in violation; and
   - For those significant income and expense accounts on which verification procedures have not been performed elsewhere, analyze such accounts for the period since the last examination and obtain by discussion with bank personnel and the review of supporting documents explanations for the significant fluctuations and unusual items noted.

7. Examiners should be alert in the course of usual examination procedures for any transactions, or the use of any bank services or equipment, which might represent violations. Examiners should be especially alert with respect to:

   - Commercial and other loans, including participations, which may have been made in connection with any political campaigns;
   - Income and expense ledger accounts for unusual entries and significant entries from an unusual source;
   - Activity in overdrafts and accounts of directors, officers, and employees; and
   - Reconcilement of bank controlled accounts such as official checks and escrow accounts.

DEFINITIONS AND AUTHORITIES

Sections 23A and 23B of the Federal Reserve Act (FR Act), as applied by the Federal banking agencies under various Federal banking statutes, govern transactions between banks and affiliated business organizations. The Gramm-Leach-Bliley Act (GLBA) amended many laws governing the affiliation of banks and other financial service providers. Among other laws, the GLBA amended the Banking Act of 1933, the Bank Holding Company Act of 1956, (BHC Act), the Interstate Banking and Branching Efficiency Act of 1994, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Exchange Act of 1934, the International Banking Act of 1978, the FR Act, the Federal Deposit Insurance Act (FDI Act), and the Home Owners' Loan Act.

Section 18(j) of the FDI Act extends the provisions of Sections 23A and 23B of the FR Act to state nonmember banks. Section 23A regulates transactions between a bank and its "affiliates," as that term is specifically defined in Section 23A. Section 23B of the FR Act was enacted as part of the Competitive Equality Banking Act of 1987 to expand the range of restrictions on transactions with affiliates. Section 10(b)(4) of the FDI Act authorizes FDIC examiners in the course of examining insured banks "to make such examinations of the affairs of any affiliate of any depository institution as may be necessary to disclose fully --- (i) the relationship between such depository institution and any such affiliate; and (ii) the effect of such relationship on the depository institution." "Affiliate" is defined in Section 3(w)(6) of the FDI Act as having the same meaning as the definition of that term in Section 2(k) of the BHC Act.

FDIC's enforcement authority also extends to certain parents and affiliates which are not bank holding companies. Section 3(u) of the FDI Act defines "institution affiliated parties" to include the controlling stockholder of an insured depository institution, or any shareholder or person who participates in the conduct of the affairs of an insured depository institution, or any independent contractor who participates in certain acts which cause significant adverse affect on an insured depository institution. This would include the parent companies of Industrial Loan Companies and other "non-bank" charters. Under Section 8(b) of the FDI Act, the FDIC can issue Orders against institution affiliated parties.

This section of the Manual discusses affiliates and subsidiaries, including the restrictions on transactions between affiliates and insured banks, exceptions to those restrictions, and the examination authority of the FDIC with respect to affiliates of nonmember insured banks. It also discusses the major provisions of the GLBA as affecting such transactions and the statutory implications for the FDIC examination process.

GRAMM-LEACH-BLILEY ACT (GLBA)

The passage of the GLBA significantly expanded the powers of bank subsidiaries of bank holding companies to engage in "financial activities," including offering insurance and securities products. The GLBA added Section 46 of the FDI Act that prescribes the circumstances in which an insured state bank may engage in financial activities as principal that may be conducted by a national bank only through a financial subsidiary. The GLBA also repealed the restrictions on banks affiliating with securities firms which were contained in Section 20 of the Glass-Steagall Act and repealed the prohibition on interlocking directors between banks and securities firms contained in Section 32.

Financial Holding Company

The GLBA authorizes the organization of a "financial holding company" (FHC) under Section 4 of the BHC Act. A FHC can engage in any activity, and may acquire shares of any company engaged in any activity, that the Board of Governors of the Federal Reserve System (the FRB) determines to be either financial in nature or incidental to such financial activity, or complementary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.

The GLBA identifies some specific activities which are determined to meet this test and prescribes a consultative process involving the shared input of both the FRB and the Secretary of the Treasury for future definition of activities determined to meet the test.

Section 4(k)(4) of the BHC Act identifies a list of specific activities deemed "financial in nature" for these purposes. Qualifying FHCs may engage in such activities without regulatory approval provided notice is given to the FRB within 30 days after the activity is commenced. The listed activities include:

- Lending, exchanging, transferring, investing for others, or safeguarding money or securities,
- Insuring, guaranteeing or indemnifying against loss or illness, or issuing or providing annuities, as principal, agent or broker,

- Providing various forms of financial, investment or economic advisory services, including advising investment companies,
- Issuing and selling instruments representing interests in pools of assets permissible for a bank to hold directly,
- Securities underwriting, dealing and market making,
- Engaging in activities that have been determined to meet the “closely related” and “proper incident” tests under Section 4(c)(8) of the BHC Act,
- Engaging in activities in the United States that the FRB has previously authorized bank holding companies and their subsidiaries to conduct abroad under Section 4(c)(13) of the BHC Act,
- Certain merchant banking activities, and
- Certain “insurance company portfolio investment” activities.

Conditions Precedent to New Activities:

The following guidelines exist relative to a bank holding company entering into new activities:

- All depository institution subsidiaries of the bank holding company must be “well capitalized” and “well managed.”
- A “satisfactory” or better CRA rating must have been received by all of the depository institution subsidiaries at their most recent examination.
- The bank holding company must file with the FRB an election to become a financial holding company.
- There is a grandfather provision for certain non-conforming activities of a company that is not now a bank holding company but then becomes one to continue to engage in commercial activities in an amount not to exceed 15 percent of its consolidated annual gross revenues, excluding bank subsidiaries. The grandfather provision will expire ten years after the date of enactment, unless extended by the FRB for an additional five years.

The FRB is the umbrella supervisor for FHC’s. As such, the FRB assesses the FHC’s overall financial condition and the systems for monitoring risks for the entity as a whole.

Financial Subsidiaries

Implementing Section 121 of the GLBA as it pertains to state nonmember banks, the FDIC added Subpart E to Part 362 of its regulations. For purposes of Subpart E, a “financial subsidiary” is defined as a subsidiary that is controlled by a state nonmember bank and engages as principal in activities which may be conducted by a national bank only through a financial subsidiary. Most activities that were identified in the GLBA as being financial in nature are already permissible for a national bank to conduct directly.

The statutory criteria that must be satisfied in order to engage in activities through a financial subsidiary are:

- The state nonmember bank and each insured depository institution affiliate of the state nonmember bank must be and continue to be well capitalized after deducting the bank’s investment, including retained earnings, in all financial subsidiaries.
- The state nonmember bank must disclose the capital deduction and the separate assets and liabilities of the subsidiary in any published financial statement.
- The state nonmember bank must comply with the ongoing financial and operational safeguards required by Section 5136A(d) of the Revised Statures of the United States, which requires operational safeguards to separate the bank from the risks of the subsidiary.
- The state nonmember bank must comply with the amendments to Sections 23A and 23B of the FR Act made applicable by Section 121(b) of the GLBA that require certain ongoing transactional restrictions.
- The state nonmember bank and all of its insured depository affiliates must have received a CRA rating of not less than a “satisfactory record of meeting community credit needs” in its most recent CRA examination.

Functional Regulation

The GLBA also provides for the functional regulation of securities and insurance activities. This means that similar activities should be regulated by the same regulator so as to promote regulatory efficiencies and eliminate burden and duplication. Accordingly, banking activities are to be regulated by bank regulators, securities activities by securities regulators and insurance activities by State insurance departments. In order for functional regulation to be effective, certain consultation and information-sharing requirements are also contained in the statute.

The BHC Act was amended to restrict the authority of the FRB to require reports, conduct examinations, impose capital requirements or take any other direct or indirect action with respect to any functionally regulated affiliate of a depository institution. Section 45 was added to the FDI Act, which made these restrictions applicable to the FDIC.

It is still necessary to determine the significance of the activities conducted by the functionally regulated subsidiaries and determine whether the level of such activities could pose a material risk to the insured depository institution. This functional regulation concept does not, however, alter the Corporation's authority under Section 10(b)(4) of the FDI Act to examine affiliates "as may be necessary to disclose fully (i) the relationship between the depository institution and the affiliate; and (ii) the effect of such relationship on the depository institution."

A functionally regulated entity under the GLBA means a company:

- Engaged in insurance activities (as agent or principal) supervised by State insurance commissioners;
- Registered with the Securities and Exchange Commission (SEC) as an investment company under the Investment Company Act of 1940;
- Registered as an investment adviser either with the SEC or any State; or
- Engaged in commodity activities regulated by the Commodities Futures Trading Commission.

EXAMINATION AUTHORITY

The authority of examiners to examine all affiliates of State nonmember banks is contained in Section 10(b) and 10(c) of the FDI Act. In exercising the authority to examine State nonmember insured banks and their affiliates, examiners are empowered by Section 10(b) to make a thorough examination of all of the affairs of the bank and its affiliates and are directed to make a full and detailed report of condition of the bank to the FDIC. The authority to examine affiliates extends to those entities set forth in Section 23A of the FR Act.

The manner in which such examinations are conducted, and the format of the reporting on their condition, are not specified by either regulation or specific policy guidance. This is the case for two reasons. First, the type of affiliate and the nature of transactions with the insured institution can vary significantly; requiring sometimes more or less review, and typically a far different type of analysis than would be conducted for financial institution affiliates. Second, the risk presented by the activities of affiliates to the insurance fund is likely to be indirect, especially for those not engaged in direct transactions with the insured institution. Examinations under the FDIC's 10(b) authority will need to be tailored to the level of risk to which the insured institution is exposed as a result of transactions between, and the operations of, the relevant affiliates.

In addition, Section 10(c) of the FDI Act empowers the FDIC to issue, in the course of an examination, subpoenas and to take and preserve testimony under oath related to any matter in respect to the affairs or ownership of any such institution or affiliate. Accordingly, individuals, corporations, partnerships, or other entities which in any way affect the bank's affairs or ownership may be subpoenaed and required to produce documents under the FDIC's Section 10(c) powers.

Proper use of Section 10(c) powers can be a valuable aid to the FDIC in carrying out its supervisory responsibilities. However, the reasons why examinations of affiliates are considered advisable or necessary by the examiner should be documented, and the extent of any such examination should have prior clearance from the Regional Office. The exercise of Section 10(c) powers will require extensive legal documentation and should only be initiated following authorization from the Director, DSC.

BANK HOLDING COMPANIES

Under Section 2 of the BHC Act a "bank holding company" is defined to include any corporation, partnership, business trust, association, or similar organizations, or any long-term trust (one which extends beyond 25 years or 21 years and 10 months after the death of individuals living on the effective date of the trust) which has control over any bank or over any bank holding company. A bank, of course, is a company and, therefore, may be a bank holding company if it controls another bank or bank holding company. By virtue of amendments to the BHC Act, one-bank holding companies, partnerships, and under certain circumstances, bank trust departments are within BHC Act limits. An existing BHC may become an FHC by notifying the FRB of its election to do so. The BHC must certify that each of the FHC's insured depository institution subsidiaries is well capitalized and well managed.

Definition of Control

Under the BHC Act, a company has control over a bank or any other company (1) if it directly or indirectly owns, controls, or has the power to vote 25 percent or more of any class of voting securities of such bank or other company, (2) if it controls, in any manner, the election of a majority of the directors of such bank or other company, or (3) the FRB determines, after notice and hearing, that the company exercises a controlling influence over the management or policies of the bank or company. Shares owned or controlled by any subsidiary of a bank holding company are considered to be indirectly owned or controlled by the holding company. Shares held or controlled directly or indirectly by trustees for the benefit of a company or the shareholders or employees of a company are deemed to be controlled by the company. Refer to FRB Regulation Y, Section 225.2 for further clarification.

There is also a rebuttable presumption of control if the FRB, as authorized, finds that a company directly or indirectly exercises a controlling influence over the management or policies of the bank or bank holding company. In order to establish guidelines implementing these sections of the BHC Act, the FRB has adopted the following presumptions of control that may be rebutted by the affected company:

1. A company that owns, controls, or has power to vote more than 5 percent of the voting securities of a bank or bank holding company if; one or more of the company's directors, trustees or partners, or officers or employees with policy-making functions, serves in any of these capacities with the bank or holding company, and no other person owns, controls or has power to vote as much as 5 percent of any class of voting securities of the bank or bank holding company.
2. A company that owns, controls or has power to vote more than 5 percent of any class of voting securities of a bank or bank holding company if; additional voting securities are owned, controlled or held with power to vote by individuals or members of their immediate families (spouse, children, grandchildren, parents or their ancestors, stepchildren or stepparents, all whether natural or adopted) who are directors, officers, trustees or partners of the company (or own directly or indirectly 25 percent or more of any class of voting securities of the company) and such holdings together with the company's holdings aggregate 25 percent or more of any class of voting securities of the bank or bank holding company. The presumption does not apply under (1) and (2) where securities are held in a fiduciary capacity and the company does not have sole discretionary authority to exercise the voting rights.
3. A company that enters into any agreement or understanding with a bank or bank holding company (other than an investment advisory agreement), such as a management contract, pursuant to which the company or any of its subsidiaries exercises significant influence with respect to the general management or overall operations of the bank or bank holding company presumably controls such bank or bank holding company.
4. 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, presumably controls the shares involved unless the agreement; is a mutual agreement among shareholders granting each other a right of first refusal with respect to their shares, is incident to a bona fide loan transaction, or relates to restrictions on transferability and continues only for such time as may reasonably be necessary to obtain from a Federal bank supervisory authority with respect to acquisition by the company of such securities.
5. A company that directly or indirectly owns securities that are convertible immediately at the option of the holder or owner into voting securities, presumably owns or controls the voting securities.

In addition to the foregoing, the FRB may, under its regulations, administratively determine that a company controls a bank or other company. Congress has apparently established 5 percent as the benchmark for determining whether or not “control" exists and the FRB has to a great extent incorporated that benchmark into its regulations dealing with the rebuttable presumption of control. Accordingly, under the BHC Act, there is a presumption that a company does not have control over a bank or other company if the company directly or indirectly owns, controls, or has the power to vote less than 5 percent of the voting securities of such bank or other company. Furthermore, a company does not have control of a bank or other company unless at the time in question that company directly or indirectly owned, controlled, or had power to vote 5 percent% or more of the voting securities of a bank or other company, or had already been found to have control by the FRB after notice and opportunity for hearing.

PARENT COMPANIES WHICH ARE NOT BANK HOLDING COMPANIES

The primary forms of insured bank whose parent company does not fall under the definition of Bank Holding Company (BHC) or Financial Institution Holding Company for the purposes of the Bank Holding Company Act (BHCA), are the Industrial Loan Company (ILC) and the Savings Bank. Both of these insured entities are otherwise defined as banks under Section 3 of the FDI Act.

ILCs are defined for the purposes of the BHCA exemption, Section 2c(2)(H), as “… an institution … which does not accept demand deposits … ; which has total assets of less than $100 million … or ; which is not acquired by any company after the … enactment of the Competitive Equality Amendments of 1987; or is an institution which does not … engage in any activity in which it was not lawfully engaged as of March 5, 1987 …” Savings Banks are defined in Section 3g of the FDI Act, and are essentially State Savings Banks.

The Competitive Equality Banking Act (CEBA) of 1987, in redefining a bank as any bank insured by the FDIC and eliminating the loophole in the BHCA for institutions that accepted demand deposits or made commercial loans but not both, also created a small group of grandfathered institutions. These "CEBA" banks are also known as "non-bank banks," have the same activity restrictions as do ILCs, and their parent companies would also not necessarily have to be Bank Holding Companies. The growth in the "non-bank bank" charter, entities sometimes called limited charter institutions, is now primarily in ILCs.

While some limited charter institutions are owned by bank holding companies, most are owned by parent companies whose limited activities and primary purpose of owning the insured institution, make these parents virtually identical to the shell bank holding company. However, ILCs can be owned by commercial parent companies. Some of these corporations are otherwise engaged in a diversity of business activities which would otherwise preclude them from owning a bank and being a bank holding company. These commercial corporations presently include some of the largest manufacturing, insurance, retail, and investment banking firms.

For more specific information regarding the various definitions, limitations, and restrictions on non-bank financial institutions, see the relevant provisions of the BHC Act, 12 U.S.C. 1843(f)(3) and Regulation Y, 12 C.F.R. 225.2 and 225.52. These are included under the Bank Holding Company Act tab in the Prentice-Hall volumes.

CEBA Credit Card Banks

CEBA credit card banks are also exempt from the BHC Act and may be owned by commercial entities. Their operations are restricted to only issuing credit cards, accepting no demand deposits, accepting only jumbo deposits ($100,000 minimum), having only one office, and not making any commercial loans.

Unitary Thrift Holding Companies

Prior to the enactment of the GLBA, any company, regardless of its activities, could acquire a single savings association if the prospective subsidiary satisfied the qualified thrift lender test (QTL).[1]

The advantages of that charter included preferential taxation, liberal branching rights, expanded subsidiary powers and virtually unlimited holding company activities. Many of the thrifts with this charter were owned by commercial entities.

The GLBA prohibits the creation of new unitary thrift holding companies that engage in commercial or other nonfinancial activities. The GLBA did, however, grandfather most unitary thrift holding companies in existence as of May 4, 1999.

Industrial Loan Companies

Industrial Loan Companies (ILCs), also known as industrial banks, are state-chartered banking institutions. While only permissible in a limited number of states, they generally have broad banking powers, and under certain circumstances ILCs may be owned by commercial entities. Specifically, an ILC that meets certain criteria is not a "bank" under the BHC Act, and any company that controls such an ILC would not be subject to FRB regulation and supervision as a bank holding company.[2] Most ILCs have Federal deposit insurance (made available under the Garn-St. Germain Depository Institutions Act of 1982 legislation) and are regulated in a similar manner to state-chartered commercial banks.

Core ILC functions are traditional financial activities that can commonly be engaged in by institutions of all charter types. An ILC can:

- offer a full range of deposits, except demand deposits (unless grandfathered);
- offer a full range of loans and other financial services to both consumer and commercial customers;
- be an original issuer of Visa or Master Card credit and debit cards;
- fund its operations with deposits and Federal Home Loan Bank (FHLB) borrowings.

If an ILC is organized as a limited purpose or credit card institution, then its products and services would be limited to specified activities.

The GLBA did not repeal the ILC exception contained in the BHC Act. As such, commercial firms may continue, as State law permits, to acquire and control ILCs without complying with the BHCA so long as the ILCs satisfy the criteria for the exception. In the case of a parent subject to the reporting requirements of another regulatory body covered under the GLBA, such as the SEC or a State insurance commissioner, the FDIC has agreements in place to share information with such functional regulators. In examining any insured depository institution, the FDIC has the authority (under 12 U.S.C. § 1820(b)(4)) to examine any affiliate of the institution, including its parent company, as may be necessary to determine the relationship between the institution and the affiliate and to determine the effect of such relationship on the institution.

Unique Characteristics of Commercial Parent Companies

Certain bank charters, such as ILCs, may have commercial parent companies in place of a traditional bank holding company or financial institution holding company. As with bank holding companies, these commercial parents can be a source of strength for their subsidiary bank by providing access to the capital and debt markets, and affording the opportunity to use a variety of technical services not always available to small or mid-size banks.

However, commercial parents also present different management challenges to the insured institution and different analytical challenges to examiners. Commercial parents may not be able to offer additional management expertise directly relevant to financial institutions. In serving the specific financial needs of a commercial company, a niche bank may be insufficiently diversified against credit or liquidity risks. Further a financial catastrophe at a parent or affiliate, unrelated to the business of the insured institution, could result in an unanticipated but immediate disruption to the earnings or operations of the insured entity.

Moreover, assessment of "extra-insured" risk factors cannot be made with the comparatively straight-forward ratio analysis used for evaluating bank holding companies. Commercial firms present more varied revenue streams and business risks. Further, while a clearly identified weakness in the insured institution will generally determine the need to conduct an assessment of the potential source of strength provided by the commercial parent, any determination of a "potential source of weakness" presented by a parent or affiliate to an otherwise healthy insured entity will be far more complex. Examiners should only undertake such an assessment following consultation and direction from the Regional Office.

For non-bank holding companies or commercial parent entities, some possible sources for financial analysis include: parent entity quarterly or annual reports, Securities and Exchange Commission filings such as 10-Ks, 10-Qs, etc., bank records on affiliates, external industry analysis sources (i.e. Moody's Standard and Poor's, etc.), internal and/or external audits, corporate press releases, newspaper articles, etc.

HOLDING COMPANY EFFECT ON SUBSIDIARY BANKS

A sound, well-managed holding company can be a source of strength for unit banks; however, if the condition of the holding company or its nonbank subsidiaries is unsound, the operation of subsidiary banks can be adversely affected.

Management

The long-term health of an institution depends on a strong, independent and attentive board. The board sets the overall tone and direction of the institution and establishes policies and procedures concerning the nature and amount of risk the institution may take.

Solid corporate governance principles recognize the following elements necessary for the successful operation of the depository affiliated institution:

Each member of the board of directors should have the skills, integrity, knowledge, and experience necessary to allow the director to fulfill his or her responsibilities to the insured institution. The qualifications should be considered in light of the institution's size, complexity and risk profile. Board membership should be considered not only on an individual basis, but also collectively such that the composition provides a well rounded set of skills, knowledge, and experience.

The board of directors is responsible for actively overseeing the affairs of the institutions. This oversight should include:

- Reviewing and approving major corporate actions and the institution's overall corporate strategies, business plans, performance objectives, risk policies and risk tolerances,
- Monitoring the institution's adherence to the strategies, plans, objectives, risk policies and risk tolerances approved by the board, including policies and standards relating to conflicts of interest management,
- Reviewing appropriate regulatory and audit reports, and
- Taking appropriate action with respect to all matters requiring board attention.

The board of directors is responsible for ensuring that the institution, its directors, management, principal shareholders, and affiliates avoid potential direct and indirect conflicts of interest and comply with Federal laws and regulations that are designed to prevent misuse of depositors' funds.

The board of directors is responsible for hiring and retaining executive officers with the skills, integrity, knowledge and expertise appropriate to the nature and scope of their responsibilities. Executive officers must have the ability to manage day-to-day operations to achieve the institution’s performance goals. They should also possess the industry expertise to assess the institution’s current performance and condition and to help the board plan for the institution’s future.

The board of directors is responsible for establishing and maintaining appropriate committees, and that written charters delineating each committee’s functions, responsibilities and membership qualifications have been adopted by the full board.

The board of directors is responsible for ensuring that the insured depository institution maintains a separate corporate existence from its affiliates. This separateness also pertains to the sound tenet that all financial and other pertinent records for the financial institution affiliate be accessible on location.

Financial Considerations

The holding company structure can provide its subsidiary bank strong financial support because of greater ability to attract and shift funds from excess capital areas to capital deficient areas. The financial support can take the form of equity capital injections and/or the funding of loans and investments. However, when the financial condition of the holding company or its nonbanking subsidiaries is tenuous, pressures can be exerted on the subsidiary banks. In order to service its debt or provide support to another nonbank subsidiary, the holding company may place inordinate financial pressure on its subsidiary banks by any of the following methods: payment of excessive dividends; pressure subsidiary banks to invest in high risk assets to increase asset yields; purchase and/or trade its high quality assets for the other affiliate's lower quality assets; purchase of unnecessary services from affiliates; or payment of excessive management or other fees.

Although no formal policy statement has been issued by the FDIC, it has long been the FDIC's position that management and other fees paid by subsidiary banks should have a direct relationship to the value of actual goods or services rendered based on reasonable costs consistent with current market values for such services. Bank files should contain adequate information to permit a determination as to what goods and services are being provided and on what basis they are being priced. Charges should not be based on resources, deposits, or earnings of the bank. In those instances when payments are large and are not or could not be justified on the basis of services received by the bank, a comment should be included in the Report of Examination.

An additional method of upstreaming funds from a bank to its parent is through the remittance of income taxes to the parent that then files a consolidated income tax return. Due to timing differences arising from the use of different accounting methods for Reports of Condition and Income (Call Reports) and for income tax purposes, a portion of taxes reflected in Reports of Income and Condition will be deferred; however, in certain instances, banks are required to remit to the holding company the entire amount of income tax expense, both current and deferred. The FDIC's Statement of Policy Income Tax Remittance by Banks to Holding Company Affiliates, indicates past transfers of this kind shall be restated on the bank's books and future tax transfers shall only include the current portion of income tax expense.

Even when the holding company is financially sound, supervisory concerns may arise as the parent issues long-term debt to fund equity capital in the subsidiaries. Although this capital raising activity, known as "double leveraging," does increase equity capital in the subsidiary, too much debt at the holding company level can generate pressure on the subsidiary to upstream additional dividends. Since the holding company often services the debt with dividends from the lead bank, holding company debt service requirements which come to exceed historical dividend payment ratios may place undue earnings pressure on the bank. Should dividends be insufficient, the holding company may attempt to create other means of generating cash, such as charging the subsidiary for management and operating expenses.

The double leverage ratio is the equity of the subsidiary, or in the case of multiple subsidiaries the combined equity of all the subsidiaries; divided by the equity of the holding company. A holding company with a ratio of 100% or less, is not using double leverage. The amount of double leverage a holding company can comfortably carry can depend on various factors; but analysis should center on the amount of earnings or cash flow which the subsidiaries, or the lead bank if the lead bank generates most of the combined company’s earnings, can upstream to the parent. Even holding companies with comparatively modest double leverage ratios can negatively affect the bank if the non-bank subsidiaries produce negative cash flow. Other leverage ratios which attempt to isolate or incorporate different segments of the holding company’s capital structure (preferred stock or minority interests for example) can be useful for assessing more complex organizations.

Fixed charge coverage is a ratio that measures the ability of the parent company to cover its interest expense. The ratio is computed by determining how many times the parent's total interest expense is "covered" by the net of parent operating income (excluding "equity in undistributed earnings") less parent operating expenses other than interest and taxes. Interest expense is defined to include one- third of parent rental expense (if any), as though premises and equipment had been mortgaged rather than leased. A bank holding company parent's position is generally considered comfortable if it shows a coverage ratio of 2 times or better. A ratio of less than 1 points to a condition of cash flow deficit, without taking debt amortization or shareholder dividends into consideration. This ratio can be misleading if there is an abnormal dividend payout from subsidiaries, the major source of income to a parent. If the payout of all subsidiaries is only 20 percent (but could be 60 percent), the coverage ratio could be very low, perhaps well under 2 times. Conversely, if the payout of earnings is an unsustainable high 90 percent, the coverage ratio could temporarily appear adequate. Therefore, it is essential to be aware of actual dividend payout from subsidiaries to the parent before final interpretation of this ratio.

Cash flow match is a more severe test of parent cash availability to meet not only interest expenses, but also operating expenses, taxes, shareholder dividends, and debt maturities. Cash "sources" are defined as all parent operating income plus tax credit (or minus taxes paid). Cash "uses" are defined as operating expenses (including interest), dividends to shareholders, and debt principal due in one year. A coverage ratio of 1.10 "times" (i.e., cash sources are 110 percent of uses) is generally considered comfortable. Many highly profitable, underleveraged BHCs reflect ratios of 1.20 times or better. Ratios under 1.00 need additional study, as the presumption is that cash flow is insufficient to maintain BHC credit, which bears upon the viability of the institution. Like the fixed-charge coverage test, this ratio also needs adjustment to be interpreted in light of subsidiaries' dividend levels. The amount of debt due in one year usually does not reflect a normalized amortization schedule, since balloon and bullet maturities create a year-to-year instability in the "amount due." If sufficient data were available, it would be more appropriate to arbitrarily introduce a "normalized" amortization schedule based on the average life of parent debt outstanding. Finally, not all parent debt needs to be serviced from parent operating income. Much of this debt is covered or matched by advances to profitable subsidiaries, so that servicing of principal is in essence automatic. Therefore, a true cash flow test would apply only to "uncovered" parent debt and only the amortization of this portion needs to be normalized in the manner described.

These cash flow measures are the best indicators of the financial support a parent company can provide to a subsidiary bank. Asset size, capitalization, revenue or profitability; even relative to the size of the insured institution, are imperfect measures for gauging potential support.

Other ratios that can be used when analyzing holding companies are included on the Relationship with Affiliates and Holding Companies page of the Report of Examination. These ratios are generally available from the Uniform Bank Holding Company Performance Report.

Economies of Scale

The holding company structure can provide significant benefits from economies of scale in areas such as audit, and data processing services, etc. Effective review of the examination report by the holding company and implementation of recommendations contained therein should assist the FDIC in the supervision of subsidiary banks.

Dual Employees

These economies of scale could extend to the employees in the case of “dual employees” or those that perform essentially the same duties for a banking entity and the affiliated organization. The use of dual-employees can be a cost-effective manner for leveraging in-house expertise or for employees that specialize in certain core competencies. Nonetheless, the use of dual-employee arrangements may present increased risk to an insured banking entity if the institution, or its management, fails to adequately monitor the hiring, training, activities, reporting, or expertise of dual-employees.

Any dual officer or employee arrangements should be consistent with sound principles of corporate governance. All bank activities, including those performed by dual employees, should be subject to the authority of an independent board of directors. Bank officers (whether they are dual employees or direct employees) must have sufficient expertise, authority, and information to act in the best interests of the insured institution at all times, under the direction of the board. A comprehensive framework of policies, procedures, legal agreements, controls, and audit must be established to govern the activities of dual officers and employees. A formal written employee sharing agreement should be established to define the employment relationship between the banking entity and affiliate. The following factors should be addressed:

- The agreement needs to be independently reviewed by the bank's board of directors to ensure that it is fair and in the best interest of the insured bank.
- Compensation arrangements need to be clearly delineated to ensure they are equitable for both the bank and affiliated entity.
- The location where the dual employee is to perform duties needs to be established and detailed, along with reporting and authority.
- The agreement should require dual employees to avoid conflicts of interest. Additionally, the agreement should state that dual employees or officers must act in the best interest of the bank while performing any activities on behalf of the bank.
- Sanctions for noncompliance should be contained in the bank's agreement.
- The agreement should provide for a periodic determination concerning the status of a dual-employee and the factors to be considered for terminating the dual-employee relationship in favor of either full-time bank or affiliated entity employment.
- Authority for managing the dual-employee relationships should be clearly assigned.
- Lines of authority for dual employees should be established. While dual employees may have other responsibilities, they must also report through appropriate lines of authority within the banking institution. The dual employee's bank responsibilities and decision-making should take precedence over any affiliate responsibilities. All activities conducted on behalf of the bank must be subject to appropriate review and authorization by bank officers, and ultimately the bank's board of directors.

Affiliate officers and employees who conduct activities on behalf of the bank (even if not formally designated as dual employees) are subject to the same level of legal and corporate duties and liabilities as a direct officer or employee of the bank. Additionally, examiners should have reasonable access to dual employees and any other affiliate employees who perform services on behalf of the bank.

Bank officers must retain control over certain key functions, including general ledger entries, regulatory reporting, cash accounts, lending activities, and investments. While dual officers and employees can provide advice and other supporting services, bank officers must retain final decision making authority. Reasonable systems should be established to ensure that bank officers have sufficient information to oversee the activities of dual officers and employees who provide services to the bank.

The institution needs to be able to devote sufficient resources for monitoring and measuring performance under the terms of the employment sharing agreement.

The extent of the relationships, including the amount of time devoted between the bank and an affiliated entity, need to be periodically reported to the directorate or an appropriate committee.

The insured banking institution utilizing a dual-employee needs to have policies and procedures in place covering account settlement for dual-employees that stipulate the manner and timing for payment in order to ensure an unanticipated affiliated loan does not occur in contravention of Sections 23A & 23B of the FR Act.

Policies and procedures dealing with dual-employee relationships should include a mechanism to ensure compliance with 12 U.S.C 1831g (Adverse Contracts). Under that statute, an institution may not enter into a written or oral contract with any person to provide goods, products, or services to, or for the benefit of, a depository institution if the performance of such contract would adversely affect the safety and soundness of the insured institution.

Examiners should review and evaluate arrangements involving shared employees and/or management for the items discussed above.

Miscellaneous Considerations

The principal benefit of bank holding companies is the tax benefit from issuing debt at the parent company level and concurrently creating equity at the bank level. Most one bank holding companies which engage in minimal other activity aside from holding the stock of the bank, were created for this purpose. The Federal Reserve ruling permitting treatment of Trust Preferred Stock as Tier 1 capital for regulatory purposes, while simultaneously allowing the consolidated holding company to treat it as debt for tax purposes, further added to the attractions of the one bank holding company.

Many of the smaller one-bank holding companies receive infrequent inspection by the Federal Reserve. Ordinarily the holding company financial statements reflect little more than the bank investment and acquisition debt. It is expected that where debt-servicing requirements may impact bank earnings, appropriate comments will be made by the examiner in the examination report. Reference is made to the Earnings section of this Manual as well as the instructions for the preparation of the Relationships with Affiliates and Holding Company report page.

Another major benefit to an individual bank that belongs to a multi-bank holding company is that it can better serve its customers by participating loans exceeding its legal lending limit. A problem could result from this practice if the loan granted exceeds the management expertise of any of the participants.

Examiners should review and evaluate current business plans and any changes thereto since the previous examination. Business plans in most instances should be reduced to written form. It is recognized that the depth and detail of written plans may properly vary, depending on the nature, scope and complexity of their operations. Occasionally, examiners may encounter situations where written plans have not been developed. In these instances, frequent and ongoing communication with management is imperative. The necessity for a written plan may be inferred from the results achieved by management to a considerable degree.

Examiners should assess whether all service relationships provided by affiliates are governed by a written agreement. Refer to Sections 23A and 23B of the FR Act for additional information on affiliate transactions.

Examiners should also determine whether the bank should have a contingency plan for all critical business functions performed by affiliated companies. Refer to outstanding Information Technology (IT) examination guidance for specifics on contingency planning.

The Potential Impact of Holding Companies on Uniform Bank Ratings

The relationship between a bank and its parent holding company and the financial condition of the holding company could affect, to a significant degree, each of the component factors in the CAMELS rating as well as the composite rating.

The financial, technical, and managerial capacity of holding companies, commercial parents, and other affiliates can provide significant and often substantial support to a subsidiary bank. This is particularly true when the bank is a comparatively small component of a much larger corporate organization.

It will not always be necessary for examiners to conduct a detailed assessment of whether a parent company can be considered a source of strength for the subsidiary financial institution. If the subsidiary bank ratings are not dependent on the resources or support of the holding company, it will not normally be necessary to conduct a detailed assessment of the parent company or affiliates. Most bank holding companies have little financial capacity independent of the bank; and are likely to provide little independent support.

In the case where a complex commercial parent company has the potential capacity to support the subsidiary bank but does not clearly dominate the bank by virtue of size, revenues, or earnings, a more detailed examination of the parent may have to be conducted if it should become necessary to show conclusively that the bank ratings should reflect the holding company as a source of strength. However, conduct of a parent company examination should be dependent first on the independent financial condition of the insured institution, the extent of risk exposure resulting from direct transactions between the insured institution and the parent company, and the extent to which the capacity of the parent company supports the Uniform Bank Ratings assigned.

When a holding company or parent is considered a potential source of strength to the insured institution, the weight of this influence on the assigned Uniform Bank Ratings should only incorporate the actual support provided at the current examination. A potential source of strength determination should not be based on projected future resources of the parent, but rather on a current assessment of the parent’s actual financial condition. Furthermore, the benefits of parental resources and the influence of these resources on the Uniform Bank Ratings will likely change if the condition of the insured institution deteriorates. In this event, evaluation of potential source of strength should incorporate not just the capacity of the parent to support the bank, but also its present willingness to do so.

Some additional factors that may be considered in assigning a rating to the financial institution subsidiary could include:

- Capital – the ability and commitment of affiliates to contribute additional capital if needed and an assessment of the pressure from the parent organization for dividends.
- Asset Quality – the quality of the assets generated through programs associated with affiliates; ability of affiliates to provide financial guarantees or collateral, purchase low quality assets, or to arrange or develop risk mitigation transactions such as credit default swaps.
- Management – independence of management and the board of directors; ability of the financial institution affiliate to make decisions independent of parent company; adequacy of audit procedures; demonstrated willingness to address examination recommendations and follow safety and soundness principles; documentation and protocols for affiliate relationships.

- Earnings - reasonable fee structure of servicing relationships; suitability of management fees paid to affiliates.
- Liquidity – access to funding sources that would not otherwise be available.
- Sensitivity – funds management strategies that are coordinated with those of affiliates; efficacy of hedging or other market activities employed by affiliates.

TYING ARRANGEMENTS

The Bank Holding Company Act Amendments of 1970 and Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 added the so-called anti-tie-in provisions to the BHC Act. (See "Tying Arrangements" under the Bank Holding Company Act tab in the Prentice-Hall volumes.) Non-bank banks, including ILCs, are subject to the anti-tying provisions of the BHC Act as well.

Essentially, the anti-tying provisions prohibit a bank from conditioning the availability or price of any of its products or services upon the customer obtaining some other product or service from the bank or an affiliate, or upon the customer providing some other product or service to the bank or an affiliate. These provisions also preclude a bank from tying its products or services to a requirement that the customer not obtain some product or service from a competitor of the bank or an affiliate. The purpose of these provisions is to prevent banks from using their ability to offer financial products, credit in particular, in a coercive manner to gain a competitive advantage in markets for nonbanking products and services. For example, a bank may not require as a necessary condition to obtaining a loan or extension of credit that the prospective borrower lease personal property or equipment from the bank's holding company or a subsidiary thereof or that the prospective borrower provide the bank, its holding company or any subsidiary thereof with office supplies or equipment.

However, it is not intended that this provision interfere with the conduct of traditional banking practices. For example, a bank may restrict the availability or vary the price of its credit, property, or services on the condition that the customer also obtains a traditional bank product from the bank or an affiliate. A "traditional bank product" is a loan, discount, deposit, and trust service. For further information regarding other exceptions and safe harbors contact Regional Office staff. For purposes of these provisions, a natural person is treated as a bank holding company if he or she controls a bank or a company that controls a bank.

Violations of these anti-tying provisions may be addressed by the bank's appropriate Federal banking agency through an enforcement action, by United States Attorneys under the direction of the Attorney General through an action for injunctive relief, or by private parties through an action for injunctive relief as well as treble damages when they have sustained damages, or are threatened by loss or damage, by reason of a violation of these provisions.

Prohibition of Preferential Loans

Title VIII essentially prohibits preferential loans to executive officers, directors, and principal shareholders of a bank from its correspondent bank. Therefore, a bank which maintains a correspondent account for another bank is precluded from making an extension of credit on preferential terms to an executive officer, director, or principal shareholder of that bank, and a bank is precluded from opening a correspondent account for another bank if such bank has outstanding an extension of credit to an executive officer, director, or principal shareholder of that bank if it is on preferential terms. Conversely, a bank which maintains a correspondent account at another bank is precluded from making an extension of credit on preferential terms to an executive officer, director, or principal shareholder of that bank, and a bank is precluded from opening a correspondent account at another bank if such bank has outstanding an extension of credit to an executive officer, director, or principal shareholder of that bank on preferential terms. Any bank that violates or any officer, director, employee, agent, or other person participating in the conduct of the affairs of such bank who violates this prohibition shall forfeit and pay a civil penalty.

CHAIN BANKING GROUPS

From a supervisory standpoint, chain-banking groups are very similar in character to multibank holding companies. They have the ability to provide many of the benefits common to multibank holding companies as well as the ability to provide the potential for unsafe and unsound banking practices. The linkage of several banks or holding companies into a chain creates a concentration of banking resources that can be susceptible to common risks. Mutually shared risks that can arise in chain banking relationships include: poor loan participation practices, common deficiencies in lending and/or investment policies, domineering or absentee ownership, insider abuses or other self-serving practices. Unfortunately, detection and correction of these problems are largely dependent on the examination process and are complicated when the chain is composed of institutions subject to different Federal and/or State regulatory agencies.

Unlike multibank holding companies, chain banking organizations do not have to report financial information on a consolidated basis, thereby making offsite monitoring difficult. In addition, they are not subject to the same types of regulations as holding companies.

A chain banking organization is defined as a group (two or more) of banks or savings and loan associations and/or their holding companies which are controlled directly or indirectly by an individual or a company acting alone or through or in concert with any other individual or company. Control is defined as: ownership, control or power to vote 25 percent or more of an organization's voting securities; the power to control in any manner of the election of a majority of the directors of an organization; or the power to exercise a controlling influence over the management or policies of an organization. These criteria are to be interpreted narrowly. For example, institutions should not be deemed to be a chain organization simply because an individual holds a title such as chairman or president unless the individual actually has control.

The control structure of a chain organization is often complex. There may be registered holding companies within the ownership or control structure of a chain organization, but it would not be deemed to be a chain if the top holder of all the insured institutions in the group is a registered holding company. One bank under a bank holding company or several banks owned by a single bank holding company are not considered a chain banking group for purposes of maintaining a list of chain banking groups.

It is the policy of the Division of Supervision and Consumer Protection to monitor and supervise banks that are a part of a chain banking organization in a manner that fully considers the consolidated chain's financial impact on the safety and soundness of the individual institution(s). The supervisory strategy for monitoring chain organizations is included in the Case Manager's Procedures Manual.

In developing an overall supervisory strategy for chain organizations, the following factors should be considered:

- The relative size and complexity of the chain's organizational structure, including the degree of centralization of operations,
- The degree and nature of control or influence being exerted over individual institutions in the chain and the managerial style and extent of direct control or influence at each institution in the chain,
- The degree of interdependence among institutions in the chain. Particular emphasis should be given to the volume and frequency of inter-institution transactions such as: loan participations or sales; purchases or sales of securities or other assets; bank holding company or bank stock loans; insider loans or transactions; and contractual obligations for services, and
- The overall condition of the institutions in the group and the condition of the chain on a consolidated basis.

AFFILIATES

The relationship of a bank with its affiliated organizations is important to the analysis of the condition of the bank itself. Because of the commonality of ownership or management that exists, transactions with affiliates may not be subject to the same sort of objective analysis that exists in transactions between independent parties. Also, affiliates offer an opportunity to engage in types of business endeavors that are prohibited to the bank itself yet those endeavors may affect the condition of the bank.

In recognition of the importance of relationships with affiliated organizations, the FDIC has been granted authority, under certain conditions, to examine affiliates in connection with its examination of a bank.

There are two primary definitions of "affiliate" which are of importance to examiners. The first is the definition set forth in Section 2(b) of the Banking Act of 1933. The second is the definition set forth in Section 23A of the Federal Reserve Act.

Affiliates as Defined in Section 23A of the Federal Reserve Act

Section 23A of the FR Act (made applicable to insured nonmember banks by Section 18(j) of the FDI Act) contains the restrictive provisions relating to transactions between banks and their affiliates.

Prior to the GLBA amendments to Sections 23A and 23B, non-bank subsidiaries of banks were not covered by the definition of "affiliate." Those sections now provide that non-bank subsidiaries of state banks are "affiliates" in the event that they qualify as "financial subsidiaries." The GLBA amendments to Sections 23A and 23B apply solely to covered transactions between a state nonmember bank and its "financial subsidiaries" as covered in Section 46 of the FDI Act.

The principal purpose of Section 23A is to safeguard the resources of banks against misuse for the benefit of organizations under common control with the bank. It was designed to prevent a bank from risking too large an amount in affiliated enterprises and to assure that extensions of credit to affiliates are properly collateralized. Section 23A, therefore, regulates loans or extensions of credit to and investments in affiliates of an insured bank in two ways; first, by restricting the amount of such loans or extensions of credit and investments, and second, by requiring that the loans or extensions of credit meet certain standards as to collateral. Four major types of affiliates are defined in Section 23A and these are discussed in the following paragraphs.

Parent Holding Company and Its Subsidiaries

The first type pertains to a parent holding company and its subsidiaries. Any company that controls the bank (holding company) as well as any other company that is controlled by the company controlling the bank (sister subsidiary) is considered to be an affiliate of the bank under Section 23A. "Control" is defined as owning, controlling, or having the power to vote (directly or indirectly) 25 percent or more of any class of voting securities; or controlling in any manner the election of a majority of the directors or trustees. The term "company" means a corporation, partnership, business trust, association, or similar organization. These definitions are very similar, although not identical, to the definitions of "control" and "company" used in the BHC Act. It is therefore possible to have a holding company-subsidiary relationship under the BHC Act that is not an affiliate relationship for the purposes of Section 23A. Control relationships existing in certain types of trusts are an example.

Section 23A grants an important exemption with respect to domestic banks that are affiliated under this definition. When a bank is 80 percent controlled by a holding company, its transactions with other banks which are also 80 percent controlled by the same holding company are largely unrestricted. The only restrictions which do apply are the general prohibitions against a bank purchasing low-quality assets from its affiliates (refer to "Restrictions on Covered Transactions with Affiliates" below for a definition of "low quality asset"), and a requirement that all transactions be consistent with safe and sound banking practices. All restrictions and limitations set forth in Section 23A are, however, applicable to transactions by a bank with its parent holding company, its non-bank subsidiaries, and its bank subsidiaries that do not meet the 80 percent exemption. They also apply to an affiliated foreign bank even where the 80 percent test is met. The rationale for the 80 percent ownership test is that it is the minimum ownership generally required for the preparation of consolidated Federal income tax returns.

Bank Subsidiaries

The second category consists of bank subsidiaries of a bank. A domestic bank, which is controlled by another bank, is an affiliate of the controlling institution for the purposes of Section 23A. Where such bank is, however, 80 percent controlled, it is granted the same exemption described above relative to sister bank affiliates in a holding company organization. Thus, the treatment of domestic bank affiliates is consistent whether the bank is affiliated through a holding company or by virtue of direct ownership or control.

A different situation exists with respect to non-bank and foreign bank subsidiaries. Directly owned subsidiaries of this type, whether majority or minority owned, are excluded from the definition of an affiliate for the purposes of Section 23A. This is in contrast to the treatment of such firms when they are holding company subsidiaries. As noted above, non-bank and foreign bank subsidiaries of a holding company are affiliates and are subject to the restrictions of Section 23A. The rationale for this contrast in treatment is that non-bank subsidiaries, when majority owned by a bank, are really an integral part of the bank and transactions between the two should not normally be restricted. With respect to minority owned nonbank subsidiaries, it is noted that most banks are restricted in their ability to own stock and several of the more common types of nonbank subsidiaries (such as bank premises and safe deposit companies) are specifically exempted anyway. While this rationale serves to mitigate concern for transactions with non-bank subsidiaries in many instances, situations may arise where a bank can be exposed to undue risk. For instance, in some states banks may be able to conduct types of businesses through a non-bank subsidiary that would be prohibited to the bank itself. While the bank's investment in such a company may be limited, there may be no restriction on the amount of loans that could be made to the affiliate to fund its operations. Where evidence exists that a particular non-bank subsidiary should be brought under the restrictions of Section 23A, this can be accomplished by specific order or regulation. Any such recommendation should be forwarded to the Regional Office accompanied by supporting information.

Interlocking Companies

The third category of affiliates may be referred to as companies interlocked with a banking organization. Any company that is interlocked with a bank or its holding company by virtue of common ownership or common directors is an affiliate of the bank for the purposes of

Section 23A. Such interlocks will arise any time that 25 percent or more of a company is owned, directly or indirectly, by or for the benefit of shareholders who have a direct or indirect ownership of 25 percent or more in either the bank or its parent holding company; or a majority of a company's board of directors also comprise a majority of the board of the bank or its parent holding company. This definition may frequently be applicable to chains of one-bank holding companies that are interlocked by ownership or board membership at the holding company level. Under this definition both the chain of holding companies and their subsidiary banks will be affiliates of a bank under examination if either of the above relevant criteria is met.

Sponsored and Advised Affiliates

The final category is comprised of sponsored and advised affiliates. For the purposes of Section 23A, a company that is sponsored and advised on a contractual basis by a bank, or by any of the bank's subsidiaries or affiliates, is an affiliate of the bank. Real estate investment trusts are an example of this type of affiliation.

Any investment company that a bank or any of its subsidiaries or affiliates serves as an investment advisor is an affiliate of the bank. An investment advisor is basically one who, pursuant to a contract, regularly furnishes advice with respect to the desirability of investing in, purchasing or selling securities, or is empowered to determine what securities shall be purchased or sold by the investment company. The rationale for the inclusion of these two types of affiliations is that banks may, in order to protect their reputation or to forestall lawsuits alleging that bad advice was given, engage in less than arms length transactions. By applying the provisions of Section 23A to such situations, a bank's potential exposure to loss can be controlled.

Additional Considerations

In addition to the four categories of affiliates defined above, Section 23A also gives to the Board of Governors of the Federal Reserve System considerable latitude in defining which companies are or are not affiliated. This can be accomplished in three ways:

1. The Board of Governors may determine that "control" exists in individual situations not coming within the control definition of the FR Act after giving notice of and opportunity for a hearing. For example, the FRB may determine that a company owning less than 25 percent of a bank's stock nonetheless exercises control over the bank and is therefore an affiliate.
2. The Board of Governors may also determine that an affiliate relationship exists in specific instances by order or regulation. For instance, the FRB may determine that the relationship between an exempted subsidiary and its parent bank is such that the potential for abusive transactions exists. The FRB may issue an order or regulation bringing transactions with such company under the provisions of Section 23A.
3. The FRB also has the power to issue an order or regulation exempting specific types of transactions or affiliate relationships from the restrictions of Section 23A, provided that it finds that such exemption is in the public interest and consistent with the purposes of the FR Act.

Two final notes relating to the definition of affiliates under Section 23A concern "control" held in a trust capacity and companies acquired for debts previously contracted.

The FR Act specifies that no company shall be deemed to own or control another company by virtue of its ownership of shares in a fiduciary capacity with two exceptions. The first relates to affiliations arising out of the "Interlocking Companies" definition. Under this definition a company is an affiliate under a trust relationship whereby a trustee controls 25 percent or more of the voting shares of a company for the benefit of shareholders who control 25 percent or more of the voting shares of a bank or its holding company. The other exception provides that ownership or control of one company by another through a business trust creates an affiliate relationship.

With respect to the acquisition of control through debts previously contracted, the FR Act specifies that such companies are not affiliates for whatever period of time applicable State or Federal law or regulation permits the bank to hold such shares. In the absence of any such law the holding period is two years from the date of acquisition upon a showing of good cause. After the expiration of the allowable holding periods, such companies are deemed affiliates.

Restrictions on "Covered Transactions" with Affiliates

Section 23A (a)(1) permits a bank to engage in covered transactions with affiliates so long as the covered transactions do not exceed, in the aggregate; (1) 10 percent of the bank's capital stock and surplus with respect to a single affiliate; (The GLBA exempted transactions between banks and their financial subsidiaries from this requirement) and (2) 20 percent of capital and surplus with respect to all affiliates. (For this maximum percentage, the GLBA provides that a bank’s investment in a financial subsidiary will not include the retained earnings of the subsidiary in the calculation). Both the FRB and the FDIC have previously interpreted capital stock and surplus to include undivided profits, capital reserves, the loan valuation reserves, and valuation reserves for securities. The GLBA added a form of “anti-evasion” protection regarding the aggregate transaction limits and collateral requirements in Section 23A and the transaction restrictions in Section 23B. Any purchase of, or investment in, the securities of a “financial subsidiary” of a bank by an affiliate of the bank will be considered a purchase of or investment in such securities by the bank.

Covered transactions are specifically described in Section 23A (b)(7)(A) through (E) but basically consist of:

- Loans to an affiliate,
- Purchase of securities issued by an affiliate,
- Purchase of nonexempt assets from an affiliate,
- Acceptance of securities issued by an affiliated company as collateral for any loan, and
- Issuance of a guarantee, acceptance, or letter of credit on behalf of (for the account of) an affiliate.

Reference is made to Section 23A (d)(2) through (7) for a listing of several types of transactions that are specifically exempted from the provisions of Section 23A. These transactions basically consist of deposit balances in bank affiliates, loans secured by U.S. or agency securities or deposit balances in the bank, readily marketable assets purchased at quoted market prices, loans purchased on a nonrecourse basis from affiliated banks, and the repurchase of loans previously sold to an affiliate with recourse.

The FR Act also contains two other important general provisions that relate to covered and exempted transactions. A bank may not purchase any "low quality asset" from an affiliate in any amount unless, pursuant to an independent credit evaluation, the bank had committed itself to purchase such asset prior to the time such asset was acquired by the affiliate. A "low quality asset" is defined as:

- An asset which was classified as "substandard," "doubtful," or "loss" or treated as "other loans especially mentioned" in the most recent report of examination or inspection of an affiliate prepared by either a State or Federal supervisory agency,
- An asset in a nonaccrual status because of deteriorating credit quality and/or past due status,
- An asset on which principal or interest payments are more than 30 days past due, or
- An asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor.

This prohibition on the purchase of low quality assets also extends to bank subsidiaries. In other words, neither a bank nor any of its subsidiaries may purchase low quality assets from an affiliate. The other provision is more general but has a similar intent. This provision requires that any covered transaction between a bank and an affiliate must be on terms and conditions that are consistent with safe and sound banking practices.

For purposes of illustration, the following loan purchase transactions provide examples of the application of Section 23A which examiners may find useful.

1. Loans Purchased from Non-Bank Subsidiaries - A bank may purchase any loan, including a classified loan, from its own non-bank subsidiaries since such companies are not considered affiliates under Section 23A. It does not matter whether the subsidiary is minority or majority owned. The only way to control such possibly objectionable activity, other than through use of Section 8 powers, would be to have the nonbank subsidiary brought under the restrictions of 23A by order or regulation.
2. Loans Purchased from Domestic Banks which are 80 Percent Owned by Either the Bank or its Parent Holding Company - A bank may purchase loans in any amount from these affiliates provided they are not "low quality" or constitute "unsound" transactions under the provisions of Section 23A. The loans may be either subject to repurchase by the affiliate or not subject to repurchase.
3. Loans Purchased from Parent Holding Company, Sister Non-Bank Affiliates, Interlocking Non-Bank Affiliates, Sponsored Affiliates and Foreign Bank Affiliates - A bank may purchase good quality loans from these affiliates subject to the 10-20 percent capital stock and surplus limitations. Other covered transactions are aggregated for purposes of applying the amount limitations. Low quality loans or loans whose terms and conditions are unsound may not be purchased in any amount. Loans secured by U.S. securities or repurchased loans which had been sold earlier by the bank to the affiliate on a with-recourse basis are exempted, however, and would be excluded in applying the amount limitations.
4. Loans Purchased from Other Domestic Bank Affiliates - These affiliates are domestic banks controlled by either the bank or its parent holding company but which are less than 80 percent owned. This also includes banks controlled by interlocking affiliates (one-bank holding company chains, for example)

whether more than or less than 80 percent owned. Loan purchase transactions with these affiliates are treated the same as loan transactions with the parent holding company, etc. (#3 above) with one exception; good quality loans may be purchased in any amount provided they are sold by the affiliated bank on a non-recourse basis.

Collateral Requirements

Loans may not be extended directly to an affiliate nor may a bank issue guarantees, acceptances, or letters of credit for the account of an affiliate unless certain collateral and margin requirements are met. Eligible collateral and margins are as follows:

- 100 percent collateral margin if the collateral consists of U.S. Government and agency securities, deposits held in the bank which are specifically segregated and earmarked, or obligations (such as notes, drafts, or acceptances) which are eligible for rediscount or purchase by a Federal Reserve Bank,
- A 110 percent margin is required if the collateral is composed of obligations of a state or political subdivision of a state,
- A 120 percent margin is required if the collateral consists of other types of debt instruments, including receivables, and
- A 130 percent margin is required if the collateral is composed of stocks, leases, or other real or personal property.

It is important to note that market value at the time of the transaction is the appropriate basis for meeting margin requirements in all instances. When any collateral is subsequently retired or amortized and the amount of the remaining collateral does not provide a sufficient margin, additional eligible collateral must be supplied in an amount sufficient to meet the collateral margin required at the inception of the transaction. Where no collateral substitutions or amortizations are involved, a shrinkage in collateral value does not create a violation so long as the margin requirement was met at the inception of the transaction.

As noted above almost any type security is acceptable (provided margin requirements are met) subject to two important limitations. First, low quality assets; as that term is defined, may not be used to meet collateral requirements and, secondly, securities issued by an affiliate of a bank may not be used to secure the obligations of that affiliate or any other affiliate of the bank.

Section 23B of the Federal Reserve Act

Section 23B of the FR Act applies to insured nonmember banks through Section 18(j) of the FDI Act. Violations of Section 23B by nonmember banks are subject to the civil money penalties of subsection (3)(A) of Section 18(j). Section 23B essentially imposes the following four restrictions:

1. A requirement that the terms of affiliate transactions be comparable to terms of similar non-affiliate transactions;
2. A restriction on the extent that a bank may, as a fiduciary, purchase securities and other assets from an affiliate;
3. A restriction on the purchase of securities where an affiliate is the principal underwriter; and
4. A prohibition on agreements and advertising providing or suggesting that a bank is responsible for the obligations of its affiliates.

Section 23B generally incorporates the definitions used in Section 23A; however, banks are not "affiliates" for purposes of Section 23B.

SUBSIDIARIES

A bank subsidiary, as defined by Section 23A of the FR Act, is any company of which 25 percent or more of any class of its voting stock is owned, controlled, or may be voted by the bank; or any company with respect to which the bank controls, in any manner, the election of a majority of its directors or trustees. While several types of subsidiaries (such as bank premises companies or safe deposit companies) have long been excluded from the provisions of Section 23A, post-GLBA, the amendments to 23A and 23B provide that non-bank subsidiaries of state banks are “affiliates” in the event that they qualify as “financial subsidiaries” under new Section 46 of the FDI Act.

The overall condition of a subsidiary can substantially affect the affairs and soundness of a bank. For example, a subsidiary in severe financial distress could precipitate a drain on the management and financial resources of the bank. To determine the overall risk that the functionally regulated entity presents to the insured depository institution as a whole, it is necessary to determine which subsidiaries are functionally regulated within the functional regulation confines (refer to applicable subsection of this chapter).

Requirements for consolidation of subsidiaries are contained in the Call Reports Instructions for essentially all majority-owned bank premises subsidiaries and other majority-owned subsidiaries, which are considered significant according to certain tests, are consolidated. Some major types of subsidiaries are addressed below:

Bank Service Corporation

A bank service corporation is defined in the Bank Service Corporation Act (BSC Act) as a corporation, whose capital stock is all owned by one or more insured banks, organized to perform "authorized services." The BSC Act limits the investment of a bank in a bank service corporation and specifies prior regulatory approval requirements. Authorized services are defined to include services such as: check and deposit sorting and posting, computation and posting of interest and other credits and charges, preparation and mailing of checks, statements, notices, and similar items, or any other clerical, bookkeeping, accounting, statistical, or similar function performed for a bank. In addition, a bank service corporation may perform any services permitted by FR regulation for a bank holding company under Section 4(c) (8) of the BHC Act.

Due to the nature of services performed by these corporations, the importance of analyzing their financial condition is obvious. In addition to authority to examine affiliates the BSC Act provides that for any bank regularly examined by a Federal supervisory agency or any subsidiary or affiliate of such bank subject to examination by that agency, which causes to be performed by contract or otherwise, any bank services for itself, whether on or off premises, such performance shall be subject to regulation and examination by such agency to the same extent as if the services were being performed by the bank itself on its own premises. The bank is also required to notify the appropriate agency of the existence of such a service relationship within 30 days after the making of the service contract or the performance of the service, whichever comes first.

Safe Deposit Corporation

A safe deposit corporation primarily performs the same functions as a safe deposit department of a bank. A primary purpose for establishing such a subsidiary is to limit the bank's liability. These corporations generally are established under applicable State statutes that may contain limits on liability of the corporation for loss to a customer in any box or compartment. The safe deposit corporation should be operated under the same set of internal procedures as a normal bank safe deposit department. Additionally, the subsidiary should be protected by a combination safe depository insurance policy to the extent State law liability limitations do not provide adequate protection.

Corporation Holding Title to Bank Premises

As the name suggests, a bank premises subsidiary holds title to the bank premises and, in most cases leases them back to the bank. Oftentimes construction/acquisition of the bank premises is financed with borrowed money and lease terms are designed to service principal and interest payments of the mortgage. State law for nonmember banks generally limits the maximum investment in a bank premises subsidiary. The amount of investment, direct or indirect, by a bank in bank premises can have a significant effect on overall net earnings. Therefore, it is essential when evaluating a bank's condition and earnings, that majority-owned bank premises subsidiaries be fully consolidated.

Securities Firm

A securities firm subsidiary is a subsidiary that:

- Engages in the sale, distribution or underwriting of stocks, bonds, debentures, notes, or other securities,
- Acts as an investment adviser to any investment company,
- Conducts any activity for which the subsidiary is required to register with the Securities and Exchange Commission as a broker/dealer, or
- Engages in any other securities activity.

Small Business Investment Companies (SBIC)

A SBIC is a company, organized under the Small Business Investment Act of 1958, which provides long-term credit and equity financing for small business concerns. Section 302(b) of that Act authorizes National banks, other member banks, and nonmember insured banks (to the extent permitted by applicable State law), to invest in stock of SBICs not exceeding (in total) 5 percent of the capital and surplus of such banks. In no event may a bank acquire 50 percent or more of the shares of any class of equity securities issued by an SBIC having actual or potential voting rights.

Agricultural Credit Corporation (ACC)

These subsidiaries, established under State law, are generally a means by which a bank can obtain funding to be able to continue to service the borrowing needs of its agricultural customers. The ACC establishes a financing relationship with the Federal Intermediate Credit Bank (FICB) by buying a participation certificate in the FICB. It is then able to borrow a certain percentage of the face value of loans by discounting those loans at the FICB on a full recourse basis. The ACC is examined and regulated by the FICB and any loans classified Doubtful or Loss at the parent bank, which are discounted at the FICB, must be replaced.

Inasmuch as lending limits to ACC's may be separate from and in addition to the bank's limit; care should be taken to avoid a concentration of credit to any individual borrower. Wholly owned ACCs should be examined by the FDIC with classifications reflected in a consolidated balance sheet and analysis of capital.

Special Purpose Finance Subsidiaries

A finance subsidiary is used as a mechanism for raising funds from outside investors through the issuance of collateralized debt or preferred stock. The parent bank places certain assets in the subsidiary to collateralize or otherwise support the securities issued by the subsidiary. Properly used, a finance subsidiary may enhance a bank's efforts to restructure its assets, obtain cheaper and more widely available funding sources, and improve overall profit performance.

Finance subsidiaries can also be used solely for the purpose of generating arbitrage profits rather than for the purpose of obtaining an additional source of funds. For example, a subsidiary might issue collateralized mortgage obligations and use the proceeds to simultaneously buy the mortgage-related collateral that will secure the collateralized mortgage obligation. Thus, the parent bank would receive no additional funds since the proceeds of the securities issuance are used to purchase the underlying collateral.

Bank management has the responsibility to carefully consider the impact of finance subsidiary transactions on the bank's overall financial position. Areas requiring attention include the following:

- Consolidation Requirements. For Reports of Income and Condition filed with the FDIC, subsidiaries that meet any one of the "significance" tests set forth in the Call Report instructions must be consolidated. Thus, securities issued to outside parties by a finance subsidiary that is wholly owned by the parent bank generally would be reported as a liability on the bank's consolidated financial statements.

- Capital Adequacy Considerations. If required to be consolidated with the parent bank for Call Report purposes, these subsidiaries must also be consolidated for purposes of evaluating capital adequacy under the FDIC's Part 325 capital regulation. As a result, finance subsidiary transactions are normally reflected as additional assets and liabilities on the bank's consolidated Report of Condition balance sheet. Because the transactions generally result in an increase in total assets with no increase in capital, the potential negative impact on the capital to asset ratio effectively limits the total dollar volume of such transactions.

- In addition, banks should carefully evaluate their overall asset/liability management, funding, and liquidity management strategies prior to entering into any proposed finance subsidiary transaction. In situations where finance subsidiary transactions are concluded in an unsafe or unsound manner, examiners should seek appropriate supervisory remedies.

Corporations Engaged in International Banking Activities

Edge Act Corporation - A Federally chartered corporation organized under Section 25(a) of the FR Act and subject to Federal Reserve Regulation K. Edge Act Corporations are allowed to engage only in international banking or other financial transactions related to international business. They are chartered and regulated by the Federal Reserve System and must have a minimum capital of $2,000,000 and a minimum life of 20 years. Their purpose is to aid in financing and stimulating foreign trade. An Edge Act subsidiary is a bank's majority-owned Edge Act Corporation and is treated for purposes of Reports of Income and Condition as a "foreign office."

Agreement Corporation

A State-chartered corporation that has agreed to operate as if it were organized under Section 25 of the FR Act and has agreed to be subject to FR Regulation K (refer to the FDIC Rules and Regulations). Banks must apply to the FR for permission to acquire stock in an Agreement Corporation, which is restricted principally to international banking operations.

Foreign Bank Subsidiary of a Limited Purpose Credit Card Bank

The GLBA adds a new provision to the BHC Act, which permits a credit card bank which is not a bank under the BHC Act to control a foreign bank if the investment in the foreign bank meets the requirements of Section 25 or 25A of the FR Act and the foreign bank qualifies under such sections; the activities of the foreign bank are permissible under otherwise applicable law; and the foreign bank does not offer any products or services in the United States.

Mortgage Banking Subsidiaries

Mortgage banking subsidiaries engage in the origination and/or purchase of mortgages for sale in the secondary market and the servicing of mortgages. The major functions of a mortgage banking subsidiary are:

- Origination, which includes application processing, underwriting, and closing,
- Secondary marketing, which includes purchases and sales, warehousing, packaging and shipping, investor relationships, and risk management, and
- Servicing, which includes mortgage accounting administration, collections, customer service, and investor reporting.

Insurance Subsidiaries

There is considerable variety in the laws and regulations of the states. Some allow bank subsidiaries to engage in insurance agency or brokerage operations, while others do not. Some limit the products that may be offered. Types of insurance products include credit liability, casualty, automobile, life, health, accident, title insurance, and private mortgage insurance. The insurance departments of the various states generally regulate insurance activities.

Real Estate Subsidiaries

State laws vary with respect to permissible real estate activities that may be conducted through bank subsidiaries. A number of states permit real estate brokerage activities. Others permit equity participations, which involve passive investment roles, and some states permit bank subsidiaries to engage in real estate development and ownership in an active role. In many cases investments are limited in terms of percentages of an institution's total assets or capital.

Real estate brokerage, management, development and investment are not permitted for national banks or their subsidiaries. For state non-member banks to invest or develop real estate, this activity must be authorized under State law and approved by the FDIC under Section 24 of the FDI Act. Real estate brokerage is considered to be an agency activity, so no FDIC approval is necessary.

EXAMINATION OF SUBSIDIARIES

Unlike affiliates, whose activities may be shielded from the insured institution through the holding company structure and the provisions of Sections 23A and 23B of the FR Act, the liabilities of a subsidiary may flow directly to the insured institution if appropriate barriers between the insured institution and its subsidiaries are not in place. Even with barriers, the legal precedents are such that there is no guaranty that the liabilities of a subsidiary may not adversely impact the parent. Thus, in order to determine the true condition of the parent organization, the risk presented by the subsidiary to the parent institution needs to be evaluated.

If the subsidiary is functionally regulated, the GLBA requires the FDIC to rely to "the fullest extent possible" on the functional regulator. Therefore, examinations conducted by the appropriate Federal and State regulators of functionally regulated entities should be used, if possible, rather than a direct examination of those entities. Examinations of functionally regulated subsidiaries are generally permissible only if:

- There is a reasonable cause to believe that the subsidiary is engaged in activities that pose a material risk to the depository institution,
- That an examination is necessary to assess risk management systems, or
- The subsidiary is not in compliance with a law that the agency has specific jurisdiction to enforce against the subsidiary.

If a high-risk profile is evident, more extensive examination procedures may be required. For a functionally regulated subsidiary, the examiner should contact the Regional Office before proceeding with any direct examination of the subsidiary's records. Any records that the bank maintains, including any written policies and procedures concerning the bank's oversight of the subsidiary, should be reviewed and assessed for adequacy. The objective is for examiners to reach a level of comfort sufficient to assess the overall condition of the subsidiary and its impact on the parent.

The Examination (ED) Modules contain examination procedures for examining subsidiaries. Refer to the Related Organizations section for additional guidance in this area.

Depending on the type of subsidiary, a more in-depth evaluation will generally involve assessment of the following areas:

Asset Quality

The examiner should attempt to ascertain the quality of assets, review delinquency reports where appropriate, and evaluate bank management oversight with respect to the subsidiary and any policies in place to determine the extent of any loss.

Funding and Liquidity

A determination should be made of the types of funding necessary for the subsidiary's activities, the reliability of present funding, and the extent to which the subsidiary's activities are being funded by the bank. An excessive reliance on any one source of funding may indicate future liquidity problems or undue reliance on the parent to provide funding.

Adequacy of Capital

To the extent possible, a determination of the adequacy of the subsidiary's capital should be made after reviewing asset quality, sources of funding, earnings, and management. Capital levels should be compared to regulatory requirements or other standards considered appropriate for the type of business the subsidiary is engaged in. This capital cushion is an important insulation to protect the bank from liabilities of the subsidiary.

In reviewing the parent bank's capital adequacy, the bank's investment in its subsidiary should be deducted from both assets and capital. This analysis will indicate the effect on the parent should the subsidiary become insolvent.

Earnings

The earnings stream of the subsidiary should be reviewed to determine if there is reliance on one time gains or if there is a failure to recognize losses on a timely basis. Fees received from the bank, salary structure and overhead expenses should be reviewed to ensure that charges are in line with those that would be made to third parties.

Management

Daily management of the subsidiary should be structured so as not to create the presumption that the activities of the subsidiaries are in any way conducted by the bank. Advertising and any required disclosures should be reviewed to ensure that the public is not given the perception that subsidiary activities are guaranteed by the bank or insured by the FDIC.

Another important management consideration is “firewalls.” The term "firewalls" is used to describe a concept of separation of responsibility for entities providing different services but which are commonly owned. Firewalls generally include separate corporate formalities, management, employees, accounting, and policies. Also, the operations of the subsidiary should be physically distinct from the operations of the insured institution. Section 362.4(c)(2) of the FDIC Rules and Regulations is an example of a firewall construction designed to insulate the bank from liability of the subsidiary; compliance with Section 362.4(c)(2) should be reviewed where applicable.

EXAMINATION AND INVESTIGATION OF UNAFFILIATED THIRD PARTY SERVICERS

Situations occasionally arise where the safety and soundness of an insured depository institution is materially affected by transactions, contracts or business arrangements with parties that are not affiliated with the institution. When such situations arise, it is necessary for the FDIC to examine the other side of the transaction. The potential impact of these business relationships on the insured depository institution necessitates a complete understanding of the nature of the transaction and relationship and its effect on the insured institution.

By statute, the FDIC has authority to obtain records of unaffiliated service providers and other counterparties relating to an insured financial institution. Such authority is not unqualified but depends on particular facts and circumstances giving rise to inquiries by the FDIC. Several statutory provisions support this conclusion: Sections 10(b) and 10(c) of the FDI Act; Section 7(c) of the BSC Act; and Sections 3(w)(5) and (6) of the FDI Act. The information that the FDIC can obtain from an unaffiliated service provider or other counterparty is not limited to specific transactions with or relating to the insured depository institution but can extend to the financial books and records of the servicer or entity so long as such documents are needed in furtherance of an examination that relates to the affairs of an insured bank.

It is important that examiners are aware of material transactions, service contracts, or other business arrangements that could have a material affect on an insured bank. If it is concluded that information is needed from an unaffiliated service provider or other counterparty to the bank, then the examiner should consult with the Regional Office. The Regional Office will assist the examiner in determining whether information is needed from an unaffiliated service provider, and if so, in obtaining the appropriate information.

Examination authority covering bank service corporations is set out in Section 7 of the BSC Act.

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[1] Qualified Thrift Lender test requires that at least 65% of the institution's assets be qualified thrift investments, primarily residential mortgages and related investments.

[2] Generally, an ILC is excepted from the BHC Act if (A) it was chartered under a State law that on March 5, 1987 required the ILC to have Federal deposit insurance, and (B) it meets at least one of the following conditions: (1) the institution does not accept demand deposits, (2) the institution's total assets are less than $100,000,000, or (3) control of the institution has not been acquired after August 10, 1987.

INTRODUCTION

Risk management is intended to minimize the cost associated with certain types of risk and provide prudent protection. The maintenance of appropriate levels of necessary insurance coverage is a key aspect in the risk management process. It deals with pure risks that are characterized by chance occurrence and may only result in a financial loss, as opposed to a speculative risk which affords the opportunity for financial gain or loss. Such pure risks are separated into three major exposure categories: liability, property, and personnel.

There are three stages in the risk management process: risk identification and analysis, risk control, and risk treatment. Identification and analysis requires a review of all aspects of the bank's present and prospective operations to determine where the bank is exposed to loss, including consultation with a reliable insurance professional. Risk control is primarily dependent upon the strength of the bank's internal controls, policies and procedures. Risk treatment refers to choosing the appropriate steps or methods to deal with a particular risk. The objective of this process is to minimize the probability of losses and costs associated with them, such as direct costs of loss prevention measures, insurance premiums, losses sustained, and related administrative expenses. A bank has several options in treating a particular risk. It can implement additional controls to minimize yet retain the risk (i.e. become a self-insurer), transfer the risk to another party through insurance or contractual transfer, or utilize a combination of both of these approaches. A basic tenet of risk management is that those risks which carry the potential for catastrophic or significant loss should not be retained, if avoidable. Conversely, it is not cost justified to insure losses which are relatively predictable and not severe. The board of directors must determine the maximum loss the bank is willing and able to assume, and should perform an annual review of the bank's risk and insurance management program.

The real value of insurance lies in the protection it affords against catastrophic losses. To the extent a bank does not have adequate coverage, losses deplete capital and impair the position of depositors and the FDIC. Examiner review and analysis of the adequacy of the bank's insurance program is clearly necessary. The various types of insurance coverage (delineated below) serve only as a guide and a reference of available insurance protection. The specific needs of a bank must be determined on an individual basis, and only by reviewing each policy in force, can the actual degree of coverage and protection be determined. Any material inadequacies of insurance coverage should be directed to management's attention. Lack of any significant coverage, board of director approval and review, or deficiencies in a bank's loss prevention program should be appropriately commented upon in the Report of Examination.

FIDELITY INSURANCE PROTECTION

Fidelity insurance protection is appropriate for all banks because it insures against certain risks that contain the potential for significant loss. Section 18(e) of the Federal Deposit Insurance Act (FDI Act) provides that the FDIC may require such coverage, and if it is not obtained, may contract for such protection and add the cost to the bank's deposit insurance assessment. However, such action would only be taken in rare instances, such as when a bank is able to obtain protection but refuses to do so.

If the bank is without coverage, a thorough investigation should be made to determine the reasons insurance protection is lacking. Such banks must continue diligent, good faith efforts to obtain reasonably priced coverage. Their efforts should be monitored periodically to confirm the actions being taken to obtain coverage, including steps necessary to satisfy any conditions that may have been imposed by an insurer as a prerequisite for coverage.

In some cases, a bank may offer alternate arrangements in lieu of the usual insurance bond. While it is difficult to generalize, these arrangements (i. e. having directors or owners sign personal guarantees or increasing the bank's capital) do not protect the bank against the same risks in essentially the same manner or to the same extent, and therefore, are generally not acceptable as substitutes for insurance coverage. However, each such offer should be appraised on its merits for whatever additional protection it might provide in the interim.

While a periodic review of internal and external security measures and controls is warranted in every bank, it is especially appropriate in a bank that is operating without fidelity insurance coverage. Ideally, this effort should be undertaken as a special project with responsibility fixed in a particular executive officer. Further, it should include a comprehensive review of the bank's existing programs, the design and implementation of additional security procedures and controls, and a formal report to the board of directors, with any actions taken by the board based on the report findings noted in the minutes of the meeting. Management should also consider using outside experts, as necessary, to assist in strengthening internal programs or possibly to help the bank qualify for fidelity protection where a carrier has previously cited specific deficiencies that require correction.

Providing Examination Information to an Insurance Carrier

Occasionally, a bank may ask to release all or part of an examination report to an insurance carrier. These inquiries should be discouraged. A bank should be able to demonstrate its insurability to prospective insurers without having to release confidential information from an FDIC examination report. Adequate information is available from the bank's records and from nonconfidential sources to enable an insurer to accurately assess its underwriting risk.

Protection From Both External and Internal Hazards

External hazard includes the possibility of dishonest, fraudulent, or criminal acts committed against the bank and its employees by the general public. Robbery, burglary, and forgery are the predominate acts. Banks endeavor to guard against losses from these sources by maintaining vaults and safes, reliable alarm systems, and other security devices which should, at a minimum, meet the requirements set forth in Part 326 of the FDIC's Rules and Regulations. Banks should also attempt to limit the size of such losses by keeping exposed cash and negotiable securities at a minimum.

Internal hazard, which poses a far greater risk, deals with the possibility of defalcations by the bank's own personnel. Banks should try to protect themselves against this hazard by maintaining clear records and effective systems of internal routine and controls. The maintenance of an appropriate level of insurance coverage helps to further limit the institution’s level of risk related to employee defalcations and other types of internal fraud.

Bankers Blanket Bond Insurance

The most common form of blanket bond used by commercial and savings banks is the Financial Institution Bond, Standard Form No. 24. Other forms may be encountered and should be thoroughly analyzed to determine the extent of coverage. Standard Form No. 24 has two different limits of liability--a single loss limit of liability and an aggregate limit of liability. The single loss limit applies to individual claims, whereas the aggregate limit applies to the total of all loss recoverable under the bond. For example, if there is a $500,000 single loss limit and a $1,000,000 aggregate limit, payment of the single loss reduces available coverage for further losses during the bond period to $500,000. When the aggregate limit of liability is exhausted, the bond automatically terminates regardless of the remaining term and without any refund of premium. In order to determine the remaining insurance coverage, the amounts of all prior and pending claims against the bond should be deducted from the stated aggregate limit.

Scope of Blanket Bond Coverage

Clause (A) - Fidelity

Covers losses as a result of dishonest or fraudulent acts by officers and employees, attorneys retained by the bank, and non-employee data processors while performing services for the insured. This clause generally excludes loss caused by a director, unless the director is also a salaried employee of the bank. "Dishonest or fraudulent acts" are defined as acts committed by such employee with the manifest intent to cause the insured to sustain such loss and obtain financial benefit for the employee or another party (other than salaries or other employee benefits earned in the normal course of employment). Coverage of losses resulting from loan activity is severely restricted. Such losses are covered only if the employee involved acts in collusion with another party to the transaction and the employee receives a financial benefit of at least $2,500.

Clause (B) - On Premises

Loss of property (as defined in the bond) resulting directly from (a) robbery, burglary, misplacement, mysterious unexplainable disappearance and damage thereto or destruction thereof, or (b) theft, false pretenses, common law or statutory larceny, committed by a person present in an office or on the premises of the insured, while the property is lodged or deposited within offices or premises located anywhere.

Clause (C) - In Transit

Identical coverage as that provided in Clause (B), except that the property is covered while in transit. The property must be in the custody of a person acting as a messenger of the bank while in transit. When an armored vehicle is not used by a transportation company, property is generally limited to written or electronic records, certified securities, and negotiable instruments.

Clause (D) - Forgery or Alteration

Optional coverage for loss through forgery or alteration of, on, or in checks, drafts, acceptances, and other negotiable instruments, as specified, which are received by the bank either over-the-counter or through clearings. Items received as a transmission through an electronic funds transfer system are not covered.

Clause (E) – Securities

Optional coverage for loss resulting from the insured having, in good faith, for its own account or for the account of others, acquired, sold or delivered, or given value, extended credit or assumed liability, on the faith of any original security, title document or agreement (as delineated in the bond).

Clause (F) - Counterfeit Currency

Covers loss resulting from the receipt by the insured in good faith, of any counterfeit or altered money of the United States or Canada or any foreign country in which the insured maintains a branch office.

Factors to Consider in Determining Adequate Amount of Blanket Bond Insurance

Often, the most difficult insurance problem confronting bank management is determining the amount of blanket bond coverage that should be maintained. While an estimate of money and securities which might be lost through burglary or robbery can be fairly accurately calculated, there are no ready measures for estimating potential losses that may arise from employee dishonesty.

The problem of determining an adequate amount of insurance coverage to indemnify for losses from external hazards is not a complex problem. Property values at risk can be estimated fairly accurately and the level of exposure from daily operations is also generally ascertainable. The various types and amounts of transactions routinely conducted should also be appraised and considered when determining appropriate levels of insurance coverage. For instance, it may be prudent to reduce the insurance coverage for forged securities (within Clause E) taken as collateral for a loan to the amount of the in-house bank lending limit. If that limit is never exceeded, the bank would not suffer a loss greater than that limit on any given transaction.

Determining an adequate amount of fidelity insurance on the bank's own personnel is a more difficult task that cannot be based solely on one precise factor. It requires the use of management and examiner judgment. Banking associations or the insurance industry may periodically develop schedules indicating the range of blanket bond coverage carried by banks grouped by deposit size. However, a bank's level of risk exposure is influenced by many variables, only one of which is deposit size. Therefore, an overall assessment of the effectiveness of the bank's internal operations must be considered. Other factors which may increase fidelity exposure and should be given consideration are: the amount of cash and securities normally held by the bank; the number of employees and their experience level; delegations of authority to employees; personnel turn-over rates; the extent of trust, information technology, or off-balance sheet activities; and whether an institution is experiencing rapidly expanding operations.

When the bank is a member of a holding company or other group of affiliated banks, one fidelity bond is usually purchased to cover the parent and all affiliated banks. In such situations, the examiner should determine that the policy is sufficient to cover the exposures of the subsidiary bank being examined. Further, examiners should also determine that any policy premiums the subsidiary bank pays to the parent holding company are not disproportionate to the bank's benefits from the group policy and that such premiums are consistent with the fair market requirements of Section 23B of the Federal Reserve Act.

Basis for Claims Under the Bankers Blanket Bond

It is standard procedure for insurance companies to write blanket bonds on a “claims made” or "discovery" basis. Under this method, the insurance company is liable up to the full amount of the policy for losses covered by the terms of the bond and discovered while the bond is in force, regardless of the date on which the loss was actually sustained by the bank. This applies even though lower coverage amounts or more restrictive terms might have been in effect on the date the loss was sustained. Alternatively, bonds may be written on a "loss-sustained" basis. This means the bonding company is liable only to the extent of the coverage for losses sustained during the period the bond is in force. Situations which prompt an insurer to write a blanket bond on a loss-sustained basis may arise from another insurer having cancelled or refused to renew a bank's bond (i.e. the insurer is not willing to assume the risk of any undiscovered losses which may have occurred while the bank was insured by another company); the loss record of the bank; poor internal controls; or uncertainty concerning management's abilities.

Blanket bonds require that a loss be reported to the bonding company within 30-days after discovery. Failure to file a report once management is aware of discovery, even if there is uncertainty as to reportability, could jeopardize coverage for that loss. In addition, coverage as to any employee automatically cancels as soon as the bank has knowledge of any dishonest or fraudulent act on the part of an employee. Coverage on such employee can only be assured by written affirmation of the insurer. Likewise, an appropriate written waiver from the insurance company should be in evidence for any individual who has been granted consent to serve as a director, officer or employee pursuant to Section 19 of the FDI Act.

Banks must also notify the underwriter within 30-days of receiving any notice of legal action being brought against it which could result in a claim under the bond. The underwriter may elect, at its option, to defend the insured. If timely notice is not given by the bank or if the underwriter elects not to defend the action, the underwriter is not liable for attorneys' fees and court costs, nor does any judgment against the bank determine the existence of bond coverage.

The general agreements to Standard Form No. 24 make the application for insurance coverage part of the bond. Any misrepresentation, omission, concealment or incorrect statement of material fact in the application may be grounds for recession of the bond. Due to this strong language in favor of bonding companies, banks must be absolutely truthful, accurate and thorough in responding to questions on bond applications and questionnaires. There may be instances when it is appropriate for examiners to review such applications and questionnaires for accuracy and completeness.

Under the present Standard Form No. 24, there are no rights of any parties to make claims under the bond after the termination or cancellation of the bond. Banks may no longer purchase the right to extend the discovery period. It is therefore vitally important for banks to make immediate notification to the underwriter upon discovery of loss covered by the terms of the bond. If there is any uncertainty in this regard, the matter should be investigated promptly to determine whether a loss has in fact occurred that is covered by the terms of the bond. Moreover, the results of any such investigation should be documented as the investigation proceeds. There is immediate termination of the bond upon the taking over of the insured by a receiver or other liquidator or by State or Federal officials. The FDIC is thus effectively barred from pursuing any claims against the bonding company which were not discovered by the bank prior to its closing.

It is critical that the examiner in a potential closing situation call to the attention of the bank's board of directors all known facts concerning any loss discovered during the examination, and the bond requirements that notice be given to the bonding company within 30-days of discovery.

Information Technology (IT) Coverage

IT coverage is provided in the bond for serviced banks under the definition of "employee," which is defined to mean each natural person, partnership, or corporation authorized by the insured to perform services as data processor of checks or other accounting records of the insured. Usually the only riders for IT coverage are those to eliminate it from the policy, which is not advisable. To further protect banks with electronic funds transfer systems (EFTS) and those with in-house computers that contract with outside programmers, additional coverage may be obtained by a rider or separate policy referred to as computer/computer related theft insurance. Usual coverage protects banks from criminal acts affecting data processing equipment, communication lines, data elements and program logic located in one or more of the insured's offices, at contract service bureaus (including financial institutions), and at automated clearing houses, switches or other electronic communications systems. For more detailed coverage of IT insurance, refer to the FFIEC IT Examination Handbook.

Blanket Bond Riders

Numerous riders are available to delete or supplement coverage for risks not included in the basic blanket bond. In some instances, a separate policy may be obtained. While not necessarily all inclusive, a list of common riders purchased by financial institutions is detailed below. All riders should be carefully reviewed since additions and deletions to the basic policy can have a significant impact on overall coverage.

Deductible and Self-Insurance Riders

Banks and insurance companies frequently use deductible clauses to customize the blanket bond coverage to a particular bank. The deductible amount generally ranges from $1,000 to $100,000, or higher, and is directly related to the willingness and ability of the bank to absorb risks. A bank with a history of few claims may choose to lower its premium costs by requesting a higher deductible on its blanket bond policy. On the other hand, a bank with a history of numerous losses may be required to utilize a deductible clause as a condition for continued blanket bond coverage. The use of deductibles obviously lowers the cost of insurance.

Automated Teller Machine Riders

Covers loss involving automated mechanical devices for disbursing money, accepting deposits, cashing checks or making credit card loans when such devices are not located within an office of the insured, and not permanently staffed with a bank teller.

Kidnapping, Ransom and Extortion Rider

Covers losses arising from any of the various forms of extortion whereby the physical well-being of a person(s) is or is believed to be imperiled.

Computer Systems Rider

Covers losses resulting from the fraudulent entry of data or from the change of data or programs within a computer system.

Excess Employee Fidelity Coverage

The purpose of such coverage is to extend the basic protection provided under the blanket bond in areas where the dollar volume of assets or exposure is particularly high. Such excess coverage usually is written in multiples of $1 million and either carries a deductible clause equal to the amount of the blanket bond (usually requires primary bond coverage of at least $250,000), or states that coverage will be provided for the full amount of the excess policy when losses exceed a specified amount. Any deductible in excess of underlying primary coverage should be discussed with management. The most common form of this coverage is the Excess Bank Employee Dishonesty Blanket Bond, Standard Form No. 28. The FDIC strongly recommends that all banks acquire this modest cost protection against the possibility of catastrophic fidelity losses, unless the primary blanket bond coverage is large enough to equal or exceed the protection provided by an excess fidelity bond.

Other Specialized Bank Insurance

This is not a comprehensive list of coverage available, but rather those frequently purchased.

Combination Safe Depository

Consists of two coverage sections that can be purchased together or separately. Clause (A) covers losses when the bank is legally obligated to pay for loss (including damage or destruction) of a customer's property held in safe deposit boxes. Clause (B) covers loss, damage, or destruction of property in customer's safe deposit boxes, whether or not the bank is legally liable, when such loss results from other than employee dishonesty. The policy commonly provides for reimbursement of legal fees in conjunction with defending suits involving alleged loss of property from safe deposit boxes.

Registered Mail and Express Insurance

Insures valuable property such as money or securities shipped by registered mail, registered air mail, express, and air express. Coverage is provided from the time the property leaves the bank until delivered to the addressee.

Transit Cash Letter Insurance

Covers loss of cash letter items in transit for collection or to a clearing house of which the insured bank is a member. It also includes costs for reproducing cash letter items. Generally, such policies do not cover items sent by registered mail or air express, or losses due to dishonest acts of employees.

Valuable Papers and Destruction of Records Policy

Covers the cost of reproducing records damaged or destroyed. It also provides the cost of research needed to develop the facts required to replace books of accounts and records.

OTHER DESIRABLE INSURANCE COVERAGE

The banking industry customarily utilizes forms of insurance for which the blanket bond, along with related policies, endorsements and special coverage previously noted, does not provide coverage or provides insufficient protection. Banks may also need many of the same types of insurance required by any business or individual. The following is a brief description of some of those types of coverage.

Liability Insurance

Directors and Officers Liability

These policies provide for the indemnification of directors and officers against legal and other expenses incurred in defending lawsuits brought against them by reason of the performance of their official duties. They protect, under two insuring clauses, against the expense of defending suits alleging director or officer misconduct and against damages that may be awarded. Clause (A) provides coverage directly to the directors and officers for loss resulting from claims made against them for their wrongful acts. Clause (B) reimburses a corporation for its loss when the corporation indemnifies its directors and officers for claims against them. An additional, optional coverage provides protection for the corporation and its own liability. This coverage is written at a minimum of $1 million (deductible $10,000 to $20,000) with the insurance company paying a portion of any claim over the deductible amount. This insurance does not cover criminal or dishonest acts, situations when the involved person obtained personal gain, or when a conflict of interest was apparent.

General Liability

Covers the bank from possible losses arising from a variety of occurrences. Typically, general liability insurance provides coverage against specified hazards, such as personal injury, medical payments, property damage, or other specific risks that may result in or create exposure to a suit for damages against the bank. Where offered, "comprehensive" general liability insurance covers all risks, except specific exclusions.

Automobile Liability and Physical Property Damage

Protects against property and liability losses arising from injury or death when a bank-owned, rented, or repossessed vehicle is involved. Non-ownership liability insurance should be considered if officers or employees use their own vehicles for bank business.

Umbrella Liability

Provides excess coverage over and above existing liability policies, as well as basic coverage for most known risks not covered by existing liability insurance.

Fixed Assets/Property Physical Damage

Adequate insurance should be maintained to cover loss or damage of the bank's fixed assets.

Fire or Extended Coverage

This insurance covers all loss as a direct result of a fire, including damage from smoke or water and chemicals used to extinguish the fire. Covering the building's contents for fire damage is additional, but often is written in combination with the policy on the building and permanent fixtures. Extended coverage indemnifies against losses from windstorm, hail, explosion, riot, civil commotion, aircraft, vehicles, and smoke damage. Damage caused by rising water or the malfunction of a steam boiler is usually not included. Most fire insurance policies contain "coinsurance" clauses, meaning insurance coverage must be maintained at a fixed proportion of the replacement value of the building. If a bank fails to maintain the required relationship of protection, all losses will be reimbursed at the lower ratio of the amount of the insurance carried to the amount required, applied to the actual value of the building at the time of the loss. When determining insurable value for fire insurance purposes, the typical base is the cost of replacing the property with a similar kind or quality at the time of loss.

Boiler and Machinery

Provides coverage for loss due to explosion or other forms of destruction of boilers, heating and/or cooling systems, and similar types of electrical equipment.

Fine Arts

Includes coverage for art objects on display whether owned by the bank or on loan from another source. Protection generally is all-risk and requires that an appraisal of the material be made regularly to establish its insurable value.

Extra Expense

Provides funds for the additional costs of reestablishing the bank's operations after fire or other catastrophe such as renting temporary quarters and/or equipment on an interim basis.

Business Interruption

Provides reimbursement for the gross earnings lost when the bank cannot operate because of fire or other catastrophe, often with a coinsurance clause.

Rental Income

Provides protection when a fire or other hazard renders the insured premises unfit for occupancy and a lessee ceases to pay rent. The policy will pay the building owner an amount equal to the reasonable rental income immediately before the loss, less any avoidable expenses.

Bank Owned/Leased Automobile

Standard coverage for accidental loss sustained through collision involving a bank automobile. Comprehensive coverage also is available for damage to an automobile other than through collision.

Lending Activities

Various types of insurance are available to cover certain risks in lending activities dependent upon what management considers necessary and warranted for the bank.

Mortgage Lending Activity

Mortgage Errors and Omissions

Protects the bank from loss when fire or all-risk insurance on real property held as collateral inadvertently has not been obtained or has expired. Generally, this insurance is not intended to overcome errors in judgment, such as inadequate coverage or insolvency of an original insurer.

Title Insurance

Insures marketability of title, access to the property, validity and enforcement of the mortgage and, subject to the stated exceptions, its priority. The policy also insures that the person to whom the bank is making the loan has title to the real estate pledged as security. Commitments for insurance are issued in advance of closing, outlining the scope of the coverage, stating the specific exceptions from coverage and the standard exceptions.

Mortgagor's Defaults

Contract with a third-party mortgage insurer to absorb all or part of the risk that the value of the mortgaged property will not cover the loan and costs. Government agencies (Federal Housing Administration {FHA} and Veterans Affairs {VA}) and private insurers provide mortgage protection coverage. This insurance is attractive to lenders who intend to sell mortgages in the secondary market.

Installment Lending Activity

Single Interest

This insurance covers losses to uninsured vehicles pledged as collateral for an extension of credit.

Nonfiling Insurance

Covers losses resulting from nonfiling of liens or recording appropriate instruments on personal property pledged as collateral under chattel mortgages, conditional sales contracts and other similar instruments.

Credit Life, Accident and Health

These types of insurance are written in conjunction with an extension of credit, especially an installment loan, and are designed to protect the bank against loss in the event of a debtor's inability to pay because of sickness, accident or death.

Fraudulent Accounts Receivable and Fraudulent Warehouse Receipts

Cover losses resulting from the pledging of fraudulent or nonexistent accounts receivable and warehouse receipts, or from situations in which the pledger does not have title. In addition, this insurance offers protection against loss arising from diversion of proceeds through acts of dishonesty.

Personnel Administration

Depending on the needs of an individual bank, there are various types of coverage that can be obtained to benefit employees or cover the loss of an employee.

Key Person Insurance

Insurance purchased for the benefit of the bank on the life of an officer when the death of such "key person" would be of such consequences as to affect the operation of the bank. The term "key person" is defined to mean any bank officer, regardless of title, who participates in major policy making functions of the bank and whose loss to the bank would be of consequence because of knowledge, experience and related qualifications. Many "key person" insurance programs are designed to provide a fringe benefit to the insured officer and family. The benefit accrues to the officer when, upon death, the board of directors of the bank directs payment of the proceeds to the officer's family.

Employee Benefit Insurance

An employee benefit program, to be effective, must be able to respond to the changing needs of employees; be competitive with other firms in the trade area who employ individuals similarly qualified to those employed by the bank; be of reasonable overall cost; and compare favorably to peer group statistics. Some insurance coverage is legally required, such as unemployment insurance, worker's compensation, and Social Security. Other commonly provided insurance policies are group insurance protection for life, health, accident, medical, hospitalization, vision, and dental. Other programs such as deferred compensation and salary continuance have been developed which provide additional fringe benefits to key officers and/or their designated beneficiaries. The premiums for such insurance are paid either in part or entirely by the bank, with the bank having no beneficial interest in the policy.

INTRODUCTION

A body of statutes, regulations and administrative rulings, both Federal and State, is an element of the regulatory framework within which banks operate. Their underlying rationale is the protection of the general public (depositors, consumers, investors, creditors, etc.) by establishing boundaries and standards within which banking activities may be conducted. The FDIC assigns a high priority to the detection and prompt correction of violations in its examination and supervisory programs. It is therefore essential for examiners to have a thorough knowledge of Federal and State laws and regulations pertinent to the bank being examined.

BASIC CAUSES AND SIGNIFICANCE OF VIOLATIONS

Causes

Although the possible causes of violations of laws and regulations may be many and diverse, infractions most often result from management's unfamiliarity with governing statues or regulations, negligence, misinterpretation of statutory or regulatory requirements or prohibitions, and/or willful noncompliance.

To address the first two general causes of violations, the bank's board of directors and/or senior management should develop:

- Policies and procedures to ensure that officers and employees are sufficiently familiar with laws and regulations,
- Monitoring systems to assure compliance in daily operations, and
- Practices or procedures to detect noncompliance and report it to the board of directors and/or management so corrective measures may be promptly initiated.

Honest differences of opinion may sometimes arise with regard to interpretation of laws or regulations. It may be necessary in such situations, especially where examiners are in doubt as to the applicability or meaning of a State statute or regulation, to consult with the Regional Office so the matter can be resolved.

Willful noncompliance is the most serious of all the possible causes of violations and needs to be thoroughly investigated by examiners. Depending on the gravity of the offense and other factors, willful noncompliance may result in recommending assessment of civil money penalties and/or consideration of action under Section 8 of the Federal Deposit Insurance Act.

Significance

The broad objective of protecting the interests of the general public is reason enough for banking activities to be conducted in accordance with laws and regulations. Bank directors and officers should be aware, however, there can be a more direct, immediate and personal reason why such activities should be legally conforming. A number of Federal statutes and regulations (and those of some states) include provisions for assessing civil money penalties against banks and/or individuals for certain infractions. In addition, laws of most states provide that directors may be held personally liable for losses sustained by a bank on illegal loans or the acquisition and holding of other nonconforming assets. Finally, infractions of laws and regulations may prompt litigation and requests for money damages by parties adversely affected by these illegal act(s). Successful legal actions by these parties could irreparably harm the institution if settlements were large.

SCHEDULING VIOLATIONS

The Violations of Laws and Regulations schedule is designed to cover violations of laws and regulations discovered during safety and soundness examinations, whether or not a dollar amount is involved. Inclusion of all violations of laws and regulations in one schedule of the examination report is desirable for the following reasons: it eliminates the necessity of including numerous separate schedules in the report, each devoted to a particular type of violation; it permits a more satisfactory review of the extent and nature of the problems in a given bank; and it results in a more forceful presentation to the officials of the examined bank.

In the Violations of Laws and Regulations schedule, examiners report and document situations which appear to be contraventions of law or regulation. However, since examiners are not final adjudicators, findings must be qualified by using the expression "apparent violation" to describe the situation, regardless of the certainty upon which the judgment is founded. Care should be exercised in scheduling apparent violations, for the erroneous designation of a violation tends to discredit the report of examination. Refer to the Report of Examination Instructions for additional guidance in scheduling apparent violations.

In order to reflect director responsibility and possible liability, it is essential that report comments include the names of directors who approved apparently illegal transactions and the date such approval was accorded. Names of dissenting directors should also be reflected. This procedure should be followed even if approval consisted merely of ratification of a group of loans, possibly identified only by numbers. When citing apparent infractions, the examiner should also state the apparent cause(s) of the violation and include management's comments or commitments as to corrective action planned. If the violation is corrected during the examination, this should be stated. When scheduling apparent violations of the FDIC's Rules and Regulations, it is generally necessary to cite the specific section or subsection of the regulation deemed to have been violated, e.g., Section 328.2 or Section 329.1(e) and the specific reasons for the apparent violation. On the other hand, any reference to a general regulation dealing with a particular subject is cited by part number, e.g., Part 329.

Comments should be as concise as the circumstances permit. Detailed descriptions and extensive remarks on violations which involve certain assets, such as adversely classified loans, may be unnecessary if appropriate reference can be made to other schedules within the examination report.

TYPES OF VIOLATIONS

The following discussion covers some of the more common types of violations encountered in safety and soundness examinations. Some of these violations relate to nonconforming assets (assets acquired or held by the bank in violation of law), while others are not associated with particular assets.

Nonconforming Assets Held

Extensions of Credit Which Exceed Bank's Legal Loan Limit

A borrower's line of credit may consist of several notes of different dates. While the total of such notes may constitute an excess line, the courts generally have held that only the note(s) which created the excess line constitutes an illegal extension. Therefore, only the advance(s) that caused the excess over the bank's legal limit will be extended. However, if this method differs from State law or practice, the latter should prevail.

To illustrate, assume the statutory lending limit for a bank is $200,000 to any one borrower. The borrower's line of credit consists of three original notes of various dates, each in the amount of $100,000. Generally, only the last note advanced has been held by the courts to be illegal. Until paid in full by the borrower, it may be a legal liability of the approving directors. The courts have also held that if several notes constitute a single transaction, the entire transaction should be treated as a unit and the entire loan considered an illegal extension for which the approving director may be held liable.

Citation of excess loan violations is to be restricted to those lines currently in excess of the bank's legal loan limit. While the directors' liability is not eliminated by reduction of an illegally excessive loan, effectiveness of the schedule is impaired by continued listing of such lines.

Nonconforming Extensions of Credit to Insiders

It is especially important that illegal credit extensions to directors, officers, employees, principal shareholders, and their interests be properly reported and corrected within the shortest possible time. Directors and officers of banks are representatives of not only the stockholders, but also depositors. Their responsibilities approach those of a trusteeship, since banks to a large extent operate with funds supplied by other than owners. Therefore, it follows that directors who allow nonconforming extensions of credit to themselves, to other members of the bank's official family, or to their business interests, are violating that trust.

Nonconforming extensions of credit to insiders and their interests may involve contraventions of not only State law but also Federal Reserve Regulation O and Section 337.3 of the FDIC Rules and Regulations. These regulations set limitations as to maximum amounts of insider indebtedness, establish certain recordkeeping requirements, and prohibit preferential terms or conditions on insider loans. Violations of Regulation O may be subject to civil money penalties. A more comprehensive discussion of these regulations is contained in the Management section of this Manual.

Nonconforming Extensions of Credit to Affiliates

All nonconforming advances to an affiliate or illegal investments in securities of an affiliate, including illegal extensions of credit to others collateralized by securities of an affiliate, are to be included as violations.

Transactions with affiliated organizations can, under certain conditions and circumstances, prove detrimental to the best interests of banks. Provisions of Section 23A of the Federal Reserve Act place restrictions on loans and dealings between member banks and their affiliates. These provisions are made applicable to nonmember banks by Section 18(j) of the Federal Deposit Insurance Act. Affiliates and the Federal statutes applicable to them are more fully discussed in the Related Organizations section of this Manual.

Loans on Which Real Estate Security Has Been Taken or Is Held in Violation of Law

In many states, laws restrict the type of real estate which can be taken as loan collateral by a bank. Limits may also be placed on the amount of a loan which can be advanced in relation to appraised value; title opinions, appraisals and reappraisals may be required; and limits on the total amount of real estate loans which can be carried by a bank at any particular time may be established. Whenever violations of these provisions are discovered, the current book value of the illegal real estate loan(s) should be scheduled. In those cases where aggregate real estate loans outstanding constitute an infraction, only the amount in excess of prescribed limitations should be extended.

Loans on Which Securities Have Been Taken or Are Held in Violation of Law

Current balances of loans on which securities have been taken in violation of law should also be included. Infractions of this type might include extensions of credit secured by own bank stock or apparent violations of Federal Reserve Regulation U.

United States Treasury Department regulations generally prohibit the pledging of certain savings bonds as collateral to a debt. In those cases where banks take such ineligible bonds as purported collateral, examiners should not recognize the loan as secured. However, the loan itself is not to be regarded as a violation and should not be included in this schedule, unless it is otherwise nonconforming; for example, it lacks a supporting financial statement required by State law for unsecured loans.

Securities Unlawfully Acquired or Held

Many states have restrictions on the type and/or amounts of securities in which a bank may invest. For example, a bank may be prohibited from acquiring common stock or certain other forms of equity investments. Exceptions are sometimes allowed for investments in subsidiaries holding title to bank premises, stock in bank service corporations, or securities taken in consideration for debts previously contracted (DPC). If a security is deemed to have been unlawfully acquired or held, the current book value amount should be extended as a violation.

Other Real Estate Acquired or Held in Violation of Law

Unless State law specifically requires a bank to divest itself of ownership within a specified period of time or rulings of the State authority provide otherwise, real estate acquired DPC and held by the bank for a longer period than permitted by statute or regulation normally will not be included in this schedule, if carried at a nominal value for identification purposes. Charged-off real estate which the bank purchased illegally, as distinguished from charged-off real estate acquired DPC, should be scheduled as an apparent violation.

Charged-Off Nonconforming Assets

An illegally held or acquired asset is still illegal at its original amount, whether or not it has been partially or completely charged-off the bank's books. If an excessive loan is made, the mere fact the bank charges off a portion of the debt does not extinguish the borrower's liability or bring the loan into conforming status. Were this interpretation not placed on the law, bank management, desiring to accommodate a borrower beyond the legal limit, could make excessive new loans and simply charge them down immediately to the legal limit, or eliminate them from the books completely. The same general rule holds true with regard to most other types of nonconforming assets.

All Other Violations

These violations of applicable laws and regulations are not associated or identified with the acquisition or holding of a nonconforming asset. They include most apparent violations of the Federal Deposit Insurance Act, the FDIC Rules and Regulations, the Bank Holding Company Act, and other similar Federal or State laws and regulations.

However, certain of these apparent violations are not scheduled in the safety and soundness report of examination. For example, apparent infractions of the Federal criminal code are reported separately, and infractions of the Truth in Lending Act or Equal Credit Opportunity Act are excluded since they are covered during separate compliance examinations.

CONTRAVENTIONS OF FDIC STATEMENTS OF POLICY

Contraventions of FDIC policy statements should be included in the Violations of Laws and Regulations schedule in the examination report when the examiner believes there is a legitimate safety and soundness concern. All contraventions of FDIC Statements of Policy should be segregated under an appropriate subheading and listed after the apparent violations cited. Refer to the Report of Examination Instructions for additional guidance.

VIOLATIONS AND THE EVALUATION OF BANK MANAGEMENT

A bank's adherence to applicable laws and regulations should be considered when assessing and ranking the management component of the CAMELS rating system. Compliance with statutory and regulatory provisions is more likely achieved when the importance of legally conforming behavior is recognized by the board of directors and senior management, and when this commitment is backed by appropriate policies and procedures. These policies and procedures must ensure compliance, prompt detection of instances of noncompliance, immediate institution of measures to effect correction, and adequate training and retraining of officers and employees to prevent future infractions. To the extent deficiencies in these functions result in violations, it is an adverse reflection on management's capabilities and should be recognized accordingly in the overall assessment of management. As stated previously in this section, the causes of apparent infractions must play a significant role in this assessment. Willful noncompliance, for example, obviously reflects much more unfavorably on management than does a violation which results from unfamiliarity with a minor provision of a technically complex statute. Nonetheless, it is important that correction of all apparent infractions be instituted promptly, regardless of their perceived importance.

REMOTE DISBURSEMENT ACTIVITIES AND ZERO-BALANCE ACCOUNTS

In an effort to establish and/or maintain customer relationships, banks often provide cash management services to corporate accounts. Two of the more common services are remote disbursement services and zero-balance accounts. Remote disbursement is a technique that enables a customer to delay settlement of a financial transaction by taking advantage of the "float" possibilities in the check clearing system. The process occurs when the maker of a check draws the instrument payable at a bank remotely located ("remote bank") from the payee named in the instrument. Remote disbursement is often used in conjunction with zero-balance accounts that permit depositors to draw checks against accounts maintained at or near a zero-balance. A corporate customer utilizing this cash management approach generally maintains a primary deposit account relationship at a bank where the principal borrowing arrangements are maintained. This bank may be referred to as a "concentration bank" and through it the customer consolidates receipts and makes general disbursements.

Zero-balance accounts obviously cannot be considered funding sources for the remote bank. More importantly, they present a credit risk due to the fact that checks are paid on accounts with insufficient collected balances on the expectation that covering funds will be provided by the customer prior to the close of the business day. The intraday exposure to the remote bank, in the form of unsecured lending against uncollected funds, is not reflected in the bank's financial statement. However, the amounts involved may be sizeable and even exceed the bank's capital.

Examiners should analyze the bank's cash management services. If a concentration bank is involved, the focus should be on the potential volatility presented by using corporate deposits as funding sources. If a remote bank is involved, the supervisory interest centers on the exposure resulting from the practice of routinely paying checks against uncollected funds. The absence of prudent safeguards and full knowledge of the creditworthiness of the customer may expose the remote bank to large and unnecessary risks and warrants comment in the examination report and the initiation of remedial measures.

FUNDS TRANSFER SYSTEM RISK

Growth of the commercial banking industry, accompanied by greater customer demand for services, has increased the importance of wire transfer activity. Wire transfer has evolved from the use of elementary Morse code to sophisticated automated switching operations linking the Federal Reserve System with various governmental agencies and commercial banks. Functions of the wire transfer operation include daily funds transfers, securities transactions and the general communication of information.

Banks may effect transfers or related messages by mail, telephone and direct access to several telecommunications systems. The size and complexity of the operation will determine which method the bank uses. Since speed is the primary reason for many wire transfers, mail requests are infrequent. The majority of banks make transfers and execute Federal funds transactions over the telephone or teletype since their size and volume does not justify maintaining automated systems. However, the tendency to automate the operation is increasing with the advent of inexpensive computer technology.

The large-dollar networks are now an integral part of the payments and clearing mechanism. A variety of networks have been established to provide funds transfer services. They include the Federal Reserve Communications System (FedWire), the Clearing House Payments System (CHIPS) and Automated Clearing House (ACH).

The volume of funds which change hands daily in the U.S. through the electronic funds transfer environment is staggering. Present estimates place this volume at over one trillion dollars. It is therefore readily apparent why the financial institutions involved in those transactions and the regulatory authorities who supervise them are concerned with the quality of internal controls and management's awareness of the inherent risks associated with the various systems.

Risk Management

Errors and omissions and fraudulent alteration of the amount or account number to which funds are to be deposited could result in a loss to the bank. Costs can include loss of funds, loss of availability of funds, interest charges, and administrative expenses associated with recovering funds and correcting problems.

Banks are exposed to settlement risk whenever provisional funds are transferred. Provisional funds are irrevocable payments that are subject to final settlement at a later time. Two levels of risk are present:

- Credit risk to participating banks whose overdraft payments for customers (including nonsettling respondents) are not covered.

- Systemic risk to network participants when other participants fail to settle. There is no settlement risk to the recipient of a FedWire transfer. However, payments received through CHIPS are provisional and expose the recipients to settlement risk if funds are released prior to final settlement.

Intraday (or daylight) overdraft risk occurs when payments are released in expectation of the future receipt of covering funds. By definition, they represent credit exposures of a very short duration, usually a few hours. Overnight overdrafts result from failure to receive covering funds or intentional extensions of credit. In either case, a bank is exposed to risks resulting from payments made against insufficient funds or credit extensions.

The examination of funds transfer activities is designed to disclose deficiencies in the internal credit and operational controls of participating institutions and to assess the adequacy of the supervision of such activities by senior management and the boards of directors of those institutions.

Management is responsible for assessing the inherent risks in the system, establishing policies and controls to protect the institution against unreasonable exposures, and monitoring the effectiveness of such safeguards. Bank supervisors have the responsibility to ensure that the financial institutions have evaluated their own risks realistically and have provided for accounting records and internal controls which are adequate to keep the exposures within acceptable limits.

Effective risk management requires that:

- An adequate accounting system be in place to determine the extent of any intraday overdrafts and potential overnight overdrafts before releasing payments;
- Payments be within established credit limits and amounts in excess of such limits involving significant credit risk be properly approved by appropriate lending authorities; and
- Institutions responsible for settling the positions of others assign responsibility for monitoring respondents' accounts at an appropriate supervisory level.

To assure that prudent practices are being followed by banking institutions in their funds transfer activities, examinations should focus, with equal emphasis, on the evaluation of credit risks and operational controls. Deficiencies disclosed in either of these areas and suggestions for improvement should be discussed with management and listed in the Report of Examination. Constructive criticism by the examiners should help the institutions strengthen procedures to minimize the risks associated with funds transfer activities. Refer to the Electronic Funds Transfer (EFT) Examination Documentation module for further guidance.

INTRODUCTION

From a bank regulator's standpoint, the essential purpose of bank earnings, both current and accumulated, is to absorb losses and augment capital. Earnings is the initial safeguard against the risks of engaging in the banking business, and represents the first line of defense against capital depletion resulting from shrinkage in asset value. Earnings performance should also allow the bank to remain competitive by providing the resources required to implement management's strategic initiatives.

The analysis of earnings includes all bank operations and activities. When evaluating earnings, examiners should develop an understanding of the bank's core business activities. Core activities are those operations that are part of a bank's normal or continuing business. Therefore, when earnings are being assessed, examiners should be aware of nonrecurring events or actions that have affected bank earnings performance, positively or negatively, and should adjust earnings on a tax equivalent (TE) basis for comparison purposes. Although the analysis makes adjustments for non-recurring events, examiners should also include within their analysis the impact that these items had on overall earnings performance. Examples of events that may affect earnings include adoption of new accounting standards, extraordinary items, or other actions taken by management that are not considered part of the bank's normal operations such as sales of securities for tax purposes or for some other reason unrelated to active management of the securities portfolio.

The exclusion of nonrecurring events from the analysis allows the examiner to analyze the profitability of core operations without the distortions caused by non-recurring items. By adjusting for these distortions, examiners are better able to compare earnings performance against the bank's past performance and industry norms (e.g., peer group data) over time.

The terms level and trend are used throughout this section of the Manual. Level analysis is the process of reviewing financial statement ratios and volumes as of a specific date. Level analysis allows for a comparison of performance, for example, to industry norms or peer group data. Trend analysis is the process of assessing the general direction or prevailing tendency (i.e., increasing, decreasing, or stable) of operating ratios or volumes over several periods (i.e., generally over a five year period) using the level of each period.

The following tools are available to assist the examiner in the assessment of earnings: the Uniform Bank Performance Report (UBPR), the bank's Consolidated Reports of Condition and Income (Call Report), the bank's financial statements and subsidiary ledgers, analytical reports prepared for the bank's senior management and board of directors, and the Examination Documentation (ED) Modules.

The UBPR can be used to perform level and trend analysis of key earnings components. Bank-prepared analytical reports can serve the same purpose while also revealing those elements of earnings of strategic interest to management. In conjunction with the UBPR and any internal analytical reports, the bank's Call Report and corresponding bank financial statements and supplementary schedules should be used for more in-depth review. The information gleaned from these schedules may provide the examiner considerable insight into bank earnings. An analysis of earnings is not complete until the examiner has a full understanding of the bank's business activities and its strategic initiatives, and has discussed the bank's financial performance and strategies with management

Further, examiners should consider the bank's marketplace when assessing earnings because institutions that operate in more competitive environments must continually adapt to current national, regional, and local economic and industry conditions to remain viable over time. Also, examiners should determine whether there are any secular, cyclical, or seasonal factors that may favorably or unfavorably affect bank earnings. Current knowledge of such conditions and factors can be obtained by reviewing economic and industry information in newspapers and industrial journals.

Earnings Analysis Trail

Generally the analysis of earnings begins with the examiner reviewing each component of the earnings analysis trail. The earnings analysis trail provides a means of isolating each major component of the income statement for individual analysis. The earnings analysis trail consists of the following income statement components: net interest income, noninterest income, noninterest expense, provision for loan and lease losses, and income taxes.

Each component of the earnings analysis trail is initially reviewed in isolation. Typically, ratios are examined to determine a broad level view of the component's performance. The level of progression along the analysis trail will depend on a variety of factors including the level and trend of the ratio(s), changes since the previous examination, and the institution's risk profile.

The balance sheet composition, or structure, is determined by management. Any material shifts in the balance sheet structure will cause changes to any ratios using a numerator or denominator from the balance sheet (e.g., average assets and average earning assets). Therefore, examiners should be aware that significant changes in the balance sheet structure can materially affect earnings performance.

Ratio Analysis

Several key UBPR ratios used in the earnings analysis are shown below. Refer to additional ratios and the UBPR User's Guide as needed.

Net Income to Average Assets Ratio

This ratio is also known as the Return on Assets (ROA) ratio and consists of bottom line after-tax net income, including securities gains/losses and extraordinary items, as a percentage of average assets. The ROA is a common starting point for analyzing earnings because it gives an indication of the return on the bank's overall activities. A typical ROA level is different, depending on the size, location, activities, and risk profile of the bank. For example, a "community" bank with a few branches may regularly achieve an ROA ratio that exceeds those realized by large wholesale banks. Although the ROA provides an overall performance measure, the individual components comprising the ROA need to be reviewed. These sub-components will be discussed later in this section.

Net Income Adjusted Subchapter S to Average Assets Ratio

In general, institutions that elect to operate as Subchapter S (Sub S) corporations are treated as pass-through entities and are not subject to Federal income taxes at the corporate level Therefore, an adjustment to net income is needed to improve the comparability between banks that are taxed at the corporate level and those that are not. Refer to the UBPR User's Guide for specific information.

Various other issues specific to Sub S corporations may also exist. For instance, several states do not recognize Federal Sub S elections. Therefore, Sub S institutions may remain subject to State corporate income taxes. Refer to outstanding guidance for additional information and the potential effects of this election on the institution's overall earnings performance.

Net Interest Income (TE) to Average Assets Ratio

The ratio of Net Interest Income (NII) to Average Assets is also known as the NII ratio and measures annualized total interest income, plus the tax benefit on tax-exempt income, less total interest expense, divided by average assets.

TE adjustments are made to enable meaningful comparisons for banks that have tax-exempt income. These adjustments are discussed in detail in the UBPR User's Guide. Consideration should be given to the impact of tax-free investments and the related adjustment(s) made to the ratio(s) when material.

This ratio typically represents the bank's largest revenue component. While a higher NII ratio is generally favorable, it can also be reflective of a greater degree of risk within the asset base. For example, a high NII ratio could indicate management is making a large number of "high-interest, high-risk" loans (for example, subprime loans). Although an increase in the NII ratio would be evident, this would not necessarily be an improvement.

The NII ratio can be broken down into two sub-component ratios: Interest Income (TE) to Average Assets and Interest Expense to Average Assets. These ratios and their related components can be analyzed to determine the root cause(s) of any changes in the ratio and their subsequent effect on the ROA.

Net Interest Income (TE) to Average Earnings Assets Ratio

This ratio is also known as the Net Interest Margin (NIM). The ratio is comprised of annualized total interest income on a TE basis, less total interest expense, divided by average earnings assets. This ratio indicates how well management employed the earning asset base. The NIM is more useful than the NII for measuring the profitability of the bank's primary activities (buying and selling money) because the denominator focuses strictly on assets that generate income rather than the entire asset base.

The sub-components of the NIM - the ratios of Interest Income to Average Earnings Assets and Interest Expense to Average Earning Assets - can be analyzed to determine the root causes of NIM changes. These ratios may change for a variety of reasons, for example, management may have restructured the balance sheet, the interest rate environment may have changed, or bank loan and deposit pricing became more or less competitive.

Noninterest Income to Average Assets Ratio

This ratio is comprised of annualized income from bank services and sources other than interest-bearing assets, divided by average assets. Level, trend, and overall contribution of noninterest income to earnings performance should be analyzed. If the contribution represents a major portion of the bank's total revenue, specific sources of noninterest income need to be identified. An assessment as to whether or not these sources are core versus nonrecurring should be made.

Noninterest income is largely of a fee nature; service charges on deposits, trust department income, mortgage servicing fees, and certain types of loan and commitment fees. The results of trading operations and a variety of miscellaneous transactions are also included. In some institutions, noninterest income is being relied upon more heavily as banks are attempting to diversify their earnings streams.

Noninterest Expense to Average Assets Ratio

This ratio is also referred to as the Overhead (OH) ratio and is calculated by annualizing expenses related to salaries and employees benefits, expenses of premises and fixed assets, and other noninterest expenses, divided by average assets. Levels and trends of each component should be assessed and the types of expenses representing the largest overhead components should be determined. Examples of the type of costs that may lead to an inordinately high level of overhead expenses include: excessive salaries and bonuses, sizable management fees paid to the bank holding company, and high net occupancy expenses caused by the purchase or construction of a new bank building.

Other related ratios such as average personnel expense per employee, average assets per employee, and the efficiency ratio may provide useful information. The level of these ratios and the overall affect on earnings performance should be analyzed. If significant, specific sources of noninterest expense need to be identified. An assessment as to whether these sources are core versus nonrecurring should be considered during the earnings analysis.

The existence of unwarranted and unjust compensation of bank insiders is of particular concern, especially when those expenses are likely to result in harm to the bank and ultimately the deposit insurance fund. In this regard, the FDIC's safety and soundness standards (Appendix A to Part 364) state that both excessive compensation and compensation that could lead to material financial loss to an institution are prohibited as unsafe and unsound practices. While just and equitable employee and directorate compensation is essential for the acquisition and retention of competent management, there are instances where bank insiders profit from unwarranted compensation. Unwarranted and unjust compensation and related expenses to bank insiders should be dealt with through whatever means are necessary to cease these abuses. This is particularly critical in lower-rated banks. In such banks, the directorate should be reminded of their fiduciary responsibility for the preservation and conservation of bank funds. Additionally, management fees assessed by parent bank holding companies should be considered for appropriateness and level since they may be significant.

Provision for Loan and Lease Losses (PLLL) to Average Assets Ratio

This ratio shows the annualized percentage of PLLL in relation to average assets. Material changes in the volume of PLLL (either positively or negatively) should be investigated. Higher provisions should result if the loan mix changes significantly from loans with lower to higher historical loss experience (e.g., from one-to-four family mortgage loans to commercial loans) or if economic conditions have declined and have produced a deterioration of loan quality. In situations where the economy is improving and loan quality is stabilizing or improving, lower PLLLs may be appropriate.

When assessing the PLLL, examiners need to determine whether the level of the ALLL is appropriate to absorb estimated credit losses inherent in the loan and lease portfolio. An ALLL that is not at an appropriate level may be due to any one or a combination of reasons. For example, an ALLL that is below an appropriate level may be caused by a decline in loan quality identified during the examination, an inaccurate ALLL methodology, or an attempt by management to manipulate earnings. If the ALLL is deemed to be materially insufficient during the examination, management will be required to take an additional PLLL to bring the ALLL to an appropriate level, thereby increasing the bank's expenses and adversely affecting earnings. Earnings ratios affected by this charge to the PLLL should be adjusted and reflected in the earnings analysis..

Refer to the Loans section of this manual and the Call Report Instructions for additional information on the ALLL.

Realized Gains/Losses on Securities to Average Assets Ratio(s)

The ratio of securities gains/losses to average assets shows the annualized percentage of net realized gains or losses on available-for-sale and held-to-maturity securities in relation to average assets. The level, trend, and overall contribution that securities transactions have on earnings performance should be analyzed.

Bank management may purchase and sell securities for many reasons, but most banks limit investment activity to ensure adequate liquidity is available to meet unanticipated funding needs and to invest excess funds (i.e., when loan demand is low). Examiners should determine whether management actively engages in the sale of securities. When management actively manages their portfolio, this securities activity should be considered part of the bank's core operations. Examiners should assess management's strategies and their implementation. For example, examiners should be alert for instances where investments with unrealized gains are sold while those with unrealized losses are held and should ascertain the reasons for these transactions. Examiners should consider these types of instances when assessing earnings prospects.

While actively selling securities may not be part of a bank's core operations, there are many reasons why management may sell securities. Among the reasons for which management may sell securities that would not be part of a bank's normal operations would be when management needs to restructure the portfolio to maintain or change portfolio duration, to maintain or change portfolio diversification, or to take advantage of some tax implications or some other combination of these reasons. When not part of a bank's core operations, examiners should eliminate the gains or losses adjusted for taxes so as to not distort core operating results. The elimination of these gains or losses allows for level and trend analysis of core operations.

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Other Considerations

Income Taxes

It is important to judge whether applicable income taxes, that is, the provision for taxes, seems appropriate and whether a shift in the effective tax rate has occurred. In determining the appropriateness of income taxes, several tax ratios are provided within the UBPR. These ratios generally compare the amount of applicable taxes to net operating income. In order to ensure that only taxable income is compared to applicable income taxes, certain adjustments are necessary for income received on municipal securities and other investments which are tax-exempt in nature. If the tax ratios provided on the UBPR differ significantly from the rate of taxes that should have been paid, based upon the bank's tax bracket, further analysis is necessary to determine the reasons for such a discrepancy. For example, a bank with a high tax ratio may have invested too heavily in tax-exempt assets, with the result that the potential tax savings was not fully realized. In addition, certain tax incentives, such as investment tax credits received in connection with the acquisition of bank equipment, may have the effect of lowering the tax rate. The ability or inability to carryback or carryforward operating losses for tax purposes will also impact the bank's effective tax rate. Tax ratios may appear abnormal due to management's failure to adequately accrue for income tax expense on a current basis. Appropriate tax accruals should be made on a regular basis and at least with enough frequency to allow for the preparation of accurate Call Reports.

In almost all cases, applicable income taxes reported in the Call Report will differ from the amounts reported to taxing authorities. The applicable income tax expense or benefit that is reflected in the Call Report should include both taxes currently paid or payable (or receivable) and deferred income taxes. Deferred income tax expense or benefit is measured as the change in the net deferred tax assets or liabilities for the period reported. Deferred tax liabilities and assets represent the amount by which taxes payable (or receivable) are expected to increase or decrease in the future as a result of "temporary differences" and net operating loss or tax credit carry forwards that exist at the Call Report date. Refer to the Call Report Glossary for additional information on FAS 109, *Accounting for Income Taxes*.

A higher than normal ratio of applicable income taxes to NOI may result from upstreaming income tax payments to a bank holding company. The FDIC issued a policy statement (refer to FDIC Law, Regulation, and Related Acts) that covers income tax allocation in a holding company structure. In general, the statement requires that cash transfers paid by the bank to the holding company not exceed the amount of tax the bank would have paid had a tax return been filed on a separate return basis. In addition, any payments made to the holding company shall not be required to be remitted until such time as those payments would have been due to the taxing authority. Thus, deferred income taxes on bank's books should not be upstreamed to the holding company until such time as those taxes would be otherwise payable to the taxing authority. Holding companies and subsidiary institutions are encouraged to enter into a written, comprehensive tax allocation agreement tailored to their specific circumstances. The agreement should be approved by the respective boards of directors. The policy statement was not intended to limit any tax elections under the Internal Revenue Code, and the term "separate return basis" recognizes that certain adjustments due to particular tax elections may, in certain periods, result in larger payments by the affiliated bank to the parent than would have been made by an unaffiliated bank to the taxing authority. Refer to the aforementioned policy statement for additional information.

Dividends

Earnings are also evaluated on their ability to support capital. This support includes maintaining capital, as well as increasing capital. High earnings retention increases capital more rapidly, but may or may not be necessary for the bank. If growth is low, profits high and capital strong, in relation to assets, a relatively high dividend payout ratio may be acceptable. On the other hand, if growth is rapid, profits are low, and capital is weak, a high dividend payout stands in the way of retaining needed capital. Under such circumstances, a lower payout ratio would clearly be appropriate.

The retention rate must be analyzed relative to the bank's potential growth rate. A bank in a developing trade area may forecast substantial growth, which cannot be supported by existing capital even if cash dividends are not paid. Since most bank stocks are viewed by the investor as income generating rather than growth related, a low dividend history may hamper the bank's ability to market a new stock offering.

The bank's flexibility to reduce dividend payments should be considered when analyzing the impact of dividends upon earnings. For example, a bank that has a highly-leveraged holding company may lack flexibility to significantly lower dividend declarations, because those dividends are being used to meet debt service requirements. Another example includes institutions that have elected a Sub S status for income tax purposes. In a Sub S institution, shareholders normally pay income taxes on their proportionate share of the institution's taxable income whether or not a dividend payment or other distribution is made. Therefore, shareholders may attempt to limit the bank's flexibility to reduce these distributions.

In undercapitalized banks, steps should be taken to strongly discourage the continuation of cash dividends and/or other distributions. If necessary, additional steps should be taken to administratively prohibit such dividends/distributions where the bank is undercapitalized and has a high risk profile, or is substantially undercapitalized, no matter what the degree of perceived risk. There may be isolated instances where the continuation of cash dividends/distributions is warranted even under fairly severe circumstances. In such cases, the continuation of these payments without supervisory action should be fully supported.

Extraordinary Items

Extraordinary items are material events and transactions that are unusual and infrequent. Both of these conditions must exist in order for an event or transaction to be reported as an extraordinary item.

To be unusual, an event or transaction must be highly abnormal or clearly unrelated to the ordinary and typical activities of banks. An event or transaction that is beyond bank management's control is not automatically considered to be unusual.

To be infrequent, an event or transaction should not reasonably be expected to recur in the foreseeable future. Although the past occurrence of an event or transaction provides a basis for estimating the likelihood of its future occurrence, the absence of a past occurrence does not automatically imply that an event or transaction is infrequent.

Only a limited number of events or transactions qualify for treatment as extraordinary items. Among these are losses that result directly from a major disaster such as an earthquake (except in areas where earthquakes are expected to recur in the foreseeable future), an expropriation, or a prohibition under a newly enacted law or regulation.

For further information, refer to APB Opinion No. 30, *Reporting the Results of Operations*.

Accounting Considerations

The analysis of earnings may be further complicated by the adoption of new accounting standards or changes in accounting methodologies. For instance, prior to the adoption of FAS 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, institutions accounted for loan origination fees and costs in different ways. When analyzing earnings, examiners should be aware of changes in accounting standards that may have materially affected related ratios and, when material, make necessary adjustments to the ratios, on a tax adjusted basis, to be able to perform trend analysis. Over time, however, adjustments will no longer need to be made as reported operating performance will reflect the implementation of the accounting changes over enough periods that trend analysis will not be affected.

FAS 91 applies to all lending and leasing transactions originated since it took effect in 1988. This accounting standard established the accounting for nonrefundable fees and costs associated with lending, committing to lend, and purchasing a loan or a group of loans. In general, FAS 91 specifies that:

1. Loan origination fees should be recognized over the life of the related loan as an adjustment of yield;

2. Certain direct loan origination costs should be recognized over the life of the related loan as a reduction of the loan's yield;
3. Most loan commitment fees should be deferred, except for specified exceptions; and
4. Loan fees, certain direct loan origination costs, and purchase premiums and discounts on loans shall be recognized as an adjustment of yield generally by the interest method based on the contractual term of the loan.

Prior to adopting FAS 91, banks generally could immediately recognize loan origination fees in income to the extent that they represented a reimbursement to the bank for actual origination costs incurred by the bank to originate the loan. This practice is no longer acceptable.

A more detailed discussion of FAS 91 can be found in the Call Report Glossary.

Quality of Bank Earnings

Earnings quality is the ability of a bank to continue to realize strong earnings performance. It is quite possible for a bank to register impressive profitability ratios and high dollar volumes of income by assuming an unacceptable degree of risk. An inordinately high ROA is often an indicator that the bank is engaged in higher risk activities. For example, bank management may have taken on loans or other investments that provide the highest return possible, but are not of a quality to assure either continued debt servicing or principal repayment. Short-term earnings will be boosted by seeking higher rates for earning assets with higher credit risk. Eventually, however, earnings may suffer if losses in these higher-risk assets are recognized.

In addition, certain of the bank's adversely classified and nonperforming assets, especially those upon which future interest payments are not anticipated, may need to be reflected on a nonaccrual basis for income statement purposes. If such assets are not placed on a nonaccrual status, earnings will be overstated. Similarly, material amounts of troubled debt restructured assets may have an adverse impact on earnings.

As previously discussed, an institution's asset quality has a close relationship to the analysis of earnings quality. Poor asset quality may necessitate increasing the PLLL to bring the ALLL to an appropriate level and must be reviewed for impact on earnings quality.

Additionally, short-term earnings performance can be enhanced by extraordinary items and tax strategies. For example, a bank may dispose of high-yielding assets to record gains in current periods, but may only be able to reinvest the funds at a lower rate of return. Levels and trends in earnings performance would be positive, although future income potential is sacrificed. Conversely, a bank might dispose of assets at a loss to take advantage of tax loss carryback provisions and enhance future earnings potential. Current earnings levels and trends would be poor in such a case, but funds recaptured through this strategy may greatly improve future earnings capacity. The point is that no analysis of earnings is complete without a consideration of earnings quality and a complete investigation and understanding of the strategies employed by bank management.

Planning and Budgeting

Strategic Plan

A strategic plan is a methodology that an organization uses to accomplish important goals and objectives. Regardless of the institution's size, a strategic plan can help an organization outline future goals and objectives and the steps needed to achieve such. For institutions that plan significant growth, new products, new branches, or other initiatives, strategic planning becomes even more important. Many institutions have formal, written strategic plans, while others rely on a much less formal method. If a formal, written strategic plan does not exist, this matter should be discussed with the board/management to determine the institution's overall goals, objectives, and long-term plans. Additional information on Corporate Planning is contained in the Management section of this manual. The Examination Documentation (ED) Modules also provide guidance in this area.

Profit Plan

A profit plan is an overall forecast of the income statement for the period based on management's decisions, intentions, and their estimation of economic conditions. It addresses such things as the anticipated level and volatility of interest rates, local economic conditions, funding strategies, asset mix, pricing, growth objectives, interest rate and maturity mismatches, etc. The accuracy of any such plan is susceptible to the attainability of the aforementioned assumptions.

Budget

Within the profit plan is a budget. The budget is essentially an expense control technique where management decides how much is intended to be spent during the period on individual overhead expense items. The budget should be consistent with the overall business or profit plan. All banks, regardless of size, should be encouraged to prepare a profit plan and budget that addresses the current year and the next operating year. The degree of sophistication or comprehensiveness of a budget and profit plan may vary considerably based on the size of the institution and the complexity of the assets and income sources.

The FDIC issued Part 364 entitled Standards for Safety and Soundness. Appendix A of Part 364 outlines standard procedures that banks should employ periodically to evaluate and monitor earnings, thereby ensuring that earnings are sufficient to maintain adequate capital and reserves. At a minimum, management's analysis of earnings should:

- Compare recent earnings trends relative to equity, assets, or other commonly used benchmarks to the institution's historical results and those of its peers;
- Evaluate the adequacy of earnings given the size, complexity, and risk profile of the institution's assets and operations;
- Assess the source, volatility, and sustainability of earnings, including the effect of nonrecurring or extraordinary income or expenses;
- Take steps to ensure that earnings are sufficient to maintain adequate capital and reserves after considering asset quality and growth rate; and
- Provide periodic earnings reports with adequate information for management and the board of directors to assess earnings performance.

A bank's profit plan and budget should be reviewed for reasonableness with particular attention paid to the underlying assumptions. The forecast and assumptions should be consistent with what is known about the bank such as the volume of classified assets, nonaccrual and renegotiated debt levels, the adequacy of the ALLL, and other examination findings that have earnings implications. Comparison between the bank's forecast for the previous year to actual performance as displayed in the bank's own reports and in the UBPR can provide a reasonableness check. Any material discrepancies should be discussed with management; and, if the explanation is unreasonable, the bank's forecast may need to be adjusted to determine the effect of more reasonable assumptions.

If there is no bank plan or budget, examiners may need to develop their own forecast to aid in their judgments. In any case, it will normally be necessary to discuss future prospects with management. Care should be taken in these discussions not to present the examiner's forecast as absolute, or to recommend specific strategies or transactions to management based on an examiner's forecast. Planning is properly the function of management. Examiner efforts are only an attempt to discover any undue risk and highlight any factors that may significantly impact future performance in either a positive or negative manner.

Deficiencies in the profit plan or budget, or the lack thereof, should be documented in the appropriate section of the examination report.

EVALUATION OF EARNINGS PERFORMANCE

Earnings Component Rating

Under the Uniform Financial Institutions Rating System, in evaluating the adequacy of a financial institution's earnings performance, consideration should be given to:

- The level of earnings, including trends and stability,
- The ability to provide for adequate capital through retained earnings,
- The quality and sources of earnings,
- The level of expenses in relation to operations,
- The adequacy of the budgeting systems, forecasting processes, and management information systems in general,
- The adequacy of provisions to maintain the ALLL and other valuation allowance accounts, and
- The earnings exposure to market risk such as interest rate, foreign exchange, and price risks.

RATING THE EARNINGS FACTOR

Earnings rated 1 are strong. Earnings are more than sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity and trend of earnings. Generally, banks rated 1 will have earnings well above peer group averages.

Earnings rated 2 would be satisfactory and sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity and trend of earnings. Earnings that are relatively static, or even experiencing a slight decline, may receive a 2 rating provided the institution's level of earnings is adequate in view of the assessment factors listed above.

Earnings rated 3 may need to improve. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.

A rating of 4 indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. Institutions so rated may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous years.

A rating of 5 indicates earnings that are critically deficient. A financial institution with earnings rated 5 is experiencing losses that represent a distinct threat to its viability through the erosion of capital.

INTRODUCTION

Liquidity represents the ability to fund assets and meet obligations as they become due. Liquidity is essential in all banks to compensate for expected and unexpected balance sheet fluctuations and provide funds for growth. Liquidity risk is the risk of not being able to obtain funds at a reasonable price within a reasonable time period to meet obligations as they become due. Because liquidity is critical to the ongoing viability of any bank, liquidity management is among the most important activities that a bank conducts.

Funds management involves estimating and satisfying liquidity needs in the most cost-effective way possible and without unduly sacrificing income potential. Effective analysis and management of liquidity requires management to measure the liquidity position of the bank on an ongoing basis and to examine how funding requirements are likely to evolve under various scenarios, including adverse conditions.

The formality and sophistication of liquidity management depends on the size and sophistication of the bank, as well as the nature and complexity of its activities. Regardless of the bank, good management information systems, strong analysis of funding requirements under alternative scenarios, diversification of funding sources, and contingency planning are crucial elements of strong liquidity management.

The adequacy of a bank's liquidity will vary. In the same bank, at different times, similar liquidity positions may be adequate or inadequate depending on anticipated or unexpected funding needs. Likewise, a liquidity position adequate for one bank may be inadequate for another. Determining a bank's liquidity adequacy requires an analysis of the current liquidity position, present and anticipated asset quality, present and future earnings capacity, historical funding requirements, anticipated future funding needs, and options for reducing funding needs or obtaining additional funds.

To provide funds to satisfy liquidity needs, one or a combination of the following must occur:

- Disposal of assets.
- Increase in short-term borrowings and/or issuance of additional short-term deposit and deposit-like liabilities.
- Increase in long-term liabilities.
- Increase in capital through earnings, capital injection, stock issuance, or issuance of other capital instruments.

Liquidity has a cost, which is a function of market conditions and the risk profile of the bank. If liquidity needs are met through holdings of high quality short-term assets, generally the cost is the income sacrificed by not holding longer term and/or lower quality assets. If funding needs are not met through liquid asset holdings, a bank may be required to incur additional liabilities, possibly under adverse market conditions at an undesirable cost.

LIQUIDITY MANAGEMENT

Overview

All banks should have board-approved written policies and procedures for the day-to-day management of liquidity. The liquidity strategy and policies should be communicated throughout the bank. The board of directors should be informed regularly of the liquidity situation of the bank, and the board should ensure that senior management monitors and controls liquidity risk. Bank management should have in place appropriate policies and procedures that set and provide for the regular review of limits on the size of liquidity positions over particular time horizons. Management information systems adequate to measure, monitor, control and report liquidity risk should be in place, and reports should be regularly provided to the board of directors and senior management. As part of a process for the ongoing measurement of funding requirements, management should analyze liquidity under various scenarios, and the underlying assumptions for such scenarios should be reviewed periodically. Relationships with lenders, other liability holders, and market participants should be diversified and reviewed periodically to ensure a capacity to access funding either through new borrowings or the sale of assets. Contingency plans must be in force and should include strategies for handling liquidity crises and procedures for addressing cash flow shortfalls in emergency situations. The bank should maintain an adequate system of internal controls that involves regular independent reviews and evaluations of the effectiveness of the liquidity management system, and that ensures necessary and appropriate remedial steps are taken.

Liquidity management includes evaluating various funding sources and the costs associated with the sources identified. Effective liquidity management does not necessarily mean that management should employ the cheapest funding source available. Management might opt to use a source that is not the cheapest in order to avoid a funding concentration, as concentrations in funding sources increase liquidity risk. Funding diversification allows management to maintain access to different funding lines and allows more flexibility in selecting the appropriate funding source. The frequency of contact with the lender and use of a funding source are two possible indicators of the strength of a funding relationship. Also, in times of financial distress, an institution will benefit from a diversified funding base rather than the situation where funding is concentrated in one source. Along with the cost of funds and diversification issues, management should consider maturity and repricing balance sheet mismatches, anticipated funding needs, and economic and market forecasts in its liquidity planning.

The funding of ongoing operations, as compared to the ability to mitigate the impact of unexpected demands for immediate liquidity, can almost be viewed as two different situations with different planning requirements. Banks with historically stable asset structures and funding bases coupled with modest growth patterns and predictable competitive environments will likely have less exposure to unanticipated liquidity events. A liquidity crisis may stem from an unexpected event and have unanticipated effects. The nature of such an event places a premium on management planning which emphasizes flexibility and diversity in funding sources. While anticipating a potential liquidity crisis should be part of management planning, the extent of such planning will and should vary from bank to bank.

Board and Senior Management Oversight

The board of directors should understand the nature and level of the institution's liquidity risk, establish the institution's tolerance for liquidity risk, and approve significant policies related to liquidity management. The board, or a committee of board members, should also ensure that senior management takes the necessary steps to monitor and control liquidity risk, which include the following:

1. Establishing procedures, guidelines, internal controls and limits for managing and monitoring liquidity to ensure adequate liquidity is maintained at all times.
2. Preparing contingency funding plans.
3. Reviewing the institution's liquidity position on a regular basis and monitoring internal and external factors and events that could have a bearing on the institution's liquidity.
4. Reviewing periodically the institution's liquidity strategies, policies, and procedures.

Regardless of the method or combination of methods chosen to manage a bank's liquidity position, it is of key importance that management formulates a policy and develops a monitoring system to ensure that liquidity needs are met on an ongoing basis. A good policy should generally provide for forward planning which takes into account the unique characteristics of the bank, management goals regarding asset and liability mix, desired earnings, and margins necessary to achieve desired earnings. Forward planning should also take into account anticipated funding needs and the means available to meet those needs. The policy should establish responsibility for liquidity and funds management decisions and provide a mechanism for necessary coordination between the different departments of the bank. This responsibility may be assigned to a committee. Whether the responsibility for liquidity and funds management rests with a committee or an individual, strategies should be based on sound, well-deliberated projections. The board of directors and the examiner should be satisfied that the assumptions used in the projections are valid and the strategies employed are consistent with projections.

Policies and Procedures

The following are examples of typical guidelines established by a sound liquidity and funds management policy:

- Provides for the establishment of an asset/liability committee. Define who will be on the committee, what its responsibilities will be, how often it will meet, how it will obtain input from the board, how its results will be reported back to the board, and who has authority to make liquidity and funds management decisions.
- Provides for the periodic review of the bank's deposit structure. Include the volume and trend of total deposits and the volume and trend of the various types of deposits offered, the maturity distribution of time deposits, rates being paid on each type of deposit, rates being paid by trade area competition, caps on large time deposits, public funds, out-of-area deposits, and any other information needed.
- Provides policies and procedures that address funding concentration in or excessive reliance on any single source or type of funding, such as brokered funds, deposits obtained through the Internet or other types of advertising, and other similar rate sensitive or credit sensitive deposits.
- Provides a method of computing the bank's cost of funds.
- In conjunction with the bank's investment policy, determines which types of investments are permitted, the desired mix among those investments, the maturity distribution and the amount of funds that will be

available, and reviews pledging opportunities and requirements.
- Conveys the board's risk tolerance and establishes target liquidity ratios such as loan-to-deposit ratio, longer-term assets funded by less stable funding sources, individual and aggregate limits on borrowed funds by type and source, or a minimum limit on the amount of short-term investments.
- Provides an adequate system of internal controls that ensures the independent and periodic review of the liquidity management process, and compliance with policies and procedures.
- Ensures that senior management and the board are given the means to periodically review compliance with policy guidelines, such as compliance with established limits and legal reserve requirements, and verify that duties are properly segregated.
- Includes a contingency plan that addresses alternative sources of funds if initial projections of funding sources and uses are incorrect or if a liquidity crisis arises. Establishes bank lines and periodically tests their use.
- Establishes a process for measuring and monitoring liquidity, such as generating pro-forma cash flow projections or using models.
- Defines approval procedures for exceptions to policies, limits, and authorizations.
- Provides for tax planning.
- Provides authority and procedures to access wholesale funding sources, and includes guidelines for the types and terms of each wholesale funding source permitted. Defines and establishes a process for measuring and monitoring unused borrowing capacity.

Management Information System

A necessary prerequisite to sound funds management decisions is a sound management information system. Reports containing certain basic information should be readily available for day-to-day liquidity and funds management and during times of stress. Report formats and their contents will vary from bank to bank depending on the characteristics of the bank and its funds management methods and practices. Normally a sound management information system will contain reports detailing the following:

- Liquidity needs and the sources of funds available to meet these needs over various time horizons and scenarios. The maturity distribution of assets and liabilities and expected funding of commitments would prove useful in preparing this report.
- List of large funds providers.
- Asset yields, liability costs, net interest margins and variations both from the prior month and budget. Such reports should be detailed enough to permit an analysis of the cause of interest margin variations.
- Longer-term interest margin trends.
- Any exceptions to policy guidelines.
- Economic conditions in the bank's trade area, interest rate projections, and any anticipated deviations from original plan/budget.
- Information concerning non-relationship or higher-cost funding programs. At a minimum, this information should include a listing of public funds obtained through each significant program, rates paid on each instrument and an average per program.
- Information on maturity of the instruments, and concentrations or other limit monitoring and reporting.

Additional types of reports may be necessary depending on the bank's circumstances.

Internal Controls

Banks should have adequate internal controls to ensure the integrity of their liquidity risk management process. An effective system of internal controls should promote effective operations, reliable financial and regulatory reporting, and compliance with relevant laws and institutional policies. Internal controls systems should provide appropriate approval processes, limits, and ensure regular and independent evaluation and review of the liquidity risk management process. Such reviews should address any significant changes in the nature of the instruments acquired, limits, and controls since the last review. Positions that exceed established limits should receive prompt attention of management.

WARNING INDICATORS AND CONTINGENCY LIQUIDITY PLAN

Management should monitor various internal as well as market indicators of liquidity problems at the institution. Indicators serve as early warning signals of a potential problem or as later stage indicators that the institution has a serious liquidity problem. The early warning indicators, while not necessarily requiring drastic corrective measures, may prompt management and the board to do additional monitoring. Examples of these indicators include the following:

- Rapid asset growth funded by potentially volatile liabilities.
- Real or perceived negative publicity.

- A decline in asset quality.
- A decline in earnings performance or projections.
- Downgrades or announcements of potential downgrades of the institution's credit rating by rating agencies.
- Cancellation of loan commitments and/or not renewing maturing loans.
- Wider secondary spreads on the bank's senior and subordinated debt, and increasing trading of the institution's debt.
- Counterparties increase collateral requirements or demand collateral for accepting credit exposure to the institution.
- Correspondent banks decrease or eliminate credit line availability.
- Counterparties and brokers are unwilling to deal in unsecured or longer-term transactions.

Indicators that the institution potentially may have a serious liquidity problem include the following:

- Volume of turndowns in the brokered markets is unusually large, forcing the institution to deal directly with fewer willing counterparties.
- Rating sensitive providers, such as money managers and public entities, abandon the bank.
- The institution receives requests from depositors for early withdrawal of their funds, or the bank has to repurchase its paper in the market.
- Transaction sizes are decreasing, and some counterparties are even unwilling to enter into short-dated transactions.
- An increasing spread paid on deposits relative to local competitors, or national or regional composites.

Liquidity Contingency Plan

Each institution's liquidity policy should have a contingency plan that addresses alternative funding if initial projections of funding sources and uses are incorrect or if a liquidity crisis arises, such as when an institution is having trouble meeting its cash letter. A liquidity contingency plan helps ensure that a bank or consolidated company can prudently and efficiently manage routine and extraordinary fluctuations in liquidity. Such a plan also helps management to monitor liquidity risk, ensure that an appropriate amount of liquid assets is maintained, measure and project funding requirements during various scenarios, and manage access to funding sources. In a crisis situation, management has little time to plan its strategy, so it is important to have a well-developed contingency liquidity plan prior to a crisis occurring. The need for contingency plans is even more critical for banks that have an increasing reliance on alternative funding sources.

The contingency plan should be updated on a regular basis and:

- Define responsibilities and decision-making authority so that all personnel understand their role during a problem-funding situation.
- Include an assessment of the possible liquidity events that an institution might encounter. The types of potential liquidity events considered should range from high-probability/low-impact events that can occur in day-to-day operations, to low-probability/high impact events that can arise through institution-specific, systemic market, or operational circumstances. As an example: Consider the impact that a credit rating downgrade or the general perception of a loss of creditworthiness would have on liquidity.
- Assess the potential for erosion (magnitude and rate of outflow) by funding source under optimistic, pessimistic, and status quo scenarios.
- Assess the potential liquidity risk posed by other activities such as asset sales and securitization programs.
- Analyze and make quantitative projections of all significant on- and off-balance sheet fund flows and their related effects.
- Match potential sources and uses of funds.
- Establish indicators that alert management to a predetermined level of potential risks.
- Identify and assess the adequacy of contingent funding sources. The plan should identify any back-up facilities (lines of credit), the conditions related to their use and the circumstances where the institution might use them. Management should understand the various conditions, such as notice periods, that could affect access to back-up lines and test the institution's ability to borrow from established backup line facilities.
- Identify the sequence in which sources of funds will be used for contingent needs. The uncertainty of the magnitude and timing of available resources may call for different priorities in different situations.
- Assess the potential for triggering legal restrictions on the bank's access to brokered deposits under PCA standards and the effect on the bank's liability structure.
- Accelerate the timeframes for reporting, such as daily cash flow schedules, in a problem liquidity situation.
- Address procedures to ensure funds will meet the overnight cash letter.
- Include an asset tracking system that monitors which assets are immediately available for pledging or sale and how much a cash sale of these assets will generate.

FUNDING SOURCES: ASSETS

Liquidity needs may be met by managing the bank's asset structure through either the sale or planned pay-down of assets. Banks relying solely on asset management focus on adjusting the price and availability of credit and the level of liquid assets held to meet cash demands in response to changes in customer asset and liability preferences. Assets normally assumed to be liquid sometimes are not liquidated easily and/or profitably. For example, investment securities may be pledged against public funds and repurchase agreements, or may be depreciated heavily because of interest rate changes. On the other hand, holding liquid assets for liquidity purposes becomes less attractive because of thin profit margins and capital maintenance requirements.

The amount of liquid assets that a bank should maintain is a function of the stability of its funding structure and the potential for rapid loan portfolio expansion. Generally, if the sources of funds are stable, established yet unused borrowing capacity is significant, and loan demand is predictable, a relatively low allowance for liquidity is required. Factors that may indicate that a higher allowance for liquidity is required include:

- The competitive environment is such that bank customers can invest in alternative instruments.
- Recent trends show substantial reduction in large liability accounts.
- Substantial deposits are short-term municipal special assessment-type accounts.
- A substantial portion of the loan portfolio consists of large problem credits with little likelihood of reduction or marketability.
- A substantial portion of the loan portfolio consists of non-marketable loans (e.g., longer term, non-amortizing, non-homogeneous loans may not be readily marketable).
- The bank expects customers to draw upon unused lines of credit or commitments in the near future.
- A concentration of credits has been extended to an industry with present or anticipated financial problems.
- A close relationship exists between individual demand accounts and principal employers in the trade area who have financial problems.
- A significant portion of assets is pledged to support wholesale borrowings.
- Access to the capital markets is impaired.

To balance profitability and liquidity, management must carefully weigh the full return on liquid assets (yield plus insurance value) against the expected higher return associated with less liquid assets. Income derived from higher yielding assets may be offset if a forced sale is necessary due to adverse balance sheet fluctuations.

Investment Portfolio

An institution’s investment portfolio can provide liquidity through maturing securities, the sale of securities for cash, or by pledging securities as collateral in a repurchase agreement or other hypothecation. For an investment to be sold or pledged as collateral, it must not be presently encumbered. That is, the security cannot be pledged, used as collateral, sold under repurchase agreement, or otherwise hypothecated. Even if unencumbered, a security that is severely depreciated, has a small face amount, or is of poor credit quality is not a good candidate for collateral.

For accounting purposes, investment portfolios are separated into three categories: held-to-maturity (HTM), available-for-sale (AFS), and trading. Securities categorized as HTM are carried at amortized cost. To categorize a security as HTM, a bank must have both the intent and ability to hold the security to maturity. If the bank has any intention of selling an HTM security prior to maturity for liquidity purposes, the security is not eligible for classification as HTM. Sale of an HTM security could potentially call into question management’s ability to hold other HTM securities to maturity. A reclassification might be required of the remaining HTM securities, categorizing them as AFS or trading. In addition, management would have difficulty categorizing future securities purchases as HTM. HTM securities, however, can be pledged or used as collateral in a repurchase agreement or other collateralized borrowing arrangements and provide the institution with a source of liquidity. Furthermore, in situations where an institution needs cash immediately, management might ignore the accounting ramifications of selling securities categorized as HTM rather than risk the institution’s viability.

Institutions typically classify securities that will be used for liquidity as AFS. AFS securities are not subject to the “intent and ability” restrictions of HTM securities. Because AFS securities are marked to market regularly, any fair value gains or losses are recognized as they occur in a separate component of equity capital known as accumulated other comprehensive income. Therefore, if the institution needs to sell, pledge, or use an AFS security as collateral, the impact on GAAP capital is mitigated because the bank has already recognized the change in value of the security. However, since the unrealized gain or loss on AFS securities is not reflected in regulatory capital prior to a sale, there will be an impact on Tier 1 Capital when the AFS securities are sold.

Asset Securitization

Institutions that securitize assets essentially transform a pool of assets into cash. Asset securitization typically involves the transfer or sale of on-balance sheet assets to a third party who issues asset-backed securities that are sold to investors in the public debt market. Investors in these securities are paid from the cash flow received from the transferred assets. Assets that are typically securitized include credit card receivables, automobile receivables, commercial and residential mortgage loans, commercial loans, home equity loans, and student loans.

Securitization can be an effective funding method for banks. However, there are several risks associated with using securitization as a funding source.

First, some securitizations have early amortization clauses to protect investors if the performance of the underlying assets does not meet pre-specified criteria. If an early amortization clause is triggered, the issuing institution must begin paying principal to bondholders earlier than originally anticipated and will have to fund new receivables that would have otherwise been transferred to the trust. The issuing institution must monitor deal performance to anticipate cash flow and funding ramifications due to early amortization clauses.

Second, if the issuing institution has a large concentration of residual assets, the institution's overall cash flow might be dependent on the residual cash flows from the performance of the underlying assets. If the performance of the underlying assets is worse than projected, the institution's overall cash flow will be less than anticipated.

Also, an issuer's marketplace reputation is crucial to its ability to generate cash from future securitizations. If this reputation is damaged, issuers might not be able to economically securitize assets and generate cash from future sales of loans to the trust. This is especially true for institutions that are relatively new to the securitization market. Also, if loans held-for-sale are funded with short-term funding, the institution will have to find alternative funding sources if it is not able to sell these assets quickly.

Finally, residual assets that the issuing institution retains are typically illiquid assets, for which there is no active market. Additionally, these assets are not acceptable collateral to pledge for borrowings.

Loan Portfolio

The loan portfolio has become a more important factor in liquidity management. Loans can be used as collateral for secured borrowings or sold for cash in the secondary loan market. Sales in the secondary market provide fee income, relief from interest rate risk, and a funding source to the originating bank. Refer to the Sources of Funds: Liabilities portion of this section for a discussion of pledging loans to secure advances.

Loan Commitments

Loan commitments, such as fee-paid letters of credit used as backup lines, are traditional uses of funds that are off-balance sheet. Management should be able to estimate the amount of unfunded commitments that will require funding over various time horizons. Management should include its estimate of anticipated demands against unfunded commitments in its internal reporting and contingency planning. Examiners should consider the nature, volume, and anticipated usage of the institution's loan commitments when assessing and rating the liquidity position.

FUNDING SOURCES: LIABILITIES

As an alternative to using assets to satisfy liquidity needs, these needs may be met through liability sources. Although core deposits continue to be a key liability funding source, many insured depository institutions have experienced difficulty attracting core deposits and are increasingly looking to wholesale funding sources to satisfy funding and liability management needs. Wholesale funding sources include, but are not limited to, Federal funds, public funds, Federal Home Loan Bank advances, the Federal Reserve's primary credit program, foreign deposits, brokered deposits, and deposits obtained through the Internet or CD listing services.

The use of such funding sources and the risks posed by them vary widely depending on a variety of factors and circumstances presented by the individual financial institution. Risks include potential increased exposure to credit, interest rate, and liquidity risk. Wholesale funding providers are generally sensitive to changes in the credit risk profile of the institutions to which they provide these funds and to the interest rate environment. For instance, such providers closely track the institution's financial condition and may be likely to curtail such funding if other investment opportunities offer more attractive interest rates. As a result, an institution may experience liquidity problems due to lack of wholesale funding availability when needed. The decision whether or not to use liability sources should be based upon a complete analysis of factors such as the costs involved, concentrations, and the degree of management expertise available. In addition to serving as a supplement to asset liquidity, liability sources may serve as an alternative even when asset sources are available. The number of banks relying solely on managing the asset structure to meet liquidity needs is declining rapidly.

The use of wholesale funding, in and of itself, is not viewed negatively. Active and effective risk management can mitigate the added risks associated with the use of wholesale funding sources. When the terms and conditions of such funding sources are well understood and well-managed, such funding can facilitate an institution's ability to meet foreseen and unforeseen liquidity and funding needs. The challenge of measuring, monitoring, and managing liquidity risk, however, will typically increase with the greater use of nontraditional funding sources and, in some cases, require enhanced funds management processes, e.g., scenario modeling. In addition, contingency planning, capital management, and the control of reputation risk will take on added significance.

An evaluation of wholesale funding should be commensurate with the degree of risk faced and the quality of bank management as articulated more fully in the bank's liquidity and funds management policies. Wholesale funding use should be consistent with the institution's funds management policies, risk limits, strategic plans, and management expertise.

Reputation risk plays a critical role in a bank's ability to access funds readily and at reasonable terms. For that reason, bank staff responsible for managing overall liquidity should be aware of any information (such as an announcement of a decline in earnings or a downgrading by a rating agency) that could affect the market's or public's perception of the soundness of the institution.

Deposits

The critical role deposits play in a bank's ongoing, successful operation clearly demonstrates the importance of implementing programs to retain and, in most instances, expand the deposit base and of monitoring the nature and volatility of the deposit structure. Increased competition for funds and the desire of most depositors to not only minimize idle, non-earning balances but also to receive market rates of interest on invested balances have given further impetus to deposit retention efforts. An effective deposit management program should, at a minimum, include the following information:

- A clearly defined marketing strategy.
- Projections for deposit growth and structure.
- Associated cost and interest rate scenarios.
- Procedures to compare results against projections.
- Steps to revise the plan when needed.

A deposit management program should take into account the make-up of the market area economy, including local and national economic conditions; the potential for investing deposits at acceptable margins; management competence; the adequacy of bank operations; the location and size of facilities; the nature and degree of bank and non-bank competition; and, the effect of monetary and fiscal policies of the Federal government on the bank's service area and money and capital markets in general.

Once a deposit development and retention program has been devised, it must be monitored and adjusted as necessary. The long-range success of such a program is closely related to management's ability to detect the need for change as early as possible. Management must not only project deposit growth, but also determine the make-up of the accounts as to stable deposits, fluctuating or seasonal deposits, and volatile deposits. Management should remain knowledgeable of the characteristics of the deposit structure via periodic internal reports. Lack of such knowledge could lead to the unwise employment of funds and subsequent problems.

Core Deposits

Core deposits are defined in the Uniform Bank Performance Report (UBPR) User Guide as the sum of demand deposits, all NOW and ATS accounts, MMDA savings, other savings deposits, and time deposits under $100,000. Core deposits are generally stable, lower cost funding sources that typically lag behind other funding sources in the need for repricing during a period of rising interest rates. These deposits are typically funds of local customers that also have a borrowing or other relationship with the institution. Convenient branch locations, superior customer service, dense ATM networks, and low or no fee accounts are significant factors associated with the inertia of these deposits. However, in some instances, core deposit accounts (e.g., time deposits) might exhibit characteristics associated with more volatile funding sources. Conversely, deposit accounts generally viewed as volatile funding (e.g., CDs larger than $100,000) might be relatively stable funding sources. Refer to the Examination Treatment of Liquidity (UBPR Ratios) section of this chapter for discussion of ratio analysis involving core deposit ratios.

Public Funds

Public funds are deposit accounts of public bodies, such as State or local municipalities. These types of deposits often must be secured and typically fluctuate on a seasonal basis due to timing differences between tax collections and expenditures. General economic conditions can also be a factor in assessing the volatility of such deposits, since public entities may experience revenue shortfalls in times of economic decline. Though regarded as generally volatile, these accounts can be reasonably stable over time, or their fluctuations quite predictable. Local municipal deposits, for example, are often required to be maintained in the local community and, therefore, may display greater stability. State and certain local deposits, on the other hand, can be bid-type deposits that may tend to be less stable. Therefore, investigation is often needed to make informed judgments as to their stability. Due to their size and potential volatility, examiners should review these deposits.

Large Depositors

For examination purposes, large deposits are defined as those concentrations of funds under one control, or payable to one entity, which aggregate 2% or more of the bank's total deposits. By virtue of their size, such deposits are considered to be potentially volatile liabilities; however, examiners may determine that certain large deposits actually remain relatively stable for long periods. Therefore, examiners must also look at the nature of the relationship between the large depositor and the institution when assessing the volatility of large deposits. For example, a board member might maintain sizable deposit accounts in the institution because of his or her relationship with the institution. These deposits in aggregate might be considered large deposits, but are not volatile funds due to the stability of the relationship. Also, in reviewing large deposits the existence of related "Other Liabilities," such as borrowings and repurchase agreements, and associated loans or investment relationships should be considered.

A bank with a concentration of deposits in a limited number of accounts or substantial sums maturing simultaneously should address within its funding strategy the potentially volatile nature of these deposits. Considerations should include pledging requirements, affiliated relationships, and impact on liquidity and funds management, and the normally narrow interest spreads associated with large deposits. To the extent that fluctuations in deposit and loan volumes adversely coincide, that is, deposits are low when loans are high, special liquidity management measures must be taken.

While the comments above deal with large deposits, similar concerns exist for other concentrated sources of funding.

Negotiable Certificates of Deposit

Negotiable certificates of deposit (CDs) warrant special attention as a component of large deposits. They are usually issued by money center or large regional banks in denominations of $1,000,000 or more and may be issued at face value with a stated rate of interest or at a discount similar to U.S. Treasury Bills. CDs of major banks are widely traded, may offer substantial liquidity, and are the underlying instruments for a market in financial futures. They are instruments ordinarily used to fund reinvestment goals of issuing banks as opposed to solving liquidity crises. Their cost and availability are closely related to overall market conditions. Any adverse publicity involving either a particular bank or banks in general can impact the CD market. These CDs have many features of borrowings and can be quite volatile. Fundamentally, there is little to distinguish these accounts from borrowings, but negotiable CDs clearly are a form of purchased funds. Intense competition for funds among financial intermediaries has led to the common use of CDs. Thus, as a practical matter, drawing technical distinctions between CDs (except for the purposes of deposit insurance or deposit assessments) as borrowings or deposits is, in large measure, academic.

Brokered and Rate Sensitive Deposits

Deposit brokers have traditionally provided intermediary services for financial institutions and investors. However, the Internet, certificate of deposit listing services, and other automated services enable investors who focus on yield to easily identify high-yielding deposit sources. Customers who focus exclusively on yield are highly rate sensitive and can be a less stable source of funding than typical relationship deposit customers. These customers may have no other relationship with the bank and have no loyalty with their deposit funds. If more attractive returns become available, these customers may rapidly transfer funds to new institutions or investments in a manner similar to that of wholesale investors. Management should be aware of the number and magnitude of such deposits.

Management should perform adequate due diligence procedures before entering any business relationship with a deposit broker. Deposit brokers are not regulated by bank regulatory agencies. Also, management should assess potential risk to earnings and capital associated with brokered or other rate sensitive deposits.

Examiners should not wait for the Prompt Corrective Action provisions of Part 325 to be triggered, or the viability of the institution to be in question, before raising relevant safety and soundness issues with regard to the use of these funding sources. If a determination is made that a bank's use of these funding sources is not safe and sound, that risks are excessive, or that they adversely affect the bank's condition, then appropriate supervisory action should be immediately taken. The following are potential red flags that may indicate the need to take action to ensure that the risks associated with brokered or other rate sensitive funding sources are managed appropriately:

- Ineffective management or the absence of appropriate expertise.
- Newly chartered institution with few relationship deposits and an aggressive growth strategy.
- Inadequate internal audit coverage.
- Inadequate information systems or controls.
- Identified or suspected fraud.
- High on- or off-balance sheet growth rates.
- Use of rate sensitive funds not in keeping with the bank's strategy.
- Inadequate consideration of risk, with management focused exclusively on rates.
- Significant funding shifts from traditional funding sources.
- The absence of adequate policy limitations on these kinds of funding sources.
- High delinquency rate or deterioration in other asset quality indicators.
- Deterioration in the general financial condition of the institution.
- Other conditions or circumstances warranting the need for administrative action.

The term "brokered deposit" means any deposit that is obtained from or through the mediation or assistance of a deposit broker. When determining if a listing service is a deposit broker under Section 337.6 of the FDIC Rules and regulations, "brokered deposits" do not include those deposits obtained by a listing service that meets the following criteria:

1. The person or entity providing the listing service is compensated solely by means of subscription fees (i.e., the fees paid by subscribers as payment for their opportunity to see the rates gathered by the listing service) and/or listing fees (i.e., the fees paid by depository institutions as payment for their opportunity to list or "post" their rates). The listing service does not require a depository institution to pay for other services offered by the listing service or its affiliates as a condition precedent to being listed.
2. The fees paid by depository institutions are flat fees: they are not calculated based on the number or dollar amount of deposits accepted by the depository institution as a result of the listing of the depository institution's rates.
3. In exchange for fees, the listing service performs no service except the gathering and transmission of information concerning the availability of deposits. This information may include an insured depository institution's name, address (including e-mail address), telephone number and interest rates. Except for providing this information, the listing service does not serve as a liaison between depositors and depository institutions. For example, the listing service does not pass information about a depositor to a depository institution.
4. The listing service is not involved in placing deposits or confirming the placement of deposits. Any funds to be invested in deposit accounts are remitted directly by the depositor to the insured depository institution and not, directly or indirectly, by or through the listing service.

For insured institutions that are not well-capitalized, brokered deposits include any deposit solicited by offering rates that significantly exceed market rates as defined by Part 337 of FDIC Rules and Regulations. Brokered deposits usually exhibit highly volatile characteristics and often carry higher interest rates than alternative sources of funds.

The use of brokered deposits by problem institutions has often been associated with abuses and contributed to failures with consequent losses to the deposit insurance funds. They can represent a consistent and heavy funding source to support unsound or rapid expansion of loan and investment portfolios.

Section 29 of the FDI Act, implemented by Part 337 of the FDIC Rules and Regulations, limits the use of brokered deposits. An undercapitalized insured depository institution may not accept, renew, or roll over any brokered deposit. An adequately capitalized insured depository institution may not accept, renew, or roll over any brokered deposit unless the institution has applied for and been granted an application for waiver by the FDIC. Only a well-capitalized insured depository institution is allowed to solicit and accept, renew, or roll over any brokered deposit without restriction.

With respect to adequately-capitalized institutions, any safety and soundness concerns arising from the acceptance of brokered deposits are ordinarily addressed by the conditions imposed in granting the waiver application. In monitoring such conditions, it is incumbent on the examiner not only to verify compliance but also to assess whether any unanticipated problems are being created.

The acceptance of brokered deposits by well-capitalized institutions is subject to the same considerations and concerns applicable to any other type of special funding. These concerns relate to volume, availability, cost, volatility, and maturities and how the use of such special funding fits into the institution's overall liability and liquidity management plans. There should be no particular stigma attached to the acceptance of brokered deposits per se and the proper use of such deposits should not be discouraged.

Deposit development and retention policies should recognize the following:

- The restrictions on accepting, renewing or rolling over brokered deposits.
- The limits imposed by prudent competition.
- The pitfalls of uninformed reliance on brokered funds.

When brokered deposits are encountered in an institution, examiners should consider the effect on the overall funding and investment strategies of the institution, and verify compliance with Part 337. Any loans tied to specific brokered deposits should receive special scrutiny. Apparent violations of Part 337 or inappropriate use of brokered deposits should be discussed with management and the board of directors.

Secured and Preferred Deposits

Secured and preferred deposits impose pledging requirements upon banks. Banks must secure U.S. government deposits, and most states authorize or require the pledge of assets to secure State and municipal deposits. Although several forms of security may be acceptable, U.S. government securities are the most commonly pledged. Many states also mandate that depositories secure trust department funds deposited in their own bank; bankruptcy court funds are often accorded similar treatment. In addition to strict regulatory or bookkeeping controls associated with pledging requirements, banks may establish various monitoring controls due to the impact pledging may have on liquidity. Accurate accounting for secured or preferred liabilities gains added importance during bank liquidations since certain secured depositors and creditors gain immediate access to a bank's most liquid assets.

Bank Investment Contracts

A Bank Investment Contract (BIC) is a deposit contract between a bank and its customer that permits the customer to deposit funds over a period of time and obligates the bank to repay the amounts deposited plus interest at a guaranteed rate to the end of the contract term. The contract term varies, and may range from six months to as long as ten years. Though not often seen today, BICs have been structured as non-transferable liabilities (i.e., not saleable in a secondary market). The customers for BICs have been, in most cases, sponsors of employee benefit plans such as pension plans or deferred compensation plans.

Examiners should consider the volume, maturity, and cost of the BIC funding in relation to both the bank's other deposit and any nondeposit funding. The examiner should be aware of the terms and conditions of the BIC contracts. BICs may provide specified periods and conditions under which additional deposits or withdrawals may be made to or from such contracts, and the bank's liquidity planning must reasonably estimate its cash flow from BIC funding under different interest rate scenarios.

International Funding Sources

As in the case of domestic sources of funds, international funding may exist in a number of forms. The most common is the Eurodollar market. Eurodollar deposits are dollar-denominated deposits taken by a bank's overseas branch or its international banking facility (IBF). They are free of reserve requirements and deposit insurance assessments. The interbank market is highly volatile, and the bank's Eurodollar deposit-taking activity should be analyzed within the same context as all other potentially volatile funding sources.

Federal Funds Purchased

Federal funds are funds deposited by banks at the Federal Reserve Banks and are designed to enable banks temporarily short of their reserve requirement to borrow reserves from banks having excess reserves. However, growth and change in the market have made this description deficient, as many market participants, including most state non-member banks, do not maintain balances at the Federal Reserve. Moreover, a Federal funds transaction does not necessarily involve the transfer of a reserve balance, as in the case of banks borrowing excess balances from their correspondent banks.

The lending and borrowing of these balances has become a convenient method employed by banks to avoid reserve deficiencies or invest excess reserves over a short period of time. In most instances, Federal funds transactions take the form of overnight or over-the-weekend unsecured transfers of immediately available funds between banks. However, banks also enter into continuing contracts having no set maturity but subject to cancellation upon notice by either party to the transaction. Banks also engage in Federal funds transactions of a set maturity, but these comprise only a small percentage of all Federal funds transactions. The vast majority of Federal funds transactions are overnight or over-the-weekend transactions. Some institutions may access Federal funds routinely, perhaps as a liability management technique whereby the buyer (borrower) attempts to utilize the acquired funds to support a rapid expansion of its loan-investment posture as a means of enhancing profits. In any event, these transactions should be supported with written verification from the lending institution.

Treasury Tax and Loan Accounts

Banks receiving Treasury Tax and Loan (TT&L) funds have the option of remitting those funds daily through a Federal Reserve Bank (remittance option) or maintaining those funds in an interest-bearing, demand account (note option). The note option permits banks to retain the TT&L funds as secured, purchased funds callable on demand. Under the note option, such funds should be shown in the examination report as deposits on the day received and as "Other Borrowed Money" on the following day. As borrowed funds, they must be analyzed as any other volatile funding source, which requires the encumbrance of assets for pledging purposes. Often, balances in TT&L accounts are not significant and do not present a material factor in assessing liquidity.

Borrowings

Large regional and money center banks, and increasingly more community banks, rely heavily on funds generated from the assumption of liabilities. Larger banks generally have access to money markets and usually find that borrowing is the most economical way for them to meet short-term or unanticipated loan demand or deposit withdrawals. Community banks generally do not have the same broad access to money markets; their reliance on funds generated from the assumption of liabilities is increasing as the availability of core deposits continues to decline.

The appropriate use of asset and liability funding sources may result in lower overall liquidity cost. By managing borrowings in a coordinated fashion with asset liquidity needs, banks can tailor liabilities to fit their cash flow needs instead of apportioning asset types and amounts to a given liability base. Locking in term funding can also reduce liquidity risk, especially if the bank can extend the duration of its liability structure. Accessing wholesale funds allows banks to obtain funds quickly and efficiently. Borrowing funds should never automatically draw criticism. Nevertheless, borrowings should be viewed as a supplemental funding source, rather than as a replacement for core deposits.

Managing liquidity through adjustments to liabilities requires management to plan strategies more carefully than if the bank managed liquidity based only on assets. If an institution is relying on borrowed funds, management should have a complete understanding of the associated risks, commensurate risk management practices, and a comprehensive contingency funding plan that specifically addresses funding as the institution's financial condition or the economy deteriorates.

Although borrowing funds has enabled many banks to meet expanding customer loan demand, this strategy is not riskless. Misuse or improper implementation of a borrowing strategy can have severe consequences. In all banks, and particularly in wholesale-funded ones, management must be constantly aware of the composition and characteristics of its funding sources. Examiners and banks should be aware of the following risks associated with borrowing funds:

- Secured borrowings can impact a bank's liquidity profile by pledging high quality assets, lessening the availability of such assets for contingent liquidity demands.
- If the institution's condition or the economic climate deteriorates, it will be more difficult to borrow funds economically, if at all, when needed the most.
- Changes in market conditions can make it difficult for the bank to secure funds and to manage its funding maturity structure.
- Due to rate competition, a bank may incur relatively high costs in obtaining funds and may lower credit quality standards in order to invest in higher yielding loans and securities. If a bank is purchasing liabilities to support assets already on its books, the high cost of borrowings may result in a negative yield spread.

- Preoccupation with obtaining funds at the lowest possible cost, without proper consideration given to diversification and to maturity distribution, intensifies a bank's exposure to funding concentrations and the risk of interest rate fluctuations, respectively.
- Management might not fully understand the terms of the particular borrowings. Some borrowings have embedded options that make their maturity or future interest rate uncertain. This uncertainty can increase the complexity of liquidity management and, under certain circumstances, may increase the cost of funding.

The extent of an institution's reaction to these risks will depend upon that particular bank's mix of funding sources and their risk tolerance. Risk tolerance is the willingness and ability of an individual or institution to borrow or lend money for a given risk/reward profile. Factors affecting risk tolerance of funds providers include:

- Obligations to fiduciary investors, such as money market funds, trust funds and pensions.
- Reliance on rating firms. Bylaws or internal guidelines may prohibit placing funds in banks that have low ratings.
- Obligations to disclose information on investment holdings.
- Self-interest in maintaining an orderly marketplace. For this reason major banks are slow in eliminating funding to other banks.
- Lack of a personal contact at the bank to provide timely and accurate information about its financial condition.

Federal Home Loan Bank (FHLB) advances have become a popular type of borrowing. To obtain advances an institution must be a member of an FHLB and, for most advances, must pledge collateral. The institution will also be subject to an annual audit verification of pledged collateral. There are many varieties of advances and the types of advances offered vary among the individual FHLBs. Access to advance funding can increase an institution's liquidity by affording an institution the ability to pledge otherwise illiquid assets as collateral. FHLB advances provide institutions with a link to the capital markets and make funds available at maturities and terms that might otherwise be unavailable. However, the FHLB scrutinizes an institution's credit risk profile on an ongoing basis. If an institution's financial condition deteriorates to a point where the FHLB begins to restrict further borrowing, the institution will suffer the effects of increased collateral requirements or reduced borrowing flexibility when it may be needed most. Specifically, if asset quality deteriorates the FHLB may refuse to renew advances upon maturity, accelerate repayment of advances due to a covenant breach, raise collateral requirements, or reduce funding lines. Thus, while FHLB advances can be structured as long-term borrowings and provide a source of stable funding, the credit sensitive nature of FHLB advances distinguishes them from traditional core deposits. FHLB advances are referred to as credit sensitive because the institution's asset quality and overall financial condition drive the collateral terms and borrowing capacity. In contrast, the interest rate on FHLB advances is a function of prevailing market conditions, the size, and the particular type of advance. Additionally, if the FHLB has a blanket lien on the institution's assets, management loses the ability to sell its assets or pledge them to secure borrowings. Management should understand the ramifications of having advance funding curtailed in the event that the institution's financial strength deteriorates, and the bank's contingency plan should identify alternative sources of funding.

Repurchase Agreements

In a securities repurchase agreement (repo), an institution agrees to sell a security to a counterparty and simultaneously commits to repurchase the security at a mutually agreed upon future date. Instead of borrowing money and pledging securities as collateral, the party to a repo transaction sells the securities today, and simultaneously agrees to buy the same security at the same price (with interest) at some point in the future. As a result, in economic terms, a repurchase agreement is a form of secured borrowing. The amount "borrowed" against the securities generally is the full market value less a reasonable "haircut." Most repos are day-to-day (overnight) funding, but terms of up to one or two years are not uncommon. Normally, the counterparty takes delivery of the securities, although a third party can hold collateral (a tri-party repo). The agreements are often standardized, using contract language adopted by the Bond Market Association. Examiners should reference the Modified Policy Statement on Repurchase Agreements of Depository Institutions with Securities Dealers and Others, dated February 25, 1998.

From an accounting standpoint, repurchase agreements involving securities are either reported as borrowings and loans or sales and repurchase commitments based on whether the selling institution maintains control over the future economic benefits associated with the underlying asset. If the repurchase agreement requires the selling institution to repurchase the identical asset sold, then, generally, the institution has retained control over the future economic benefits and should report the transaction as a borrowing. If the repurchase agreement does not require the bank to repurchase the identical security sold, the agreement is reported as a sale of the securities and a commitment to purchase securities. For accounting purposes, a reverse repurchase agreement, which requires the buying institution to sell back the identical asset purchased, is treated as a loan. If the reverse repurchase agreement does not require the institution to resell the identical security purchased, it is reported as a purchase of the securities and a commitment to sell securities.

The vast majority of repurchase agreements mature in three months or less. One-day transactions are known as overnight repos, while transactions longer in duration are referred to as term repos. Institutions typically use repurchase agreements as short-term, relatively low cost, funding mechanisms. Likewise, reverse repos are used as short-term investment alternatives to other money market instruments, such as Federal funds. The interest rate paid on a repurchase agreement depends on the type of underlying collateral. In general, the higher the credit quality of the collateral and the easier the security is to deliver and hold, the lower the repo rate. Supply and demand factors for the underlying collateral also influence the repo rate.

Properly administered repurchase agreements that are conducted within a comprehensive asset/liability management program are not normally subject to regulatory criticism. However, repos that are inadequately controlled may expose an institution to risk of loss and will be regarded as an unsuitable investment practice. Since the market value of the underlying security may change during the term of the transaction, both parties to a repo may experience credit exposure. Although repo market participants normally limit their credit exposure by requiring margin collateral and by regularly marking term transactions to market, there is no substitute for a thorough credit review of repo counterparties prior to the initiation of transactions. For banks, broker/dealers are common counterparties.

Many portfolio managers have severely underestimated the credit risk associated with the performance of a counterparty and have failed to adopt the basic safeguards necessary to assure proper control over the underlying securities. Because of the numerous control deficiencies found to be associated with these transactions, the FDIC has established minimum standards for any depository institution engaged in repurchase agreement transactions. Financial institutions that are actively engaged in repurchase transactions should be encouraged to have even more comprehensive controls to suit their particular circumstances.

The risks inherent in repurchase agreement transactions should be controlled by an institution through policy guidelines that, at a minimum, provide the following:

- Establish written credit policies.
- Require identification and periodic credit evaluations of each counterparty.
- Establish maximum position and exposure limits for each counterparty.
- Mandate individual or master written agreements for all repurchase transactions that specify acceptable collateral types and maturities, call defaults and sellout provisions, ownership rights, substitute collateral rights, and persons authorized to transact business on behalf of both parties.
- Provide for acceptable control provisions over underlying securities.

Banks engaging in or planning to engage in the sale of repurchase agreements to retail customers are urged to consult with legal counsel competent in the field of securities law to determine what constitutes sufficient disclosure to customers as well as to ensure compliance with the antifraud and other applicable provisions of Federal and State securities law.

The full text of the policy statement on repurchase agreement transactions can be found in the Prentice-Hall volumes.

Dollar Repurchase Agreements

Dollar repurchase agreements, also known as dollar repos and dollar rolls, provide financial institutions with an alternative method of borrowing against securities owned. Unlike "standard" repurchase agreements, dollar repos require the buyer to return to the seller substantially similar, versus identical, securities. Dealers typically offer dollar roll financing to institutions as a means of covering short positions in particular securities. Short positions arise when a dealer sells securities that it does not currently own for forward delivery. To avoid the costs associated with failing on a delivery, dealers are willing to offer attractive financing rates in exchange for the use of the institution's securities in covering a short position. Savings associations are the primary participants among financial institutions in dollar roll transactions, and mortgage pass through securities are typically used as the underlying collateral.

Supervisory authorities do not normally take exception to dollar repos, provided that the transactions are conducted for legitimate purposes and the institution has instituted appropriate controls. However, dollar repos that are designed to permanently dispose of securities while circumventing accounting rules for loss recognition will be viewed as an unsuitable investment practice.

To qualify as borrowings, dollar repos must require the buyer to return to the seller "substantially similar" securities by the settlement date, which cannot exceed 12 months from the inception of the transaction. Mortgage pass-through securities repurchased are considered "substantially similar" to those sold if all of the following conditions are met. The securities must:

- Be collateralized with similar mortgages.
- Be issued by the same agency and be part of the same program.
- Have the same remaining weighted average maturity.
- Be priced to have similar market yields.
- Have identical coupon rates.
- Satisfy good delivery requirements.

In addition, securities used in dollar repo transactions must have been held in the seller's investment portfolio for a minimum of 35 consecutive days prior to the initiation of the contract.

Examiners should require appropriate financial statement adjustments in cases where institutions have improperly reported dollar repurchase transactions.

Federal Reserve Bank

The Federal Reserve Banks provide short-term collateralized credit to banks at the Federal Reserve's discount window. The discount window is available to any insured depository institution that maintains deposits subject to reserve requirements. Banks must execute borrowing agreements and fully collateralize all borrowing to the satisfaction of the Federal Reserve. U.S. government securities are the most acceptable and most common type of collateral in obtaining a Reserve Bank loan, although any "bankable" asset is acceptable for pledging. Other acceptable collateral consists of mortgage-backed, asset-backed, municipal, sovereign, or corporate securities, and loans (municipal, commercial, 1- to 4-family residential). Collateral may be transferred to the Federal Reserve, held by the borrower in custody, held by a third party, or reflected by book entry. Types of discount window credit include primary credit (generally overnight credit to meet temporary liquidity needs), secondary credit (available to institutions that do not qualify for primary credit), extended credit (in exceptional circumstances for institutions under liquidity strain), and emergency credit (rare circumstances).

The Federal Reserve's primary credit program was designed to ensure adequate liquidity in the banking system and is intended as a back-up of short-term funds for eligible institutions. In general, depository institutions with composite CAMELS ratings of 1, 2, or 3 that are at least adequately capitalized are eligible for primary credit.

Since primary credit can serve as a viable source of back-up, short-term funds, examiners should view the occasional use of primary credit as appropriate and unexceptional. At the same time, examiners should be cognizant of the implications that too frequent use of these relatively expensive funds may have for the earnings, financial condition, and overall safety and soundness of the institution. Over-reliance on primary credit borrowings or any one source of short-term contingency funds may be symptomatic of deeper operational and/or financial difficulties. Institutions should ensure that use of primary credit facilities is accompanied by viable takeout or exit strategies.

Secondary credit is available to depository institutions that do not qualify for primary credit. This program entails a higher level of Reserve Bank administration and oversight than primary credit. The secondary credit rate is above the primary credit rate. The discount window is a means to provide relief to institutions that face temporary, unforeseen liquidity pressures. If an individual bank's borrowing becomes a regular occurrence, Reserve Bank officials will review the purpose of the borrowing and encourage the bank to initiate a program to eliminate the need for such borrowings. Appropriate reasons for borrowing include preventing overnight overdrafts, loss of deposits or borrowed funds, unexpected loan demand, liquidity and cashflow needs, operational or computer problems, or a tightened Fed Funds market.

The Federal Reserve will not permit banks that are not viable to borrow at the discount window. In 1991, the Federal Reserve Act was modified by the Federal Deposit Insurance Corporation Improvement Act to limit a bank's ability to access the discount window. Section 10B(b) limits Reserve Banks advances to not more than 60 days in any 120-day period for undercapitalized institutions. This limit may be overridden only if the primary Federal banking agency supervisor certifies the borrower's viability or if, following an examination of the borrower by the Federal Reserve, the Chairman of the Board certifies in writing to the Reserve Bank that the borrower is viable. These certifications may be renewed for additional 60-day periods.

THE ROLE OF CAPITAL AND THE BANK HOLDING COMPANY

Bank Holding Company Considerations

Discussion of liquidity and funds management thus far has addressed independent banks. While the principles are also generally true of holding company subsidiaries, there are additional factors that need to be considered. For larger holding companies, many of the management decisions and planning functions already discussed for liquidity management are performed at the corporate level for all subsidiary banks. Loans can be shifted through sales or participations within the affiliated group from banks with excessive loan demand to others with inadequate loan demand. Banks with unpledged assets or unused borrowing capacity can lend assets, cross collateralize an affiliate's borrowings, or fund liabilities for other banks in the chain. Purchased liabilities can be attracted at the corporate level and inserted anywhere in the affiliated group. Therefore, in viewing liquidity or interest sensitivity in subsidiary banks, it can be misleading to review only the mix, maturity and rate sensitivity of an individual bank's balance sheet. Also, examiners should consider Sections 23A and B of the Federal Reserve Act, State law, and the FFIEC Supervisory Policy on Securities Lending when reviewing transactions between affiliates.

Examiners should obtain holding company-wide information regarding the consolidated organization's approach to liquidity management that detail such items as where decisions are being made, and what alternatives or options are available through the parent or within the organization to provide for liquidity and control of rate sensitivity. While there is no reason to criticize the existence of centralized planning and decision making, there remains a legal responsibility of an individual bank's board of directors for managing its independent and unique affairs. It is important that they be aware of the bank's strategy and performance and provide informed approval.

The typical bank holding company has no independent source of revenue, no liquid assets, and a leveraged balance sheet. It is the subsidiary bank(s) that ultimately provides funds to service the parent's debt. However, the funds upstreamed to the parent company will be more of a factor in assessing the individual subsidiary bank's earnings and capital than the liquidity position.

Trust Preferred Securities

Trust preferred securities (TPS) have credit characteristics of deeply subordinated debt with long term maturities. TPS are hybrid instruments that are generally considered debt securities when purchased by banks as investments, but have equity characteristics as the Federal Reserve allows their inclusion to a maximum of 25% of Tier 1 capital for the issuer, a BHC. Given the long term nature of trust preferred securities, it is more appropriate to view these instruments as part of the issuer's capital structure rather than a source of liquidity. After issuing TPS the BHC might downstream the cash proceeds to a subsidiary bank. In this case, the nonrecurring nature of the cash contribution to the downstream bank should be viewed more as a capital injection rather than as a funding source for ongoing operations. Examiners should consider the specific characteristics of TPS held as an investment and assess its marketability. Some TPS may be publicly traded while others may be actively traded in over-the-counter markets. Market makers for certain TPS are developing. On the other hand, certain TPS may not be actively traded and are thus relatively illiquid investments.

The Role of Equity in Evaluating Liquidity

Issuing new equity is a relatively slow and costly way to raise funds and should not be viewed as an immediate or direct source of liquidity. Raising capital to fund anticipated growth or a new business line presents management considerations distinct from liquidity concerns (e.g., return on equity targets, dilution of existing shareholder value, and the market's perception of the growth or development strategy). However, to the extent that a strong capital position helps an institution to quickly obtain additional debt and to economically raise funds, issuing equity can be appropriately considered a liquidity facilitator. An institution's capital level and its willingness and ability to raise additional equity should be considered when assessing liquidity.

Commercial Paper

Commercial paper is generally a short-term, negotiable promissory note, issued for short-term funding needs by a bank holding company, large commercial bank, or other large commercial business. Commercial paper usually matures in 270 days or less, is not collateralized, and is purchased by institutional investors. Rating agencies, such as Standard & Poor's and Moody's, rate these instruments based on the issuer's financial condition. A smaller community bank without agency ratings or name recognition in the market might find commercial paper to be an impractical and cost-prohibitive funding source. Given the short-term, debt-like nature of commercial paper, a holding company's ability to issue this instrument and downstream the funds to a subsidiary bank would provide an additional funding source and, therefore, have a positive impact on the bank's liquidity position.

EVALUATION OF A BANK'S LIQUIDITY

Liquidity Component Rating

Perhaps more than any of the other component ratings, except the management component, the liquidity component should be assigned in the context of other financial factors. Banks with very strong capital positions and earnings fundamentals are likely to be able to easily fund ongoing operations and have no difficulty raising liquidity for even unforeseen events. Conversely, banks with low levels of capital, weak earnings, or asset deterioration, may find financing to be more expensive or borrowing line maturities reduced.

Under the *Uniform Financial Institutions Rating System*, in evaluating the adequacy of a financial institution's liquidity position, consideration should be given to the current level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds management practices relative to the institution's size, complexity, and risk profile. In general, funds management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, funds management practices should ensure that liquidity is not maintained at a high cost, or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

RATING THE LIQUIDITY FACTOR

A rating of 1 indicates strong liquidity levels and well-developed funds management practices. The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.

A rating of 2 indicates satisfactory liquidity levels and funds management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds management practices.

A rating of 3 indicates liquidity levels or funds management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds management practices.

A rating of 4 indicates deficient liquidity levels or inadequate funds management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.

A rating of 5 indicates liquidity levels or funds management practices so critically deficient that the continued viability of the institution is threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

Liquidity is rated "1" through "5" with respect to the following:

- Volatility of deposits
- Reliance on interest-sensitive funds and frequency and level of borrowings
- Unused borrowing capacity
- The capability of management to properly identify, measure, monitor, and control the institution's liquidity position, including the effectiveness of funds management strategies, liquidity policies, management information systems, and contingency funding plans
- Level of diversification of funding sources
- Ability to securitize assets
- Availability of assets readily convertible into cash
- Ability to pledge assets
- Impact of holding company and affiliates
- Access to money markets
- The institution's earnings performance
- The institution's capital position
- The nature, volume, and anticipated usage of the institution's credit commitments

In appraising liquidity, attention should be directed to the bank's average liquidity over a specific period as well as its liquidity position on a particular date. Examination procedures for liquidity analysis are included in the Examination Documentation (ED) Modules. Refer to the ED Liquidity Module for additional guidance.

UBPR Ratio Analysis

The UBPR is an invaluable analytical tool that shows the impact of management's decisions and economic conditions on a bank's earnings performance and balance sheet composition. Examiners should employ UBPR ratios as helpful tools to analyze the institution's liquidity position. UBPR ratios should be viewed in concert with the institution's internal liquidity ratios on a level and trend basis when assessing the liquidity position. Peer group comparisons might not be meaningful since the liquidity and funding needs will be different for each institution.

Some of the more common ratios that examiners use are:

- Net Short-Term Non Core Funding Dependence
- Net Non-Core Funding Dependence
- Net Loans and Leases to Deposits
- Net Loans and Leases to Total Assets
- Short-Term Assets to Short-Term Liabilities
- Pledged Securities to Total Securities
- Brokered Deposits to Deposits
- Core Deposits to Total Assets

Examiners should recognize that UBPR liquidity ratio analysis might not provide an accurate picture of the institution's liquidity position. Characteristics and behavior of asset and liability accounts should be scrutinized prior to analyzing liquidity ratios. Loans, securities, deposits, and borrowings should be evaluated before using UBPR ratios to draw conclusions concerning the liquidity position.

For example, the UBPR User Guide defines the types of deposit accounts included in "core deposits." Core deposits are generally considered stable, low cost funding sources, but, at a particular institution, core deposit account balances might fluctuate significantly or might be more prone to run-off. For example, out of area CDs less than $100,000 obtained from an Internet listing service are included in core deposits under the UBPR definition, but it is nevertheless likely that such deposits should not be viewed as a stable funding source. Likewise, a local depositor might have CDs larger than $100,000 in a community institution. The UBPR definition categorizes CDs larger than $100,000 as non-core liabilities. However, should the institution be in good condition, such deposits are likely stable sources of funds because of the customer's loyalty; but should the institution experience financial problems, such deposits might also be volatile due to the uninsured nature of the deposits. Similarly, the UBPR categorizes FHLB advances as non-core funding. However, some advances are long-term and serve as a stable funding source. As long as the FHLB advances are fully collateralized to the satisfaction of the FHLB, it is likely that the advances will be renewed at maturity. Yet, as discussed above, FHLB advances are more credit sensitive than deposits. For these and similar reasons, examiners must consider these ratios in light of the particular circumstances; the community, the balance sheet composition, the risk profile, and other relevant and unique characteristics of the institution.

INTRODUCTION

Sensitivity to market risk (the S component) addresses the degree to which changes in interest rates, foreign exchange rates, commodity prices or equity prices can adversely affect a financial institution's earnings or capital. For most institutions, market risk primarily reflects exposures to changes in interest rates. The S component focuses on an institution's ability to identify, monitor, manage and control its market risk, and provides institution management with a clear and focused indication of supervisory concerns in this area.

This examination guidance focuses on the nature of the examiner's qualitative assessment of a bank's interest rate risk (IRR) when rating sensitivity to market risk. In addition, examiners may use these examination guidelines when evaluating foreign exchange, commodity, or equity price risk.

This guidance is divided into the following additional sections:

- Examination Standards and Goals,
- Types of Interest Rate Risk,
- Management Responsibilities for IRR,
- IRR Measurement Methods,
- IRR Measurement System Review,
- Variance Analysis,
- Other Market Risk Factors,
- Rating Sensitivity to Market Risk, and
- Market Risk Glossary.

EXAMINATION STANDARDS AND GOALS

Joint Agency Policy Statement on Interest Rate Risk

In 1996, the FDIC and other federal banking regulators adopted the S component and issued the Joint Agency Policy Statement on Interest Rate Risk (Policy Statement). The Policy Statement identifies the key elements of sound interest rate risk management and describes prudent principles and practices for each of these elements. It emphasizes the importance of adequate oversight by a bank's board of directors and senior management and of a comprehensive risk management process. The Policy Statement also describes the critical factors affecting the agencies' evaluation of a bank's interest rate risk when making a determination of capital adequacy. The principles and practices identified in the Policy Statement describe the standards the FDIC uses to evaluate the adequacy and effectiveness of a bank's interest rate risk management and the adequacy of its capital in light of its interest rate risk profile. These standards are incorporated and reflected throughout this guidance.

FDIC examination procedures follow a risk-focused framework that incorporates the Policy Statement's guidelines and efficiently allocates examination resources. Examination scope will vary depending upon each bank's interest rate risk exposure relative to earnings and capital, and related strength of risk management processes. This section of the Manual is intended to provide a thorough background on the interest rate risk management process and examination guidance related to it. It is not an exhaustive study of IRR measurement methods. Nor will every examination entail all of the procedures and methodologies discussed.

There are three primary examination goals:

- Evaluate the interest rate risk management program,
- Determine any safety and soundness concerns, and
- Recommend corrective action when warranted.

The interest rate risk examination procedures accomplish those goals and:

- Limit examination scrutiny and resources for banks that demonstrate financial strength, effective management, and minimal IRR,
- Focus examination resources on banks that demonstrate significant interest rate risk, and
- Expedite offsite analysis.

Examination procedures for Market Risk are included in the Division of Supervision and Consumer Protection (DSC) Examination Documentation (ED) Modules and this Chapter. Refer to the ED Modules for basic examination procedures and other information.

TYPES OF INTEREST RATE RISK

Interest rate risk is the exposure of a bank's current or future earnings and capital to adverse interest rate changes. Interest rate fluctuations affect earnings by changing net interest income and other interest-sensitive income and expense levels. Interest rate changes affect capital by changing the net present value of a bank's future cash flows, and the cash flows themselves, as rates change. Accepting this risk is a normal part of banking and can be an important source of profitability and shareholder value. However, excessive interest rate risk can threaten banks' earnings, capital, liquidity, and solvency. Interest rate risk has many components, including repricing risk, basis risk, yield curve risk, option risk, and price risk.

Repricing risk results from timing differences between coupon changes or cash flows from assets, liabilities, and off-balance sheet instruments. For example, long-term fixed-rate securities funded by short-term deposits may create repricing risk. If interest rates change, then deposit funding costs will change more quickly than the yield on the securities. Likewise, the present value of the securities (i.e., their market price) will change more than the value of the deposits, thereby affecting the value of capital.

Basis risk results from weak correlation between coupon rate changes for assets, liabilities, and off-balance sheet instruments. For example, LIBOR-based deposit rates may change by 50 basis points, while Prime-based loan rates may only change by 25 basis points during the same period.

Yield curve risk results from changing rate relationships between different maturities of the same index. For example, a 30-year Treasury bond's yield may change by 200 basis points, but a three-year Treasury note's yield may change by only 50 basis points during the same time period.

Option risk results when a financial instrument's cash flow timing or amount can change as a result of market interest rate changes. This can adversely affect earnings by reducing asset yields or increasing funding costs, and it may reduce the net present value of expected cash flows.

For example, assume that a bank purchased a callable bond, issued when market interest rates were 10 percent, that pays a 10 percent coupon and matures in 30 years. If market rates decline to eight percent, the bond's issuer will call the bond (new debt will be less costly).

At call, the issuer effectively repurchases the bond from the bank. As a result, the bank will not receive the cash flows that it originally expected (10 percent for 30 years). Instead, the bank must invest that principal at the new, lower market rate.

Examples of instruments with embedded options include various types of bonds and notes with call or put provisions, loans which give borrowers the right to prepay balances, and various types of non-maturity deposit instruments which give depositors the right to withdraw funds at any time, often without penalty.

Price risk results from changes in the value of marked-to-market financial instruments that occur when interest rates change.

For example, trading portfolios, held-for-sale loan portfolios, and mortgage servicing assets contain price risk. When interest rates decrease, mortgage servicing asset values generally decrease. Since those assets are marked-to-market, any value loss must be reflected in current earnings.

Sources of Interest Rate Risk

The adequacy of a bank's IRR management system depends on its ability to identify and effectively capture all material activities and products that expose the bank to interest rate risk and then measure the specific risks presented. A review of the following items will allow examiners to identify material bank exposures and the type of risks presented.

- Interest Rate Risk Standards Analysis (IRRSA),
- Bank interest rate risk analysis, and independent review findings,
- Related bank policies and procedures,
- Balance sheet and account data,
- Strategic and business plans,
- Product pricing guidelines,
- Hedging or derivative activity, and
- Current and prior related examination findings.

Funding sources may create repricing risk, basis risk, yield curve risk, or option risk. Examiners should evaluate the fundamental relationship between funding sources and asset structure. Potentially volatile or market-based funding sources may increase interest rate risk, especially when matched to a longer-term asset portfolio. For example, fixed-rate mortgages funded by purchased Federal funds create repricing risk. Funding costs may increase substantially, while asset yields remain fixed.

Non-maturity deposits may mitigate some interest rate risk. Non-maturity deposit funding costs generally demonstrate less volatility than market interest rates. As a result, high non-maturity deposit volumes may actually reduce repricing risk and moderate overall IRR. However, significant interest rate or economic changes can rapidly alter customers' non-maturity deposit behavior.

Non-maturity deposit assumptions are crucial components of any interest rate risk measurement system and require careful review and analysis. Those assumptions should be reasonable and well supported.

Off-balance sheet derivatives may introduce complex interest rate risk exposures. Depending on the specific instrument, derivatives may create repricing, basis, yield curve, option, or price risk.

Mortgage banking operations create price risk within the loan pipeline, held-for-sale portfolio, and mortgage servicing rights portfolio. Interest rate changes affect not only current values, but also determine future business volume and related fee income.

Fee income businesses may contain IRR, particularly mortgage banking, trust, credit card servicing, and non-deposit investment sales. Changing interest rates may dramatically affect such activities.

Product pricing strategies may introduce IRR, particularly basis risk or yield curve risk. If funding sources and assets are linked to different market indices, then basis risk exists. If funding sources and assets are linked to similar indices with different maturities, then yield curve risk exists.

Embedded options associated with assets and liabilities, and off-balance sheet derivatives can create interest rate risk. Embedded options include any feature that can alter an instrument's cash flows when interest rates change. Many instruments contain various embedded options, including:

- Non-maturity deposits,
- Callable bonds,
- Structured notes,
- Derivatives,
- Mortgage loans, and
- Mortgage-backed securities (MBS).

Mortgage loans and MBSs contain prepayment options. Borrowers may prepay loan principal at any time, which alters the mortgages' cash flows and creates material interest rate risk considerations.

MANAGEMENT RESPONSIBILITIES

The board of directors must ensure that management effectively identifies, measures, monitors, and controls interest rate risk. The policies, procedures, and systems used to achieve those goals comprise the interest rate risk management program.

Although many methodologies effectively guide interest rate risk management, all programs should address:

- Board and senior management oversight,
- Strategies, risk limits, and controls,
- Risk identification and measurement,
- Monitoring and reporting, and
- Independent review.

The bank's complexity and risk profile should determine its interest rate risk management program's formality and sophistication. Less sophisticated programs may be adequate for banks that maintain basic balance sheet structures, have only moderate exposure to embedded options, and do not employ complex strategies. However, all procedures should be clearly documented and senior management should actively supervise daily operations.

More complex banks will likely need more formal, detailed interest rate risk management programs. In such cases, management should establish specific controls and produce cogent analysis that addresses all major risk exposures. At those banks, internal controls should include a more thorough independent review process for interest rate risk analysis and more rigorous requirements for separation of duties.

Board Oversight

Effective board oversight is the cornerstone of sound risk management. The board must understand the bank's risk exposures and how those risks affect current operations and strategic plans. The board's three primary interest rate risk oversight responsibilities are to:

- Establish strategy and acceptable risk tolerance levels, including policies, risk limits, and management authority and responsibility,
- Monitor interest rate risk to prevent excessive risk exposure, and
- Provide adequate interest rate risk management resources.

The board of directors is responsible for approving the overall policies of the bank with respect to interest rate risk and for ensuring that management takes the steps necessary to identify, measure, monitor, and control these risks. The board or a committee of the board should review market risk information at least quarterly. The information should be timely in nature and in sufficient detail to allow the board to understand and assess the performance of senior management in monitoring and controlling these risks, and to gauge compliance with the board-approved policies. In addition, the board or one of its committees should periodically re-evaluate significant interest rate risk management policies as well as overall business strategies that affect the interest rate risk exposure of the bank.

Senior Management Oversight

Senior management's responsibilities include both long-range and daily interest rate risk management. Senior management should:

- Implement procedures that translate the board's policies into clear operating standards,
- Maintain a measurement system that identifies, measures, and monitors interest rate risk, and
- Establish effective internal controls over interest rate risk measurement, monitoring, and reporting.

Strategies, Risk Limits, and Controls

Effective board and senior management oversight requires reasonable strategies, prudent risk limits, and clear internal controls. Internal controls should address management authority and responsibility, permissible activities, and staffing needs.

Strategies should address all relevant interest rate risk factors, such as capital, earnings, balance sheet structure, economic and interest rate forecasts, and long-term business plans. Management should develop strategies that address the board's policies and risk limits. Those strategies may incorporate off-balance sheet activities, balance sheet structure changes, product pricing guidelines, and other management tactics.

Strategy detail and formality will depend upon the bank's size, complexity, and management expertise. All related activities, including lending, deposits, and investments should be coordinated. Generally, the management committee responsible for interest rate risk should include a representative from each major product area.

Risk limits should establish the board's interest rate risk tolerance by restricting earnings and capital volatility for given interest rate movements. The board should document and approve risk limits that guide management's activities and those limits should be stringent enough to prevent exposures that create safety and soundness concerns.

Limits should reflect the bank's complexity and capital strength. Further, they should relate directly to the internal measurement system's methodology, and should specifically address interest rate risk effects on reported earnings and capital.

Management should maintain exposure within the established limits. Internal controls should ensure that when exposures exceed the risk limits, management promptly reviews the exception and reports it to the board. The board should review all policy and risk limit exceptions. However, effective limits should provide management with the flexibility to respond to changing economic conditions.

Earnings-based risk limits may include volatility restrictions on:

- Net interest margin,
- Net operating income, and
- Net income.

Capital-based risk limits may include volatility restrictions on:

- Economic value of equity and
- Regulatory capital.

Authority and responsibility should be clearly defined by identifying the individuals and/or committees responsible for managing interest rate risk and ensuring that there is adequate separation of duties in key elements of the risk management process to avoid potential conflicts of interest. Banks should have risk measurement, monitoring and control functions with clearly defined duties that are sufficiently independent from position-taking functions of the bank and which report risk exposures directly to senior management and the board of directors. The nature and scope of such safeguards should be in accordance with the size and structure of the bank. They should also be commensurate with the volume and complexity of interest rate risk incurred by the bank and the complexity of its transactions and commitments. Larger or more complex banks should have a designated independent unit responsible for the design and administration of the bank's interest rate risk measurement, monitoring, and control functions.

Permissible activities should identify the strategies and instruments that management can use to control interest rate risk. Policies should specifically describe the instruments and activities that the board authorizes and those that management may not use without prior board approval.

Staffing resources should permit effective interest rate risk management, including:

- Sufficient staff to operate measurement systems, including back-up personnel,
- Appropriate analytic expertise, and
- Adequate training and staff development.

Risk Identification and Measurement

Prudent risk management demands accurate, timely interest rate risk quantification. Although many measurement methods exist, an effective system must clearly identify, quantify, and report the bank's risks.

When evaluating IRR, well-managed banks should consider both earnings and economic value approaches. Reduced earnings, or losses, can harm capital, liquidity, and even marketplace perception. Economic value of equity (EVE) measurements provide longer-term earnings and capital analysis.

Products and activities that are new to the bank should undergo a careful pre-acquisition review to ensure that the bank understands their interest rate risk characteristics and can incorporate them into its risk management process. When analyzing whether or not a product or activity introduces a new element of interest rate risk exposure, the bank should be aware that changes to an instrument's maturity, repricing or repayment terms can materially affect the product's interest rate risk characteristics.

Risk Monitoring and Reporting

Banks should maintain systems that report interest rate risk in an accurate, timely, and informative manner. At least quarterly, senior management and the board should review those reports. However, banks that engage in complex activities or take greater risks should assess IRR more frequently. Interest rate risk reports should contain sufficient detail to permit management and the board to:

- Identify interest rate risk sources and levels,
- Evaluate key assumptions, including interest rate forecasts, deposit behavior, and loan prepayments, and
- Verify compliance with policies and risk limits.

Internal Control and Independent Review

Establishing and maintaining an effective system of controls is critical to the general safe and sound functioning the of bank and the market risk management process in particular. Banks should have adequate internal controls to ensure the integrity of their interest rate risk management process. These internal controls should promote effective and efficient operations, reliable financial reporting, and compliance with institutional policies and relevant regulations. With regard to control policies and procedures, attention should be given to appropriate approval processes, adherence to exposure limits, reconciliations, reporting, reviews, and other mechanisms designed to provide a reasonable assurance that the institution's IRR management objectives are achieved.

An important element of a bank's internal control system over its IRR management process is regular independent evaluation and review. Internal reviews of the IRR measurement system should include assessments of the assumptions, parameters, and methodologies used. Such reviews should seek to understand, test, and document the current measurement process, evaluate the system's accuracy, and recommend solutions to any identified weaknesses. The independent review should adhere to a set of minimum standards, as well as encompass the desirable scope discussed below.

Independent Review Standards

The purpose of the independent review is to ensure that the interest rate risk measurement and management processes are sound. Regardless of whether the review is performed by internal staff or external resources, it is important that these parties be independent of any operational responsibility for the measurement system. They should not have any involvement in either developing the measurement system or performing any of the routine internal control functions such as reconciling data inputs, developing assumptions, or performing variance analysis.

The scope, responsibility, and authority for the independent review should be clearly documented, encompass all material aspects of the measurement process, and be performed annually. The scope of the independent review should generally be defined by the internal audit staff and approved by the audit committee. However, subject to board approval, it is acceptable for another department of the bank, separate from the group that measures interest rate risk, to define, perform, and document the independent review. The following minimum standards apply to all institutions' review processes:

- **Independence** – Parties performing the independent review should not be involved in the interest rate risk measurement process. Institutions may use internal staff, an outsourcing arrangement, or a combination of the two, to independently appraise the measurement system. Management may find that the internal audit department, or other staff independent of the measurement system, has the knowledge and skills to perform certain aspects of the review while using external resources for other areas. When the assessment of the measurement system is outsourced, senior management and the board should assure that the procedures used meet the same standards required of an internal review.

- **Skills and Knowledge** – Senior management must ensure that individuals performing the independent review have the requisite knowledge and skills to competently assess the measurement system and its control environment.

- **Transparency** – The procedures used in the independent review of the measurement system should be clearly documented and work papers should be available to management, auditors, or examiners for review. Senior management should ensure that they have access to work papers even when external sources perform the review.

- **Communication of Results –** Procedures should be established for reporting independent review findings on an annual basis to the board or board-delegated committee for discussion and approval.

Scope of Independent Review

The independent review serves as a means to independently assess the adequacy of bank's measurement system. The level and depth of independent review performed by an institution should be commensurate with the bank's activities. More complex institutions should have a more rigorous independent review process than less complex institutions. Smaller, less complex institutions may rely upon less formal review. At a minimum each institution should have procedures in place to independently review the input process, the assumptions, and the system output reports.

System-input process review should evaluate the adequacy and appropriateness of the following:

- The level of knowledge and skill of the individuals responsible for the measurement system,
- The reconciliation of the measurement system's data to the bank's general ledger,
- The rules and methods of account aggregation used in the measurement system,
- The accurate capture of contractual terms within the measurement system, and
- The source, completeness, accuracy, and procedures for external data feeds.

Assumption reviews should address the following issues:

- The process of developing assumptions for all material asset, liability and off balance sheet exposures.
- The process for reviewing and approving key assumptions,
- The periodic review of assumptions for relevance, applicability, and reasonableness, and
- The completeness of assumption analysis and its supporting documentation.

System output and reporting assessments should include coverage of the following**:**

- The inclusion of a sufficiently broad range of potential rate scenarios,
- The accuracy of the IRR measurement, the assurance that all material exposures are captured,
- The timeliness and frequency of reporting to management and the board,
- The compliance with operating policies and approved risk limits, and
- The performance and documentation of variance analyses.

Theoretical and Mathematical Validation

The level of calculation validation depends on the complexity of an institution's activities. The complexity of many measurement systems demands specialized knowledge and skills to be able to verify the mathematical equations. Many vendors will provide clients with a certification that their measurement system calculations have been validated. Institutions relying on this method should obtain verification/certifications each time a new version of the measurement system is employed by the bank. Vendor independent reviews should meet the same minimum standards that apply to bank independent reviews.

Some vendors may be unwilling to fully share underlying calculations or code with clients. In this case it is expected that management will have compensating controls in place to reasonably assure that the measurement systems are performing accurate calculations. One method of doing so is to run parallel measurement systems using different software and compare the results of the two systems for any significant differences.

IRR MEASUREMENT METHODS

Interest rate risk measurement systems can range from simple gap measurement systems to more sophisticated programs that include stochastic modeling of data. Despite the variety in measurement systems, all systems require verifiable account data, rely heavily on assumptions, and lose precision when analyzing complex instruments or volatile markets. In general, but depending on the complexity and range of activities of the individual bank, banks should have interest rate risk measurement systems that assess the effects of rate changes on both earnings and economic value. These systems should provide meaningful measures of a bank's current levels of interest rate risk exposure, and should be capable of identifying any excessive exposures that might arise. Measurement systems should:

- Assess all material interest rate risk associated with a bank's assets, liabilities, and off balance sheet positions,
- Utilize generally accepted financial concepts and risk measurement techniques, and
- Have well-documented assumptions and parameters.

Regardless of the measurement system, its usefulness depends on the validity of the underlying assumptions and the accuracy of the basic methodologies used to model IRR exposure. In designing interest rate risk measurement systems, banks should ensure that the degree of detail about the nature of their interest sensitive positions is commensurate with the complexity and risk inherent in those positions. Most important, measurement systems are only a forecasting tool and can not flawlessly predict cash flows, earnings, or capital.

Measurement System Approaches

Interest rate risk measurement systems use an earnings approach, an economic value approach, or a blend of those two approaches.

The earnings approach focuses on risks to reported earnings, usually over a shorter-term time horizon. Typically, earnings systems estimate risk for up to two years. In addition, estimating future earnings permits regulatory capital forecasts.

The earnings approach traditionally focuses on net interest income. However, many systems now incorporate components that measure the price risk from instruments accounted for at market value or lower-of-cost or market value. Those systems estimate gains and losses from assets that include loans held for sale, trading portfolios, and mortgage servicing rights. Maturity gap analysis and simulation models are examples of earnings approaches to IRR measurement.

The economic value approach estimates the bank's economic value of equity for forecasted interest rate changes. EVE represents the net present value of all asset, liability, and off-balance sheet cash flows. Interest rate movements change the present values of those cash flows. This method assumes that all financial instruments will be held until final payout or maturity. The economic value approach might provide a broader scope than the earnings approach, since it captures all anticipated cash flows.

The economic value approach best suits banks that mark most instruments to market. At banks that value most instruments at historical cost, economic value measurements can also effectively estimate interest rate risk. However, in those banks, EVE changes might be recognized over a longer time frame (through reported earnings).

As a result, banks often blend the two approaches. Management may use an earnings approach to evaluate short-term performance and an economic approach to monitor the bank's long-term viability. Despite using different methodologies, the two approaches generally should provide a consistent view of interest rate risk exposures.

Gap Analysis

Gap systems use an accrual approach to identify risk to net interest income. Typically, gap systems identify maturity and repricing mismatches between assets, liabilities, and off-balance sheet instruments. Gap schedules segregate rate-sensitive assets, rate-sensitive liabilities, and off-balance sheet instruments according to their repricing characteristics. Then, the analysis summarizes the repricing mismatches for each defined time horizon. Additional calculations convert that mismatch into risk to net interest income. Gap analysis may identify periodic, cumulative, or average mismatches.

The most common gap ratio formula is:

$$\frac{\text{Rate-Sensitive Assets } {}^{\textit{minus}} \text{ Rate-Sensitive Liabilities}}{\text{Average Earning Assets}}$$

Occasionally, average assets or total assets may be used in place of average earning assets. However, those denominators can underestimate interest rate risk.

The gap ratio can and should be used to calculate the potential impact on interest income for a given rate change. This is done by multiplying the gap ratio by the assumed rate change. The result estimates the change to the net interest margin.

For example, a bank has a 15% one-year average gap. If rates decline 2%, then the net interest margin will decline by 30 basis points (15% x .02). This estimate assumes a static balance sheet and an immediate, sustained interest rate shift.

Gap analysis has several advantages. Specifically, it:

- Does not require sophisticated technology.
- May be relatively simple to develop and use.
- Can provide clear, easily interpreted results.

However, gap's weaknesses often overshadow its strengths, particularly for larger, more complex banks. For example, gap analysis:

- Generally captures only repricing risk.
- May not identify intra-period repricing risk.
- Does not measure EVE.
- Generally can not analyze complex instruments.

Some gap systems attempt to capture basis, yield curve, and option risk. Multiple schedules (dynamic or scenario gap analysis) can show effects from nonparallel yield curve shifts. Additionally, sensitivity factors may be applied to account categories. Those factors assume that coupon rates will change by a certain percentage for a given change in a market index. That market index is designated as the driver rate (sophisticated systems may use multiple driver rates). Those sensitivity percentages, also called beta factors, may dramatically change the results.

Banks often use sensitivity factors to refine non-maturity deposit analysis. For example, management may determine that its MMDA cost of funds will increase 25 basis points whenever the six-month Treasury bill rate increases by one percent. Thus, management might consider only 25% of MMDA balances rate-sensitive for gap analysis. Management may expand its analysis by preparing gap schedules that assume different market rate movements and changing customer behaviors.

Gap analysis may provide sufficient interest rate risk measurements for some banks. However, gap analysis may be ineffective for banks with complex structures, sophisticated activities, or significant exposures to embedded options.

Simulation Analysis

Simulation analysis determines the effect of interest rate changes on short-term net interest income, net income, and, in some cases, EVE. Simulation models generate results for a range of possible interest rate scenarios and exposures.

Banks may vary simulation rate scenarios based on factors such as pricing strategies, balance sheet composition, and hedging activities. Simulation may also measure risk presented by non-parallel yield curve shifts. Any simulation system's accuracy, though, depends on the assumptions and data used. Inaccurate data or unreasonable assumptions render simulation results meaningless. Simulation models are often not "user friendly" and may require more data and expertise than other interest rate risk measurement systems.

Simulation systems vary greatly, both in methodology and sophistication. Some systems focus on short-term earnings, some concentrate on EVE, and others blend those views. Despite those differences, most simulation systems share two characteristics: They require advanced information systems and technical expertise.

Duration Analysis

Duration is a measure of the percentage change in the economic value of a position that will occur given a small change in the level of interest rates. It reflects the timing and size of cash flows that occur before the instrument's contractual maturity.

Macaulay duration, duration's simplest form, calculates the weighted average term to maturity of a security's cash flows. Duration, stated in months or years, always:

- Declines as time elapses,
- Equals less than maturity for instruments with payments prior to maturity,
- Equals maturity for zero-coupon instruments,
- Is lower for instruments with higher coupons., and
- Is lower for amortizing instruments.

An example of a Macaulay duration calculation can be found in the glossary for this section of the manual.

Modified duration, calculated from Macaulay duration, estimates price sensitivity for small interest rate changes. An instrument's modified duration represents its percentage price change given a small change in the level of interest rates. Thus, it serves as a proxy interest rate risk measure.

However, modified duration assumes that interest rate shifts will not change an instrument's cash flows. As a result, it does not estimate price sensitivity for instruments with embedded options (for example, callable bonds or mortgages) with an acceptable level of precision. Banks with significant option risk should not rely upon modified duration alone to measure interest rate risk.

An example of a modified duration calculation can be found in the glossary section.

Effective duration estimates price sensitivity more accurately than modified duration for instruments with embedded options and is calculated using valuation models that contain option pricing components. First, the user must determine the instrument's current value. Next, the valuation model assumes an interest rate change (usually 100 basis points) and estimates the new instrument's value, based on that assumption. The percentage change between the current and forecasted values represents the instrument's effective duration.

All duration measures assume a linear price/yield relationship. However, that relationship actually is curvilinear. Therefore, duration may only accurately estimate price sensitivity for rather small (up to 100 basis point) interest rate changes. Convexity-adjusted duration should be used to more accurately estimate price sensitivity for larger interest rate changes (over 100 basis points). An illustration and further discussion of convexity can be found in the glossary section.

EVE may be calculated using duration. For example, assume that a bank has rate sensitive assets (RSA) valued at $10,000 with a duration of 4 years and rate sensitive liabilities (RSL) valued at $9,000 with a duration of 4 years. For a 1% interest rate change, the following will occur:

- RSA value changes $400 ($10,000 x 4 x 1%),
- RSL value changes $360 ($9,000 x 4 x 1%), and
- EVE changes by $40 ($400 - $360).

Despite matching the duration of assets and liabilities, the bank's EVE changes by four percent when rates change by one percent. This results from the dollar duration gap created by the difference between RSA and RSL volume. Thus, banks that use duration to manage interest rate risk should match dollar weighted asset and liability durations, not raw duration.

Duration analysis provides significant advantages over gap analysis. Duration analysis yields a single interest rate risk number and considers all expected cash flows. Thus, duration generates a more comprehensive interest rate risk measurement. Duration analysis can provide more accuracy than maturity gap analysis for measuring and managing IRR.

Despite those advantages, duration analysis contains some significant weaknesses. Accurate duration calculations demand sophisticated accounting and information systems. Further, duration accurately measures value changes for only relatively small interest rate fluctuations. Therefore, banks must frequently update duration measures during volatile interest rate environments.

IRR MEASUREMENT SYSTEM REVIEW

Well-run insured depository institutions should have an interest rate risk measurement system appropriate to the composition of the bank's balance sheet and risk profile. The measurement system should capture all material sources of interest rate risk, and be capable of generating meaningful reports for senior management and the board of directors. Bank management should ensure that risk is measured over a probable range of potential interest rate changes, including meaningful stress situations. Further, the measurement system must be subject to appropriate internal controls and periodic independent review. The bank's IRR measurement process should be well documented and administered by individuals with sufficient technical knowledge.

A bank's interest rate risk measurement system is an indispensable facet of its risk management process. Examiners rely heavily upon the output of banks' interest rate risk measurement systems in assessing sensitivity to market risk. Accordingly, the seamless operation of such systems is critical and a review of their operation is a crucial element of the examination process. The review process should address the following items:

- Capabilities of the measurement system,
- Adequacy of system inputs,
- Reasonableness of material assumptions,
- Usefulness of system output/reports, and
- Adequacy of periodic variance analysis.

System Capabilities

The interest rate risk measurement system must capture and reliably estimate the bank's material risk exposures. Therefore, the system should consider all significant risk factors. For example, if the bank has material holdings of mortgage loans or mortgage-backed securities, then the system should incorporate prepayment projections.

Management should fully understand the measurement system, including its:

- Capabilities,
- Limitations,
- Quantitative methodology, and

- Assumptions.

System documentation should provide complete information regarding the above factors. Both purchased and internally developed systems should be supported by complete documentation. Management should be familiar with and retain all system documentation. If the system fails to adequately capture significant risks or relies on unsupported methodology, then management should correct the deficiencies in order to produce reliable interest rate risk measurements.

Many computer-based interest rate risk measurement systems are used for other management information system operations, such as strategic planning, earnings forecasts, and generation of public disclosures. The review of such measurement systems may require an analysis of the system as an aspect of the information technology (IT) component of the examination. IT topics which may need to be reviewed during the measurement system examination and coordinated with the information technology examiner include: system acquisition and development; testing and validation; system security; serviced applications; and system operation. In addition, vendor systems often require additional components (for example, an option pricing module) or periodic updates. Without the needed components, the system may not calculate accurate results. Examiners should verify that the system contains the components and updates needed to generate accurate measurements. Refer to the Federal Financial Institution Examination Council (FFIEC) IT Examination Handbooks for guidance relating to information technology review.

Adequacy of Measurement System Inputs

The system's objective data should reflect the bank's current condition. Examination of the system's inputs should focus on the process for inputting and reconciling the measurement system data, categorizing and aggregating account data, ensuring the completeness of account data, and assessing the effectiveness of internal controls and the independent review processes.

The bank's internal control process must be comprehensive enough to ensure that data inputs are accurate and complete prior to running the measurement system and generating management reports. The bank may input data into the system either manually or by using electronic data extract programs, or a combination of these approaches. Internal control procedures should be established to ensure that measurement system inputs agree with the general ledger balances and that contractual terms are accurately captured. Institutions can verify the system inputs by either having experienced personnel review them and reconcile the balances to the general ledger or by using automated software that can identify and report exception items.

In addition to capturing account balances, institutions with complex balance sheets also need to employ measurement systems that can adequately address the embedded market risk of all material on- and off-balance sheet activity. Most measurement systems allow for the following contractual terms to be entered:

- Current balance,
- Contractual principal and interest payment amounts and payment frequency,
- Contractual coupon rates (including repricing frequency),
- Contractual caps and floors,
- Contractual maturity, and
- Contractual optionality (such as securities or borrowing calls).

Account aggregation is the process of grouping together, either at the customer or sub-ledger level, accounts of similar types and cash flow characteristics. This is an important component of the data input process. Very few modeling systems have the capacity to model customer behavior at the individual account level. While not as precise as entering each individual customer account into the measurement system, account aggregation improves the measurement system's efficiencies. Typically, loans of similar rate, maturity, and type (e.g., 6%, 30-year, residential loans) are aggregated. Grouping 6%, 30-year residential loans together may be appropriate, but grouping together 6% fixed rate loans with 6% variables is not.

The degree of account aggregation will vary from one institution to another and depends on the measurement system used and the degree of precision an institution desires. Analysis should include both contractual and behavioral characteristics when determining cash flow patterns. The process of determining which accounts will be combined should be transparent, documented, and periodically reviewed. Further, requests for changes to existing groupings or for new account aggregations should be formalized and documented. Institutions should maintain documentation (similar to a chart of accounts) disclosing the characteristics of the assets, liabilities, and off-balance sheet products that the account aggregation represents.

Assumptions

Assessing the reasonableness of assumptions is a critical component of an interest rate risk measurement system review. Unreasonable assumptions render even the most complex interest rate risk measurement system ineffective. It is important that assumptions reflect management's ability to change rates, customer behaviors, and current local and macro-economic factors. Assumptions are typically derived using a combination of internal analysis and external sources. All material assumptions, regardless of the source, should be supported with analysis and documentation.

Assumptions are used to capture the following key parameters or characteristics:

- Potential or projected interest rate movements,
- Driver rate relationships,
- Non-maturity deposit (NMD) rate sensitivity, and
- Customer behaviors.

It is imperative that material assumptions be updated regularly to reflect the current market and operating environment. Further, the process for developing material assumptions should be formalized and periodically assessed (at least annually for critical assumptions). This periodic assessment of the processes and sources used to generate assumptions may prompt management to reevaluate its assumptions in order to better reflect current strategies or customer behaviors. For example, the beta factor for Money Market Deposit Accounts (MMDA) may need to change because of customers' altered perceptions on the outlook of alternative investment options.

Projected interest rate assumptions are an important component of measuring interest rate risk and may be generated by internal analysis or external sources. Internal interest rate forecasts may be derived from implied forward yield curves, economic analysis, or historical regressions. Management should have documentation of the market interest rate assumptions available for examiner review. Most institutions perform scenario analysis using "deterministic" interest rate yield curves. With the deterministic method, all interest rate scenarios are set by the user: that is, management selects which potential interest rate changes to simulate in the model. The deterministic method differs from the more complex and sophisticated "stochastic" method where multiple scenarios are generated using random path variables. (Further discussion of deterministic and stochastic methods may be found in the glossary for this section of the manual.)

Institutions with material levels of complex instruments or significant repricing mismatches should measure their risk using several yield curve scenarios, including nonparallel yield curve shifts. This enables the institution to identify its level of vulnerability to significantly flatter or steeper yield curves. Institutions that have financial instruments indexed to different or multiple yield curves must evaluate the different yield curves used. For instance, institutions with instruments tied to the Cost of Funds Index (COFI) or the London Interbank Offered Rate (LIBOR) must consider corresponding yield curves in scenario projections. Rate sensitive non-interest income earnings streams such as mortgage banking activities should also be measured under various rate scenarios.

These analyses should be performed using the base case interest rate scenario, as well as low probability rate scenarios, so that management can better estimate the impact to earnings and capital levels from stressed interest rate scenarios. The base case interest rate scenario should be consistent with other forecasts used throughout the bank's planning process. Further, interest rate scenarios modeled should remain reasonably consistent across reporting periods. Any changes in the source of interest rate forecasts between the reporting periods should be justified and documented. While similar to the budgeting process, IRR scenario analysis differs from it by measuring the potential impact of low probability events where the budget process uses management's expected or most likely rate scenario.

Driver rates are used extensively in most income simulation and EVE models. They capture the relationship between the primary market interest rates, or driver rates, and the pricing of bank products within the measurement system. While in practice there may be no direct connection between the bank's rate and the driver rate, the driver is chosen to act as proxy for management's reaction in response to market changes. This frees the bank from the need to explicitly set rates for each loan or deposit type for each projected scenario. In most cases, the bank's rate is set to move at some fraction of the driver rate, often referred to as a spread or beta factor. For example, management might specify that the rate paid on MMDAs will increase 25 basis points when the one-year Treasury bill yield increases 100 basis points. By designating these spread relationships, pricing on all products linked to that driver rate will change to reflect the relationship built into the model by management. More complex systems will use a variety of driver rates, tailored to different products. While most systems maintain static rate relationships, more sophisticated systems can alter the relationships for different interest rate environments.

Spread assumptions should be based on an analysis of the relationship between the product (e.g., MMDA) and the driver rate (e.g., Federal funds rate). Correlation analysis can be performed to quantify the historical relationship between the product and driver rates. This analysis also may be used to determine the level of basis risk when instruments are tied to different indices. For instance, if an institution enters into a leveraging strategy that is funded by borrowings tied to LIBOR and invests in U.S. Treasury securities, a correlation analysis can be performed to determine how closely these rates move together. Less correlated instruments present greater basis risk.

Non-maturity deposit (NMD) rate sensitivity is one of the most difficult and critical assumptions that bank management makes when measuring interest rate risk. The potential reactions of both management and customers are important and need to be taken into account. Just as customers have control over the level and location of their deposit accounts, management has broad control over the rates paid on these accounts. In setting rates, management must take into account a wide array of factors, including local and national competition, the bank's potential funding needs, and the relative costs of alternative funding sources. The rate movement assumptions modeled for NMDs should reflect both aspects of this relationship: management's control over rates and customers' control over their funds. Consideration should be given not only to historical correlation analysis, but also to management's intentions regarding future movements. More sophisticated systems allow for different reactions for increasing versus decreasing rates.

Customer behavior assumptions are important elements to the measurement of optionality exposure and typically have significant impacts on both sides of the balance sheet. For example, prepayment or extension risk on loans and mortgage-related securities, non-maturity deposit decay rates, and product growth are highly influenced by the direction of interest rates. Therefore, it is critical that customer behavior assumptions be reasonable and reflect each interest rate scenario measured. For example, loan prepayment assumptions should vary with the interest rate scenarios measured, such that an increasing rate environment should typically reflect lower prepayments than a declining interest rate environment.

Other market factors that influence customer behaviors include geographic location, local competition, type and sophistication of clientele (retail versus commercial customers). Behavioral assumptions may be derived from internal analysis or external sources. For instance, banks may use dealer median mortgage prepayment assumptions, when appropriate, or determine their own prepayment assumptions based on their unique portfolio characteristics.

Documentation and support of all significant assumptions, including projected rates, spreads, customer behavior, and NMD rates should be maintained and be available for examiner review. Many vendor-supported or outsourced measurement systems have only limited ability to change model assumptions, in which case documentation may be limited. Even in those cases, an analysis of the applicability of the embedded assumptions to the subject bank should be performed and maintained. More complex systems entail a vast array of assumptions, and thorough documentation of every one cannot be realistically expected. However, management should be familiar with those assumptions that represent the most sensitive aspects of the institution or model, and place the greatest emphasis on supporting and documenting them.

Model-Sensitivity Analysis

Bank management should periodically analyze the sensitivity of the model's significant assumptions. When management includes assumptions based on strategic initiatives, it is imperative that they assess the impact of not meeting projections. For instance, an institution planning to increase commercial lending by 10% using core deposit growth should assess the impact of falling short of the projected level of core deposits and having to obtain higher cost funding. The bank should, for example, measure other scenarios such as low or no growth of core deposits in order to develop an understanding of the bank's exposure to interest rate risk if projections are not achieved. Similar scenarios should be developed for alternative loan growth rates. This example again illustrates the distinction between the budgeting process and interest rate risk measurement. The budget process forecasts earnings and balance sheet changes based on most likely scenarios, while interest rate risk measurement analyzes potential exposure to low probability events.

System Management Reports

Many asset liability management systems offer an array of summary reports (such as a chart of accounts and account attribute reports) that aid management in the review of measurement system assumptions. These reports may also provide information regarding the contractual terms and parameters that have been entered into the system for various account types and financial instruments.

Many measurement systems are capable of providing summary reports detailing key model assumptions. Examiners should review a copy of these reports when analyzing a measurement system. If an institution is unable to provide assumption summaries, examiners should determine whether the absence of the report is due to measurement system limitations or bank personnel's lack of familiarity with system capabilities. Typically, measurement system user manuals will provide a list of reports that may be generated by the system.

Assumption summary reports are an important tool that management and examiners can use to ensure that assumptions have been entered into the measurement system properly. These reports can also be useful to examiners when management does not maintain adequate and separate documentation of assumptions. For example, a comparison of current assumptions can be made by reviewing historical assumption reports.

To ensure proper controls regarding significant changes to measurement system assumptions, an institution should have formalized procedures for reviewing the reasonableness of measurement system assumptions and policies that control when changes to significant assumptions are permitted.

Measurement System Results

Once both basic data and assumptions have been input, the measurement system performs calculations based on mathematical relationships and equations embedded in the system. These calculations measure the interest rate risk in the bank's assets, liabilities and off-balance sheet positions. The measurement system should generate summary reports that highlight the bank's sensitivity to changes in market interest rates given various interest rate scenarios. These reports typically indicate the change in net income or net interest income and/or economic value of equity. Some systems may provide a gap report highlighting asset/liability mismatches over various time horizons. More detailed reports may be available on some systems that can be used to test the reasonableness, consistency, and accuracy of the output. They may also assist the examiner in identifying or verifying the system's underlying assumptions. Comparative reports identifying sources of interest rate risk may also be available.

Management should have formalized procedures in place for reviewing the measurement system results and reporting to the board or a board-delegated committee. Reports provided to the board and senior management should be clear, concise, timely, and informative in order to assist the board and senior management in decision making. The results of the measurement system should also highlight deviations from board-approved interest rate risk exposure limits. Examiners should review the follow-up action and communication, if any, relevant to any material breaches in board-approved limits. Examiners may also find it helpful to review the presentations or analyses provided to senior management or board members in advance of a formal asset/liability committee (ALCO) meeting, as well as the minutes of such meetings.

VARIANCE ANALYSIS

Variance analysis can provide valuable insights into the accuracy and reasonableness of the model and is an integral part of the control process for IRR measurement and management. It is intended to help develop an understanding of the primary causes of the material variances, while also providing a means to improve the precision of the interest rate risk measurement system. Periodic variance analysis helps assure management and the board that the system is accomplishing its primary goal of providing meaningful information on the level of interest rate risk, present and planned. It also helps to validate the implementation of the IRR monitoring and measurement system at a particular institution. While a particular model may be mathematically valid and in use at numerous banks, a flawed implementation can subvert its usefulness. Variance analysis provides an opportunity to validate the implementation, as well as to providing an opportunity for a deeper understanding of both the system and its results.

IRR model variance analysis involves the identification of material differences between actual and forecasted income statement and balance sheet amounts, and then ascertaining the causes for these differences. Variances can be readily identified by direct comparison of the financial statements for a particular forecast period, or by using key financial indicators, such as Net Interest Margin, Cost of Funds, or Asset Yields comparisons.

In order to provide effective control and feedback, variance analysis should be done periodically, and no less frequently than annually. Further, management should document the analysis, highlighting the material variances and the primary causes for them, and summarize any action proposed and/or taken based on that analysis.

The potential causes for variances can be broken down into three major components–mathematics, data, or assumptions. Mathematical flaws, while relatively rare in widely available purchased systems, can occur and are generally within the purview of the independent review process, not the ongoing variance analysis. Data errors should be minimized by a robust internal control process. This will assure that the starting point for the measurement system accurately reflects all material holdings, terms, and conditions. Inaccuracies in the initial data, either in terms of dollar volumes, maturities, embedded options, or associated interest rates, can only lead to flawed results.

Assumption variances

All IRR measurement systems rely heavily on a series of assumptions and assessing the reasonableness of these assumptions is critical to ensuring the integrity of the measurement system results. Just as actual financial results can be expected to vary from forecasts, the assumptions that form the basis of that forecast can be expected to vary. Institutions should have formalized procedures for periodically identifying material difference between assumed and realized values, in order to identify the key drivers of the variance, over the time period measured. Even absent material financial variances, the model's significant assumptions should be compared to actual performance. Compensating differences may have masked important variances. For example an institution with a large mortgage portfolio may find that actual prepayment speeds were significantly higher than projected, while new loan production has replaced the run-off. In this case, there may only be an immaterial variance in the ending loan balance, but a significant variance in projected and actual prepayments. Left undetected, a repeat of such an error could lead to inaccurate modeling and inappropriate management actions.

Given the large number of assumptions inherent in all but the simplest measurement systems, a thorough review of every assumption at each measurement cycle is an unrealistic expectation. However, certain key sets of assumptions should be checked against actual behavior on a regular basis. Key assumptions that bear particular attention include those dealing with rate movements, driver rates, prepayment speeds, and account aggregation.

Interest rate movement assumptions are arguably the most obvious and common sources of variances in a measurement system. While many systems assume an instantaneous and parallel shift in interest rates, others allow for much more complex and realistic changes. Common modeling scenarios include ramped rate changes, yield curve twists, and different spread or beta factors for the up versus down rate changes. Actual yield curve changes that closely mirror those modeled are rare and not expected. Variance analysis should be used to isolate the differences attributable to rate assumptions from other factors in order to better identify and understand how those factors' influenced results for that measurement period.

Driver rate variances will occur when actual bank rate changes do not mirror the driver rate changes. Variance analysis is used to determine the significance of the difference, and should address whether it is due to lack of correlation between the subject and driver rate (i.e.; the driver moved, but the bank rate did not), or due to an inappropriate beta factor. One driver-rate assumption that commonly causes significant variances is associated with NMD rate assumptions. If the measurement system forecasted an increasing net interest margin in a rising rate environment, while the actual performance resulted in a declining margin when rates rose, the cause is generally the NMD assumptions. Many models treat NMD rates as very insensitive to yield curve changes, when actual practice is to manage these rates much more actively. This can lead to model measurements that show the bank as asset sensitive or neutral, when past performance has shown it to be liability sensitive. Periodic variance analysis will identify this discrepancy and allow management to more effectively use the IRR measurement tool. Ideally, the relationship between the subject and driver rates should be documented, and the relationship should factor in not only historical correlations but also management's intention with regard to future movements.

Prepayment speeds can be and are affected by interest rates, loan size, geographic area, credit score, and fixed versus variable rates, to name only a few factors. Larger institutions actively track internal prepayment data, while smaller institutions can obtain prepayment statistics from a wide variety of sources. Banks typically choose a readily available market proxy for an aggregated portion of their own portfolio when modeling IRR. Proper aggregation and proxy selection are key to appropriate prepayment modeling. Prepayment variance analysis will assist in ascertaining whether differences between actual and forecast results are due to the proxy's actual prepayment speeds differing from the forecast or due to the subject bank's prepayment speeds differing from the proxy's. When the proxy speed forecasts appear accurate, but bank prepayments differ significantly, management may need to select a different proxy instrument or otherwise adjust the model to better reflect the portfolio's characteristics.

Aggregation rules which are inappropriate can lead to significant variances. The larger or more varied the portfolio, the more significant the aggregation rules become, and the more likely that finer gradations can and should be used. In very large portfolios, geographic breakdowns (e.g., California versus Iowa mortgages) might be necessary for reasonably accurate modeling. Aggregation rules apply to deposit assumptions as well. CDs of different rates and maturities may react differently to changing rates. Likewise, MMDA balances should not be aggregated with jumbo savings accounts.

Many models measure static IRR, that is, what would happen to the current balance sheet if only interest rates changed. Others incorporate management projections about asset and liability growth and changes in product mix. Variance analysis in the latter instance is complicated by the need to segregate variances due to balance sheet changes from those caused by rate movements and correlations factors.

OTHER MARKET RISK FACTORS

Although interest rate risk is the principal market risk taken by most banks, other activities can dramatically increase (or reduce) a bank's exposure and sensitivity to market risk exposure.

Foreign exchange activities expose banks to the price (exchange rate) risk that results from volatile currency markets. Exchange rates depend upon a variety of global and local factors that are difficult to predict, including interest rates, economic performance, and political developments.

Commodity activities involve using contracts (including futures and options) for fungible, bulk goods, to speculate or hedge. Commodity prices depend upon many factors, including weather, economic conditions, and political developments that are exceptionally difficult to forecast.

Generally, banks should only use foreign exchange or commodity activities to control specific market risks. Management, independent of the broker/dealer, should demonstrate expertise commensurate with the activities undertaken. In addition, management should produce documented analysis that clearly details the effectiveness of all foreign exchange and commodity activities. That analysis should be prepared at least quarterly and presented to the board for its review.

Equity trading and investing creates market risk exposure, since changes in equity prices can adversely affect earnings and capital. The board and management have a responsibility to identify, measure, monitor, and control trading activity risks. Management should carefully monitor all equity investments, regularly evaluate the resulting market risk exposure, and provide timely reports to the board.

Certain restrictions on this activity are contained in Part 362 of the FDIC Rules and Regulations, “Activities and Investments of Insured State Banks” which implements Section 24 of the Federal Deposit Insurance Act (FDI Act). Section 24 prohibits an insured state bank from directly, or indirectly, acquiring or retaining any equity investment of a type that is not permissible for a national bank. National banks are generally prohibited from owning equity securities and, by extension, insured state banks are also enjoined from this activity. However, there are three exceptions to the referenced section 24 prohibition. One of these exceptions enables certain insured state banks (grandfathered banks) to retain and continue to invest in common or preferred stock, or shares of investment companies. The FDIC has extended this exception by regulation to enable banks having the grandfathered authority to hold the subject investments through majority-owned subsidiaries provided the bank is well-capitalized.

Foreign exchange, commodities, and equity trading require a high level of technical and managerial expertise. The risk management and measurement systems needed to operate them effectively are likewise highly sophisticated and require rigorous monitoring and testing. Foreign exchange, commodity, or equity speculation, absent the necessary controls and sufficient capital may be considered an unsafe and unsound practice. When necessary, contact the designated Capital Markets and Securities Specialist in your region for additional guidance.

EVALUATION OF A BANK’S SENSITIVITY TO MARKET RISK FACTOR

When evaluating the bank’s market risk, examiners must consider both qualitative and quantitative factors. While taking into consideration the institution’s size and the nature and complexity of its activities, the assessment should focus on the risk management process, especially management’s ability to measure, monitor, and control market risk. In addition to adequate systems and controls, examiners should evaluate the potential for market risk to adversely affect earnings and capital. Consideration should also be given to the trend in the institution’s recent risk measurements, the overall accuracy of the available measurements, and the presence of items with particularly volatile or uncertain interest rate sensitivity.

RATING THE SENSITIVITY TO MARKET RISK FACTOR

Changes in interest rates expose banks to the risk of loss, which may, in extreme cases, threaten the survival of the institution. The sensitivity to market risk component rates the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or economic capital. The S rating reflects the market risk taken, management's ability to identify, measure, monitor, and control that risk, and the financial protection provided by earnings and capital. After evaluating all of the relevant factors, one of the five following S ratings should be assigned, in accordance with Uniform Financial Institutions Rating System definitions.

Banks rated 1 have well controlled market risk and there is minimal potential that the earnings performance or capital position will be adversely affected. Risk management practices are strong for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide substantial support for the degree of market risk taken by the institution.

Banks rated 2 have adequately controlled market risk and there is only moderate potential that the earnings performance or capital position will be adversely affected. Risk management practices are satisfactory for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide adequate support for the degree of market risk taken by the institution.

Banks rated 3 need to improve market risk control or there is significant potential that the earnings performance or capital position will be adversely affected. Risk management practices need to be improved given the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital may not adequately support the degree of market risk taken by the institution.

Banks rated 4 have unacceptable market risk control or there is high potential that the earnings performance or capital position will be adversely affected. Risk management practices are deficient for the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital provide inadequate support for the degree of market risk taken by the institution.

Banks rated 5 have unacceptable control of market risk or the level of market risk taken by the institution is an imminent threat to its viability. Risk management practices are wholly inadequate for the size, sophistication, and level of market risk accepted by the institution.

MARKET RISK GLOSSARY

Deterministic Rate Scenarios

A method where the user specifies all future interest rate levels completely at their discretion. The following are examples of commonly used deterministic interest rate scenarios:

Rate Shock Scenario – In this scenario, the rate shock is immediate and sustained. For instance in a plus 300 basis point scenario the full effect of the rate increase would be administered immediately and remain for all time periods measured.

Rate Ramp Scenario – In this scenario, the rate movements are gradual and applied over the time period measured. For example, when measuring a 300 basis point rate increase during a 12-month period, the rate increase could be 25 basis point interest rate increases administered each month.

Stair Step Scenario – Rate shocks are administered at more infrequent time intervals over the measured period but each increment is sustained and of equal amounts. For instance, in a 300 basis point increasing rate environment measured over a one-year time period, rates may be incrementally increased 75 basis points once every quarter as opposed to monthly rate ramps.

Non-parallel yield curve shifts are set by bank management at different reflection points on the yield curve during the period measured. Again these may be performed as a rate shock, rate ramp, or stair step scenarios.

Stochastic Models

Stochastic modeling consists of the modeling of an uncertain variable over time. It recognizes that market variables, such as interest rates, exhibit a general trend (drift) and some degree of volatility around that trend. Stochastic models provide a framework for the evaluation of the impact of embedded options in financial instruments.

In the general context, constraints are usually imposed so that the model is representative of current market conditions. For example, if Treasury securities are priced using interest rate paths, a constraint may be imposed, so that, the average present value derived from all the paths, must equal the observed market price of the Treasury securities. In such a case, the model can also be classified as a Stochastic No Arbitrage Model.

Stochastic models require more sophisticated software and significant additional computer processing power as well.

Monte Carlo Simulation

A Monte Carlo simulation randomly generates a sufficiently large sample set from a reasonable population of a variable such as an interest rate. The stochastic model provides a framework for the evolution of the variable, and a Monte Carlo simulation is an application of that stochastic model. The randomness in games of chance is similar to how Monte Carlo simulation selects values at random to simulate a model. When you turn a roulette wheel, you know that one of a range of numbers will come up, but you do not know which for any particular turn. It is the same concept with Monte Carlo simulation where the variables (e.g., interest rates, security prices) have a known range of values but an uncertain value for any particular time. Monte Carlo simulations can take into account returns, volatility, correlations, and other factors. Monte Carlo programs generate thousands or millions of different scenarios by randomly changing a component for each run or iteration. Monte Carlo simulation allows the banker to simulate thousands of market-like scenarios and learn the probability of a particular outcome or a range of outcomes. Assume that the investment portfolio is run through 20,000 simulations, projecting 20,000 separate scenarios over a two-year period, and acceptable results occur 16,000 times. This means that there is an 80 percent probability that the portfolio will perform at an acceptable level. Like any financial model, the results are sensitive to underlying assumptions. The number of runs or simulations is also important. For example, a Monte Carlo model with only 500 iterations might not have been able to predict the stock market crash of 1987.

Spread Types

Static Spread – Spread, that when added to the implied forward rates, discounts the cash flows back to its observed market value. For an instrument without embedded optionality, the static spread is the best measure of return in excess of the risk-free rates provided by that instrument. For instruments with embedded optionality, it may useful to calculate a static spread ONLY as a starting point for comparison with the more appropriate mark-to-market spread measure, the option adjusted spread (OAS, defined below).

Option Adjusted Spread (OAS) – Spread, that when added to all interest rate paths generated in a Monte Carlo simulation, discounts the cash flows of an instrument back to its observed market value. This measure only applies to instruments with embedded optionality. The Static Spread applies to instruments without embedded optionality. For example, consider a mortgage backed security (MBS), which typically contains an embedded prepayment option. Assume the Static Spread is 75 basis points. The OAS would be less than the static spread of 75 basis points because the volatility of interest rates reflected in an OAS framework assigns more value to the borrower's prepayment option, thus reducing the value to the MBS investor.

OAS Process: In a stochastic valuation model, the average value generated by all the interest rate paths must equal the currently observed price of the security. The initial computation in the model is based on an assumed spread. The security value derived is compared to the observed.

Duration Calculations

Macaulay duration calculates the weighted average term to maturity of a security's cash flows. Assume a bond with three years remaining to maturity, bearing a 5% coupon rate paid annually, when a 10% yield is required.

Macaulay Duration Calculation
3 year bond, 5% coupon, 10% yield

Year	Payment	PV	x	T	PVxT
1	$50	$45.5	x	1 =	$45.5
2	$50	$41.3	x	2 =	$82.6
3	$1,050	<u>$788.9</u>	x	3 =	<u>$2,366.7</u>
		$875.7			$2,494.8

T = Time period payment is received

Macaulay Duration = 2,494.8 / 875.7
= 2.85 years

Modified duration, calculated from Macaulay duration, estimates price sensitivity for small interest rate changes.

Modified Duration Calculation
3 year bond, 5% coupon, 10% yield
Macaulay Duration = 2.85 years

$$\textbf{Modified Duration} = \frac{\text{Macaulay Duration}}{1 + (\text{Yield} / n)}$$

= 2.85 / 1.10

n = coupons per year

Modified Duration = 2.59%

The formula of the percentage change in price (Δ%) which is:

$$\Delta\% = \textit{minus}\ \text{Modified Duration} \times \Delta\ \text{Yield} \times 100$$

The minus sign recognizes the inverse relationship of price and yield. For a 100 basis point change in rates, the estimated change in price is equal to the modified duration.

Using the modified duration of 2.59% calculated above, the price of the bond would change 2.59% for every 100bp change in rates. If rates changed by only 50bp, the bond would change by 1.29%.

$\Delta\%$ = Modified Duration x Δ Yield x 100
= 2.59% x 50bp x 100
= 2.59% x .5
= 1.295%

The formula for the dollar change in price:

$\Delta\$$ = *minus* Price x Modified Duration x Δ Yield x 100

If the price of the bond had been $875.66, then its approximate change in value (price) if rates change by 50bp would be

= -$875.66 x 1.295%
= -$11.34

If rates fell, the estimated value would be $887.00, while if rates rose the estimated value would fall to $864.32.

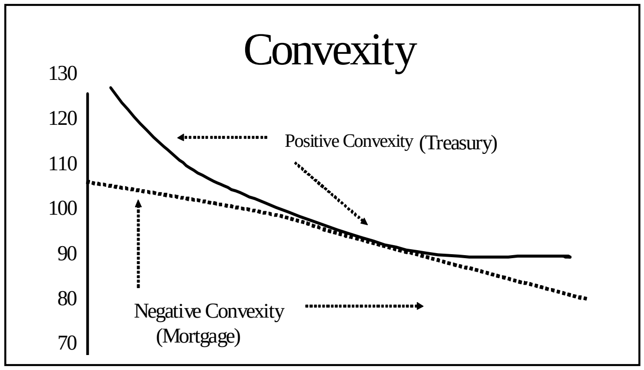
For very small changes (1 to 5 basis points) the duration based price forecast will be precise. For larger changes (100bp or more) the result will only approximate the change in price. The larger the change, the larger the approximation error. The reason for the error is the non-linear price/yield relationship, or convexity.

Convexity

Convexity describes the nonlinear price/yield relationship. Option-free instruments display positive convexity. When rates decline, a positively convex instrument's price increases at an increasing rate. When rates rise, a positively convex instrument's price decreases at a decreasing rate.

Negative convexity causes the duration of a security to lengthen when a rates rise and shorten when rates fall. Instruments that contain embedded options demonstrate negative convexity. When rates decline, a negatively convex instrument's price increases at a decreasing rate. When rates rise, the price of a negatively convex instrument will decline at an increasing rate.

As the following chart illustrates in the +200 to +300bp range, the value of the treasury security changes relatively less in value in comparison to the sample mortgage security, which declines more significantly. However, as yields decrease, the treasury security gains value at an increasing rate, while the mortgage security gains only modestly. As interest rates decline, the likelihood that borrowers will refinance (exercise prepayment option) increases. Therefore, the value of a mortgage security does not increase at the same rate or magnitude as a decline in interest rates.



Effective Duration and Effective Convexity are used to calculate bonds with embedded options. The calculation provides an approximate price change of a bond given a parallel yield curve shift. Measures of modified duration and convexity do not provide accurate calculations of price sensitivity for bonds with embedded options. Effective duration and convexity provide a more accurate view of price sensitivity since the measures allow for cash flows to change due to a change in yield. Formula:

Effective Duration $= V_{-} - V_{+} \div 2V_{O}$ (Change Y)

Effective Convexity $= V_{+} + V_{-} - 2V_{O} \div 2V_{O}$ (Change Y) ^{2}

Where,

Change Y = Change in market interest rate used to calculate new values
V_{+} = Price if yield is increased by Change Y
V_{-} = Price if yield is decreased by Change Y
V_{O} = Initial price per $100 of par value

Assume: a three-year callable bond's current market value is $98.60 ($V_{O}$); that interest rates are projected to change by 100 basis points (Y); that the price of this bond given a 100 basis point increase in rates is $96.75 ($V_{+}$); and that the price of this bond given a 100 basis point decrease in rates is $99.98 ($V_{-}$).

To calculate effective duration and convexity:

Effective Duration =99.98 – 96.75÷2(98.60)(.01)
= 1.64

Effective Convexity=96.75 + 99.98 – 2(98.60)÷2(98.60)(.01)²
= -23.83

If we assume interest rates increase 100 bps, the approximate price change due to effective duration is the following:

Percentage Price Change = -Effective Duration x Yield Change
Percentage Change in Price = -1.64 x .01 = -1.64%

The approximate price change due to effective convexity is the following:

$\frac{1}{2}$ x Effective Convexity x (Yield Change)^2
$\frac{1}{2}$ x -23.83 x $(0.01)^2$ x 100 = -0.12%

Thus this bond's price would be expected to decrease by about 1.76% given a 100 bps rise in rates:

Effective Duration	=	-1.64%
Effective Convexity	=	-<u>0.12%</u>
		-1.76%

INTRODUCTION TO THE BANK SECRECY ACT

The Financial Recordkeeping and Reporting of Currency and Foreign Transactions Act of 1970 (31 U.S.C. 5311 et seq.) is referred to as the Bank Secrecy Act (BSA). The purpose of the BSA is to require United States (U.S.) financial institutions to maintain appropriate records and file certain reports involving currency transactions and a financial institution's customer relationships. Currency Transaction Reports (CTRs) and Suspicious Activity Reports (SARs) are the primary means used by banks to satisfy the requirements of the BSA. The recordkeeping regulations also include the requirement that a financial institution's records be sufficient to enable transactions and activity in customer accounts to be reconstructed if necessary. In doing so, a paper and audit trail is maintained. These records and reports have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings.

The BSA consists of two parts: Title I Financial Recordkeeping and Title II Reports of Currency and Foreign Transactions. Title I authorizes the Secretary of the Department of the Treasury (Treasury) to issue regulations, which require insured financial institutions to maintain certain records. Title II directed the Treasury to prescribe regulations governing the reporting of certain transactions by and through financial institutions in excess of $10,000 into, out of, and within the U.S. The Treasury's implementing regulations under the BSA, issued within the provisions of 31 CFR Part 103, are included in the FDIC's Rules and Regulations and on the FDIC website.

The implementing regulations under the BSA were originally intended to aid investigations into an array of criminal activities, from income tax evasion to money laundering. In recent years, the reports and records prescribed by the BSA have also been utilized as tools for investigating individuals suspected of engaging in illegal drug and terrorist financing activities. Law enforcement agencies have found CTRs to be extremely valuable in tracking the huge amounts of cash generated by individuals and entities for illicit purposes. SARs, used by financial institutions to report identified or suspected illicit or unusual activities, are likewise extremely valuable to law enforcement agencies.

Several acts and regulations expanding and strengthening the scope and enforcement of the BSA, anti-money laundering (AML) measures, and counter-terrorist financing measures have been signed into law and issued, respectively, over the past several decades. Several of these acts include:

- Money Laundering Control Act of 1986,
- Annuzio-Wylie Anti-Money Laundering Act of 1992,
- Money Laundering Suppression Act of 1994, and
- Money Laundering and Financial Crimes Strategy Act of 1998.

Most recently, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act (more commonly known as the USA PATRIOT Act) was swiftly enacted by Congress in October 2001, primarily in response to the September 11, 2001 terrorist attacks on the U.S. The USA PATRIOT Act established a host of new measures to prevent, detect, and prosecute those involved in money laundering and terrorist financing.

FINANCIAL CRIMES ENFORCEMENT NETWORK REPORTING AND RECORDKEEPING REQUIREMENTS

Currency Transaction Reports and Exemptions

U.S. financial institutions must file a CTR, Financial Crimes Enforcement Network (FinCEN) Form 104 (formerly known as Internal Revenue Service [IRS] Form 4789), for each currency transaction over $10,000. A currency transaction is any transaction involving the physical transfer of currency from one person to another and covers deposits, withdrawals, exchanges, or transfers of currency or other payments. Currency is defined as currency and coin of the U.S. or any other country as long as it is customarily accepted as money in the country of issue.

Multiple currency transactions shall be treated as a single transaction if the financial institution has knowledge that the transactions are by, or on behalf of, any person and result in either cash in or cash out totaling more than $10,000 during any one business day. Transactions at all branches of a financial institution should be aggregated when determining reportable multiple transactions.

CTR Filing Requirements

<u>**Customer and Transaction Information**</u>

All CTRs required by 31 CFR 103.22 of the Financial Recordkeeping and Reporting of Currency and Foreign

Transactions regulations must be filed with the IRS. Financial institutions are required to provide all requested information on the CTR, including the following for the person conducting the transaction:

- Name,
- Street address (a post office box number is not acceptable),
- Social security number (SSN) or taxpayer identification number (TIN) (for non-U.S. residents), and
- Date of birth.

The documentation used to verify the identity of the individual conducting the transaction should be specified. Signature cards may be relied upon; however, the specific documentation used to establish the person's identity should be noted. A mere notation that the customer is "known to the financial institution" is insufficient. Additional requested information includes the following:

- Account number,
- Social security number or taxpayer identification number of the person or entity for whose account the transaction is being conducted (should reflect all account holders for joint accounts), and
- Amount and kind of transaction (transactions involving foreign currency should identify the country of origin and report the U.S. dollar equivalent of the foreign currency on the day of the transaction).

The financial institution must provide a contact person, and the CTR must be signed by the preparer and an approving official. Financial institutions can also file amendments on previously filed CTRs by using a new CTR form and checking the box that indicates an amendment.

CTR Filing Deadlines

CTRs filed with the IRS are maintained in the FinCEN database, which is made available to Federal Banking Agencies[1] and law enforcement. Paper forms are to be filed within 15 days following the date of the reportable transaction. If CTRs are filed using magnetic media, pursuant to an agreement between a financial institution and the IRS, a financial institution must file a CTR within 25 calendar days of the date of the reportable transaction. A third option is to file CTRs using the Patriot Act Communication System (PACS), which also allows up to 25 calendar days to file the CTR following the reportable transaction. PACS was launched in October 2002 and permits secure filing of CTRs over the Internet using encryption technology. Financial institutions can access PACS after applying for and receiving a digital certificate.

Examiners reviewing filed CTRs should inquire with financial institution management regarding the manner in which CTRs are filed before evaluating the timeliness of such filings. If for any reason a financial institution should withdraw from the magnetic tape program or the PACS program, or for any other reason file paper CTRs, those CTRs must be filed within the standard 15 day period following the reportable transaction.

Exemptions from CTR Filing Requirements

Certain "persons" who routinely use currency may be eligible for exemption from CTR filings. Exemptions were implemented to reduce the reporting burden and permit more efficient use of the filed records. Financial institutions are not required to exempt customers, but are encouraged to do so. There are two types of exemptions, referred to as "Phase I" and "Phase II" exemptions.

"Phase I" exemptions may be granted for the following "exempt persons":

- A bank[2], to the extent of its domestic operations;
- A Federal, State, or local government agency or department;
- Any entity exercising governmental authority within the U.S. (U.S. includes District of Columbia, Territories, and Indian tribal lands);
- Any listed entity other than a bank whose common stock or analogous equity interests are listed on the New York, American, or NASDAQ stock exchanges (with some exceptions);
- Any U.S. domestic subsidiary (other than a bank) of any "listed entity" that is organized under U.S. law and at least 51 percent of the subsidiary's common stock is owned by the listed entity.

"Phase II" exemptions may be granted for the following:

- A "non-listed business," which includes commercial enterprises that do not have more than 50% of the business gross revenues derived from certain ineligible businesses. Gross revenue has been interpreted to reflect what a business actually earns from an activity conducted by the business, rather than the sales volume of such activity. "Non-listed businesses" must

[1] Federal Banking Agencies consist of the Federal Reserve Board (FRB), Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), National Credit Union Administration (NCUA), and the FDIC.

[2] Bank is defined in The U.S. Department of the Treasury (Treasury) Regulation 31 CFR 103.11.

also be incorporated or organized under U.S. laws and be eligible to do business in the U.S. and may only be exempted to the extent of its domestic operations.

- A "payroll customer," which includes any other person not covered under the "exempt person" definition that operates a firm that regularly withdraws more than $10,000 in order to pay its U.S. employees in currency. "Payroll customers" must also be incorporated and eligible to do business in the U.S. "Payroll customers" may only be exempted on their withdrawals for payroll purposes from existing transaction accounts.

Commercial transaction accounts of sole proprietorships can qualify for "non-listed business" or "payroll customer" exemption.

Exemption of Franchisees

Franchisees of listed corporations (or of their subsidiaries) are not included within the definition of an "exempt person" under "Phase I" unless such franchisees are independently exempt as listed corporations or listed corporation subsidiaries. For example, a local corporation that holds an ABC Corporation franchise is not a "Phase I" "exempt person" simply because ABC Corporation is a listed corporation; however, it is possible that the local corporation may qualify for "Phase II" exemption as a "non-listed business," assuming it meets all other exemption qualification requirements. An ABC Corporation outlet owned by ABC Corporation directly, on the other hand, would be a "Phase I" "exempt person" because ABC Corporation's common stock is listed on the New York Stock Exchange.

Ineligible Businesses

There are several higher-risk businesses that may not be exempted from CTR filings. The nature of these businesses increases the likelihood that they can be used to facilitate money laundering and other illicit activities. Ineligible businesses include:

- Non-bank financial institutions or agents thereof (this definition includes telegraph companies, and money services businesses [currency exchange, check casher, or issuer of monetary instruments in an amount greater than $1,000 to any person in one day]);
- Purchasers or sellers of motor vehicles, vessels, aircraft, farm equipment, or mobile homes;
- Those engaged in the practice of law, medicine, or accountancy;
- Investment advisors or investment bankers;
- Real estate brokerage, closing, or title insurance firms;
- Pawn brokers;
- Businesses that charter ships, aircraft, or buses;
- Auction services;
- Entities involved in gaming of any kind (excluding licensed para mutual betting at race tracks);
- Trade union activities; and
- Any other activities as specified by FinCEN.

Additional Qualification Criteria for Phase II Exemptions

Both "non-listed businesses" and "payroll customers" must meet the following additional criteria to be eligible for "Phase II" exemption:

- The entity has maintained a transaction account with the financial institution for at least twelve consecutive months;
- The entity engages in frequent currency transactions that exceed $10,000 (or in the case of a "payroll customer," regularly makes withdrawals of over $10,000 to pay U.S. employees in currency); and
- The entity is incorporated or organized under the laws of the U.S. or a state, or registered as, and eligible to do business in the U.S. or state.

The financial institution may treat all of the customer's transaction accounts at that financial institution as a single account to qualify for exemption. There may be exceptions to this rule if certain accounts are exclusively used for non-exempt portions of the business. (For example, a small grocery with wire transfer services has a separate account just for its wire business).

Accounts of multiple businesses owned by the same individual(s) are generally not eligible to be treated as a single account. However, it may be necessary to treat such accounts as a single account if the financial institution has evidence that the corporate veil has been pierced. Such evidence may include, but is not limited to:

- Businesses are operated out of the same location and/or utilize the same phone number;
- Businesses are operated by the same daily management and/or board of directors;
- Cash deposits or other banking transactions are completed by the same individual at the same time for the different businesses;
- Funds are frequently intermingled between accounts or there are unexplained transfers from one account to the other; or
- Business activities of the entities cannot be differentiated.

More than one of these factors must typically be present in order to provide sufficient evidence that the corporate veil has been pierced.

Transactions conducted by an "exempt person" as agent or on behalf of another person are not eligible to be exempted based on being transacted by an "exempt person."

Exemption Qualification Documentation Requirements

Decisions to exempt any entity should be based on the financial institution taking reasonable and prudent steps to document the identification of the entity. The specific methodology for performing this assessment is largely at the financial institution's discretion; however, results of the review must be documented. For example, it is acceptable to document that a stock is listed on a stock market by relying on a listing of exchange stock published in a newspaper or by using publicly available information through the Securities and Exchange Commission (SEC). To document the subsidiary of a listed entity, a financial institution may rely on authenticated corporate officer's certificates or annual reports filed with the SEC. Annually, management should also ensure that "Phase I" exempt persons remain eligible for exemption (for example, entities remain listed on National exchanges.)

For "non-listed businesses" and "payroll customers," the financial institution will need to document that the entity meets the qualifying criteria both at the time of the initial exemption and annually thereafter. To perform the annual reviews, the financial institution can verify and update the information that it has in its files to document continued eligibility for exemption. The financial institution must also indicate that it has a system for monitoring the transactions in the account for suspicious activity as it continues to be obligated to file Suspicious Activity Reports on activities of "exempt persons," when appropriate. SARs are discussed in detail within the "Suspicious Activity Reporting" section of this chapter.

Designation of Exempt Person Filings and Renewals

Both "Phase I" and "Phase II" exemptions are filed with FinCEN using Form TD F 90-22.53 - Designation of Exempt Person. This form is available on the Internet at FinCEN's website. The designation must be made separately by each financial institution that treats the person in question as an exempt customer. This designation requirement applies whether or not the designee has previously been treated as exempt from the CTR reporting requirements within 31 CFR 103. Again, the exemption applies only to transactions involving the "exempt person's" own funds. A transaction carried out by an "exempt person" as an agent for another person, who is the beneficial owner of the funds involved in a transaction in currency can not be exempted.

Exemption forms for "Phase I" persons need to be filed only once. A financial institution that wants to exempt another financial institution from which it buys or sells currency must be designated exempt by the close of the 30 day period beginning after the day of the first reportable transaction in currency with the other financial institution. Federal Reserve Banks are excluded from this requirement.

Exemption forms for "Phase II" persons need to be renewed and filed every two years, assuming that the "exempt person" continues to meet all exemption criteria, as verified and documented in the required annual review process discussed above. The filing must be made by March 15th of the second calendar year following the year in which the initial exemption was granted, and by every other March 15th thereafter. When filing a biennial renewal of the exemption for these customers, the financial institution will need to indicate any change in ownership of the business. Initial exemption of a "non-listed business" or "payroll customer" must be made within 30 days after the day of the first reportable transaction in currency that the financial institution wishes to include under the exemption. Form TD F 90-22.53 can be also used to revoke or amend an exemption.

CTR Backfiling

Examiners may determine that a financial institution has failed to file CTRs in accordance with 31 CFR 103, or has improperly exempted customers from CTR filings. In situations where an institution has failed to file a number of CTRs on reportable transactions for any reason, examiners should instruct management to promptly contact the IRS Detroit Computing Center (IRS DCC), Compliance Review Group for instructions and guidance concerning the possible requirement to backfile CTRs for those affected transactions. The IRS DCC will provide an initial determination on whether CTRs should be backfiled in those cases. Cases that involve substantial noncompliance with CTR filing requirements are referred to FinCEN for review. Upon review, FinCEN may correspond directly with the institution to discuss the program deficiencies that resulted in the institution's failure to appropriately file a CTR and the corrective action that management has implemented to prevent further infractions.

When a backfiling request is necessary, examiners should direct financial institutions to write a letter to the IRS at the IRS Detroit Computing Center, Compliance Review Group Attn: Backfiling, P.O. Box 32063, Detroit, Michigan, 48232-0063 that explains why CTRs were not filed. Examiners should also provide the financial institution a copy of the "Check List for CTR Filing Determination" form available on the FDIC's website. The financial institution will need to complete this form and include it with the letter to the IRS.

Once an institution has been instructed to contact IRS DCC for a backfiling determination, examiners should notify both their Regional Special Activities Case Manager (SACM) or other designees and the Special Activities Section (SAS) in Washington, D.C. Specific contacts are listed on the FDIC's Intranet website. Requisite information should be forwarded electronically via e-mail to these contacts.

Currency and Banking Retrieval System

The Currency and Banking Retrieval System (CBRS) is a database of CTRs, SARs, and CTR Exemptions filed with the IRS. It is maintained at the IRS Detroit Computing Center. The SAS, as well as each Region's SACM and other designees, has on-line access to the CBRS. Refer to your Regional Office for a full listing of those individuals with access to the FinCEN database.

Examiners should routinely receive volume and trend information on CTRs and SARs from their Regional SACM or other designees for each examination or visitation prior to the pre-planning process. In addition, the database information may be used to verify CTR, SAR and/or CTR Exemption filings. Detailed FinCEN database information may be used for expanded BSA reviews or in any unusual circumstances where examiners suspect certain forms have not been filed by the financial institution, or where suspicious activity by individuals has been detected.

Examiners should provide all of the following items they have available for each search request:

- The name of the subject of the search (financial institution and/or individual/entity);
- The subject's nine-digit TIN/SSN (in Part III of the CTR form if seeking information on the financial institution and/or Part I of the CTR form if seeking information on the individual/entity); and
- The date range for which the information is requested.

When requesting a download or listing of CTR and SAR information, examiners should take into consideration the volume of CTRs and SARs filed by the financial institution under examination when determining the date range requested. Except under unusual circumstances, the date range for full listings should be no greater than one year. For financial institutions with a large volume of records, three months or less may be more appropriate.

Since variations in spellings of an individual's name are possible, accuracy of the TIN/SSN is essential in ensuring accuracy of the information received from the FinCEN database. To this end, examiners should also identify any situations where a financial institution is using more than one tax identification number to file their CTRs and/or SARs. To reduce the possibility of error in communicating CTR and SAR information/verification requests, examiners are requested to e-mail or fax the request to their Regional SACM or other designee.

Other FinCEN Reports

Report of International Transportation of Currency or Monetary Instruments

Treasury regulation 31 CFR 103.23 requires the filing of FinCEN Form 105, formerly Form 4790, to comply with other Treasury regulations and U.S. Customs disclosure requirements involving physical transport, mailing or shipping of currency or monetary instruments greater than $10,000 at one time out of or into the U.S. The report is to be completed by or on behalf of the person requesting the transfer of the funds and filed within 15 days. However, financial institutions are not required to report these items if they are mailed or shipped through the postal service or by common carrier. Also excluded from reporting are those items that are shipped to or received from the account of an established customer who maintains a deposit relationship with the bank, provided the item amounts are commensurate with the customary conduct of business of the customer concerned.

In situations where the quantity, dollar volume, and frequency of the currency and/or monetary instruments are not commensurate with the customary conduct of the customer, financial institution management will need to conduct further documented research on the customer's transactions and determine whether a SAR should be filed with FinCEN. Please refer to the discussion on "Customer Due Diligence" and "Suspicious Activity Reporting" within this chapter for detailed guidance.

Reports of Foreign Bank Accounts

Within 31 CFR 103.24, the Treasury requires each person who has a financial interest in or signature authority, or other authority over any financial accounts, including bank, securities, or other types of financial accounts, maintained in a foreign country to report those relationships to the IRS annually if the aggregate value of the accounts exceeds

$10,000 at any point during the calendar year. The report should be filed by June 30 of the succeeding calendar year, using Form TD F 90-22.1 available on the FinCEN website. By definition, a foreign country includes all locations outside the United States, Guam, Puerto Rico, the Virgin Islands, the Northern Mariana Islands, American Samoa, and Trust Territory of the Pacific Islands. U.S. military banking facilities are excluded. Foreign assets including securities issued by foreign corporations that are held directly by a U.S. person, or through an account maintained with a U.S. office of a bank or other institution are not subject to the BSA foreign account reporting requirements. The bank is also not required to report international interbank transfer accounts ("nostro accounts") held by domestic banks. Also excluded are accounts held in a foreign financial institution in the name of, or on behalf of, a particular customer of the financial institution, or that are used solely for the transactions of a particular customer. Finally, an officer or employee of a federally-insured depository institution branch, or agency office within the U.S. of a foreign bank that is subject to the supervision of a Federal bank regulatory agency need not report that he or she has signature or other authority over a foreign bank, securities or other financial account maintained by such entities unless he or she has a personal financial interest in the account.

FinCEN Recordkeeping Requirements

Required Records for Sales of Monetary Instruments for Cash

Treasury regulation 31 CFR 103.29 prohibits financial institutions from issuing or selling monetary instruments purchased with cash in amounts of $3,000 to $10,000, inclusive, unless it obtains and records certain identifying information on the purchaser and specific transaction information. Monetary instruments include bank checks, bank drafts, cashier's checks, money orders, and traveler's checks. Furthermore, the identifying information of all purchasers must be verified. The following information must be obtained from a purchaser who has a deposit account at the financial institution:

- Purchaser's name;
- Date of purchase;
- Type(s) of instrument(s) purchased;
- Serial number(s) of each of the instrument(s) purchased; and
- Amounts in dollars of each of the instrument(s) purchased.

If the purchaser does not have a deposit account at the financial institution, the following additional information must be obtained:

- Address of the purchaser (a post office box number is not acceptable);
- Social security number (or alien identification number) of the purchaser;
- Date of birth of the purchaser; and
- Verification of the name and address with an acceptable document (i.e. driver's license).

The regulation requires that multiple purchases during one business day be aggregated and treated as one purchase. Purchases of different types of instruments at the same time are treated as one purchase and the amounts should be aggregated to determine if the total is $3,000 or more. In addition, the financial institution should have procedures in place to identify multiple purchases of monetary instruments during one business day, and to aggregate this information from all of the bank branch offices.

If a customer first deposits the cash in a bank account, then purchases a monetary instrument(s), the transaction is still subject to this regulatory requirement. The financial institution is not required to maintain a log for these transactions, but should have procedures in place to recreate the transactions.

The information required to be obtained under 31 CFR 103.29 must be retained for a period of five years.

Funds Transfer and Travel Rule Requirements

Treasury regulation 31 CFR Section 103.33 prescribes information that must be obtained for funds transfers in the amount of $3,000 or more. There is a detailed discussion of the recordkeeping requirements and risks associated with wire transfers within the "Banking Services and Activities with Greater Potential for Money Laundering and Terrorist Financing Vulnerabilities" discussion within this chapter.

Records to be Made and Retained by Financial Institutions

Treasury regulation 31 CFR 103.33 states that each financial institution must retain either the original or a microfilm or other copy/reproduction of each of the following:

- A record of each extension of credit in an amount in excess of $10,000, except an extension of credit secured by an interest in real property. The record must contain the name and address of the borrower, the loan amount, the nature or purpose of the loan, and the date the loan was made. The stated purpose can be very general such as a passbook loan, personal loan, or business loan. However, financial institutions should be encouraged to be as specific as possible when stating the loan purpose. Additionally, the purpose of a renewal, refinancing, or consolidation is not required as long as the original purpose has not changed and the original statement of purpose is retained for a period of five years after the renewal, refinancing or consolidation has been paid out.

- A record of each advice, request, or instruction received or given regarding any transaction resulting in the transfer of currency or other monetary instruments, funds, checks, investment securities, or credit, of more than $10,000 to or from any person, account, or place outside the U.S. This requirement also applies to transactions later canceled if such a record is normally made.

Required Records for Deposit Accounts

Treasury regulation 31 CFR 103.34 requires banking institutions to obtain and retain a social security number or taxpayer identification number for each deposit account opened after June 30, 1972, and before October 1, 2003. The same information must be obtained for each certificate of deposit sold or redeemed after May 31, 1978, and before October 1, 2003. The banking institution must make a reasonable effort to obtain the identification number within 30 days after opening the account, but will not be held in violation of the regulation if it maintains a list of the names, addresses, and account numbers of those customers from whom it has been unable to secure an identification number. Where a person is a nonresident alien, the banking institution shall also record the person's passport number or a description of some other government document used to verify his/her identity.

Furthermore, 31 CFR 103.34 generally requires banks to maintain records of items needed to reconstruct transaction accounts and other receipts or remittances of funds through a bank. Specific details of these requirements are in the regulation.

Record Retention Period and Nature of Records

All records required by the regulation shall be retained for five years. Records may be kept in paper or electronic form. Microfilm, microfiche or other commonly accepted forms of records are acceptable as long as they are accessible within a reasonable period of time. The record should be able to show both the front and back of each document. If no record is made in the ordinary course of business of any transaction with respect to which records are required to be retained, then such a record shall be prepared in writing by the financial institution.

CUSTOMER IDENTIFICATION PROGRAM

Section 326 of the USA PATRIOT Act, which is implemented by 31 CFR 103.121, requires banks, savings associations, credit unions, and certain non-federally regulated banks to implement a written Customer Identification Program (CIP) appropriate for its size and type of business. For Section 326, the definition of **financial institution** encompasses a variety of entities, including **banks**, agencies and branches of foreign banks in the U.S., thrifts, credit unions, private banks, trust companies, investment companies, brokers and dealers in securities, futures commission merchants, insurance companies, travel agents, pawnbrokers, dealers in precious metals, check cashers, casinos, and telegraph companies, among many others identified at 31 USC 5312(a)(2) and (c)(1)(A). As of October 1, 2003, all institutions and their operating subsidiaries must have in place a CIP pursuant to Treasury regulation 31 CFR 103.121.

The CIP rules do not apply to a **financial institution**'s foreign subsidiaries. However, **financial institutions** are encouraged to implement an effective CIP throughout their operations, including their foreign offices, except to the extent that the requirements of the rule would conflict with local law.

Applicability of CIP Regulation

The CIP rules apply to **banks**, as defined in 31 CFR 103.11 that are subject to regulation by a Federal Banking Agency and to any non-Federally-insured credit union, private bank or trust company that does not have a Federal functional regulator. Entities that are regulated by the U.S. Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) are subject to separate rulemakings. It is intended that the effect of all of these rules be uniform throughout the financial services industry.

CIP Requirements

31 CFR 103.121 requires a **bank** to develop and implement a written, board-approved CIP, appropriate for its size and type of business that includes, at a minimum, procedures for:

- Verifying a customer's true identity to the extent reasonable and practicable and defining the methodologies to be used in the verification process;
- Collecting specific identifying information from each customer when opening an account;
- Responding to circumstances and defining actions to be taken when a customer's true identity cannot be appropriately verified with "reasonable belief;"
- Maintaining appropriate records during the collection and verification of a customer's identity;
- Verifying a customer's name against specified terrorist lists; and
- Providing customers with adequate notice that the **bank** is requesting identification to verify their identities.

While not required, a **bank** may also include procedures for:

- Specifying when it will rely on another **financial institution** (including an affiliate) to perform some or all of the elements of the CIP.

Additionally, 31 CFR 103.121 provides that a **bank** with a Federal functional regulator must formally incorporate its CIP into its written board-approved anti-money laundering program. The FDIC expanded Section 326.8 of its Rules and Regulations to require each **FDIC-supervised institution** to implement a CIP that complies with 31 CFR 103.121 and incorporate such CIP into a bank's written board-approved BSA compliance program (with evidence of such approval noted in the board meeting minutes). Consequently, a **bank** must specifically provide:

- Internal policies, procedures, and controls;
- Designation of a compliance officer;
- Ongoing employee training programs; and
- An independent audit function to test program.

The slight difference in wording between the Treasury's and FDIC's regulations regarding incorporation of a bank's CIP within its anti-money laundering program and BSA compliance program, respectively, was not intended to create duplicative requirements. Therefore, an FDIC-regulated **bank** must include its CIP within its anti-money laundering program and the latter included under the "umbrella" of its overall BSA/AML program.

CIP Definitions

As discussed above, both Section 326 of the USA PATRIOT Act and 31 CFR 103.121 specifically define the terms **financial institution** and **bank**. Similarly, specific definitions are provided for the terms **person**, **customer**, and **account**. Both bank management and examiners must properly understand these terms in order to effectively implement and assess compliance with CIP regulations, respectively.

Person

A **person** is generally an individual or other legal entity (such as registered corporations, partnerships, and trusts).

Customer

A **customer** is generally defined as any of the following:

- A **person** that opens a new **account** (**account** is defined further within the discussion of CIP definitions);
- An individual acting with "power of attorney"(POA)[3] who opens a new **account** to be owned by or for the benefit of a **person** lacking legal capacity, such as a minor;
- An individual who opens an **account** for an entity that is not a legal person, such as a civic club or sports boosters;
- An individual added to an existing **account** or one who assumes an existing debt at the **bank;** or
- A deposit broker who brings new customers to the bank (as discussed in detail later within this section).

The definition of **customer** excludes:

- A financial institution regulated by a Federal Banking Agency or a bank regulated by a State bank regulator[4];
- A department or agency of the U.S. Government, of any state, or of any political subdivision of any state;
- Any entity established under the laws of the U.S., of any state, or of any political subdivision of any state, or under an interstate compact between two or more states, that exercises governmental authority on behalf of the U.S. or any such state or political subdivision (U.S. includes District of Columbia and Indian tribal lands and governments); or

[3] If a POA individual opens an account for another individual with legal capacity or for a legal entity, then the **customer** is still the account holder. In this case, the POA is an agent acting on behalf of the **person** that opens the account and the CIP must still cover the account holder (unless the person lacks legal capacity).

[4] The IRS is not a Federal functional regulator. Consequently, money service businesses, such as check cashers and wire transmitters that are regulated by the IRS are not exempted from the definition of customer for CIP purposes.

- Any entity, other than a bank, whose common stock or analogous equity interests are listed on the New York or American Stock Exchanges or whose common stock or analogous equity interests have been designated as a NASDAQ National Market Security listed on the NASDAQ Stock Market (except stock or interests listed under the separate "NASDAQ Small-Cap Issues" heading). A listed company is exempted from the definition of **customer** only for its domestic operations.

The definition of **customer** also excludes a **person** who has an existing account with a bank, provided that the bank has a "reasonable belief" that it knows the true identity of the **person**. So, if the **person** were to open an additional account, or renew or roll over an existing account, CIP procedures would not be required. A bank can demonstrate that is has a "reasonable belief" that it knows the identity of an existing customer by:

- Demonstrating that it had similar procedures in place to verify the identity of **persons** prior to the effective date of the CIP rule. (An "affidavit of identity" by a bank officer is not acceptable for demonstrating "reasonable belief.")
- Providing a history of **account** statements sent to the **person.**
- **Maintaining account** information sent to the IRS regarding the **person's accounts** accompanied by IRS replies that contain no negative comments.
- Providing evidence of loans made and repaid, or other services performed for the **person** over a period of time.

These actions may not be sufficient for existing account holders deemed to be high risk. For example, in the situation of an import/export business where the identifying information on file only includes a number from a passport marked as a duplicate with no additional business information on file, the bank should follow all of the CIP requirements provided in 31 CFR 103.121 since it does not have sufficient information to show a "reasonable belief" of the true identity of the existing account holder.

Account

An **account** is defined as a formal, ongoing banking relationship established to provide or engage in services, dealings, or other financial transactions including:

- Deposit accounts;
- Transaction or asset accounts ;
- Credit accounts, or any other extension of credit;
- Safety deposit box or other safekeeping services;
- Cash management, custodian, and trust services; or
- Any other type of formal, ongoing banking relationship.

The definition of **account** specifically excludes the following:

- Product or service where a formal banking relationship is NOT established with a **person**. Thus CIP is not intended for infrequent transactions and activities (already covered under other recordkeeping requirements within 31 CFR 103) such as:
    - Check cashing,
    - Wire transfers,
    - Sales of checks,
    - Sales of money orders;
- Accounts acquired through an acquisition, merger, purchase of assets, or assumption of liabilities (as these "new" accounts were not initiated by customers);[5] and
- Accounts opened for the purpose of participating in an employee benefit plan established under the Employee Retirement Income Security Act of 1974 (ERISA).

Furthermore, the CIP requirements do not apply to a **person** who does not receive banking services, such as a **person** who applies for a loan but has his/her application denied. The **account** in this circumstance is only opened when the bank enters into an enforceable agreement to provide a loan to the **person** (who therefore also simultaneously becomes a **customer**).

Collecting Required Customer Identifying Information

The CIP must contain account opening procedures that specify the identifying information obtained from each customer prior to opening the account. The minimum required information includes:

- Name.
- Date of birth, for an individual.

[5] Accounts acquired by purchase of assets from a third party are excluded from the CIP regulations, provided the purchase was not made under an agency in place or exclusive sale arrangement, where the bank has final approval of the credit. If under an agency arrangement, the bank may rely on the agent third party to perform the bank's CIP, but it must ensure that the agent is performing the bank's CIP program. For example, a pool of auto loans purchased from an auto dealer after the loans have already been made would not be subject to the CIP regulations. However, if the bank is directly extending credit to the borrower and is using the car dealer as its agent to gather information, then the bank must ensure that the dealer is performing the bank's CIP.

- Physical address[6], which shall be:
    - for an individual, a residential or business street address (An individual who does not have a physical address may provide an Army Post Office [APO] or a Fleet Post Office [FPO] box number, or the residential or business street address of next of kin or of another contact individual. Using the box number on a rural route is acceptable description of the physical location requirement.)
    - for a person other than an individual (such as corporations, partnerships, and trusts), a principal place of business, local office, or other physical location.
- Identification number including a SSN, TIN, Individual Tax Identification Number (ITIN), or Employer Identification Number (EIN).

For non-U.S. persons, the bank must obtain one or more of the following identification numbers:

- Customer's TIN,
- Passport number and country of issuance,
- Alien identification card number, and
- Number and country of issuance of any other (foreign) government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard.

When opening an account for a foreign business or enterprise that does not have an identification number, the bank must request alternative government-issued documentation certifying the existence of the business or enterprise.

Exceptions to Required Customer Identifying Information

The bank may develop, include, and follow CIP procedures for a customer who at the time of account opening, has applied for, but has not yet received, a TIN. However, the CIP must include procedures to confirm that the application was filed before the customer opens the account and procedures to obtain the TIN within a reasonable period of time after the account is opened.

There is also an exception to the requirement that a bank obtain the above-listed identifying information <u>from the customer</u> prior to opening an account in the case of credit card accounts. A bank may obtain identifying information (such as TIN) <u>from a third-party source</u> prior to extending credit to the customer.

Verifying Customer Identity Information

The CIP should rely on a **risk-focused** approach when developing procedures for verifying the identity of each customer to the extent reasonable and practicable. A bank need not establish the accuracy of every element of identifying information obtained in the account opening process, but must do so for enough information to form a "reasonable belief" that it knows the true identity of each customer. At a minimum, the **risk-focused** procedures must be based on, but not limited to, the following factors:

- Risks presented by the various types of accounts offered by the bank;
- Various methods of opening accounts provided by the bank;
- Various sources and types of identifying information available; and
- The bank's size, location, and customer base.

Furthermore, a bank's CIP procedures must describe when the bank will use **documentary verification methods**, **non-documentary verification methods**, or a **combination of both methods**.

<u>Documentary Verification</u>

The CIP must contain procedures that set forth the specific documents that the bank will use. For an individual, the documents may include:

- Unexpired government-issued identification evidencing nationality or residence, and bearing a photograph or similar safeguard, such as a driver's license or passport.

For a person other than an individual (such as a corporation, partnership, or trust), the documents may include:

- Documents showing the existence of the entity, such as certified articles of incorporation, a government-issued business license, a partnership agreement, trust instrument, a certificate of good standing, or a business resolution.

<u>Non-Documentary Verification</u>

[6] The bank MUST obtain a physical address: a P.O. Box alone is NOT acceptable. Collection of a P.O. Box address and/or alternate mailing address is optional and potentially very useful as part of the bank's Customer Due Diligence (CDD) program.

Banks are not required to use non-documentary methods to verify a customer's identity. However, if a bank chooses to do so, a description of the approved non-documentary methods must be incorporated in the CIP. Such methods may include:

- Contacting the customer,
- Checking references with other financial institution,
- Obtaining a financial statement, and
- Independently verifying the customer's identity through the comparison of information provided by the customer with information obtained from consumer reporting agencies (for example, Experian, Equifax, TransUnion, Chexsystems), public databases (for example, Lexis, Dunn and Bradstreet), or other sources (for example, utility bills, phone books, voter registration bills).

The bank's non-documentary procedures must address situations such as:

- The inability of a customer to present an unexpired government-issued identification document that bears a photograph or similar safeguard;
- Unfamiliarity on the bank's part with the documents presented;
- Accounts opened without obtaining documents;
- Accounts opened without the customer appearing in person at the bank (for example, accounts opened through the mail or over the Internet); and
- Circumstances increasing the risk that the bank will be unable to verify the true identity of a customer through documents.

Many of the risks presented by these situations can be mitigated. A bank that accepts items that are considered secondary forms of identification, such as utility bills and college ID cards, is encouraged to review more than a single document to ensure that it has formed a "reasonable belief" of the customer's true identity. Furthermore, in instances when an account is opened over the Internet, a bank may be able to obtain an electronic credential, such as a digital certificate, as one of the methods it uses to verify a customer's identity.

<u>Additional Verification Procedures for Customers (Non-Individuals)</u>

The CIP must address situations where, based on a risk assessment of a new account that is opened by a customer that is not an individual, the bank will obtain information about individuals with authority or control over such accounts, in order to verify the customer's identity. These individuals could include such parties as signatories, beneficiaries, principals, and guarantors. As previously stated, a risk-focused approach should be applied to verify customer accounts. For example, in the case of a well-known firm, company information and verification could be sufficient without obtaining and verifying identity information for all signatories. However, in the case of a relatively new or unknown firm, it would be in the bank's best interest to obtain and verify a greater volume of information on signatories and other individuals with control or authority over the firm's account.

Inability to Verify Customer Identity Information

The CIP must include procedures for responding to circumstances in which the bank cannot form a reasonable belief that it knows the true identity of a customer. These procedures should describe, at a minimum, the following:

- Circumstances when the bank should not open an account;
- The terms or limits under which a customer may use an account while the bank attempts to verify the customer's identity (for example, minimal or no funding on credit cards, holds on deposits, limits on wire transfers);
- Situations when an account should be closed after attempts to verify a customer's identity have failed; and
- Conditions for filing a SAR in accordance with applicable laws and regulations.

Recordkeeping Requirements

The bank's CIP must include recordkeeping procedures for:

- Any document that was relied upon to verify identity noting the type of document, the identification number, the place of issuance, and, if any, the dates of issuance and expiration;
- The method and results of any measures undertaken to perform non-documentary verification procedures; and
- The results of any substantive discrepancy discovered when verifying the identifying information obtained.

Banks are not required to make and retain photocopies of any documents used in the verification process. However, if a bank does choose to do so, it must ensure that these photocopies are physically secured to adequately protect against possible identity theft. In addition, such photocopies should not be maintained with files and documentation relating to credit decisions in order to avoid any potential problems with consumer compliance regulations.

Required Retention Period

All required customer identifying information obtained in the account opening process must be retained for five years after the account is closed, or in the case of credit card accounts, five years after the account is closed or becomes dormant. The other "required records" (descriptions of documentary and non-documentary verification procedures and any descriptions of substantive discrepancy resolution) must be retained for five years after the record is made. If several accounts are opened at a bank for a customer simultaneously, all of the required customer identifying information obtained in the account opening process must be retained for five years after the last account is closed, or in the case of credit card accounts, five years after the last account is closed or becomes dormant. As in the case of a single account, all other "required records" must be kept for five years after the records are made.

Comparison with Government Lists of Known or Suspected Terrorists

The CIP must include procedures for determining whether the customer appears on any list of known or suspected terrorists or terrorist organizations issued by any Federal government agency and designated as such by the Treasury in consultation with the other Federal functional regulators.

The comparison procedures must be performed and a determination made within a reasonable period of time after the account is opened, or earlier, as required and directed by the issuing agency. Since the USA PATRIOT Act Section 314(a) Requests, discussed in detail under the heading entitled "Special Information Sharing Procedures to Deter Money Laundering and Terrorist Activities," are one-time only searches, they are not applicable to the CIP.

Adequate Customer Notice

The CIP must include procedures for providing customers with adequate notice that the bank is requesting information to verify their identities. This notice must indicate that the institution is collecting, verifying, and recording the customer identity information as outlined in the CIP regulations. Furthermore, the customer notice must be provided prior to account opening, with the general belief that it will be clearly read and understood. This notice may be posted on a lobby sign, included on the bank's website, provided orally, or disclosed in writing (for example, account application or separate disclosure form). The regulation provides sample language that may be used for providing adequate customer notice. In the case of joint accounts, the notice must be provided to all joint owners; however, this may be accomplished by providing notice to one owner for delivery to the other owners.

Reliance on Another Financial Institution's CIP

A bank may develop and implement procedures for relying on another financial institution for the performance of CIP procedures, yet the CIPs at both entities do not have to be identical. The reliance can be used with respect to any bank customer that is opening or has opened an account or similar formal relationship with the relied-upon financial institution. Additionally, the following requirements must be met:

- Reliance is reasonable, under the circumstances;
- The relied-upon financial institution (including an affiliate) is subject to the same anti-money laundering program requirements as a bank, and is regulated by a Federal functional regulator (as previously defined); and
- A signed contract exists between the two entities that requires the relied-upon financial institution to certify annually that it has implemented its anti-money laundering program, and that it will perform (or its agent will perform) the specified requirements of the bank's CIP.

To strengthen such an arrangement, the signed contract should include a provision permitting the bank to have access to the relied-upon institution's annual independent review of its CIP.

Deposit Broker Activity

The use of deposit brokers is a common funding mechanism for many financial institutions. This activity is considered higher risk because each deposit broker operates under its own operating guidelines to bring customers to a bank. Consequently, the deposit broker may not be performing sufficient Customer Due Diligence (CDD), Office of Foreign Assets Control (OFAC) screening (refer to the detailed OFAC discussion provided elsewhere within this chapter), or CIP procedures. The bank accepting brokered deposits relies upon the deposit broker to have sufficiently performed all required account opening procedures and to have followed all BSA and AML program requirements.

Deposit Broker is Customer

Regulations contained in 31 CFR 103.121 specifically defines the term customer as a person (individual, registered corporation, partnership, or trust). Therefore, according to this definition, if a deposit broker opens an account(s), the customer is the deposit broker NOT the deposit broker's clients.

Deposit Broker's CIP

Deposit brokers must follow their own CIP requirements for their customers. If the deposit broker is registered with the SEC, then it is required to follow the same general CIP requirements as banking institutions and is periodically examined by the SEC for compliance. However, if the deposit broker does not come under the SEC's jurisdiction, they may not be following any due diligence laws or guidelines.

As such, banks accepting deposit broker accounts should establish policies and procedures regarding the brokered deposits. Policies should establish minimum due diligence procedures for all deposit brokers providing business to the bank. The level of due diligence a bank performs should be commensurate with its knowledge of the deposit broker and the broker's known business practices.

Banks should conduct **enhanced** due diligence on unknown and/or unregulated deposit brokers. For protection, the bank should determine that the:

- Deposit broker is legitimate;
- Deposit broker is following appropriate guidance and/or regulations;
- Deposit broker's policies and procedures are sufficient;
- Deposit broker has adequate CIP verification procedures;
- Deposit broker screens clients for OFAC matches;
- BSA/OFAC audit reviews are adequate and show compliance with requirements; and
- Bank management is aware of the deposit broker's anticipated volume and transaction type.

Special care should be taken with deposit brokers who:

- Are previously unknown to the bank;
- Conduct business or obtain deposits primarily in another country;
- Use unknown or hard-to-contact businesses and banks for references;
- Provide other services which may be suspect, such as creating shell corporations for foreign clients;
- Advertise their own deposit rates, which vary widely from those offered by banking institutions; and
- Refuse to provide requested due diligence information or use methods to get deposits placed before providing information.

Banks doing business with deposit brokers are encouraged to include contractual requirements for the deposit broker to establish and conduct procedures for minimum CIP, CDD, and OFAC screening.

Finally, the bank should monitor brokered deposit activity for unusual activity, including cash transactions, structuring, and funds transfer activity. Monitoring procedures should identify any "red flags" suggesting that the deposit broker's customers (the ultimate customers) are trying to conceal their true identities and/or their source of wealth and funds.

Additional Guidance on CIP Regulations

Comprehensive guidance regarding CIP regulations and related examination procedures can be found within FDIC FIL 90-2004, Guidance on Customer Identification Programs. On January 9, 2004, the Treasury, FinCEN, and the Federal Financial Institutions Examination Council (FFIEC) regulatory agencies issued joint interpretive guidance addressing frequently asked questions (FAQs) relating to CIP requirements in FIL-4-2004. Additional information regarding CIP can be found on the FinCEN website.

SPECIAL INFORMATION SHARING PROCEDURES TO DETER MONEY LAUNDERING AND TERRORIST ACTIVITIES

Section 314 of the USA PATRIOT Act covers special information sharing procedures to deter money laundering and terrorist activities. These are the only two categories that apply under Section 314 information sharing; no information concerning other suspicious or criminal activities can be shared under the provisions of Section 314 of the USA PATRIOT Act. Final regulations of the following two rules issued on March 4, 2002, became effective on September 26, 2002:

- Section 314(a), codified into 31 CFR 103.100, requires **mandatory** information sharing between the U.S. Government (FinCEN, Federal law enforcement agencies, and Federal Banking Agencies) and financial institutions.
- Section 314(b), codified into 31 CFR 103.110, encourages **voluntary** information sharing between financial institutions and/or associations of financial institutions.

Section 314(a) – Mandatory Information Sharing Between the U.S. Government and Financial Institutions

A Federal law enforcement agency investigating terrorist activity or money laundering may request that FinCEN solicit, on its behalf, certain information from a financial institution or a group of financial institutions on certain individuals or entities. The law enforcement agency must provide a written certification to FinCEN attesting that credible evidence of money laundering or terrorist activity exists. It must also provide specific identifiers such as date of birth, address, and social security number of the individual(s) under investigation that would permit a financial institution to differentiate among customers with common or similar names.

Section 314(a) Requests

Upon receiving an adequate written certification from a law enforcement agency, FinCEN may require financial institutions to perform a search of their records to determine whether they maintain or have maintained accounts for, or have engaged in transactions with, any specified individual, entity, or organization. This process involves providing a Section 314(a) Request to the financial institutions. Such lists are issued to financial institutions every two weeks by FinCEN.

Each Section 314(a) request has a unique tracking number. The general instructions for a Section 314(a) Request require financial institutions to complete a **one-time** search of their records and respond to FinCEN, if necessary, within **two weeks**. However, individual requests can have different deadline dates. Any specific guidelines on the request supercede the general guidelines.

<u>Designated Point-of-Contact for Section 314(a) Requests</u>

All financial institutions shall designate at least one point-of-contact for Section 314(a) requests and similar information requests from FinCEN. FDIC-supervised financial institutions must promptly notify the FDIC of any changes to the point-of-contact, which is reported on each Call Report.

Financial Institution Records Required to be Searched

The records that must be searched for a Section 314(a) Request are specified in the request itself. Using the identifying information contained in the 314(a) request, financial institutions are required to conduct a **one-time** search of the following records, **whether or not they are kept electronically (subject to the limitations below)**:

- Deposit account records;
- Funds transfer records;
- Sales of monetary instruments (purchaser only);
- Loan records;
- Trust department records;
- Securities records (purchases, sales, safekeeping, etc.);
- Commodities, options, and derivatives; and
- Safe deposit box records (but only if searchable electronically).

According to the general instructions to Section 314(a), financial institutions are NOT required to research the following documents for matches:

- Checks processed through an account for a payee,
- Monetary instruments for a payee,
- Signature cards, and
- CTRs and SARs previously filed.

The general guidelines specify that the record search need only encompass current accounts and accounts maintained by a named subject during the preceding twelve (12) months, and transactions not linked to an account conducted by a named subject during the preceding six (6) months. Any record described above that is not maintained in electronic form need only be searched if it is required to be kept under federal law or regulation.

Again, if the specific guidelines or the timeframe of records to be searched on a Section 314(a) Request differ from the general guidelines, they should be followed to the extent possible. For example, if a particular Section 314(a) Request asks financial institutions to search their records back eight years, the financial institutions should honor such requests to the extent possible, even though BSA recordkeeping requirements generally do not require records to be retained beyond five years.

Reporting of "Matches"

Financial institutions typically have a two-week window to complete the one-time search and respond, if necessary to FinCEN. If a financial institution identifies an account or transaction by or on behalf of an individual appearing on a Section 314(a) Request, it must report back to FinCEN that it has a "positive match," unless directed otherwise. When reporting this information to FinCEN, no additional details, unless otherwise instructed, should be provided other than the fact that a "positive match" has been identified. In situations where a financial institution is unsure of a match, it may contact the law enforcement agency specified in the Section 314(a) Request. Negative responses to Section 314(a) Requests are not required; the financial institution does not need to respond to FinCEN on a Section 314(a) Request if there are no matches to the institution's records. Financial institutions are to be reminded that unless a name is repeated on a subsequent Section 314(a) Request, that name does not need to be searched again.

The financial institution **must not** notify a customer that he/she has been included on a Section 314(a) Request. Furthermore, the financial institution must not tell the customer that he/she is under investigation or that he/she is suspected of criminal activity.

Restrictions on Use of Section 314(a) Requests

A financial institution may only use the information identified in the records search to report "positive matches" to FinCEN and to file, when appropriate, SARs. If the financial institution has a "positive match," account activity with that customer or entity is not prohibited; it is acceptable for the financial institution to open new accounts or maintain current accounts with Section 314(a) Request subjects; the closing of accounts is not required. However, the Section 314(a) Requests may be useful as a determining factor for such decisions if the financial institution so chooses. Unlike OFAC lists, Section 314(a) Requests are not permanent "watch lists." In fact, Section 314(a) Requests are not updated or corrected if an investigation is dropped, a prosecution is declined, or a subject is exonerated, as they are point-in-time inquiries. Furthermore, the names provided on Section 314(a) Requests do not necessarily correspond to convicted or indicted persons; rather, a Section 314(a) Request subject need only be "reasonably suspected," based on credible evidence of engaging in terrorist acts or money laundering to appear on the list.

<u>SAR Filings</u>

If a financial institution has a positive match within its records, it is not required to automatically file a SAR on the identified subject. In other words, the subject's presence on the Section 314(a) Request should not be the sole factor in determining whether to file a SAR. However, prudent BSA compliance practices should ensure that the subject's accounts and transactions be scrutinized for suspicious or unusual activity. If, after such a review is performed, the financial institution's management has determined that the subject's activity is suspicious, unusual, or inconsistent with the customer's profile, then the timely filing of an SAR would be warranted.

Confidentiality of Section 314(a) Requests

Financial institutions must protect the security of the Section 314(a) Requests, as they are confidential. As stated previously, a financial institution must not tip off a customer that he/she is the subject of a Section 314(a) Request. Similarly, a financial institution cannot disclose to any person or entity, other than to FinCEN, its primary Federal functional regulator, or the Federal law enforcement agency on whose behalf FinCEN is requesting information, the fact that FinCEN has requested or obtained information from a Section 314(a) Request.

FinCEN has stated that an affiliated group of financial institutions may establish one point-of-contact to distribute the Section 314(a) Requests for the purpose of responding to requests. However, the Section 314(a) Requests should not be shared with foreign affiliates or foreign subsidiaries (unless the request specifically states otherwise), and the lists cannot be shared with affiliates or subsidiaries of bank holding companies that are not financial institutions.

Notwithstanding the above restrictions, a financial institution is authorized to share information concerning an individual, entity, or organization named in a Section 314(a) Request from FinCEN with other financial institutions and/or financial institution associations in accordance with the certification and procedural requirements of Section 314(b) of the USA PATRIOT Act discussed below. However, such sharing shall not disclose the fact that FinCEN has requested information on the subjects or the fact that they were included within a Section 314(a) Request.

<u>Internal Financial Institution Measures for Protecting Section 314(a) Requests</u>

In order to protect the confidentiality of the Section 314(a) Requests, these documents should only be provided to financial institution personnel who need the information to conduct the search and should not be left in an unprotected or unsecured area. A financial institution may provide the Section 314(a) Request to third-party information technology service providers or vendors to perform/facilitate the record searches so long as it takes the necessary steps to ensure that the third party appropriately safeguards the information. It is important to remember that the financial institution remains ultimately responsible for the performance of the required searches and to protect the security and confidentiality of the Section 314(a) Requests.

Each financial institution must maintain adequate procedures to protect the security and confidentiality of requests from FinCEN. The procedures to ensure confidentiality will be considered adequate if the financial institution applies procedures similar to those it has established to comply with Section 501 of the Gramm-Leach-Bliley Act (15 USC 6801) with regard to the protection of its customers' non-public personal information.

Financial institutions should keep a log of all Section 314(a) Requests received and any "positive matches" identified and reported to FinCEN. Additionally, documentation that all required searches were performed is essential. The financial institution should not need to keep copies of the Section 314(a) Requests, noting the unique tracking number will suffice. Some financial institutions may choose to destroy the Section 314(a) Requests after searches are performed. If a financial institution chooses to keep the Section 314(a) Requests for audit/internal review purposes, it should not be criticized for doing so, as long as it appropriately secures them and protects their confidentiality.

FinCEN has provided financial institutions with general instructions, FAQs, and additional guidance relating to the Section 314(a) Request process. These documents are revised periodically and may be found on FinCEN's Web site.

Section 314(b) - Voluntary Information Sharing

Section 314(b) of the USA PATRIOT Act encourages financial institutions and financial institution associations (for example, bank trade groups and associations) to share information on individuals, entities, organizations, and countries suspected of engaging in possible terrorist activity or money laundering. Section 314(b) limits the definition of "financial institutions" used within Section 314(a) of USA PATRIOT Act to include only those institutions that are required to establish and maintain an anti-money laundering program; this definition includes, but is not limited to, banking entities regulated by the Federal Banking Agencies. The definition specifically excludes any institution or class of institutions that FinCEN has designated as ineligible to share information. Section 314(b) also describes the safe harbor from civil liability that is provided to financial institutions that appropriately share information within the limitations and requirements specified in the regulation.

Restrictions on Use of Shared Information

Information shared on a subject from a financial institution or financial institution association pursuant to Section 314(b) cannot be used for any purpose other than the following:

- Identifying and, where appropriate, reporting on money laundering or terrorist activities;
- Determining whether to establish or maintain an account, or to engage in a transaction; or
- Assisting in the purposes of complying with this section.

Annual Certification Requirements

In order to avail itself to the statutory safe harbor protection, a financial institution or financial institution association must annually certify with FinCEN stating its intent to engage in information sharing with other similarly-certified entities. It must further state that it has established and will maintain adequate procedures to protect the security and confidentiality of the information, as if the information were included in one of its own SAR filings. The annual certification process involves completing and submitting a "Notice for Purposes of Subsection 314(b) of the USA PATRIOT Act and 31 CFR 103.110." The notice can be completed and electronically submitted to FinCEN via their website. Alternatively, the notice can be mailed to the following address: FinCEN, P.O. Box 39, Mail Stop 100, Vienna, VA 22183. It is important to mention that if a financial institution or financial institution association improperly uses its Section 314(b) permissions, its certification can be revoked by either FinCEN or by its Federal Banking Agency.

Failure to follow the Section 314(b) annual certification requirements will result in the loss of the financial institution or financial institution association's statutory safe harbor and could result in a violation of privacy laws or other laws and regulations.

Verification Requirements

A financial institution must take reasonable steps to verify that the other financial institution(s) or financial institution association(s) with which it intends to share information has also performed the annual certification process discussed above. Such verification can be performed by reviewing the lists of other 314(b) participants that are periodically provided by FinCEN. Alternatively, the financial institution or financial institution association can confirm directly with the other party that the certification process has been completed.

Other Important Requirements and Restrictions

Section 314(b) requires virtually the same care and safeguarding of sensitive information as Section 314(a), whether the bank is the "provider" or "receiver" of information. Refer to the discussions provided above and within "Section 314(a) – Mandatory Information Sharing Between the U.S. Government and Financial Institutions" for detailed guidance on:

- SAR Filings and
- Confidentiality of Section 314(a) Requests (including the embedded discussion entitled "Internal Financial Institution Measures for Protecting Section 314(a) Requests").

Actions taken pursuant to shared information do not affect a financial institution's obligations to comply with all BSA and OFAC rules and regulations. For example, a financial institution is still obligated to immediately contact law enforcement and its Federal regulatory agency, by telephone, when a significant reportable violation requiring immediate attention (such as one that involves the financing of terrorist activity or is of an ongoing nature) is being conducted; thereafter, a timely SAR filing is still required.

FinCEN has provided financial institutions with general instructions, registration forms, FAQs, and additional guidance relating to the Section 314(b) information sharing process. These documents are revised periodically and may be found on FinCEN's website.

CUSTOMER DUE DILIGENCE (CDD)

The cornerstone of strong BSA/AML programs is the adoption and implementation of comprehensive CDD policies, procedures, and controls for all customers, particularly those that present a higher risk for money laundering and terrorist financing. The concept of CDD incorporates and builds upon the CIP regulatory requirements for identifying and verifying a customer's identity.

The goal of a CDD program is to develop and maintain an awareness of the unique financial details of the institution's customers and the ability to relatively predict the type and frequency of transactions in which its customers are likely to engage. In doing so, institutions can better identify, research, and report suspicious activity as required by BSA regulations. Although not required by statute or regulation, an effective CDD program provides the critical framework that enables the institution to comply with regulatory requirements.

Benefits of an Effective CDD Program

An effective CDD program protects the reputation of the institution by:

- Preventing unusual or suspicious transactions in a timely manner that potentially exposes the institution to financial loss or increased expenses;
- Avoiding criminal exposure from individuals who use the institution's resources and services for illicit purposes; and
- Ensuring compliance with BSA regulations and adhering to sound and recognized banking practices.

CDD Program Guidance

CDD programs should be tailored to each institution's BSA/AML risk profile; consequently, the scope of CDD programs will vary. While smaller institutions may have more frequent and direct contact with customers than their counterparts in larger institutions, all institutions should adopt and follow an appropriate CDD program.

An effective CDD program should:

- Be commensurate with the institution's BSA/AML risk profile, paying particular attention to higher risk customers,
- Contain a clear statement of management's overall expectations and establish specific staff responsibilities, and
- Establish monitoring systems and procedures for identifying transactions or activities inconsistent with a customer's normal or expected banking activity.

Customer Risk

As part of an institution's BSA/AML risk assessment, many institutions evaluate and apply a BSA/AML risk rating to its customers. Under this approach, the institution will obtain information at account opening sufficient to develop a "customer transaction profile" that incorporates an understanding of normal and expected activity for the customer's occupation or business operations. While this practice may not be appropriate for all institutions, management of all institutions should have a thorough understanding of the money laundering or terrorist financing risks of its customer base and develop and implement the means to adequately mitigate these risks.

Due Diligence for Higher Risk Customers

Customers that pose higher money laundering or terrorist financing risks present increased exposure to institutions. Due diligence for higher risk customers is especially critical in understanding their anticipated transactions and implementing a suspicious activity monitoring system that reduces the institution's reputation, compliance, and transaction risks. Higher risk customers and their transactions should be reviewed more closely at account opening and more frequently throughout the term of the relationship with the institution.

The USA PATRIOT Act requires special due diligence at account opening for certain foreign accounts, such as foreign correspondent accounts and accounts for senior foreign political figures. An institution's CDD program should include policies, procedures, and controls reasonably designed to detect and report money laundering through correspondent accounts and private banking accounts that are established or maintained for non-U.S. persons. Guidance regarding special due diligence requirements is provided in the next section entitled "Banking Services and Activities with Greater Potential for Money Laundering and Enhanced Due Diligence Procedures."

BANKING SERVICES AND ACTIVITIES WITH GREATER POTENTIAL FOR MONEY LAUNDERING AND ENHANCED DUE DILIGENCE PROCEDURES

Certain financial services and activities are more vulnerable to being exploited in money laundering and terrorist financing activities. These conduits are often utilized because each typically presents an opportunity to move large amounts of funds embedded within a large number of similar transactions. Most activities discussed in this section also offer access to international banking and financial systems. The ability of U.S. financial institutions to conduct the appropriate level of due diligence on customers of foreign banks, offshore and shell banks, and foreign branches is often severely limited by the laws and banking practices of other countries.

While international AML and Counter-Terrorist Financing (CTF) standards are improving through efforts of several international groups, U.S. financial institutions will still need effective systems in their AML and CTF programs to understand the quality of supervision and assess the integrity and effectiveness of controls in other countries. Higher risk areas discussed in this section include:

- Non-bank financial institutions (NBFIs), including money service businesses (MSBs);
- Foreign correspondent banking relationships;
- Payable-through accounts;
- Private banking activities;
- Numbered accounts;
- Pouch activities;
- Special use accounts;
- Wire transfer activities; and
- Electronic banking.

Financial institutions offering these higher risk products and services must enhance their AML and CDD procedures to ensure adequate scrutiny of these activities and the customers conducting them.

Non-Bank Financial Institutions and Money Service Businesses

Non-bank financial institutions (NBFIs) are broadly defined as institutions that offer financial services. Traditional financial institutions ("banks" for this discussion) that maintain account relationships with NBFIs are exposed to a higher risk for potential money laundering activities because these entities are less regulated and may have limited or no documentation on their customers. Additionally, banks may likewise be exposed to possible OFAC violations for unknowingly engaging in or facilitating prohibited transactions through a NBFI account relationship.

NBFIs include, but are not limited to:

- Casinos or card clubs;
- Securities brokers/dealers; and
- Money Service Businesses (MSBs)
  - currency dealers or exchangers;
  - check cashers;
  - issuers, sellers, or redeemers of traveler's checks, money orders, or stored value cards;
  - money transmitters; and
  - U.S. Post Offices (money orders).

Money Service Businesses

As indicated above, MSBs are a subset of NBFIs. Regulations for MSBs are included within 31 CFR 103.41. All MSBs were required to register with FinCEN using Form TD F 90-22.55 by December 31, 2001, or within 180 days after the business begins operations. Thereafter, each MSB must renew its registration every two years.

MSBs are a major industry, and typically operate as independent businesses. Relatively few MSBs are chains that operate in multiple states. MSBs can be sole-purpose entities but are frequently tied to another business such as a liquor store, bar, grocery store, gas station, or other multi-purpose entity. As a result, many MSBs are frequently unaware of their legal and regulatory requirements and have been historically difficult to detect. A bank may find it necessary to inform MSB customers about the appropriate MSB regulations and requirements.

Most legitimate MSBs should not refuse to follow regulations once they have been informed of the requirements. If they do, the bank should closely scrutinize the MSBs activities and transactions for possible suspicious activity.

MSBs typically do not establish on-going customer relationships, and this is one of the reasons that MSB customers are considered higher risk. Since MSBs do not have continuous relationships with their clients, they generally do not obtain key due diligence documentation, making customer identification and suspicious transaction identification more difficult.

Banks with MSB customers also have a risk in processing third-party transactions through their payment and other banking systems. MSB transactions carry an inherent potential for the facilitation of layering. MSBs can be conduits for illicit cash and monetary instrument transactions, check kiting, concealing the ultimate beneficiary of the funds, and facilitating the processing of forged or fraudulent items such as treasury checks, money orders, traveler's checks, and personal checks.

MSB Agents

MSBs that are agents of such commonly known entities as Moneygram or Western Union should be aware of their legal requirements. Agents of such money transmitters, unless they offer another type of MSB activity, do NOT have to independently register with FinCEN, but are maintained on an agency list by the "actual" MSB (such as Western Union). However, this "actual" MSB is responsible for providing general training and information requirements to their agents and for aggregating transactions on a nationwide basis, as appropriate.

Check Cashers

FinCEN defines a check casher as a business that will cash checks and/or sell monetary or other instruments over $1,000 per customer on any given day. If a company, such as a local mini-market, will cash only personal checks up to $100 per day AND it provides no other financial services or instruments (such as money orders or money transmittals), then that company would NOT be considered a check casher for regulatory purposes or have to register as an MSB.

Exemptions from CTR Filing Requirements

MSBs are subject to BSA regulations and OFAC sanctions and, as such, should be filing CTRs, screening customers for OFAC matches, and filing SARs, as appropriate. MSBs cannot exempt their customers from CTR filing requirements like banks can, and banks may not exempt MSB customers from CTR filing, unless the "50 Percent Rule" applies.

The "50 Percent Rule" states that if a MSB derives less than 50 percent of its gross cash receipts from money service activities, then it can be exempted. If the bank exempts a MSB customer under the "50 Percent Rule," it should have documentation evidencing the types of business conducted, receipt volume, and estimations of MSB versus non-MSB activity.

Policies and Procedures for Opening and Monitoring NBFI and MSB Relationships

Banks that maintain account relationships with NBFIs or MSBs should perform greater due diligence for these customers given their higher risk profile. Management should implement the following due diligence procedures for MSBs:

- Identify all NBFI/MSB accounts;
- Determine that the business has met local licensing requirements;
- Ascertain if the MSB has registered or re-registered with FinCEN and obtain a copy of the filing or verify the filing on FinCEN's website;
- Determine if the MSB has procedures to comply with BSA regulations and OFAC monitoring;
- Establish the types and amounts of currencies/instruments handled, and any additional services provided;
- Note the targeted customer base;
- Determine if the business sends or receives international wires and the nature of the activity;
- Determine if the MSB has procedures to monitor and report suspicious activity; and
- Obtain a copy of the MSBs independent BSA review, if available.

Management should document in writing the responses to the items above and update MSB customer files at least annually. In addition, management should continue to monitor these higher risk accounts for suspicious activity. The FDIC does not expect the bank to perform an examination of the MSB; however, the bank should take reasonable steps to document that MSB customers are aware of and are complying with appropriate regulations.

For additional information, examiners should instruct bank management to consult the FinCEN website developed specifically for MSBs. This website contains guidance, registration forms, and other materials useful for MSBs to understand and comply with BSA regulations. Bank customers who are uncertain if they are covered by the definition of MSBs can also visit this site to determine if their business activities qualify.

Foreign Correspondent Banking Relationships

Correspondent accounts are accounts that financial institutions maintain with each other to handle transactions for themselves or for their customers. Correspondent accounts between a foreign bank and U.S. financial institutions are much needed, as they facilitate international trade and investment. However, these relationships may pose a higher risk for money laundering.

Transactions through foreign correspondent accounts are typically large and would permit movement of a high volume of funds relatively quickly. These correspondent accounts also provide foreign entities with ready access to the U.S. financial system. These banks and other financial institutions may be located in countries with unknown AML regulations and controls ranging from strong to weak, corrupt, or nonexistent.

The USA PATRIOT Act establishes reporting and documentation requirements for certain high-risk areas, including:

- Special due diligence requirements for correspondent accounts and private banking accounts which are addressed in 31 CFR 103.181.
- Verification procedures for foreign correspondent account relationships which are included in 31 CFR 103.185.
- Foreign banks with correspondent accounts at U.S. financial institutions must produce bank records, including information on ownership, when requested by regulators and law enforcement, as detailed in Section 319 of the USA PATRIOT Act and codified at 31 CFR 103.185.

The foreign correspondent records detailed above are to be provided within seven days of a law enforcement request and within 120 hours of a Federal regulatory request. Failure to provide such records in a timely manner may result in the U.S. financial institution's required termination of the foreign correspondent account. Such foreign correspondent relationships need only be terminated upon the U.S. financial institution's written receipt of such instruction from either the Secretary of the Treasury or the U.S. Attorney General. If the U.S. financial institution fails to terminate relationships after receiving notification, the U.S. institution may face civil money penalties.

The Treasury was also granted broad authority by the USA PATRIOT Act (codified in 31 USC 5318[A]), allowing it to establish special measures. Such special measures can be established which require U.S. financial institutions to perform additional recordkeeping and/or reporting or require a complete prohibition of accounts and transactions with certain countries and/or specified foreign financial institutions. The Treasury may impose such special measures by regulation or order, in consultation with other regulatory agencies, as appropriate.

Shell Banks

Sections 313 and 319 of the USA PATRIOT Act implemented (by 31 CFR 103.177 and 103.185, respectively) a new provision of the BSA that relates to foreign correspondent accounts. Covered financial institutions (CFI) are prohibited from establishing, maintaining, administering, or managing a correspondent account in the U.S. for or on behalf of a foreign shell bank.

A correspondent account, under this regulation, is defined as an account established by a CFI for a foreign bank to receive deposits from, to make payments or other disbursements on behalf of a foreign financial institution, or to handle other financial transactions related to the foreign bank. An account is further defined as any formal banking or business relationship established to provide:

- Regular services,
- Dealings, and
- Other financial transactions,

and may include:

- Demand deposits,
- Savings deposits,
- Any other transaction or asset account,
- Credit account, or
- Any other extension of credit.

A foreign shell bank is defined as a foreign bank without a physical presence in any country. Physical presence means a place of business that:

- Is maintained by a foreign bank;
- Is located at a fixed address (other than solely an electronic address or a post-office box) in a country in which the foreign bank is authorized to conduct banking activities;
- Provides at that fixed address:
    - One or more full-time employees,
    - Operating records related to its banking activities; and
- Is subject to inspection by the banking authority that licensed the foreign bank to conduct banking activities.

There is one exception to the shell bank prohibition. This exception allows a CFI to maintain a correspondent account with a foreign shell bank if it is a regulated affiliate. As a regulated affiliate, the shell bank must meet the following requirements:

- The shell bank must be affiliated with a depository institution (bank or credit union, either U.S. or foreign) in the U.S. or another foreign jurisdiction.
- The shell bank must be subject to supervision by the banking authority that regulates the affiliated entity.

Furthermore, in any foreign correspondent relationship, the CFI must take reasonable steps to ensure that such an account is not being used indirectly to provide banking services to other foreign shell banks. If the CFI discovers that a foreign correspondent account is providing indirect services in this manner, then it must either prohibit the indirect services to the foreign shell bank or close down the foreign correspondent account. This activity is referred to as “nested” correspondent banking and is discussed in greater detail below under “Foreign Correspondent Banking Money Laundering Risks.”

Required Recordkeeping on Correspondent Banking Accounts

As mentioned previously, a CFI that maintains a foreign correspondent account must also maintain records identifying the owners of each foreign bank. To minimize recordkeeping burdens, ownership information is not required for:

- Foreign banks that file form FR-7 with the Federal Reserve, or
- Publicly traded foreign banks.

A CFI must also record the name and street address of a person who resides in the U.S. and who is willing to accept service of legal process on behalf of the foreign institution. In other words, the CFI must collect information so that law enforcement can serve a subpoena or other legal document upon the foreign correspondent bank.

Certification Process

To facilitate information collection, the Treasury, in coordination with the banking industry, Federal regulators and law enforcement agencies, developed a certification process using special forms to standardize information collection. The use of these forms is not required; however, the information must be collected regardless. The CFI must update, or re-certify, the foreign correspondent information at least once every three years.

For new accounts, this certification information must be obtained within 30 calendar days after the opening date. If the CFI is unable to obtain the required information, it must close all correspondent accounts with that foreign bank within a commercially reasonable time. The CFI should review certifications to verify their accuracy. The review should look for potential problems that may warrant further research or information. Should a CFI know, suspect, or have reason to suspect that any certification information is no longer correct, the CFI must request the foreign bank to verify or correct such information within 90 days. If the information is not corrected within that time, the CFI must close all correspondent accounts with that institution within a commercially reasonable time.

Foreign Correspondent Banking Money Laundering Risks

Foreign correspondent accounts provide clearing access to foreign financial institutions and their customers, which may include other foreign banks. Many U.S. financial institutions fail to ascertain the extent to which the foreign banks will allow other foreign banks to use their U.S. accounts. Many high-risk foreign financial institutions have gained access to the U.S. financial system by operating through U.S. correspondent accounts belonging to other foreign banks. These are commonly referred to as “nested” correspondent banks.

Such nested correspondent bank relationships result in the U.S. financial institution’s inability to identify the ultimate customer who is passing a transaction through the foreign correspondent’s U.S. account. These nested relationships may prevent the U.S. financial institution from effectively complying with BSA regulations, suspicious activity reporting, and OFAC monitoring and sanctions.

If a U.S. financial institution’s due diligence or monitoring system identifies the use of such nested accounts, the U.S.

financial institution should do one or more of the following:

- Perform due diligence on the nested users of the foreign correspondent account, to determine and verify critical information including, but not limited to, the following:
  - Ownership information,
  - Service of legal process contact,
  - Country of origin,
  - AML policies and procedures,
  - Shell bank and licensing status,
  - Purpose and expected volume and type of transactions;
- Restrict business through the foreign correspondent's accounts to limited transactions and/or purposes; and
- Terminate the initial foreign correspondent account relationship.

Necessary Due Diligence on Foreign Correspondent Accounts

Because of the heightened risk related to foreign correspondent banking, the U.S. financial institution needs to assess the money laundering risks associated with each of its correspondent accounts. The U.S. financial institution should understand the nature of each account holder's business and the purpose of the account. In addition, the U.S. financial institution should have an expected volume and type of transaction anticipated for each foreign bank customer.

When a new relationship is established, the U.S. financial institution should assess the management and financial condition of the foreign bank, as well as its AML programs and the home country's money laundering regulations and supervisory oversight. These due diligence measures are in addition to the minimum regulation requirements.

Each U.S. financial institution maintaining foreign correspondent accounts must establish appropriate, specific, and, where necessary, enhanced due diligence policies, procedures, and controls as required by 31 CFR 103.181. The U.S. financial institution's AML policies and programs should enable it to reasonably detect and report instances of money laundering occurring through the use of foreign correspondent accounts.

The regulations specify that additional due diligence must be completed if the foreign bank is:

- Operating under an offshore license;
- Operating under a license granted by a jurisdiction designated by the Treasury or an intergovernmental agency (such as the Financial Action Task Force [FATF]) as being a primary money laundering concern; or
- Located in a bank secrecy or money laundering haven.

Internal financial institution policies should focus compliance efforts on those accounts that represent a higher risk of money laundering. U.S. financial institutions may use their own risk assessment or incorporate the best practices developed by industry and regulatory recommendations.

Offshore Banks

An offshore bank is one which does not transact business with the citizens of the country that licenses the bank. For example, a bank is licensed as an offshore bank in Spain. This institution may do business with anyone in the world except for the citizens of Spain. Offshore banks are typically a revenue generator for the host country and may not be as closely regulated as banks that provide financial services to the host country's citizens. The host country may also have lax AML standards, controls, and enforcement. As such, offshore licenses can be appealing to those wishing to launder illegally obtained funds.

The FATF designates Non-Cooperative Countries and Territories (NCCTs). These countries have been so designated because they have not applied the recommended international anti-money laundering standards and procedures to their financial systems. The money laundering standards established by FATF are known as the Forty Recommendations. Further discussion of the Forty Recommendations and NCCTs can be found at the FATF website.

Payable Through Accounts

A payable through account (PTA) is a demand deposit account through which banking agencies located in the U.S. extend check writing privileges to the customers of other domestic or foreign institutions. PTAs have long been used in the U.S. by credit unions (for example, for checking account services) and investment companies (for example, for checking account services associated with money market management accounts) to offer customers the full range of banking services that only a commercial bank has the ability to provide.

International PTA Use

Under an international PTA arrangement, a U.S. financial institution, Edge corporation, or the U.S. branch or agency of a foreign bank (U.S. banking entity) opens a master checking account in the name of a foreign bank operating outside the U.S. The master account is subsequently divided by the foreign bank into "sub-accounts" each in the name of one of the foreign bank's customers. Each sub-account holder becomes a signatory on the foreign bank's account at the U.S. banking entity and may conduct banking activities through the account.

Financial institution regulators have become aware of the increasing use of international PTAs. These accounts are being marketed by U.S. financial institutions to foreign banks that otherwise would not have the ability to offer their customers direct access to the U.S. banking system. While PTAs provide legitimate business benefits, the operational aspects of the account make it particularly vulnerable to abuse as a mechanism to launder money. In addition, PTAs present unique safety and soundness risks to banking entities in the U.S.

Sub-account holders of the PTA master accounts at the U.S. banking entity may include other foreign banks, rather than just individuals or corporate accounts. These second-tier foreign banks then solicit individuals as customers. This may result in thousands of individuals having signatory authority over a single account at a U.S. banking entity. The PTA mechanism permits the foreign bank operating outside the U.S. to offer its customers, the sub-account holders, U.S. denominated checks and ancillary services, such as the ability to receive wire transfers to and from sub-accounts and to cash checks. Checks are encoded with the foreign bank's account number along with a numeric code to identify the sub-account.

Deposits into the U.S. master account may flow through the foreign bank, which pools them for daily transfer to the U.S. banking entity. Funds may also flow directly to the U.S. banking entity for credit to the master account, with further credit to the sub-account.

Benefits Associated with Payable Through Accounts

While the objectives of U.S. financial institutions marketing PTAs and the foreign banks which subscribe to the PTA service may vary, essentially three benefits currently drive provider and user interest:

- PTAs permit U.S. financial institutions to attract dollar deposits from the home market of foreign banks without jeopardizing the foreign bank's relationship with its clients.
- PTAs provide fee income potential for both the U.S. PTA provider and the foreign bank.
- Foreign banks can offer their customers efficient and low-cost access to the U.S. banking system.

Risks Associated with Payable Through Accounts

The PTA arrangement between a U.S. banking entity and a foreign bank may be subject to the following risks:

- *Money Laundering risk* – the risk of possible illegal or improper conduct flowing through the PTAs.
- *OFAC risk* – the risk that the U.S. banking entity does not know the ultimate PTA customers which could facilitate the completion of sanctioned or blocked transactions.
- *Credit risk* - the risk the foreign bank will fail to perform according to the terms and conditions of the PTA agreement, either due to bankruptcy or other financial difficulties.
- *Settlement risk* - the risk that arises when the U.S. banking entity pays out funds before it can be certain that it will receive the corresponding deposit from the foreign bank.
- *Country risk* - the risk the foreign bank will be unable to fulfill its international obligations due to domestic strife, revolution, or political disturbances.
- *Regulatory risk* - the risk that deposit and withdrawal transactions through the PTA may violate State and/or Federal laws and regulations.

Unless a U.S. banking entity is able to identify adequately, and understand the transactions of the ultimate users of the foreign bank's account maintained at the U.S. banking entity, there is a potential for serious illegal conduct.

Because of the possibility of illicit activities being conducted through PTAs at U.S. banking entities, financial institution regulators believe it is inconsistent with the principles of safe and sound banking for U.S. banking entities to offer PTA services without developing and maintaining policies and procedures designed to guard against the possible improper or illegal use of PTA facilities.

Policy Recommendations

Policies and procedures must be fashioned to enable each U.S. banking entity offering PTA services to foreign banks to:

- Identify sufficiently the ultimate users of its foreign bank PTAs, including obtaining (or having the ability to obtain) substantially the same type of information on the ultimate users as the U.S. banking entity obtains for its domestic customers.
- Review the foreign bank's own procedures for identifying and monitoring sub-account holders, as

well as the relevant statutory and regulatory requirements placed on the foreign bank to identify and monitor the transactions of its own customers by its home country supervisory authorities.
- Monitor account activities conducted in the PTAs with foreign banks and report suspicious or unusual activity in accordance with Federal regulations.

Termination of PTAs

It is recommended the U.S. banking entity terminate a PTA with a foreign bank as expeditiously as possible in the following situations:

- Adequate information about the ultimate users of the PTAs cannot be obtained.
- The U.S. banking entity cannot adequately rely on the home country supervisor to require the foreign bank to identify and monitor the transactions of its own customers.
- The U.S. banking entity is unable to ensure that its PTAs are not being used for money laundering or other illicit purposes.
- The U.S. banking entity identifies ongoing suspicious and unusual activities dominating the PTA transactions.

Private Banking Activities

Private banking has proven to be a profitable operation and is a fast-growing business in U.S. financial institutions. Although the financial service industry does not use a standard definition for private banking, it is generally held that private banking services include an array of all-inclusive deposit account, lending, investment, trust, and cash management services offered to high net worth customers and their business interests. Not all financial institutions operate private banking departments, but they typically offer special attention to their best customers and ensure greater privacy concerning the transactions and activities of these customers. Smaller institutions may offer similar services to certain customers while not specifically referring to this activity as private banking.

Confidentiality is a vital element in administering private banking relationships. Although customers may choose private banking services to manage their assets, they may also seek confidential ownership of their assets or a safe, legal haven for their capital. When acting as a fiduciary, financial institutions may have statutory, contractual, or ethical obligations to uphold customer confidentiality.

Typically, a private banking department will service a financial institution's wealthy foreign customers, as these customers may be conducting more complex transactions and using services that facilitate international transactions. Because of these attributes, private banking also appeals to money launderers.

Examiners should evaluate the financial institution management's ability to measure and control the risk of money laundering in the private banking area and determine if adequate AML policies, procedures, and oversight are in place to ensure compliance with laws and regulations and adequate identification of suspicious activities.

Policy Recommendations

At a minimum, the financial institution's private banking policies and procedures should address:

- Acceptance and approval of private banking clients;
- Desired or targeted client base;
- Products and services that will be offered;
- Effective account opening procedures and documentation requirements; and
- Account review upon opening and ongoing thereafter.

In addition, the financial institution must:

- Document the identity and source of wealth on all customers requesting custody or private banking services;
- Understand each customer's net worth, account needs, as well as level and type of expected activity;
- Verify the source and accuracy of private banking referrals;
- Verify the origins of the assets or funds when transactions are received from other financial service providers;
- Review employment and business information, income levels, financial statements, net worth, and credit reports; and
- Monitor the account relationship by:
    - Reviewing activity against customer profile expectations,
    - Investigating extraordinary transactions,
    - Maintaining an administrative file documenting the customer's profile and activity levels,
    - Maintaining documentation that details personal observations of the customer's business and/or personal life, and
    - Ensuring that account reviews are completed periodically by someone other than the private banking officer.

Financial institutions should ensure, through independent review, that private banking account officers have adequate documentation for accepting new private banking account funds and are performing the responsibilities detailed above.

Enhanced Due Diligence for Non-U.S. Persons Maintaining Private Banking Accounts

Section 312 of the USA PATRIOT Act, implemented by 31 CFR 103.181, requires U.S. financial institutions that maintain private banking accounts for non-U.S. persons to establish enhanced due diligence policies, procedures, and controls that are designed to detect and report money laundering.

Private banking accounts subject to requirements under Section 312 of the USA PATRIOT Act include:

- Accounts, or any combination of accounts with a minimum deposit of funds or other assets of at least $1 million;
- Accounts established for one or more individuals (beneficial owners) that are neither U.S. citizens, nor lawful permanent residents of the U.S.; or
- Accounts assigned to or managed by an officer, employee, or agent of a financial institution acting as a liaison between the financial institution and the direct or beneficial owner of the account.

Regulations for private banking accounts specify that enhanced due diligence procedures and controls should be established where appropriate and necessary with respect to the applicable accounts and relationships. The financial institution must be able to show it is able to reasonably detect suspicious and reportable money laundering transactions and activities.

A due diligence program is considered reasonable if it focuses compliance efforts on those accounts that represent a high risk of money laundering. Private banking accounts of foreign customers inherently indicate higher risk than many U.S. accounts; however, it is incumbent upon the financial institution to establish a reasonable level of monitoring and review relative to the risk of the account and/or department.

A financial institution may use its own risk assessment or incorporate industry best practices into its due diligence program. Specific due diligence procedures required by Section 312 of USA PATRIOT Act include:

- Verification of the identity of the nominal and beneficial owners of an account;
- Documentation showing the source of funds; and
- Enhanced scrutiny of accounts and transactions of senior foreign political figures, also known as "politically exposed persons" (PEPs).

Identity Verification

The financial institution is expected to take reasonable steps to verify the identity of both the nominal and the beneficial owners of private banking accounts. Often, private banking departments maintain customer information in a central confidential file or use code names in order to protect the customer's privacy. Because of the nature of the account relationship with the bank liaison and the focus on a customer's privacy, customer profile information has not always been well documented.

Other methods used to maintain customer privacy include:

- Private Investment Corporation (PIC),
- Offshore Trusts, and
- Token Name Accounts.

PICs are established to hold a customer's personal assets in a separate legal entity. PICs offer confidentiality of ownership, hold assets centrally, and provide intermediaries between private banking customers and the potential beneficiaries of the PICs or trusts. A PIC may also be a trust asset. PICs are incorporated frequently in countries that impose low or no taxes on company assets and operations, or are bank secrecy havens. They are sometimes established by the financial institution for customers through their international affiliates – some high profile or political customers have a legitimate need for a higher degree of financial privacy. However, financial institutions should exercise extra care when dealing with beneficial owners of PICs and associated trusts because they can be misused to conceal illegal activities. Since PICs issue bearer shares, anonymous relationships in which the financial institution does not know and document the beneficial owner should not be permitted.

Offshore trusts can operate similarly to PICs and can even include PICs as assets. Beneficial owners may be numerous; regardless, the financial institution must have records demonstrating reasonable knowledge and due diligence of beneficiary identities. Offshore trusts should identify grantors of the trusts and sources of the grantors' wealth.

Furthermore, OFAC screening may be difficult or impossible when transactions are conducted through PICs, offshore trusts, or token name accounts 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 as other accounts. That is, the OFAC screening process must include the account's beneficial ownership as well as the official account name.

Documentation of Source of Funds

Documentation of the source of funds deposited into a private banking account is also required by Section 312 of the USA PATRIOT Act. Customers will frequently transfer large sums in single transactions and the financial institution must document initial and ongoing monetary flows in order to effectively identify and report suspicious activity. Understanding how high net worth customers' cash flows, operational income, and expenses flow through a private banking relationship is an integral part of understanding the customer's wealth picture. Due diligence will often necessitate that the financial institution thoroughly investigate the customer's expected transactions.

Enhanced Scrutiny of Politically Exposed Persons

Enhanced scrutiny of accounts and transactions involving senior foreign political figures, their families and associates is required by law in order to guard against laundering the proceeds of foreign corruption.

Illegal activities related to foreign corruption were brought under the definition of money laundering by Section 315 of USA PATRIOT Act. Abuses and corruption by political officials not only negatively impacts their home country's finances, but can also undermine international government and working group efforts against money laundering. A financial institution doing business with corrupt PEPs can be exposed to significant reputational risk, which could result in adverse financial impact through news articles, loss of customers, and even civil money penalties (CMPs). Furthermore, a financial institution, its directors, officers, and employees can be exposed to criminal charges if they did know or should have known (willful blindness) that funds stemmed from corruption or serious crimes.

As such, PEP accounts can present a higher risk. Enhanced scrutiny is appropriate in the following situations:

- Customer asserts a need to have the foreign political figure or related persons remain secret.
- Transactions are requested to be performed that are not expected given the customer's account profile.
- Amounts and transactions do not make sense in relation to the PEP's known income sources and uses.
- Transactions exceed reasonable amounts in relation to the PEP's known net worth.
- Transactions are large in relation to the PEP's home country financial condition.
- PEP's home country is economically depressed, yet the PEP's home country transactions funding the account remain high.
- Customer refuses to disclose the nominal or beneficial owner of the account or provides false or misleading information.
- Net worth and/or source of funds for the PEP are unidentified.

Additional discussion of due diligence procedures for these accounts can be found in interagency guidance issued in FDIC FIL-6-2001, dated in January 2001, "Guidance on Enhanced Scrutiny for Transactions That May Involve the Proceeds of Foreign Official Corruption."

Fiduciary and Custody Services within the Private Banking Department

Although fiduciary and agency activities are circumscribed by formal trust laws, private banking clients may delegate varying degrees of authority (discretionary versus nondiscretionary) over assets under management to the financial institution. In all cases, the terms under which the assets are managed are fully described in a formal agreement, also known as the "governing instrument" between the customer and the financial institution.

Even though the level of authority may encompass a wide range of products and services, examiners should determine the level of discretionary authority delegated to private banking department personnel in the management of these activities and the documentation required from customers to execute transactions on their behalf. Private banking department personnel should not be able to execute transactions on behalf of their clients without proper documentation from clients or independent verification of client instructions.

Concerning investments, fiduciaries are also required to exercise prudent investment standards, so the financial institution must ensure that if it is co-trustee or under direction of the customer who retains investment discretion, that the investments meet prudent standards and are in the best interest of the beneficiaries of the trust accounts.

Trust agreements may also be structured to permit the grantor/customer to continue to add to the corpus of the trust account. This provides another avenue to place funds into the banking system and may be used by money launderers for that purpose.

Investment management services have many similar characteristics to trust accounts. The accounts may be discretionary or nondiscretionary. Transactions from clients through a private banking department relationship manager should be properly documented and able to be independently verified. The portfolio manager should also document the investment objectives.

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 referrals from other departments in the financial institution or from outside investment advisors. The customer, or 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, again by the customer. In this case, it is important for the financial institution to know the customer. Procedures for proper administration should be established and reviewed frequently.

Numbered Accounts

A numbered account, also known as a pseudonym account, is opened not under an individual or corporate name, but under an assigned number or pseudonym. These types of numbered accounts are typically services offered in the private banking department or the trust department, but they can be offered anywhere in the institution.

Numbered accounts present some distinct customer advantages when it comes to privacy. First, all of the computerized information is recorded using the number or pseudonym, not the customer's real name. This means that tellers, wire personnel, and various employees do not know the true identity of the customer. Furthermore, it protects the customer against identity theft. If electronic financial records are stolen, the number or pseudonym will not provide personal information. Statements and any documentation would simply show the number, not the customer's true name or social security number.

However, numbered accounts offered by U.S. financial institutions must still meet the requirements of the BSA and specific customer identification and minimum due diligence documentation should be obtained. Account opening personnel must adequately document the customer due diligence performed, and access to this information must be provided to employees reviewing transactions for suspicious activity.

If the financial institution chooses to use numbered accounts, they must ensure that proper procedures are in place. Here are some minimum standards for numbered or pseudonym accounts:

- The BSA Officer should ensure that all required CIP information is obtained and well documented. The documentation should be readily available to regulators upon request.
- Management should ensure that adequate suspicious activity review procedures are in place. These accounts are considered to be high risk, and, as such, should have enhanced scrutiny. In order to properly monitor for unusual or suspicious activities, the person(s) responsible for monitoring these accounts must have the identity of the customer revealed to them. <u>All transactions for these accounts should be reviewed at least once a month or more frequently.</u>
- The financial institution's system for performing OFAC reviews, Section 314(a) Requests, or any other inquiries on its customer databases, must be able to check the actual names and relevant information of these individuals. Typically the software will screen just the account name on the trial balance. Consequently, if the name is not on the trial balance, then it could be overlooked in this process. Management should thoroughly document how it will handle such situations, as well as each review that is performed.

Examiners should include the fact that the financial institution's policy allows for numbered accounts on the "Confidential – Supervisory Section" page of the Report of Examination. Given the high risk nature of this account type, examiners should review them at every examination to ensure that management is adequately handling these accounts.

Pouch Activities

Pouch activities involve the use of a common carrier to transport currency, monetary instruments, and other documents usually from outside the U.S. to a domestic bank account. Pouches can originate from an individual or another financial institution and can contain any kind of document, including all forms of bank transactions such as demand deposits and loan payments. The contents of the pouch are not always subject to search while in transport, and considerable reliance is placed on the financial institution's internal control systems designed to account for the contents and their transfer into the institution's accounts.

Vulnerabilities in pouch systems can be exploited by those looking for an avenue to move illegally-gained funds into the U.S. Law enforcement has uncovered money laundering schemes where pouches were used to transfer:

- Bulk currency, both U.S. and foreign, and
- Sequentially numbered monetary instruments, such as traveler's checks and money orders.

Once these illegal funds are deposited into the U.S. financial institution, they can be moved – typically through use of a wire transfer – anywhere in the world. As such, pouches are used by those looking to legitimize proceeds and obscure the true source of the funds.

Financial institutions establish pouch activities primarily to provide a service. The risks associated with a night deposit drop box (one example of pouch activity) are very different from financial institutions that provide document and currency transport from their international offices to banking offices in the U.S.

A prime benefit of having pouch services is the speed with which international transactions can be placed in the U.S. domestic banking system by avoiding clearing a transaction through several international banks in order to move the funds into the U.S. This benefit is particularly advantageous for customers in countries that do not do direct business with the U.S., including those countries that:

- May require little or no customer identification,
- Are well-known secrecy havens, or
- Are considered NCCTs.

Examination Guidance

Examiners should ascertain if a financial institution offers pouch services. If it does provide these services, examiners must verify that all pouch activity is included in AML programs and is thoroughly monitored for suspicious activity.

Examiners are strongly encouraged to be present during one or more pouch openings during the examination. By reviewing the procedures for opening and documenting items in the pouches, along with records maintained of pouch activities, examiners should be able to ascertain or confirm the degree of risk undertaken and the sufficiency of AML program in relation to the institution's pouch activity.

Special Use Accounts

Special use accounts are in-house accounts established to handle the processing of multiple customer transactions within the financial institution. These accounts are also known as concentration accounts, omnibus, or suspense accounts and serve as settlement accounts. They are used in many areas of a financial institution, including private banking departments and in the wire transfer function. They present heightened money laundering risks because controls may be lax and an audit trail of customer information may not be easy to follow since transactions do not always maintain the customer identifying information with the transaction amount. In addition, many financial institution employees may have access to the account and have the ability to make numerous entries into and out of the account. Balancing of the special use account is also not always the responsibility of one individual, although items posted in the account are usually expected to be processed or resolved and settled in one day.

Financial institutions that use special use accounts should implement risk-based procedures and controls covering access to and operation of these accounts. Procedures and controls should ensure that the audit trail provides for association of the identity of transactor, customer and/or direct or beneficial owner with the actual movement of the funds. As such, financial institutions must maintain complete records of all customer transactions passing through these special use accounts. At a minimum, such records should contain the following information:

- Customer name,
- Customer address,
- Account number,
- Dollar value of the transaction, and
- Dates the account was affected.

Wire Transfer Activities

The established wire transfer systems permit quick movement of funds throughout the U.S. banking system and internationally. Wire transfers are commonly used to move funds in various money laundering schemes. Successive wire transfers allow the originator and the ultimate beneficiary of the funds to:

- Obtain relative anonymity,
- Obfuscate the money trail,
- Easily aggregate funds from a large geographic area,
- Move funds out of or into the U.S., and
- "Legitimize" illegal proceeds.

Financial institutions use two wire transfer systems in the U.S., the Fedwire and the Clearing House Interbank Payments System (CHIPS). A telecommunications network, the Society for Worldwide Interbank Financial Telecommunications (SWIFT), is often used to send messages with international wire transfers.

Fedwire transactions are governed by the Uniform Commercial Code Article 4a and the Federal Reserve Board's Regulation J. These laws primarily facilitate business conduct for electronic funds transfers; however, financial institutions must ensure they are using procedures for identification and reporting of suspicious and unusual transactions.

Wire Transfer Money Laundering Risks

Although wire systems are used in many legitimate ways, most money launderers use wire transfers to aggregate funds from different sources and move them through accounts at different banks until their origin cannot be traced. Money laundering schemes uncovered by law enforcement agencies show that money launderers aggregate funds from multiple accounts at the same financial institution, wire those funds to accounts held at other U.S. financial institutions, consolidate funds from these larger accounts, and ultimately wire the funds to offshore accounts in countries where laws are designed to facilitate secrecy. In some cases the monies are then sent back into the U.S. with the appearance of being legitimate funds.

It can be challenging for financial institutions to identify suspicious transactions due to the:

- Large number of wire transactions that occur in any given day;
- Size of wire transactions;
- Speed at which transactions move and settle; and
- Weaknesses in identifying the customers (originators and/or beneficiaries) of such transactions at the sending or receiving banks.

A money launderer will often try to make wire transfers appear to be for a legitimate purpose, or may use "shell companies" (corporations that exist only on paper, similar to shell banks discussed above in the section entitled "Foreign Correspondent Banking Relationships"), often chartered in another country. Money launderers usually look for legitimate businesses with high cash sales and high turnover to serve as a front company.

<u>Mitigation of Wire Transfer Money Laundering Risks</u>

Familiarity with the customer and type of business enables the financial institution to more accurately analyze transactions and thereby identify unusual wire transfer activity. With appropriate CDD policies and procedures, financial institutions should have some expectation of the type and volume of activity in accounts, especially if the account belongs to a high-risk entity or the customer uses higher-risk products or services. Consideration should be given to the following items in arriving at this expectation:

- Type and size of business;
- Customer's stated explanation for activity;
- Historical customer activity; and
- Activity of other customers in the same line of business.

Wire Transfer Recordkeeping Requirements

BSA recordkeeping rules require the retention of certain information for funds transfers and the transmittal of funds. Basic recordkeeping requirements are established in 31 CFR 103.33 and require the maintenance of the following records on all wire transfers originated over $3,000:

- Name and address of the originator,
- Amount of the payment order,
- Execution date of the payment order,
- Payment instructions received from the originator,
- Identity of the beneficiary's financial institution, and
- As many of the following items that are received with the transfer order:
  - Name and address of the beneficiary,
  - Account number of the beneficiary, and
  - Any other specific identifier of the beneficiary.

In addition, as either an intermediary bank or a beneficiary bank, the financial institution must retain a complete record of the payment order. Furthermore, the $3,000 minimum limit for retention of this information does not mean that wire transfers under this amount should not be reviewed or monitored for unusual activity.

Funds Transfer Record Keeping and Travel Rule Regulations

Along with the BSA recordkeeping rules, the Funds Transfer Recordkeeping and Travel Rule Regulations became effective in May of 1996. The regulations call for standard recordkeeping requirements to ensure all institutions are obtaining and maintaining the same information on all wire transfers of $3,000 or more. Like the BSA recordkeeping requirements, these additional recordkeeping requirements were put in place to create a paper trail for law enforcement to investigate money laundering schemes and other illegal activities.

Industry best practices dictate that domestic institutions should encourage all foreign countries to attach the identity of the originator to wire information as it travels to the U.S. and to other countries. Furthermore, the financial institution sending or receiving the wire cannot ensure adequate OFAC verification if they do not have all of the appropriate originator and beneficiary information on wire transfers.

Necessary Due Diligence on Wire Transfer Customers

To comply with these standards and regulations, a financial institution needs to know its customers. The ability to trace funds and identify suspicious and unusual transactions hinges on retaining information and a strong knowledge of the customer developed through comprehensive CDD procedures. Financial institution personnel must know the identity and business of the customer on whose behalf wire transfers are sent and received. Wire room personnel must be trained to identify suspicious or unusual wire activities and have a strong understanding of the bank's OFAC monitoring and reporting procedures.

Review and monitoring activity should also take place subsequent to sending or receiving wires to further aid in identification of suspicious transactions. Reviewers should look for:

- Unusual wire transfer activity patterns;
- Transfers to and from high-risk countries; or
- Any of the "red flags" relating to wire transfers (refer to the "Identification of Suspicious Transactions" discussion included within this chapter.)

Risks Associated with Wire Transfers Sent with "Pay Upon Proper Identification" Instructions

Financial institutions should also be particularly cautious of wire transfers sent or received with "Pay Upon Proper Identification" (PUPID) instructions. PUPID transactions allow the wire transfer originator to send funds to a financial institution location where an individual or business does not have an account relationship. Since the funds receiver does not have an account at the financial institution, he/she must show prior identification to pick up the funds, hence the term PUPID. These transactions can be legitimate, but pose a higher than normal money laundering risk.

Electronic Banking

Electronic banking (E-Banking) consists of electronic access (through direct personal computer connection, the Internet, or other means) to financial institution services, such as opening deposit accounts, applying for loans, and conducting transactions. E-banking risks are not as significant at financial institutions that have a stand-alone "information only" website with no transactional or application capabilities. Many financial institutions offer a variety of E-banking services and it is very common to obtain a credit card, car loan, or mortgage loan on the Internet without ever meeting face-to-face with a financial institution representative.

The financial institution should have established policies and procedures for authenticating new customers obtained through E-banking channels. Customer identification policies and procedures should meet the minimum requirements of the USA PATRIOT Act and be sufficient to cover the additional risks related to customers opening accounts electronically. New account applications submitted over the Internet increase the difficulty of verifying the application information. Many financial institutions choose to require the prospective customer to come into an office or branch to complete the account opening process, while others will not. If a financial institution completes the entire application process over the Internet, it should consider using third-party databases or vendors to provide:

- Positive verification, which ensures that material information provided by an applicant matches information from third-party sources;
- Negative verification, which ensures that information provided is not linked to previous fraudulent activity; and
- Logical verification, which ensures that the information is logically consistent.

In addition to initial verification, a financial institution must also authenticate the customer's identity each time an attempt is made to access his/her private information or to conduct a transaction over the Internet. The authentication methods involve confirming one or more of these three factors:

- Information only the user should know, such as a password or personal identification number (PIN);
- An object the user possesses, such as an automatic teller machine (ATM) card, smart card, or token; or
- Something physical of the user, such as a biometric characteristic like a fingerprint or iris pattern.

Automated Clearing House Transactions and Electronic Initiation Systems

Additionally, the National Automated Clearing House Association (NACHA) has provided standards which mandate the use of security measures for automated clearing house (ACH) transactions initiated through the Internet or electronically. These guidelines include ensuring secure access to the electronic and Internet systems in conjunction with procedures reasonably designed to identify the ACH originator.

Interagency guidance on authenticating users of technology and the identity of customers is further discussed in FDIC FIL-69-2001, "Authentication in an Electronic Environment." This FIL not only identifies the risk of access to systems and information, it also emphasizes the need to verify the identity of electronic and/or Internet customers, particularly those who request account opening and new services online.

MONITORING BANK SECRECY ACT COMPLIANCE

Section 8(s) of the Federal Deposit Insurance Act, which implements 12 U.S.C. 1818, requires the FDIC to:

- Develop regulations that require insured financial institutions to establish and maintain procedures reasonably designed to assure and monitor compliance with the BSA;
- Review such procedures during examinations; and
- Describe any problem with the procedures maintained by the insured depository institution within reports of examination.

To satisfy Section 8(s) requirements, at a minimum, examiners must review BSA at each regular safety and soundness examination. In addition, the FDIC must conduct its own BSA examination at any intervening Safety and Soundness examination conducted by a State banking authority if such authority does not review for compliance with the BSA. Section 326.8 of the FDIC's Rules and Regulations establishes the minimum BSA program requirements for all state nonmember banks, which are necessary to assure compliance with the financial recordkeeping and reporting requirements set forth within the provisions of the Treasury regulation 31 CFR 103.

Part 326.8 of the FDIC's Rules and Regulations

Minimum Requirements of the BSA Compliance Program

The BSA compliance program must be in writing and approved by the financial institution's board of directors, with approval noted in the Board minutes. Best practices dictate that Board should review and approve the policy annually. In addition, financial institutions are required to develop and implement a Customer Identification Program as part of their overall BSA compliance program. More specific guidance regarding the CIP program requirements can be found within the "Customer Identification Program" discussion within this section of the DSC Risk Management Manual of Examination Policies (DSC Manual).

A financial institution's BSA compliance program must meet four minimum requirements, as detailed in Section 326.8 of the FDIC's Rules and Regulations. The procedures necessary to establish an adequate program and assure reasonable compliance efforts designed to meet these minimum requirements are discussed in detail below:

1. *A system of internal controls.* At a minimum, the system must be designed to:

    a. Identify reportable transactions at a point where all of the information necessary to properly complete the required reporting forms can be obtained. The financial institution might accomplish this by sufficiently training tellers and personnel in other departments or by referring large currency transactions to a designated individual or department. If all pertinent information cannot be obtained from the customer, the financial institution should consider declining the transaction.
    b. Monitor, identify, and report possible money laundering or unusual and suspicious activity. Procedures should provide that high-risk accounts, services, and transactions are regularly reviewed for suspicious activity.
    c. Ensure that all required reports are completed accurately and properly filed within required timeframes. Financial institutions should consider centralizing the review and report filing functions within the banking organization.
    d. Ensure that customer exemptions are properly granted, recorded, and reviewed as appropriate, including biennial renewals of "Phase II" exemptions. Exempt accounts must be reviewed at least annually to ensure that the exemptions are still valid and to determine if any suspicious or unusual activity is occurring in the account. The

BSA compliance officer should review and initial all exemptions prior to granting and renewing them.

e. Ensure that all information sharing requests issued under Section 314(a) of the USA PATRIOT Act are checked in accordance with FinCEN guidelines and are fully completed within mandated time constraints.
f. Ensure that guidelines are established for the optional providing and sharing of information in accordance with 314(b) of the USA PATRIOT Act and the written employment verification regulations (as specified in Section 355 of the USA PATRIOT Act).
g. Ensure that the financial institution's CIP procedures comply with regulatory requirements.
h. Ensure that procedures provide for adequate customer due diligence in relation to the risk levels of customers and account types. Adequate monitoring for unusual or suspicious activities cannot be completed without a strong CDD program. The CDD program should assist management in predicting the types, dollar volume, and transaction volume the customer is likely to conduct, thereby providing a means to identify unusual or suspicious transactions for that customer.
i. Establish procedures for screening accounts and transactions for OFAC compliance that include guidelines for responding to identified matches and reporting those to OFAC.
j. Provide for adequate due diligence, monitoring, and reporting of private banking activities and foreign correspondent relationships. The level of due diligence and monitoring must be commensurate with the inherent account risk.
k. Provide for adequate supervision of employees who accept currency transactions, complete reports, grant exemptions, open new customer accounts, or engage in any other activity covered by the Financial Recordkeeping and Reporting of Currency and Foreign Transactions regulations at 31 CFR 103.
l. Establish dual controls and provide for separation of duties. Employees who complete the reporting forms should not be responsible for filing them or for granting customer exemptions.

2. *Independent testing for compliance with the BSA and Treasury's regulation 31 CFR Part 103*. Independent testing of the BSA compliance program should be conducted by the internal audit department, outside auditors, or qualified consultants. Testing must include procedures related to high-risk accounts and activities. Although not required by the regulation, this review should be conducted at least annually. Financial institutions that do not employ outside auditors or consultants or that do not operate internal audit departments can comply with this requirement by utilizing employees who are not involved in the currency transaction reporting or suspicious activity reporting functions to conduct the reviews. The BSA compliance officer, even if he/she does not participate in the daily BSA monitoring and reporting of BSA, can <u>never suffice</u> for an independent review.

The scope of the independent testing should be sufficient to verify compliance with the financial institution's anti-money laundering program. Additionally, all findings from the audit should be provided within a written report and promptly reported to the board of directors or appropriate committee thereof. Testing for compliance should include, at a minimum:

a. A test of the financial institution's internal procedures for monitoring compliance with the BSA, including interviews of employees who handle cash transactions and their supervisors. The scope should include all business lines, departments, branches, and a sufficient sampling of locations, including overseas offices.
b. A sampling of large currency transactions, followed by a review of CTR filings.
c. A test of the validity and reasonableness of the customer exemptions granted by the financial institution.
d. A test of procedures for identifying suspicious transactions and the filing of SARs. Such procedures should incorporate a review of reports used by management to identify unusual or suspicious activities.
e. A review of documentation on transactions that management initially identified as unusual or suspicious, but, after research, determined that SAR filings were not warranted.
f. A test of procedures and information systems to review compliance with the OFAC regulations. Such a test should include a review of the frequency of receipt of OFAC updates and interviews to determine personnel knowledge of OFAC procedures.
g. A test of the adequacy of the CDD program and the CIP. Testing procedures should ensure that established CIP standards are appropriate for the various account types, business lines, and departments. New accounts from various areas in the financial institution should be sampled to

ensure that CDD and CIP efforts meet policy requirements.

h. A review of management reporting of BSA-related activities and compliance efforts. Such a review should determine that reports provide necessary information for adequate BSA monitoring and that they capture the universe of transactions for that reporting area. (For example, the incoming wire transfer logs should contain all the incoming transfers for the time period being reviewed).

i. A test of the financial institution's recordkeeping system for compliance with the BSA.

j. Documentation of the scope of the testing procedures performed and the findings of the testing.

Independent Testing Workpaper Retention

Retention of workpapers from the independent testing or audit of BSA is expected and those workpapers must be made available to examiners for review upon request. It is essential that the scope and findings from any testing procedures be thoroughly documented. Procedures that are not adequately documented will not be accepted as being in compliance with the independent testing requirement.

3. *The designation of an individual or individuals responsible for coordinating and monitoring day-to-day compliance with BSA.* To meet the minimum requirement, each financial institution must designate a senior official within the organization to be responsible for overall BSA compliance. Other individuals in each office, department or regional headquarters should be given the responsibility for day-to-day compliance. The senior official in charge of BSA compliance should be in a position, and have the authority, to make and enforce policies. This is not intended to require that the BSA administrator be an "executive officer" under the Federal Reserve Board's Regulation O.

4. *Training for appropriate personnel.* At a minimum, the financial institution's training program must provide training for all operational personnel whose duties may require knowledge of the BSA, including, but not limited to, tellers, new accounts personnel, lending personnel, bookkeeping personnel, wire room personnel, international department personnel, and information technology personnel. In addition, an overview of the BSA requirements should be given to new employees and efforts should be made to keep executives and directors informed of changes and new developments in BSA regulations.Training should be comprehensive, conducted regularly, and clearly documented. The scope of the training should include:

   - The financial institution's BSA policies and procedures;
   - Identification of the three stages of money laundering (placement, layering, and integration);
   - "Red flags" to assist in the identification of money laundering (similar to those provided within the "Identification of Suspicious Transactions" discussion within this chapter);
   - Identification and examples of suspicious transactions;
   - The purpose and importance of a strong CDD program and CIP requirements;
   - Internal procedures for CTR and SAR filings;
   - Procedures for reporting BSA matters, including SAR filings to senior management and the board of directors;
   - Procedures for conveying any new BSA rules, regulations, or internal policy changes to all appropriate personnel in a timely manner; and
   - OFAC policies and procedures.

Depending on the financial institution's needs, training materials can be purchased from banking associations, trade groups, and outside vendors, or they can be internally developed by the financial institution itself. Copies of the training materials must be available in the financial institution for review by examiners.

BSA VIOLATIONS AND ENFORCEMENT

Procedures for Citing Apparent Violations in the Report of Examination

Apparent Violations of the U.S. Department of the Treasury's regulation 31 CFR 103 - Financial Recordkeeping and Reporting of Currency and Foreign Transactions

As stated previously, Treasury's regulation 31 CFR 103 establishes the minimum recordkeeping and reporting requirements for currency and foreign transactions by financial institutions. Failure to comply with the requirements of 31 CFR 103 may result in the examiner citing an apparent violation(s). Apparent violations of 31 CFR 103 are generally for specific issues such as:

- Failure to adequately identify and report large cash transactions in a timely manner;

- Failure to report Suspicious Activities, such as deposit layering or structuring cash transactions;
- Failure to reasonably identify and verify customer identity; and
- Failure to maintain adequate documentation of financial transactions, such as the purchase or sale of monetary instruments and originating or receiving wire transfers.

All apparent violations of the BSA should be reported in the Violations of Laws and Regulations pages of the Report of Examination. When preparing written comments related to apparent violations cited as a result of deficient BSA compliance practices, the following information should be included in each citation:

- Reference to the appropriate section of the regulation;
- Nature of the apparent violation;
- Date(s) and amount of the transaction(s);
- Name(s) of the parties to the transaction;
- Description of the transaction; and
- Management's response, including planned or taken corrective action.

In preparing written comments for apparent violations of the BSA, examiners should focus solely on statements of fact, and take precautions to ensure that subjective comments are omitted. Such statements would include an examiner attributing the infraction to a cause, such as management oversight or computer error. For all violations of 31 CFR 103, the Treasury reserves the authority to determine if civil penalties should be pursued. Examiner comments on the supposed causes of apparent violations may affect the Treasury's ability to pursue a case.

Random, isolated apparent violations do not require lengthy explanations or write-ups in the Report of Examination. In such cases, the section of the regulation violated, and identification of the transaction and/or instance will suffice. Examiners are also encouraged to group violations by type. When there are several exceptions to a particular section of the regulation, for example, late CTR filing, examiners should include a minimum of three examples in the Report of Examination citation. The remainder of the violations under that specific regulation can be listed as a total, without detailing all of the information. For example, detail three late CTR filings with customer information, dates, and amounts, but list a total in the apparent violation write-up for 55 instances identified during the examination.

If an examiner chooses not to include each example in the apparent violation citation, the examiners should provide bank management with a separate list so that they can identify and, if possible, correct the particular violation. A copy of the list must also be maintained in the BSA examination workpapers.

Additionally, deficient practices may violate more than one regulation. In such circumstances, the apparent violations can be grouped together. However, all of the sections of each violated regulation must be cited. Each apparent violation must be recorded on the BSA Data Entry sheet and submitted with the Report of Examination for review and transmittal.

Apparent Violations of Section 326.8 of the FDIC Rules and Regulations

In situations where deficiencies in the BSA compliance program are serious or systemic in nature, or apparent violations result from management's inability or unwillingness to develop and administer an effective BSA compliance program, examiners should cite an apparent violation(s) of the appropriate subsection(s) of Section 326.8, within the Report of Examination. Additionally, apparent violations of 31 CFR 103 that are repeated at two or more examinations, or dissimilar apparent violations that are recurring over several examinations, may also point towards a seriously deficient compliance program. When such deficiencies persist within the financial institution, it may be appropriate for examiners to consider the overall program to be deficient and cite an apparent violation of Section 326.8.

Specifically, an apparent violation of Section 326.8(b)(1) should be cited when the weaknesses and deficiencies identified in the BSA compliance program are significant, repeated, or pervasive. Citing a Section 326.8(b)(1) violation indicates that the program is inadequate or substantially ineffective. Furthermore, these deficiencies, if uncorrected, significantly impair the institution's ability to detect and prevent potential money laundering or terrorist financing activities.

An apparent violation of Section 326.8(b)(2) should be cited when weaknesses and deficiencies cited in the Customer Identification Program mitigate the institution's ability to reasonably establish, verify and record customer identity. An apparent violation of 326.8(b)(2) would generally be associated with specific weaknesses that would be reflected in apparent violations of 31 CFR 103.121, which establishes the minimum requirements for Customer Identification Programs.

An apparent violation of Section 326.8(c) should be cited for a specific program deficiency to the extent that deficiency is attributed to internal controls, independent testing, individual responsible for monitoring day-to-day compliance, or training. If an apparent violation of Section 326.8(c) is determined to be an isolated program weakness that does not significantly impair the effectiveness of the overall compliance program, then a Section 326.8(b) should **not** be cited. If one or more program violations are cited under Section 326.8(c), or are accompanied by notable infractions of Treasury's regulation 31 CFR 103, or management is unwilling or unable to correct the reported deficiencies, the aggregate citations would likely point toward an ineffective program and warrant the additional citing of a 326.8(b) program violation, in addition to the other program, and/or financial recordkeeping violations.

When preparing written comments related to apparent violations cited as a result of deficient BSA compliance program, as defined in Section 326.8, the following information should be included in each citation:

- Nature of the violation(s);
- Name(s) of the individual(s) responsible for coordinating and monitoring compliance with the BSA (BSA officer);
- Specific internal control deficiencies that contributed to the apparent violation(s); and
- Management's response, including planned or taken corrective action.

BSA Workpapers Evidencing Apparent Violations

BSA examination workpapers that support BSA/AML apparent violation citations, enforcement actions, SARs, and CMP referrals to the Treasury should be maintained for 5 years, since they may be needed to assist further investigation or other supervisory response. Examination workpapers should not generally be included as part of a SAR, enforcement action recommendation, or Treasury referral, but may be requested for additional supporting information during a law enforcement investigation.

Civil Money Penalties and Referrals to FinCEN

When significant apparent violations of the BSA, or cases of willful and deliberate violations of 31 CFR 103 or Section 326.8 of the FDIC's Rules and Regulations are identified at a state nonmember financial institution, examiners should determine if a recommendation for CMPs is appropriate. This assessment should be conducted in accordance with existing examiner guidance for consideration of CMPs, detailed within the DSC Manual.

Civil penalties for negligence and willful violations of BSA are detailed in 31 CFR 103.57. This section states that <u>negligent</u> violations of any regulations under 31 CFR 103 shall not exceed $500. <u>Willful</u> violations for any reporting requirement for financial institutions under 31 CFR 103 can be assessed a civil penalty up to $100,000 and no less than $25,000. CMPs may also be imposed by the FDIC for violations of final Cease and Desist Orders issued under our authority granted in Section 8(s) of the Federal Deposit Insurance Act (FDI Act). In these cases, the penalty is established by Section 8(i)(2) of the FDI Act at up to $5,000 per day for each day the violation continues. Recommendations for civil money penalties for violations of Cease and Desist Orders should be handled in accordance with outstanding FDIC Directives.

Furthermore, Section 363 of the USA PATRIOT Act increases the maximum civil and criminal penalties from $100,000 to up to $1,000,000 for violations of the following sections of the USA PATRIOT Act:

- Section 311: Special measures enacted by the Treasury for jurisdictions, financial institutions, or international transactions or accounts of primary money laundering concern;
- Section 312: Special due diligence for correspondent accounts and private banking accounts; and
- Section 313: Prohibitions on U.S. correspondent accounts with foreign shell banks.

Referring Significant Violations of the BSA to FinCEN

Financial institutions that are substantially noncompliant with the BSA should be reviewed by the FDIC for recommendation to FinCEN regarding the issuance of CMPs. FinCEN is the administrator of the BSA and has the authority to assess CMPs against any domestic financial institution, including any insured U.S. branch of a foreign bank, and any partner, director, officer, or employee of a domestic financial institution for violations of the BSA and implementing regulations. Criminal prosecution is also authorized, when warranted. However, referrals to FinCEN do not preclude the FDIC from using its authority to take formal administrative action.

Factors to consider for determining when a referral to FinCEN is warranted and the guidelines established for preparing and forwarding referral documentation are detailed in examiner guidance. When examiners identify serious BSA program weaknesses at an institution, including significant apparent violations, the examiner should consult with the Regional SACM before proceeding further.

Generally, a referral should be considered when the types and nature of apparent violations of the BSA result from a nonexistent or seriously deficient BSA and anti-money laundering compliance program; expose the financial institution to a heightened level of risk for potential money laundering activity; or demonstrate a willful or flagrant disregard for the requirements of the BSA. Normally, isolated incidences of noncompliance should not be referred for penalty consideration. Even if the type of violation was cited previously, referral would not be appropriate if the apparent violations involved are genuine misunderstandings of the BSA requirements or inadvertent violations, the deficiencies are correctable in the normal course of business and proper corrective action has been taken or committed to by management.

A referral may be warranted in the absence of previous violations if the nature of apparent violations identified at the current examination is serious. An example would be failing to file FinCEN Form 104, Currency Transaction Report, on nonexemptible businesses or businesses that, while exemptible, FinCEN, as a matter of policy will not authorize the financial institution to exempt. To illustrate, the failure to file CTRs on transactions involving an individual or automobile dealer (both nonexemptible) is of greater concern to FinCEN than a failure to file CTRs on a recently opened supermarket which has not yet been added to the bank's exempt list or a golf course where the financial institution believed that it qualified for a unilateral exemption as a sports arena. This doesn't mean that the failure to file CTRs on a supermarket should never be referred. Failure to file CTRs on a supermarket that is a front for organized crime, that has no customers yet has large receipts, or that has currency transaction activity that far exceeds its expected revenues would warrant referral.

Mitigating Factors to Consider

Other considerations in, deciding whether to recommend criminal/civil penalties include the financial institution's past history of compliance, and whether the current system of policies, procedures, systems, internal controls, and training are sufficient to ensure a satisfactory level in the future. Senior management's attitude and commitment toward compliance as evidenced by their involvement and devotion of resources to compliance programs should also be considered. Any mitigating factors should be given full consideration. Mitigating factors would include:

- The implementation of a comprehensive compliance program that ensures a high level of compliance including a system for aggregating currency transactions.
- Volunteer reporting by the institution of apparent violations discovered on its own during the course of internal audits. This does not apply to situations where examiners disclose apparent violations and the institution comes forward voluntarily to head off a possible referral.
- Positive efforts to assist law enforcement, including the reporting of suspicious transactions and the filing of Suspicious Activity Reports.

It should be noted that FinCEN does not categorize violations as substantive or technical. However, FinCEN does recognize the varying nature of violations and the fact that not all violations require a referral.

Content of a Well-Developed Referral

A well-developed referral is one that contains sufficient detail to permit FinCEN to ascertain: the number, nature and severity of apparent violations cited; the overall level of BSA compliance; the severity of any weaknesses in the financial institution's compliance program; and the financial institution's ability to achieve a satisfactory level of compliance in the future.

A summary memorandum detailing these issues should be prepared by the field examiner and submitted to the Regional Office for review. At a minimum, each referral should include a copy of this memorandum, the Report of Examination pages that discuss BSA findings, and a civil monetary penalty assessment. Documents contained in the referral package need to be conclusion-oriented and descriptive with facts supporting summary conclusions. It is not sufficient to say that the financial institution has written policies and procedures or that management provides training to employees. Referrals are much more useful when they discuss the specific deficiencies identified within the compliance programs, policies and procedures, systems, management involvement, and training.

Discussing the Referral Process with Financial Institution Management

Examiners should not advise the financial institution that a civil money penalty referral is being submitted to FinCEN. If an investigation by law enforcement is warranted, it may be compromised by disclosure of this information. It is permissible to tell management that FinCEN will be notified of all apparent violations of the BSA cited. However, examiners are not to provide any oral or written communication to the financial institution passing judgment on the willfulness of apparent violations.

Criminal Penalties

Treasury regulation 31 CFR 103.59 notifies institutions that they can be subject to criminal penalties if convicted for willful violations of the BSA of not more than $1,000 and/or one year in prison. If such a BSA violation is committed to further any other Federal law punishable by more than a year in prison (such as fraud, money laundering, theft, illegal narcotics sales, etc.) then harsher penalties can be imposed. In these cases, the perpetrator, upon conviction, can be fined not more than $10,000 and/or be imprisoned not more than 5 years.

In addition, criminal penalties may also be charged against any person who knowingly makes any false, fictitious, or fraudulent statement or representation in any BSA report. Upon conviction of such an act, the perpetrator may be fined not more than $10,000 and/or imprisoned for 5 years.

Certain violations of the BSA allow for the U.S. Government to seize the funds related to the crime. The USA PATRIOT Act amended the BSA to provide for funds forfeiture in cases dealing with foreign crimes, U.S. interbank accounts, and in connection with some currency transaction reporting violations. Furthermore, the U.S. Government can seize currency or other monetary instruments physically transported into or out of the U.S. when required BSA reports go unfiled or contain material omissions or misstatements.

Supervisory Actions

The FDIC has the authority to address less than adequate compliance with the BSA through various formal or informal administrative actions. If a specific violation of Section 326.8 or 31 CFR 103 is not corrected or the same provision of a regulation is cited from one examination to the next, Section 8(s) of the FDI Act requires the FDIC to consider formal enforcement action as described in Section 8(b) or 8(c) of the FDI Act. However, the FDIC has determined that informal enforcement action, such as a Board Resolution or a Memorandum of Understanding may be a more appropriate supervisory response, given related circumstances and events, which may serve as mitigating factors.

Violations of a technical and limited nature would not necessarily reflect an inadequate BSA program; as such, it is important to look at the type and number of violations before determining the appropriate administrative action. If the Regional Office reviews a case with significant violations, it should determine whether an enforcement action is necessary. Under such circumstances, if the Regional Office determines that a Cease and Desist action is **not** appropriate, then documentation supporting that decision should be maintained at the Regional Office and a copy of that documentation submitted to the Special Activities Section in Washington, D.C.

Memoranda of Understanding (MOU) and Board Resolutions (BBR)

In certain cases, the Regional Office may determine that a BBR or a MOU is an appropriate action to deal with an institution's BSA weaknesses. BBRs should only be used in circumstances where recommendations are minor and do not affect the overall adequacy of the institution's BSA compliance program. Unlike a BBR, a MOU is a bi-lateral agreement between the financial institution and the FDIC. When the Regional Office deems that a MOU is appropriate, the examiners, reviewer, the Regional SACM, and the Regional legal department may work together to formulate the provisions of the action and obtain appropriate approvals as soon as possible after the examination.

Cease and Desist Orders

Section 8(s) of the FDI Act grants the FDIC the power to issue Cease and Desist Orders solely for the purpose of correcting BSA issues at state nonmember banks. In situations where BSA/AML program weaknesses expose the institution to an elevated level of risk to potential money laundering activity, are repeatedly cited at consecutive examinations, or demonstrate willful noncompliance or negligence by management, a Section 8(b) Order to Cease and Desist should be considered by the Regional Office. Cases referred to FinCEN for civil money penalties should also be reviewed for **formal** supervisory action.

When a Cease and Desist Order is deemed to be appropriate, the examiners, reviewer, the Regional SACM, and the Regional legal department should work together to formulate the provisions of the action and obtain appropriate approvals as soon as possible after the examination. Specific details are contained in the Formal and Informal Actions Procedures (FIAP) Manual.

Removal/Prohibition Orders

If deficiencies or apparent violations of Section 326.8 or 31 CFR 103 involve negligent or egregious action or inaction by institution-affiliated parties (IAPs), other formal actions may be appropriate. In such situations where the IAP exposes the institution to an elevated risk of, or has facilitated or participated in actual transactions involving money laundering activity, utilization of Section

8(e) of the FDI Act, a removal/prohibition action, should be considered.

In cases where apparent violations of Section 326.8 and/or 31 CFR Section 103 have been committed by an IAP(s) and appear to involve criminal intent, examiners should contact the Regional SACM or other designees about filing a SAR on the IAP(s). If the involvement of the IAP(s) in the criminal activity warrants, the Regional Office should also consider contacting the Federal Bureau of Investigation (FBI) or other Federal law enforcement agency via phone or letter to provide them a referral of the SAR and indicate the FDIC's interest in pursuit of the case.

IDENTIFICATION OF SUSPICIOUS TRANSACTIONS

Effective BSA/AML compliance programs include controls and measures to identify and report suspicious transactions in a timely manner. An institution should have in place a CDD program sufficient to be able to make an informed decision about the suspicious nature of a particular transaction. This section highlights unusual or suspicious activities and transactions that may indicate potential money laundering through structured transactions, terrorist financing, and other schemes designed for illicit purposes. Often, individuals involved in suspicious activity will use a combination of several types of unusual transactions in an attempt to confuse or mislead anyone attempting to identify the true nature of their activities.

Structuring is the most common suspicious activity reported to FinCEN. Structuring is defined as breaking down a sum of currency that exceeds the $10,000 CTR reporting level per the regulation, into a series of transactions at or less than $10,000. The transactions do not need to occur on any single day in order to constitute structuring. Money launderers have developed many ways to structure large amounts of cash to evade the CTR reporting requirements. Examiners should be alert to multiple cash transactions that exceed $10,000, but may involve other monetary instruments, bank official checks, travelers' checks, savings bonds, loans and loan payments, or even securities transactions as the offsetting entry. The transactions could also involve the exchange of small bank notes for large ones, but in amounts less than $10,000. Structuring of cash transactions to evade CTR filing requirements is often the easiest of suspicious activities to identify. It is subject to criminal and civil violations of the BSA regulations as implemented within 31 CFR 130.63. This regulation states that any person who structures or assists in structuring a currency transaction at a financial institution for the purpose of evading CTR reporting, or causes or attempts to cause a financial institution to fail to file a CTR, or causes the financial institution to file a CTR that contains a material omission or misstatement of fact, is subject to the criminal and civil violations of the BSA regulations. Financial institutions are required by the BSA to have monitoring procedures in place to identify structured transactions.

Knowledge of the three stages of money laundering (discussed below) has multiple benefits for financial institutions. These benefits include, but are not limited to, the following:

- Identification and reporting of illicit activities to FinCEN,
- Prevention against losses stemming from fraud,
- Prevention against citation of apparent violations of BSA and SAR regulations, and
- Prevention against assessment of CMPs by FinCEN and/or the FDIC.

The following discussions and "red flag" lists, while not all-inclusive, identify various types of suspicious activity/transactions. These lists are intended to serve as a reference tool and should not be used to make immediate and definitive conclusions that a particular activity or series of transactions is illegal. They should be viewed as potentially suspicious warranting further review. The activity/transactions may not be suspicious if they are consistent with a customer's legitimate business.

The Three Stages of Money Laundering

There are three stages in typical money laundering schemes:

1. Placement,
2. Layering, and
3. Integration.

Placement

Placement, the first stage of money laundering, involves the placement of bulk cash into the financial system without the appearance of being connected to a criminal activity. There are many ways cash can be placed into the system. The simplest way is to deposit cash into a financial institution; however, this is also one of the riskier ways to get caught laundering money. To avoid notice, banking transactions involving cash are likely to be conducted in amounts under the CTR reporting thresholds; this activity is referred to as "structuring."

Furthermore, the use of false identities to conduct these transactions is common; banking officers should be vigilant in looking for false identification documents. In an attempt to conceal their activities, money launderers will often resort to “smurfing” activities to get illicit funds into a financial institution. “Smurfing” is the process of using several individuals to deposit illicit cash proceeds into many accounts at one or several financial institutions in a single day.

Furthermore, cash can be exchanged for traveler’s checks, food stamps, or other monetary instruments, which can then also be deposited into financial institutions. Placement can also be done by purchasing goods or services, such as a travel/vacation package, insurance policies, jewelry, or other “high-ticket” items. These goods and services can then be returned to the place of purchase in exchange for a refund check, which can then be deposited at a financial institution with less likelihood of detection as being suspicious. Smuggling cash out of a country and depositing that cash into a foreign financial institution is also a form of placement. Illegally-obtained funds can also be funneled into a legitimate business as cash receipts and deposited without detection. This type of activity actually combines placement with the other two stages of money laundering, layering and integration, discussed below.

Layering

The second stage of money laundering is typically layering. This stage is the process of moving and manipulating funds to confuse their sources as well as complicating or partially eliminating the paper trail. Layering may involve moving funds in various forms through multiple accounts at numerous financial institutions, both domestic and international, in a complex series of transactions. Examples of layering transactions include:

- Transferring funds by check or monetary instrument;
- Exchanging cashier’s checks and other monetary instruments for other cashier’s checks, larger or smaller, possibly adding additional cash or other monetary instruments in the process;
- Performing intrabank transfers between accounts owned or controlled by common individuals (for example, telephone transfers);
- Performing wire transfers to accounts under various customer and business names at other financial institutions;
- Transferring funds outside and possibly back into the U.S. by various means such as wire transfers, particularly through “secrecy haven” countries;
- Obtaining certificate of deposit (CD) secured loans and depositing the loan disbursement check into an account (when the loan is defaulted on, there is no loss to the bank); and
- Depositing a refund check from a canceled vacation package or insurance policy.

Layering transactions may become very complex and involve several of these methods to hide the trail of funds.

Integration

The third stage of money laundering is integration, which typically follows the layering stage. However, as mentioned in the discussion of the placement stage, integration can be accomplished simultaneously with the placement of funds. After the funds have been placed into the financial system and insulated through the layering process, the integration phase is used to create the appearance of legality through additional transactions such as loans, or real estate deals. These transactions provide the criminal with a plausible explanation as to where the funds came from to purchase assets and shield the criminal from any type of recorded connection to the funds.

During the integration stage, the funds are returned in a usable format to the criminal source. This process can be achieved through various schemes, such as:

- Inflating business receipts,
- Overvaluing and undervaluing invoices,
- Creating false invoices and shipping documents,
- Establishing foreign trust accounts,
- Establishing a front company or phony charitable organization, and
- Using gold bullion schemes.

These schemes are just a few examples of the integration stage; the possibilities are not limited.

Money Laundering Red Flags

Some activities and transactions that are presented to a financial institution should raise the level of concern regarding the possibility of potential money laundering activity. Evidence of these “red flags” in an institution’s accounts and transactions should prompt the institution, and examiners reviewing such activity, to consider the possibility of illicit activities. While these red flags are not evidence of illegal activity, these common indicators should be part of an expanded review of suspicious activities.

<u>General</u>

- **Refusal or reluctance to proceed with a transaction, or abruptly withdrawing a transaction.** A customer may be reluctant to proceed, or may even withdraw all or a portion of a transaction after being informed that a CTR will be filed, or that the purchase of a monetary instrument will be recorded. This action would be taken to avoid BSA reporting and recordkeeping requirements.

- **Customer refusal or reluctance to provide information or identification.** A customer may be reluctant, or even refuse to provide identifying information when opening an account, cashing a check, recording the purchase of a monetary instrument, or providing information necessary to file a CTR.

- **Structured or recurring, non-reportable transactions.** An individual or group may attempt to avoid BSA reporting and recordkeeping requirements by breaking up, or structuring a currency transaction or purchase of monetary instruments in amounts less than the reporting/recordkeeping thresholds. Transactions may also be conducted with multiple banks, branches, customer service representatives, accounts, and/or on different days in an attempt to avoid reporting requirements.

- **Multiple third parties conducting separate, but related, non-reportable transactions.** Two or more individuals may go to different tellers or branches and each conduct transactions just under the reporting/recordkeeping threshold. (This activity is often referred to as "smurfing.")

- **Even dollar amount transactions.** Numerous transactions are conducted in even dollar amounts.

- **Transactions structured to lose the paper trail.** The bank may be asked to process internal debits or credits containing little or no description of the transaction in an attempt to "separate" a transaction from its account.

- **Significant increases in the number or amount of transactions.** A large increase in the number or amount of transactions involving currency, the purchase of monetary instruments, wire transfers, etc., may indicate potential money laundering.

- **Transactions which are not consistent with the customer's business, occupation, or income level.** Transactions should be consistent with the customer's known business or income level.

- **Transactions by non-account holders.** A non-account holder conducts or attempts to conduct transactions such as currency exchanges, the purchase or redemption of monetary instruments, with no apparent legitimate reason.

<u>Cash Management: Branch and Vault Shipments</u>

- **Change in currency shipment patterns.** Significant changes in currency shipment patterns between vaults, branches and/or correspondent banks as noted on cash shipment records may indicate a potential money laundering scheme occurring in a particular location.

- **Large increase in the cash supply.** A large, sustained increase in the cash balance would normally cause some increase in the number of CTRs filed. Another example of a red flag in this area would be a rapid increase in the size and frequency of cash deposits with no corresponding increase in non-cash deposits.

- **Currency shipments to or from remote locations**. Unusually large transactions between a small, remote bank and a large metropolitan bank may also indicate potential money laundering.

- **Significant exchanges of small denomination bills for large denomination bills**. Significant increases resulting from the exchange of small denominations for large denominations may be reflected in the cash shipment records.

- **Significant requirement for large bills.** Branches whose large bill requirements are significantly greater than the average may be conducting large currency exchanges. Branches that suddenly stop shipping large bills may be using them for currency exchanges.

- **International cash shipments funded by multiple monetary instruments.** This involves the receipt of funds in the form of multiple official bank checks, cashier's checks, traveler's checks, or personal checks that are drawn on or issued by U.S. financial institutions. They may be made payable to the same individual or business, or related individuals or businesses, and may be in U.S. dollar amounts that are below the BSA reporting/recordkeeping threshold. Funds are then shipped or wired to a financial institution outside the U.S.

- **Other unusual domestic or international shipments.** A customer requests an outgoing shipment or is the beneficiary of a shipment of currency, and the instructions received appear inconsistent with normal cash shipment practices. For example, the customer directs the bank to ship the funds to a foreign country and advises the bank to expect same day return of funds from sources different than the beneficiary named, thereby changing the source of the funds.

- **Frequent cash shipments with no apparent business reason**. Frequent use of cash shipments that is not justified by the nature of the customer's business may be indicative of money laundering.

Currency Exchanges and Other Currency Transactions

- **Unusual exchange of denominations**. An individual or group seeks the exchange of small denomination bills (five, ten and twenty dollar bills) for large denomination bills (hundred dollar bills), without any apparent legitimate business reason.

- **Check cashing companies**. Large increases in the number and/or amount of cash transactions for check cashing companies.

- **Unusual exchange by a check cashing service.** No exchange or cash back for checks deposited by an individual who owns a check cashing service can indicate another source of cash.

- **Suspicious movement of funds.** Suspicious movement of funds out of one financial institution, into another financial institution, and back into the first financial institution can be indicative of the layering stage of money laundering.

Deposit Accounts

- **Minimal, vague or fictitious information provided**. An individual provides minimal, vague, or fictitious information that the financial institution cannot readily verify.

- **Lack of references or identification.** An individual attempts to open an account without references or identification, gives sketchy information, or refuses to provide the information needed by the financial institution.

- **Non-local address**. The individual does not have a local residential or business address and there is no apparent legitimate reason for opening an account with the bank.

- **Customers with multiple accounts.** A customer maintains multiple accounts at a bank or at different banks for no apparent legitimate reason. The accounts may be in the same names or in different names with different signature authorities. Routine inter-account transfers provide a strong indication of accounts under common control.

- **Frequent deposits or withdrawals with no apparent business source**. The customer frequently deposits or withdraws large amounts of currency with no apparent business source, or the business is of a type not known to generate substantial amounts of currency.

- **Multiple accounts with numerous deposits under $10,000**. An individual or group opens a number of accounts under one or more names, and makes numerous cash deposits just under $10,000, or deposits containing bank checks or traveler's checks, or a combination of all of these.

- **Numerous deposits under $10,000 in a short period of time**. A customer makes numerous deposits under $10,000 in an account in short periods of time, thereby avoiding the requirement to file a CTR. This includes deposits made at an ATM.

- **Accounts with a high volume of activity and low balances**. Accounts with a high volume of activity, which carry low balances, or are frequently overdrawn, may be indicative of money laundering or check kiting.

- **Large deposits and balances.** A customer makes large deposits and maintains large balances with little or no apparent justification.

- **Deposits and immediate requests for wire transfers or cash shipments**. A customer makes numerous deposits in an account and almost immediately requests wire transfers or a cash shipment from that account to another account, possibly in another country. These transactions are not consistent with the customer's legitimate business needs. Normally, only a nominal amount remains in the original account.

- **Numerous deposits of small incoming wires or monetary instruments, followed by a large outgoing wire**. Numerous small incoming wires and/or multiple monetary instruments are deposited into an account. The customer then requests a large outgoing wire to another institution or country.

- **Accounts used as a temporary repository for funds.** The customer appears to use an account as a temporary repository for funds that ultimately will be transferred out of the financial institution, sometimes to foreign-based accounts. There is little account activity.

- **Funds deposited into several accounts, transferred to another account, and then transferred outside of the U.S.** This involves the deposit of funds into several accounts, which are then combined into one account, and ultimately transferred outside the U.S. This activity is usually not consistent with the known legitimate business of the customer.

- **Disbursement of certificates of deposit by multiple bank checks.** A customer may request disbursement of the proceeds of a certificate of deposit or other investments in multiple bank checks, each at or under $10,000. The customer can then negotiate these checks elsewhere for currency. The customer avoids the CTR requirements and severs the paper trail.

- **Early redemption of certificates of deposits**. A customer may request early redemption of certificates of deposit or other investments within a relatively short period of time from the purchase date of the certificate of deposit or investment. The customer may be willing to lose interest and incur penalties as a result of the early redemption.

- **Sudden, unexplained increase in account activity or balance**. There may be a sudden, unexplained increase in account activity, both from cash and from non-cash items. An account may be opened with a nominal balance that subsequently increases rapidly and significantly.

- **Limited use of services.** Frequent large cash deposits are made by a corporate customer, who maintains high balances but does not use the financial institution's other services.

- **Inconsistent deposit and withdrawal activity.** Retail businesses may deposit numerous checks, but there will rarely be withdrawals for daily operations.

- **Strapped currency**. Frequent deposits of large amounts of currency, wrapped in currency straps that have been stamped by other financial institutions.

- **Client, trust and escrow accounts**. Substantial cash deposits by a professional customer into client accounts, or in-house company accounts, such as trust and escrow accounts.

- **Large amount of food stamps.** Unusually large deposits of food stamps, which may not be consistent with the customer's legitimate business.

<u>Lending</u>

- **Certificates of deposits used as collateral.** An individual buys certificates of deposit and uses them as loan collateral. Illegal funds can be involved in either the certificate of deposit purchase or utilization of loan proceeds.

- **Sudden/unexpected payment on loans**. A customer may suddenly pay down or pay off a large loan, with no evidence of refinancing or other explanation.

- **Reluctance to provide the purpose of the loan or the stated purpose is ambiguous**. A customer seeking a loan with no stated purpose may be trying to conceal the true nature of the loan. The BSA requires the bank to document the purpose of all loans over $10,000, with the exception of those secured by real property.

- **Inconsistent or inappropriate use of loan proceeds**. There may be cases of inappropriate disbursement of loan proceeds, or disbursements for purposes other than the stated loan purpose.

- **Overnight loans.** A customer may use "overnight" loans to create high balances in accounts.

- **Loan payments by third parties.** Loans that are paid by a third party could indicate that the assets securing the loan are really those of a third party, who may be attempting to conceal ownership of illegally, gained funds.

- **Loan proceeds used to purchase property in the name of a third party, or collateral pledged by a third party.** A customer may use loan proceeds to purchase, or may pledge as collateral, real property in the name of a trustee, shell corporation, etc.

- **Permanent mortgage financing with an unusually short maturity, particularly in the case of large mortgages.**

- **Structured down payments or escrow money transactions**. An attempt to "structure" a down payment or escrow money transaction may be made in order to conceal the true source of the funds used.

- **Attempt to sever the paper trail**. Attempts may be made by the customer or bank to sever any paper trail connecting a loan to the collateral.

- **Wire transfer of loan proceeds**. A customer may request that loan proceeds be wire transferred for no apparent legitimate reason.

- **Disbursement of loan proceeds by multiple bank checks**. A customer may request disbursement of loan proceeds in multiple bank checks, each under $10,000. The customer can then negotiate these checks elsewhere for currency. The customer avoids the currency transaction reporting requirements and severs the paper trail.

- **Loans to companies outside the U.S.** Unusual loans to offshore customers, and loans to companies incorporated in "secrecy havens" are higher risk activities.

- **Financial statement.** Financial statement composition of a business differs greatly from those of similar businesses.

Monetary Instruments

- **Structured purchases of monetary instruments.** An individual or group purchases monetary instruments with currency in amounts below the $3,000 BSA recordkeeping threshold.

- **Replacement of monetary instruments**. An individual uses one or more monetary instruments to purchase another monetary instrument(s).

- **Frequent purchase of monetary instruments without apparent legitimate reason**. A customer may repeatedly buy a number of official bank checks or traveler's checks with no apparent legitimate reason.

- **Deposit or use of multiple monetary instruments**. The deposit or use of numerous official bank checks or other monetary instruments, all purchased on the same date at different banks or different issuers of the instruments may indicate money laundering. These instruments may or may not be payable to the same individual or business.

- **Incomplete or fictitious information**. The customer may conduct transactions involving monetary instruments that are incomplete or contain fictitious payees, remitters, etc.

- **Large cash amounts.** The customer may purchase cashier's checks, money orders, etc., with large amounts of cash.

Safe Deposit Boxes

- **Frequent visits.** The customer may visit a safe deposit box on an unusually frequent basis.

- **Out-of-area customers.** Safe deposit boxes may be opened by individuals who do not reside or work in the banks service area.

- **Change in safe deposit box traffic pattern.** There may be traffic pattern changes in the safe deposit box area. For example, more people may enter or enter more frequently, or people carry bags or other containers that could conceal large amounts of cash.

- **Large amounts of cash maintained in a safe deposit box**. A customer may access the safe deposit box after completing a transaction involving a large withdrawal of cash, or may access the safe deposit box prior to making cash deposits which are just under $10,000.

- **Multiple safe deposit boxes**. A customer may rent multiple safe deposit boxes if storing large amounts of currency.

Wire Transfers

- **Wire transfers to countries widely considered "secrecy havens."** Transfers of funds to well known "secrecy havens."

- **Incoming/outgoing wire transfers with instructions to the receiving institution to pay upon proper identification**. The instructions to the receiving bank are to "pay upon proper identification." If paid for in cash, the amount may be just under $10,000 so no CTR is required. The purchase may be made with numerous official checks or other monetary instruments. The amount of the transfer may be large, or the funds may be sent to a foreign country.

- **Outgoing wire transfers requested by non-account holders.** If paid in cash, the amount may be just under $10,000 to avoid the CTR filing requirement.

Alternatively, the transfer may be paid with several official checks or other monetary instruments. The funds may be directed to a foreign country.

- **Frequent wire transfers with no apparent business reason**. A customer's frequent wire transfer activity is not justified by the nature of their business.

- **High volume of wire transfers with low account balances.** The customer requests a high volume of incoming and outgoing wire transfers but maintains low or overdrawn account balances.

- **Incoming and outgoing wires in similar dollar amounts**. There is a pattern of wire transfers of similar amounts both into and out of the customer's account, or related customer accounts, on the same day or next day. The customer may receive many small incoming wires, and then order a large outgoing wire transfer to another city or country.

- **Large wires by customers operating a cash business**. Could involve wire transfers by customers operating a mainly cash business. The customers may be depositing large amounts of currency.

- **Cash or bearer instruments used to fund wire transfers**. Use of cash or bearer instruments to fund wire transfers may indicate money laundering.

- **Unusual transaction by correspondent financial institutions.** Suspicious transactions may include: (1) wire transfer volumes that are extremely large in proportion to the asset size of the bank; (2) when the bank's business strategy and financial statements are inconsistent with a large volume of wire transfers, particularly outside the U.S.; or (3) a large volume of wire transfers of similar amounts in and out on the same or next day.

- **International funds transfer(s) which are not consistent with the customer's business**. International transfers, to or from the accounts of domestic customers, in amounts or with a frequency that is inconsistent with the nature of the customer's known legitimate business activities could indicate money laundering.

- **International transfers funded by multiple monetary instruments**. This involves the receipt of funds in the form of multiple official bank checks, traveler's checks, or personal checks that are drawn on or issued by U.S. financial institutions and made payable to the same individual or business, or related individuals or businesses, in U.S. dollar amounts that are below the BSA reporting threshold. The funds are then wired to a financial institution outside the U.S.

- **Other unusual domestic or international funds transfers.** The customer requests an outgoing wire or is the beneficiary of an incoming wire, and the instructions appear inconsistent with normal wire transfer practices. For example, the customer directs the bank to wire the funds to a foreign country and advises the bank to expect same day return of funds from sources different than the beneficiary named, thereby changing the source of the funds.

- **No change in form of currency.** Funds or proceeds of a cash deposit may be wired to another country without changing the form of currency.

<u>Other Activities Involving Customers and Bank Employees</u>

- **Questions or discussions on how to avoid reporting/recordkeeping**. This involves discussions by individuals about ways to bypass the filing of a CTR or recording the purchase of a monetary instrument.

- **Customer attempt to influence a bank employee not to file a report**. This would involve any attempt by an individual or group to threaten, bribe, or otherwise corruptly influence a bank employee to bypass the filing of a CTR, the recording of purchases of monetary instruments, or the filing of a SAR.

- **Lavish lifestyles of customers or bank employees**. Lavish lifestyles of customers or employees, which are not supported by their current salary, may indicate possible involvement in money laundering activities.

- **Short-term or no vacations.** A bank employee may be reluctant to take any vacation time or may only take short vacations (one or two days).

- **Circumvention of internal control procedures**. Overrides of internal controls, recurring exceptions, and out-of-balance conditions may indicate money laundering activities. For example, bank employees may circumvent wire transfer authorizations and approval policies, or could split wire transfers to avoid ceiling limitations.

- **Incorrect or incomplete CTRs**. Employees may frequently submit incorrect or incomplete CTRs.

Terrorist Financing Red Flags

Methods used by terrorists to generate funds can be both legal and illegal. In the U.S., it is irrelevant whether terrorist funding is obtained legally or illegally; any funds provided to support terrorist activity are considered to be laundered money. Funding from both legal and illegal sources must be laundered by the terrorist in order to obscure links between the terrorist group (or cell) and its funding sources and uses. Terrorists and their support organizations typically use the same methods that criminal groups use to launder funds. In particular, terrorists appear to favor:

- Cash smuggling, both by couriers or in bulk cash shipments;
- Structured deposits and/or withdrawals;
- Purchases of monetary instruments;
- Use of credit and/or debit cards; and
- Use of underground banking systems.

While it is not the primary function of an examiner to identify terrorist financing while examining an institution for BSA compliance, examiners and financial institution management should be cognizant of suspicious activities or unusual transactions that are common indicators of terrorist financing. Institutions are encouraged to incorporate procedures into their BSA/AML compliance programs that address notifying the proper Federal agencies when serious concerns of terrorist financing activities are encountered. At a minimum, these procedures should require the institution to contact FinCEN's Financial Institutions Hotline to report such activities.

SUSPICIOUS ACTIVITY REPORTING

Part 353 of the FDIC's Rules and Regulations requires insured state nonmember banks to report known or suspected criminal offenses to the Treasury. The SAR form to be used by financial institutions is Form TD F 90-22.47 and is available on the FinCEN website. FinCEN is the repository for these reports, but content is owned by the Federal Banking Agencies. The SAR form is used to report many types of suspected criminal violations. Details of the criminal violations can be found in the Criminal Violations section of this manual.

Suspicious Activities and Transactions Requiring SAR Filings

Among the suspicious activities required to be reported are any transactions aggregating $5,000 or more that involve potential money laundering, suspected terrorist financing activities, or violations of the BSA. However, if a financial institution insider is involved in the suspicious transaction(s), a SAR must be filed at any transaction amount. Other suspected criminal activity requires filing a SAR if the transactions aggregate $5,000 or more and a suspect can be identified. If the financial institution is unable to identify a suspect, but believes it was an actual or potential victim of a criminal violation, then a SAR must be filed for transactions aggregating $25,000 or more. Although these are the required transaction levels for filing a SAR, a financial institution may voluntarily file a SAR for suspicious transactions below these thresholds. SAR filings are not used for reporting robberies to local law enforcement, or for lost, counterfeit, or stolen securities that are reported pursuant to 17 CFR 240.17f-1.

If the suspicious transaction involves currency and exceeds $10,000, the financial institution will also need to file a CTR in addition to a SAR.

For suspected money laundering and violations of the BSA, a financial institution must file a SAR, if it knows, suspects, or has reason to suspect that:

- The transaction involves funds derived from illegal activities or is intended or conducted in order to conceal funds or assets derived from illegal activities (including without limitation, the ownership, nature, source, location, or control of such funds or assets), as part of a plan to violate or evade any Federal law or regulation or to avoid any transaction reporting requirement under Federal law;
- The transaction is designed to evade any regulation promulgated under the BSA; or
- The transaction has no business or apparent lawful purpose or is not the sort of transaction in which the particular customer would normally be expected to engage, and the financial institution knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction.

Preparation of the SAR Form

The SAR form requires the financial institution to complete detailed information about the suspect(s) of the transaction, the type of suspicious activity, the dollar amount involved, along with any loss to the financial institution, and information about the reporting financial institution. Part V of the SAR form requests a narrative description of the suspect violation and transactions and is used to document what supporting information and records the financial institution retains. This section is considered very critical in terms of explaining the apparent criminal activity to law enforcement and regulatory agencies. The information provided in this section should be complete, accurate, and well-organized. This section should contain additional information on suspects, describe instruments and methods of facilitating the transaction, and provide any follow-up action taken by the financial institution. Data inserts in the form of tables or graphics are discouraged as they are not compatible with the SAR database at FinCEN. Also, attachments to a SAR form will not be stored in the database because they do not conform to the database format. Consequently, a narrative in Part V that states only "see attached" will result in no meaningful description of the transaction, rendering the record in this field insufficient.

The financial institution is also encouraged to detail a listing of documentation available that supports the SAR filing in Part V of the SAR form. This notice will provide law enforcement the awareness necessary to ensure timely access to vital information, if further investigation results from the SAR filing. All documentation supporting the SAR must be stored by the financial institution for five years and is considered property of the U.S. Government.

FinCEN has provided ongoing guidance on how to prepare SAR forms in its publication, "SAR Activity Reviews," under a section on helpful hints, tips, and suggestions on SAR filing. These publications are available at the FinCEN website. Financial institution management should be encouraged to review current and past issues as an aid in properly completing SARs.

SAR Filing Deadlines

By regulation, SAR forms are required to be filed no later than 30 calendar days after the date of initial detection of facts that may constitute a basis for filing a SAR. If no suspect was identified on the date of detection of the incident requiring the filing, a financial institution may delay filing a SAR for an additional 30 calendar days in order to identify a suspect. In no case shall reporting be delayed more than 60 days after the date of initial detection of a reportable transaction.

Customers Engaging in Ongoing Suspicious Activity

If a customer's suspicious activity continues to occur, FinCEN recommends the financial institution file an update on the activity and amounts every 90 days using the SAR form. In such instances, the financial institution should aggregate the dollar amount of previously reported activity and the dollar amount of the newer activity and put this amount in the box on the SAR requesting "total dollar amount involved in known or suspicious activity." Similarly, for the date range of suspicious activity, the financial institution should maintain the original "start" date and extend the "to" date to include the 90 day period in which the suspicious and reportable activity continued.

Failure to File SARs

If an examiner determines that a financial institution has failed to file a SAR when there is evidence to indicate a report should have been filed, the examiner should instruct the financial institution to immediately file the SAR. If the financial institution refuses, the examiner should complete the SAR and cite violations of Part 353 of the FDIC's Rules and Regulations, providing limited details of suspicious activity or the SAR in the Report of Examination. In instances involving a senior officer or director of the financial institution, examiners may prepare the SAR, rather than request the financial institution to do so in order to ensure that the SAR explains the suspicious activity accurately and completely. Each Regional Office is responsible for monitoring SARs filed within that region. Examiner-prepared SARs should be forwarded to their Regional Special Activities Case Manager to ensure timely and proper filing. Any examiner-prepared SARs and all supporting documents should be maintained in the field office files for five years.

SAR Filing Methods

SARs can be filed in paper form, by magnetic tape, or through the Patriot Act Communications System. Financial institutions may contact law enforcement and their Federal Banking Agency to notify them of the suspicious activity, and these contacts should be noted on the SAR form.

Notification to Board of Directors of SAR Filings

Section 353.3 of the FDIC's Rules and Regulations requires the financial institution's board of directors, or designated committee, be promptly notified of any SAR filed. However, if the subject of the SAR is a senior officer or member of the board of directors of the financial institution, notification to the board of directors should be handled differently in order to avoid violating Federal laws that prohibit notifying a suspect or person involved in the suspicious transaction that forms the basis of the SAR. In these situations, it is recommended that appropriate senior personnel not involved in the suspicious activity be advised of the SAR filing and this process be documented.

In cases of financial institutions that file a large volume of SARs, it is not necessary that the board of directors, or designated committee thereof, review each and every SAR document. It is acceptable for the BSA officer to prepare an internal tracking report that briefly discusses all of the SARs filed for a particular month. As long as this tracking report is meaningful in content, then the institution will still be meeting the requirements of Part 353 of the FDIC's Rules and Regulations. Such a report would identify the following information for each SAR filed:

- Customer's name and any additional suspects;
- Social Security Number or TIN;
- Account number (if a customer);
- The date range of suspicious activity;
- The dollar amount of suspicious activity;
- Very brief synopsis of reported activity (for example, "cash deposit structuring" or "wire transfer activity inconsistent with business/occupation"); and
- Indication of whether it is a first-time filing or repeat filing on the customer/suspects.

Such a tracking report promotes efficiency in review of multiple SAR filings. Nevertheless, there are still some SARs that the board of directors, or designated committee thereof, should review individually. Such "significant SARs" would include those that involve insiders (notwithstanding the guidance above regarding the handling of SARs involving board members and senior management), suspicious activity above an internally determined dollar threshold, those involving significant check kiting activity, etc. Financial institutions are encouraged to develop their own parameters for defining "significant SARs" necessitating full reviews; such guidance needs to be written and formalized within board approved BSA policies and procedures.

Safe Harbor for Institutions on SAR Filings

A financial institution that files a SAR is accorded safe harbor from civil liability for filing reports of suspected or known criminal violations and suspicious activities with appropriate authorities. Any financial institution that is subpoenaed or otherwise requested to disclose information contained in a SAR or the fact that a SAR was filed to others shall decline to produce the SAR or provide any information or statements that would disclose that a SAR has been prepared or filed. This prohibition does not preclude disclosure of facts that are the basis of the SAR, as long as the disclosure does not state or imply that a SAR has been filed on the underlying information.

Recently, the safe harbor protections were reiterated and expanded. Section 351 of the USA PATRIOT Act, amended Section 5318(g)(3) of 31 USC and included directors, officers, employees, and agents of the financial institutions who participate in preparing and reporting of SARs under safe harbor protections. Section 355 of the USA PATRIOT Act, implemented at Section 18(w) of the FDI Act, established a means by which financial institutions can share factual information of suspected involvement in criminal activity with each other in connection with references for employment. To comply, employment references must be written and the disclosure made without malicious intent. The financial institution still may not disclose that a SAR was filed. The sharing of employment information is voluntary and should be done under adequate procedures, which may include review by the institution's legal counsel to assess potential for claims of malicious intent.

Examination Guidance

Examiners should ensure that the financial institution has procedures in place to identify and report suspicious activity for all of the financial institution's departments and activities. The guidance may be contained in several policies and procedures; however, it may be advisable for the financial institution to centrally manage the reporting of suspicious activities to ensure that transactions are being reported, when appropriate. A single point of contact can also expedite law enforcement contacts and requests to review specific SARs and their supporting documentation.

As part of its BSA and anti-money laundering programs, the financial institution's policies should detail procedures for complying with suspicious activity reporting requirements. These procedures should define reportable suspicious activity. Financial institutions are encouraged to elaborate and clarify definitions using examples and discussion of the criminal violations. Parameters to filter transactions and review for customer suspicious activity should also be established. Typically, the criteria will be used to identify exceptions to expected customer and transaction activity patterns and identify high-risk customers, whose accounts and transactions should be subject to enhanced scrutiny. Procedures to facilitate accurate and timely filing of SARs, as well as to ensure proper maintenance of supporting documentation, should also be prescribed. Procedures to document decisions not to file a SAR should also be established. Reporting requirements, including reporting SAR filings to senior management and institution directors should be defined. Any additional actions, such as closer monitoring or closing of an involved account(s) that the financial institution may wish to take should be defined in the policy. Many institutions are concerned about facilitating money laundering by continuing to process these suspicious transactions. As there is no requirement to close an account, the institution should assess each situation and provide corresponding guidance on this area in its policy. If the financial institution does plan to close an account that is under investigation by law enforcement, then the institution should notify law enforcement of its intent to close the account.

SAR Database

If examiners need specific SAR filing information, they should contact their Regional SACM or other designees. These specially designated individuals have access to the FinCEN computer system and the database containing records of SAR filings. The database contains information from SARs filed by all federally insured financial institutions. The database is maintained according to the numbered reporting fields in the SAR form, so information can be searched, for example, by suspect, type of violation, or location.

Under current guidance, examiners should obtain a listing or copies of the SARs filed in the current and previous two years by a financial institution for pre-examination planning purposes. Additional searches may be requested as needed, such as to identify whether a SAR has been filed for suspicious activity discovered during the examination, or to obtain information about additional SAR filings on a particular suspect or group of transactions.

For additional guidance on obtaining SAR data, refer to the detailed instructions provided within the "Currency and Banking Retrieval System" discussion within the "Financial Crimes Enforcement Network Reporting and Recordkeeping Requirements" section of this chapter.

OFFICE OF FOREIGN ASSETS CONTROL

The Treasury's Office of Foreign Assets Control administers laws that impose economic and trade sanctions based on foreign policy and national security objectives. Sanctions have been established against various entities and individuals such as targeted foreign countries, terrorists, international narcotics traffickers, and those engaging in activities relating to the proliferation of weapons of mass destruction. Collectively, such individuals and companies are called Specially Designated Nationals (SDNs) and Blocked Persons.

OFAC acts under Presidential wartime and national emergency powers, in addition to authority granted by specific legislation. OFAC has powers to impose controls on transactions and to freeze foreign assets under U.S. jurisdiction. Sanctions can be specific to the interests of the U.S.; however, many sanctions are based on United Nations and other international mandates. Sanctions can include one or more of the following:

- Blocking of assets,
- Trade embargoes,
- Prohibition on unlicensed trade and/or financial transactions,
- Travel bans, and
- Other financial and commercial prohibitions.

A complete list of countries and other specially-designated targets that are currently subject to U.S. sanctions and a detailed description of each order can be found on the Treasury website.

OFAC Applicability

OFAC regulations apply to all U.S. persons and entities, including financial institutions. As such, all U.S. financial institutions, their branches and agencies, international banking facilities, and domestic and overseas branches, offices, and subsidiaries must comply with OFAC sanctions.

Blocking of Assets, Accounts, and Transactions

OFAC regulations require financial institutions to block accounts and other assets and prohibit unlicensed trade and financial transactions with specified countries. Assets and accounts must be blocked when that property is located in the U.S., or is held by, possessed by, or under the control of U.S. persons or entities. The definition of assets and property can include anything of direct, indirect, present, future, and contingent value. Since this definition is so broad, it can affect many types of products and services provided by financial institutions.

OFAC regulations also direct that prohibited accounts of and transactions with SDNs and Blocked Persons need to be blocked or rejected. Generally, U.S. financial institutions must block or freeze funds that are remitted by or on behalf of a blocked individual or entity, are remitted to or through a blocked entity, or are remitted in connection with a transaction in which a blocked entity has an interest. For example, a financial institution cannot send a wire transfer to a blocked entity; once a payment order has been received from a customer, those funds must be placed in an account on the blocked entity's behalf. The interest rate must be a commercially reasonable rate (i.e., at a rate currently offered to other depositors with similar deposit size and terms). Customers cannot cancel or amend payment orders on blocked funds after the U.S.

financial institution has received the order or the funds in question. Once these funds are blocked, they may be released only by specific authorization from the Treasury. Full guidelines for releasing blocked funds are available on the OFAC website. Essentially, either the financial institution or customer files an application with OFAC to obtain a license or authorization to release the blocked funds.

Rejected transactions are those that are to be stopped because the underlying action is prohibited and cannot be processed per the sanctions program. Rejected transactions are to be returned to the sending institution. Transactions include, but are not limited to, the following:

- Cash deposits;
- Personal, official, and traveler's checks;
- Drafts;
- Loans;
- Obligations;
- Letters of credit;
- Credit cards;
- Warehouse receipts;
- Bills of sale;
- Evidences of title;
- Negotiable instruments, such as money orders;
- Trade acceptances;
- Wire transfers;
- Contracts;
- Trust assets; and
- Investments.

OFAC Reporting Requirements

OFAC imposes reporting requirements for blocked property and blocked or rejected transactions. OFAC does not take control of blocked or rejected funds, but it does require financial institutions to report all blocked property to OFAC annually by September 30th. Additionally, financial institutions must notify OFAC of blocked or rejected transactions within 10 days of their occurrence.

When an institution identifies an entity that is an exact match, or has many similarities to a subject listed on the SDN and Blocked Persons List, the institution should contact OFAC Compliance at 1-800-540-6322 for verification. Unless a transaction involves an exact match, it is recommended that the institution contact OFAC Compliance before blocking assets.

Issuance of OFAC Lists

OFAC frequently publishes updates to its list of SDNs and Blocked Persons. This list identifies individuals and companies owned or controlled by, or acting for or on behalf of, targeted countries. It also includes those individuals, groups, and entities, such as terrorists and narcotics traffickers designated under programs that are not country-specific. OFAC adds and removes names as necessary and appropriate and posts those updates to its website. The Special Activities Section in Washington D.C. notifies FDIC-supervised institutions that updates to the SDN and Blocked Persons List are available through Financial Institution Letters.

Maintaining an updated SDN and Blocked Persons list is essential to an institution's compliance with OFAC regulations. It is important to remember that outstanding sanctions can and do change and names of individuals and entities are added to the list frequently. Financial institutions should establish procedures to ensure that its screening information is up-to-date to prevent accepting, processing, or facilitating illicit financial transactions and the potential civil liability that may result.

Financial Institution Responsibilities – OFAC Programs and Monitoring Systems

Financial institutions are subject to the prohibitions and reporting required by OFAC regulations; however, there are not any regulatory program requirements for compliance. Neither OFAC nor Federal financial institution regulators have established laws or regulations dictating what banking records must be screened for matches to the OFAC list, or how frequently reviews should be performed. A violation of law occurs only when the institution conducts a blocked or rejected transaction, <u>regardless</u> of whether the financial institution is aware of it. Additionally, institutions that fail to block and report a transfer (which is subsequently blocked by another bank) may be subject to adverse publicity, fines, and even criminal penalties.

OFAC has the authority to assess CMPs for any sanction violation, and these penalties can be severe. Over the past several years, OFAC has had to impose millions of dollars in CMPs involving U.S. financial institutions. The majority of these fines resulted from institution's failure to block illicit transfers when there was a reference to a targeted country or SDN. While the maximum penalties are established by law, OFAC will consider the Federal banking regulator's most recent assessment of the financial institution's OFAC compliance program as one of the mitigating factors for determining any penalty. In addition, OFAC can pursue criminal penalties if there is any evidence of criminal intent on the part of the financial institution or its employees. Criminal penalties provide for imprisonment up to 30 years and fines ranging up to $10 million.

Furthermore, financial institutions are not permitted to transfer responsibility for OFAC compliance to correspondent banks or a contracted third party, such as a data processing service provider. Each financial institution is responsible for every transaction occurring by or through its systems. If a sanctioned transaction transverses several U.S. financial institutions, all of these institutions will be subject to the same civil or criminal action, with the exception of the financial institution that blocked or rejected the transaction, as appropriate.

Examination Considerations

Financial institutions should establish and maintain effective OFAC programs and screening capabilities in order to facilitate safe and sound banking practices. It is not the examiner's primary duty to identify unreported accounts or transactions within an institution. Rather, examination procedures should focus on evaluating the adequacy of an institution's overall OFAC compliance program and procedures, including the systems and controls in place to reasonably assure accounts and transactions are blocked and rejected.

In reviewing an institution's OFAC compliance program, examiners should evaluate the operational risks the financial institution is willing to accept and determine if this exposure is reasonable in comparison with the business type, department or product, customer base, and cost of an effective screening program for that particular institution, based on its risk profile.

The FDIC strongly recommends that each financial institution adopt a risk-focused, written OFAC program designed to ensure compliance with OFAC regulations. An effective OFAC program should include the following:

- Written policies and procedures for screening transactions and new customers to identify possible OFAC matches;
- Qualified individual to monitor compliance and oversee blocked funds;
- OFAC risk-assessment for various products and departments within the financial institution;
- Guidelines and internal controls to ensure the periodic screening of all existing customer accounts;
- Procedures for obtaining and maintaining up-to-date OFAC lists of blocked countries, entities, and individuals;
- Methods for conveying timely OFAC updates throughout the financial institution, including offshore locations and subsidiaries;
- Procedures for handling and reporting prohibited OFAC transactions;
- Guidance for SAR filings on OFAC matches, if appropriate, such as when criminal intent or terrorist activity is involved;
- Internal review or audit of the OFAC processes in each affected department; and
- Training for all appropriate employees, including those in offshore locations and subsidiaries.

Departmental and product risk assessments are fundamental to a sound OFAC compliance program. These assessments allow institution management to ensure appropriate focus on high-risk areas, such as correspondent banking activities and electronic funds transfers. An effective program will filter as many transactions as possible through OFAC's SDN and Blocked Persons List, whether they are completed manually or through the use of a third party software program. However, when evaluating an institution's compliance program, examiners should consider matters such as the size and complexity of the institution. Adequate compliance procedures can and should be targeted to transactions that pose the greatest risk to an institution. Some transactions may be difficult to capture within a risk-focused compliance program. For example, a customer could write a personal check to a blocked entity; however, the only way the financial institution that the check is drawn upon could block those funds would be if it reviewed the payee on each personal check, assuming the information is provided and legible. Under current banking practices, this would be costly and time consuming. Most financial institutions do not have procedures for interdicting these transactions, and, yet, if such a transaction were to be processed by a U.S. financial institution, it is a violation of OFAC regulations and could result in CMPs against the bank.

However, if a financial institution only screens its wire transfers through the OFAC SDN and Blocked Persons List and never screens its customer database, that is a much higher and, likely, unacceptable risk for the financial institution to assume in relation to the time and expense to perform such a review. Particular risk areas that should be screened by all financial institutions include:

- Incoming and outgoing electronic transactions, such as ACH;
- Funds transfers, including message or instruction fields;
- Monetary instrument sales; and

- Account beneficiaries, signors, powers of attorney, and beneficial owners.

As mentioned previously, account and transaction screening may be done manually, or by utilizing computer software available from the Treasury website or other third party vendors. In fact, many institutions have outsourced this function. If automated, OFAC offers the SDN list in a delimited file format file that can be imported into some software programs. Commercial vendors also offer several OFAC screening software packages with various capabilities and costs. If an institution utilizes an automated system to screen accounts and transactions, examiners should ensure that the institution's policies and procedures address the following:

- OFAC updates are timely;
- OFAC verification can be and is completed in a reasonable time;
- Screening is completed by all of bank departments and related organizations; and
- Process is reasonable in relation to the institution's risk profile.

Wholly-owned securities and insurance subsidiaries of financial institutions must also adopt an OFAC compliance program tailored to meet industry specific needs. The OFAC website provides additional reference material to these industries concerning compliance program content and procedures.

OFAC maintains current information and FAQs on its website. For any questions, OFAC encourages financial institutions to contact its Compliance Hotline at 800-540-6322 (7:30am-6:00pm, weekdays).

EXAMPLES OF PROPER CITATION OF APPARENT VIOLATIONS OF BSA-RELATED REGULATIONS IN THE REPORT OF EXAMINATION

The situations depicted in the examples below are intended to provide further clarification on when and how to cite apparent violations of the BSA and implementing regulations, within the context of findings that are typical for BSA reviews conducted during regular Safety & Soundness examinations. As is often the case, deficiencies identified within an institution's BSA compliance policies and procedures may lead to the citation of one or more apparent violations. The identification of numerous and/or severe deficiencies may indicate an ineffective and inadequate program. When an institution's BSA compliance program is considered inadequate, an apparent violation of Part 326.8(b)(1) of the FDIC's Rules and Regulations should also be cited.

Example 1

An examiner is conducting a BSA review at Urania Bank, a $100 million dollar financial institution in El Paso, Texas. The examiner identifies a systemic violation because the financial institution has not filed CTRs on cash purchases of monetary instruments. This is an apparent violation of 31 CFR 103.22(b)(1). The examiner also identifies a complete failure to scrub the institution's database against 314(a) Requests. This is an apparent violation of 31 CFR 103.100(b)(2). In addition, the examiner identifies numerous incomplete CTRs in apparent violation of 31 CFR 103.27(d). Because of the internal control inadequacies, the examiner also cites an apparent violation of Section 326.8(c)(1). The examiner further determines that the problems are sufficiently serious, warranting the citation of an apparent violation of Section 326.8(b)(1) for failure to develop and provide for an adequate BSA program. After doing additional research, the examiner determines that an apparent violation of Section 326.8(c)(2) should also be cited for inadequate independent testing that should have identified the ongoing weaknesses found by the examiner. Furthermore, the examiner decides that an apparent violation of Section 326.8(c)(4) should be cited for inadequate training. Employees are given cursory BSA training each year; however, no training exists for appropriate identification of cash activity and adequate CTR filings. The examiner also determines that an apparent violation of Section 326.8(c)(3) is appropriate because the BSA officer at Urania Bank comes in only two days per week. This is clearly inadequate for a financial institution of this size and complexity, as exhibited by the systemic BSA problems. In addition to fully addressing these deficiencies in the Violations and Risk Management sections of the Report of Examination, the Examiner-In-Charge fully details the findings, weaknesses, and management responses on the Examiner Comments and Conclusions pages.

Example 2

Examiners at Delirium Thrift, a $500 million financial institution in Southern California, begin the BSA review by requesting the wire transfer log for incoming and outgoing transactions. Information being obtained by the institution for the outgoing wire transfers is identified as inadequate. Consequently, the examiners cite an apparent violation of 31 CFR 103.33(g)(1). Additional research reveals that deficiencies in the wire log information are attributed to several branch locations that are failing to provide sufficient information to the wire transfer department. Because the deficiencies are isolated to transactions originating in a few locations, examiners determine that the deficiencies are not systemic and the overall program remains effective. However, because it is evident in interviews with several branch employees that their training in this area has been lacking, examiners also cite an apparent violation of Section 326.8(c)(4) and request that the institution implement a comprehensive training program that encompasses all of its service locations.

Example 3

Examiners at the independent BSA examination of Bullwinkle Bank and Trust, Moose-Bow, Iowa, a $30 million financial institution, were provided no written BSA policies after several requests. However, actual internal practices for BSA compliance were found to be fully satisfactory for the size and BSA risk-level of the financial institution. Given the low risk profile of the institution, including a nominal volume of reportable transactions being processed by the institution, the BSA/AML procedures in place are sufficient for the institution. Therefore, examiners cite only an apparent violation of Section 326.8(b)(1) for failure to develop an adequate *written* BSA compliance program that is approved by the financial institution's board of directors.

Example 4

Appropriately following pre-examination scoping requirements, examiners obtain information from their Regional SACM or other designees on previous SAR filings relating to money laundering. Upon arrival at Mission Achievement Bank, Agana, Guam, a $250 million financial institution with overseas branches, examiners determine that several of the accounts upon which money laundering SARs had been previously filed are still open and evidencing ongoing money laundering activity. However, the financial institution has failed to file subsequent SARs on this continued activity in these accounts and/or the parties involved. Consequently, the examiner appropriately cites apparent violations of Section 353.3(a) of the FDIC Rules and Regulations for failure to file SARs on this ongoing activity. Further analysis identifies that the failure to appropriately monitor for suspicious or unusual transactions in its high-risk accounts and subsequently file SARs is a systemic problem at the financial institution. Because of the institution-wide problem, the examiner cites an apparent violation of Section 326.8(c)(1) for inadequate internal controls. Furthermore, after consultation with the Regional SACM, the examiner concludes that the institution's overall BSA program is inadequate because of the failures to identify and report suspicious activities and, therefore, cites an apparent violation of Section 326.8(b)(1).

The examples below provide examiner guidance for preparing written comments for apparent violations of the BSA and implementing regulations. In general, write-ups should fully detail the nature and severity of the infraction(s). These comments intentionally omit the management responses that should accompany all apparent violation write-ups.

Part 326.8(b)(1) of the FDIC Rules and Regulations

Part 326.8(b)(1) requires each bank to "develop and provide for the continued administration of a program reasonably designed to assure and monitor compliance with recordkeeping and reporting requirements" of the Bank Secrecy Act, or 31 CFR 103. The regulation further states that "the compliance program shall be written, approved by the bank's board of directors, and noted in the minutes."

The Board and the senior management team have not adequately established and maintained appropriate procedures reasonably designed to assure and monitor the financial institution's compliance with the requirements of the BSA and related regulations. This assessment is evidenced by the weak internal controls, policies, and procedures as identified at this examination. Furthermore, the Board and senior management team have not made a reasonable effort to assure and monitor compliance with recordkeeping and reporting requirements of the BSA. As a result, apparent violations of other sections of Part 326.8 of the FDIC Rules and Regulations and 31 CFR 103 of the U.S. Treasury Recordkeeping Regulations have been cited.

Part 326.8(b)(2) of the FDIC Rules and Regulations

Part 326.8(b)(2) states that each bank must have a customer identification program to be implemented as part of the BSA compliance program.

Management has not provided for an adequate customer identification program. Current policy requirements do not meet the minimum provisions for a customer identification program, as detailed in 31 CFR 103. Current policies and practices require no documentation for new account openings on the Internet with the exception of a "verification e-mail" sent out confirming that the signer wants to open the account. Signature cards are mailed off-site to the Internet customer, who signs them and mails them back without any evidence of third-party verification, such as notary seal. Based on the risk of these types of accounts, this methodology for verification is clearly inadequate to meet regulatory requirements and sound customer due diligence.

Part 326.8(c)(1) of the FDIC Rules and Regulations

Part 326.8(c)(1) states, in part, that the compliance program shall, at a minimum, provide for a system of internal controls to assure ongoing compliance.

Management has not provided for an adequate system of internal controls to assure ongoing compliance. Examiners identified the following internal control deficiencies:

- Incomplete BSA and AML policies for a bank with a high-risk profile.
- Insufficient identification systems for CTR reporting.
- Late CTR filings.
- Insufficient reporting mechanisms for identification of structured transactions and other suspicious activity.
- Weak oversight over high-risk customers.
- Insufficient customer identification program and customer due diligence.

Due to the financial institution's high-risk profile, management should go beyond minimum CIP requirements and do a sufficient level of due diligence that provides for a satisfactory evaluation of the customer. Management must provide for adequate reporting mechanisms to identify large cash transactions as well as suspicious activity. Timely completion and review of appropriate reports, in conjunction with a sufficient level of due diligence, should allow for the accurate and timely reporting of CTRs and SARs.

Part 326.8(c)(2) of the FDIC Rules and Regulations

Part 326.8(c)(2) states that the compliance program shall provide for independent testing for compliance to be conducted by an outside party or bank personnel who have no BSA responsibility or oversight.

The financial institution's BSA policies provide for independent testing. However, the financial institution has not received an independent review for over three years. An annual review of the BSA program should be completed by a qualified independent party. This review should incorporate all of the high-risk areas of the institution, including cash-intensive accounts and transactions, sales and purchases of monetary instruments; customer exemption list; electronic funds transfer activities, and compliance with customer identification procedures.

Part 326.8(c)(3) of the FDIC Rules and Regulations

Part 326.8(c)(3) states that the compliance program shall designate an individual or individuals responsible for coordinating and monitoring day-to-day compliance.

The board of directors has named Head Teller Ben Bison as the BSA officer. While Mr. Bison has a basic understanding of CTR filing, he does not have any training on detecting and reporting suspicious activity. Furthermore, Ben Bison does not have policy-making authority over the BSA function. Management needs to appoint someone with policy-making authority as the institution's BSA Officer.

Part 326.8(c)(4) of the FDIC Rules and Regulations

Part 326.8(c)(4) states that the compliance program shall provide training for appropriate personnel.

Example 1:

While BSA training programs are adequate, management has trained less than half of the appropriate operational personnel during the last calendar year. Management must ensure that all appropriate personnel, including the board of directors and officers, receive adequate BSA training a minimum of once per year and ongoing for those whose duties require constant awareness of the BSA requirements.

Example 2:

BSA training needs improvement. While regular BSA training sessions are developed and conducted for branch operations personnel, the training programs do not address internal BSA policies and, more importantly, BSA and anti-money laundering regulations. Management must ensure that comprehensive BSA training is provided to all directors, officers, and appropriate operational personnel. Training should be provided at least annually, and must be ongoing for those whose duties require constant awareness of BSA requirements. The training must be commensurate with the institution's BSA risk-profile and provide specific employee guidance on detecting unusual or suspicious transactions beyond the detection of cash structuring transactions.

Part 353.3 of the FDIC Rules and Regulations and 31 C.F.R. 103.18

Part 353.3(a) and 31 C.F.R. 103.18 state, in part, that Suspicious Activity Reports (SARs) should be filed when:

- Insider abuse is involved in any amount;

- Transactions aggregating $5,000 or more when the suspect can be identified;
- Transactions aggregating $25,000 or more when the suspect can not be identified; and
- Transactions aggregating $5,000 or more that involve money laundering or violations of the BSA… if the bank knows, suspects, or has reason to suspect that:
    - The transaction involves funds derived from illegal activities,
    - The transaction is designed to evade BSA reporting requirements, or
    - The transaction has no business or apparent lawful purpose or is not the sort of transaction in which the particular customer would normally be expected to engage, and the bank knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction.

Management failed to file SARs on several different deposit account customers, all of which appeared to be structuring cash deposits to avoid the filing of CTRs. These transactions all appeared on large cash transaction reports reviewed by management; however, no one in the institution researched the transactions or filed SARs on the incidents. Management must file SARs on the following customer transactions and appropriately review suspicious activity and file necessary SARs going forward.

Account Number	Dates	Total Cash Deposited
123333	02/20/xx-02/28/xx	$50,000
134445	03/02/xx-03/15/xx	$32,300
448832	01/05/xx-03/10/xx	$163,500
878877	03/10/xx-03/27/xx	$201,000

Part 353.3(b) of the FDIC Rules and Regulations and 31 C.F.R. 103.18(b)(3)

Part 353.3(b) of the FDIC Rules and Regulations and 31 C.F.R. 103.18(b)(3) state that a bank shall file a suspicious activity report (SAR) no later than 30 calendar days after the date of initial detection of facts that may constitute a basis for filing a SAR. In no case shall reporting be delayed more than 60 calendar days after the date of initial detection.

Management and the board have failed to file several hundred SARs within 30 calendar days of the initial detection of the suspicious activity. The BSA officer failed to file any SARs for the time period of June through August 20XX. This information was verified through use of the FinCEN database, which showed than no SARs had been filed during that time period. In addition, SARs filed from February through May of 20XX were filed between 65 days and 82 days of the initial detection of the activity. Management must ensure that suspicious activity reports are not only identified, but also filed in a timely manner.

Part 353.3(f) of the FDIC Rules and Regulations

Part 353.3(f) of the FDIC Rules and Regulations states that bank management must promptly notify its board of directors, or a committee thereof, of any report filed pursuant to Part 353 (Suspicious Activity Reports).

Management has not properly informed the board of directors of SARs filed to report suspicious activities. The management team has provided the board with erroneous reports showing that the bank has filed SARs, when, in fact, the management team never did file such SARs. Board and committee minutes clearly indicate a reliance on these reports as accurate.

31 C.F.R. 103.22(c)(2)

This section of the Financial Recordkeeping Regulations requires the bank to treat multiple transactions totaling over $10,000 as a single transaction.

Management's large cash aggregation reports include only those cash transactions above $9,000. Because of this weakness in the reporting system's set-up, the report failed to pick up transactions below $9,000 from multiple accounts with one owner. The following transactions were identified which should have been aggregated and a CTR filed. Management needs to alter or improve their system in order to identify such transactions.

Customer Name / Account #	Date	Amount
Mini Meat Market		
122222222	12/12/xx	$8,000
122233333	12/12/xx	$4,000
122222222	12/16/xx	$6,000
122233333	12/16/xx	$5,000
Claire's Club Sandwiches		
a/k/a Claire's Catering		
15555555	12/22/xx	$4,000
17777777	12/22/xx	$7,000
17777788	12/22/xx	$3,000

31 C.F.R. 103.22(d)(6)(i)

This section of the Financial Recordkeeping regulation states that a bank must document monitoring of exempt person transactions. Management must review exempt accounts at least one time per year and must document appropriate monitoring and review of each exempt account.

Management has exempted three customers, but has failed to document monitoring of their accounts. Management has stated that they did monitor the account transactions and no suspicious activity appears evident; however, management must retain appropriate documentation for all account monitoring of exempt customers. Such monitoring documentation could include, but is not limited to:

- Reviews of exempt customers cash transactions,
- Review of monthly statements and monthly activity,
- Interview notes with account owners or visitation notes from reviewing the place of business,
- Documenting changes of ownership, or
- Documenting changes in amount, timing, or type of transaction activity.

31 C.F.R. 103.27(a)

This section of the Financial Recordkeeping regulation requires the financial institution to retain all Currency Transaction Reports for five years.

Management failed to keep copies of all of the CTRs filed during the past five years. Management can locate CTRs filed for the past two years but has not consistently retained CTR copies for the three years preceding. Management needs to make sure that its record-keeping systems allow for the retention and retrieval of all CTRs filed for the previous five year time period.

31 C.F.R. 103.27(d)

This section of the Financial Recordkeeping regulation requires the financial institution to include all appropriate information required in the CTR.

Management has consistently failed to obtain information on the individual conducting the transaction unless that person is also the account owner. This information is required in the CTR and must be completed. Since this is a systemic failure, management needs to ensure proper training is provided to tellers and other key employees to ensure that this problem is corrected.

31 C.F.R. 103.121(b)(2)(i)(A)(4)(ii)

This section of the Financial Recordkeeping regulation states that the financial institution must obtain a tax identification number or number and country of issuance of any government-issued documentation.

The financial institution's policies and programs require that all employees obtain minimum customer identification information; however, accounts in the Vermont Street Branch have not been following minimum account opening standards. Over half of the accounts opened at the Vermont Street Branch since October 1, 2003, when this regulation came into effect, have been opened without tax identification numbers or similar personal identification number for non-U.S. citizens. Management must ensure that BSA policies and regulations are followed throughout the institution and verify through BSA officer reviews and independent reviews that requirements are being met.

WEB-SITE REFERENCES

Financial Crimes Enforcement Network (FinCEN):
www.fincen.gov

FinCEN Money Services Businesses:
www.msb.gov

Financial Action Task Force:
www.oecd.org/fatf

Office of Foreign Assets Control:
www.ustreas.gov/offices/eotffc/ofac

INTRODUCTION

The early detection of apparent fraud and insider abuse is an essential element in limiting the risk to the FDIC's deposit insurance funds and uninsured depositors. Although it is not possible to detect all instances of apparent fraud and insider abuse, potential problems can often be uncovered when certain warning signs are evident. It is essential for examiners to be alert for irregular or unusual activity and to fully investigate the circumstances surrounding the activity. Examiners should not restrict concern to internal crimes, but should also be alert to any attempts by outsiders to defraud financial institutions.

This section is organized by separate subject areas with each providing a summary of potential problems, a listing of warning signs of possible fraud and insider abuse, and suggested action for investigation. The lists are not all-inclusive but rather cover only those areas in which fraud and insider abuse occur most frequently. This section is designed to help alert examiners to possible fraudulent activity and insider abuse. It is intended to serve as a reference source during examinations and should be used as a supplement to standard examination procedures on an "as-needed" basis.

Any important situations should be commented on in the Report of Examination. Appropriate comments should be included in the Examination Conclusions and Comments schedule and in any other report pages as applicable.

Note the restrictions on disclosing irregular transactions in examination reports. This is more fully explained in the Report of Examination Instructions.

Any apparent criminal activity should be investigated thoroughly and reported on the Interagency Criminal Referral Form. The procedures for reporting apparent criminal violations are included in the Criminal Violations Section, Part IV.

SUBJECT AREAS

Included under each of the following subject areas is a summary of potential problems, a listing of warning signs of potential fraud and insider abuse and suggested action for investigation.

1. Corporate Culture/Ethics
2. Insider Transactions
3. Loan Participations
4. Real Estate Lending
5. Secured Lending
6. Third Party Obligations
7. Lending to Buy Tax Shelter Investments
8. Linked Financing/Brokered Deposits
9. Credit Cards and ATM Transactions
10. Advance Fee Schemes
11. Offshore Transactions
12. Wire Transfers
13. Money Laundering
14. Securities Trading Activities
15. Miscellaneous

CORPORATE CULTURE/ETHICS

Potential Problems

Complete dominance of an institution's policies and administration by one or a few directors may lead to inept management at lower levels. Absence of a written code of conduct may make it difficult to discipline directors, officers or employees who may be involved in questionable activities and may cause problems for directors, officers, employees and agents under the Bank Bribery Statute (18 U.S.C. 215). The code of conduct should identify allowable nonbank activities and acceptable gifts or gratuities received in the normal course of business.

Warning Signs

1. Absence of a code of ethics.
2. Absence of a clear policy restricting or requiring disclosure of conflicts of interest.
3. Absence of a policy restricting gifts and gratuities.
4. Lack of oversight by the institution's board of directors, particularly outside directors.

5. Absence of planning, training, hiring and organizational policies.

6. Absence of clearly defined authorities and lack of definition of the responsibilities that accompany the authorities.

7. Lack of independence of management in acting on recommended corrections.

8. CEO controls internal and outside auditors.

9. Lax control and review of expense accounts.

Suggested Action

Review the institution's code of conduct. Determine if there is a policy covering conflicts of interest and if prohibited practices are clearly stated along with the consequences for failure to refrain from these practices. Determine whether all insider interests are accurately reported to the institution's board of directors. Closely review the minutes of the board of directors' meetings and note the reporting of insider interests and the dominance of any director(s) in discussion of policy matters and administration. Also note the discussion of insider transactions and see if there are any directors who frequently or consistently vote against insider transactions in general or against those of one or more insiders in particular. Attempt to determine the reason for the dissent. If directors, officers and employees are required to report gifts and gratuities from present or potential customers, review the report to see if the gifts or gratuities conform to the institution's guidelines.

INSIDER TRANSACTIONS

Potential Problems

Insider fraud has accounted for over one-half of all bank fraud and embezzlement cases closed by the FBI during the past several years. Insiders are in a position of trust and can abuse that trust for their own personal benefit. Insider abuses include failure to disclose their interests that borrow from the institution or otherwise have business dealings with the institution; diverting assets and income for their own use; misuse of position by approving questionable transactions for relatives, friends and/or business associates; abuse of expense accounts; acceptance of bribes and gratuities; and other questionable dealings related to their positions at the institution. Insider abuse undermines confidence in institutions and often leads to failure.

Warning Signs

1. Insider lending personal funds to customers or borrowing from customers.

2. Insider involvement in silent trusts or partnerships and/or shell corporations.

3. Insider appears to receive special favors from institution customers or shows unusual favoritism toward certain institution customers.

4. Insider purchases assets from the institution, directly or indirectly, and there is no evidence of independent appraisal of the assets.

5. Insider has apparent reciprocal lending arrangements with insiders of other institutions and his/her institution has correspondent relationships with those institutions.

6. Insider is involved in a business that arranges its financing through the institution.

7. Insider "perks" include use of expensive institution-owned automobiles, boats, airplanes, housing, etc., where the institution's earnings do not appear to support such extravagance.

8. Insider heavily indebted and debt service appears to require most, if not all, of the insider's salary.

9. Insider financial statements show large or unusual fluctuations. Net worth cannot be reconciled from disclosed sources of income.

10. Insider is financing large purchases (home, auto, etc.) through private, nonbanking sources that may have a business relationship with the institution.

11. Insider financial statement reflects heavy concentration of high-risk investments and speculative ventures.

12. Insider sells personal assets to third party and the institution provides financing without benefit of an independent appraisal.

13. Insiders or their interests frequently appear on transaction suspense item listings or on computer-generated past due loan lists, but do not appear on the "updated" version presented to the board of directors or to examiners.

14. Insider "unofficially" guarantees loans and/or loan participations.

15. Insider is responsible for clearing up audit exceptions on loan balance confirmations.

16. Insider "forgets" to process credit entry for official bank checks causing the account to be out-of-balance because checks are sometimes paid (debited) before the credit is posted, sometimes several days later.

17. Insider conducts a cash transaction over $10,000 but "forgets" to have the institution file a Currency Transaction Report or asks an employee to "structure" the transaction to avoid filing a Currency Transaction Report with the Internal Revenue Service.

18. Insider's stock in the institution is pledged to secure loans obtained from sources other than financial institutions. If true, what is the purpose of the loan and are payments current?

19. Insider conducts personal business from the institution using equipment, supplies, employees, etc., and/or spends most of their time out of the institution on business unrelated to the institution.

20. Insider has substance abuse problems or is known to associate with people who have these problems.

21. Insider is known to associate with "high rollers".

22. Insider suggests that institution change servicers or vendors even though there appears to be no problem with the current servicers or vendors.

23. Insider abruptly suggests changes in outside auditors or legal counsel.

24. Insider loans increase dramatically at about the same time as the institution is recapitalized.

25. Insider's major assets are parcels of real estate that appear to increase in value at a rate that is not consistent with market conditions.

26. Insider sells his stock to an Employee Stock Option Plan (ESOP), sometimes arranging for the ESOP to obtain a loan to purchase the stock.

27. Insider's interests have a direct business relationship with the institution and compensation for services is not commensurate with the level of services provided.

28. Insider agrees to buy fixed assets from the institution with the understanding that the institution will repurchase the fixed assets at some future date.

29. Insider receives incentive pay or "bonuses" based on volume of loans generated.

30. Insider buys a home from a builder whose development project is financed by the institution.

31. Insider is involved in "churning" of the institution's securities portfolio.

32. Insider arranges sale of EDP equipment at book value in connection with the conversion to a new data processing servicer. Also check "side" deals.

33. Insider authorizes ORE related expenses such as landscaping, remodeling, etc., when such expenses do not appear justified. (May be making improvements or repairs to personal residence.)

34. Insider makes frequent trips at the institution's expense to areas where the institution has no business relationships.

35. Insider will not allow employees to talk to examiners.

36. Insider keeps an unusual number of customer files in his/her office.

37. Insider is making payments on other borrowers' loans.

38. Insider's loan is being paid by someone else.

39. Insider receives commissions on credit life insurance premiums and those commissions are not properly adjusted in cases where the insurance company gives rebates for the borrower's prepayment of the loan or gives refunds to borrowers for premium overcharges.

40. Insider sells some of his/her personal stock of the institution to borrowers (as a condition for approving loan) and buys more stock from the institution at about the same time that the institution is under pressure to increase capital.

41. Insider purchases investment securities for his personal portfolio through the institution but

"forgets" to reimburse the institution until a few days or weeks later, and then only if the investment has increased in value. In spite of the increase in value, the insider only pays the original purchase price to the institution.

42. Insider's accounts at the institution are frequently overdrawn. Deposits to cover overdrafts come from loans or some undisclosed source.

43. Insider maintains total control over the institution and does not allow other officers and employees to make independent decisions.

44. Insider has past due loans at other financial institutions.

45. Insider maintains signed, blank notes in personal or customer loan files.

46. Insider is rumored to have financial problems due to divorce, business failure, gambling losses, etc.

47. Insider maintains several personal accounts outside of his/her own institution.

48. Insider frequently takes loan papers out of the institution for customer signatures; personally handles the disbursement of the loan proceeds; routinely cashes checks for customer loan proceeds; and insists on personally handling certain past due accounts as a "special favor" to certain customers.

49. Insider insists that different audit firms audit different divisions or departments. (Hopes there will be no comparison of findings between firms.)

50. Insider insists that different departments be audited at different times. (Makes it easier to hide fraudulent inter-departmental transactions.)

Suggested Action

Review all insider transactions to see if they comply with policy and applicable state and federal regulations. Follow up on any exceptions. Any nonconforming transactions should be discussed with the institution's board of directors. Apparent fraudulent activities should be referred to the proper authorities.

LOAN PARTICIPATIONS

Potential Problems

Loan participations can lead to substantial losses if not documented properly and if not subjected to the same credit standards and reviews as direct loans. Participations purchased as an accommodation to affiliated institutions often do not receive the same scrutiny as those purchased from non-affiliated institutions. Informal repurchase agreements between participating institutions may be used to circumvent legal lending limitations and could subject institutions to substantial undisclosed contingent liabilities. Participations may also be used to disguise delinquencies and avoid adverse classifications.

Warning Signs

1. Excessive participation of loans between closely related institutions, correspondent institutions and branches or departments of the lending institution.

2. Absence of any formal participation agreement.

3. Poor or incomplete loan documentation.

4. Investing in out-of-territory participations.

5. Reliance on third party guaranties.

6. Large paydown or payoff of previously classified loans.

7. Some indication that there may be informal repurchase agreements on some participations.

8. Lack of independent credit analysis.

9. Volume of loan participations is high in relation to the size of the institution's own loan portfolio.

10. Evidence of lapping of loan participations. For example, the sale of a loan participation equal or greater than, and at or about the same time as, a participation that has matured or is about to mature.

11. Disputes between participating institutions over documentation, payments, or any other aspect of the loan participation transaction.

12. Formal participation agreements are missing; therefore, responsibilities and rights of all participating institutions may be unclear.

13. Participations between affiliated institutions may be "placed" without the purchasing institution having the benefit of reviewing normal credit information,

particularly where there is dominant ownership and a "rubber stamp" board of directors.

14. Payments that are not distributed to each participant according to the participation agreement may indicate preferential treatment; or where the participants are affiliated, it may indicate an attempt to disguise the delinquent status of the loans in the weaker institutions.

15. Informal guaranties by insiders may be one method of disguising insider transactions.

16. There is some indication that the credit information contained in the selling institution's files is not the same as the credit information in the purchasing institution's files.

17. Be aware of reciprocal arrangements in the sale/purchase of participations. For example, Institution A sells a 100% participation in a loan to an insider of the selling institution to Institution B which, in turn sells a 100% participation in a loan to one of their insiders to Institution A.

18. There are a number of outstanding items in correspondent accounts just prior to or during an examination or audit which relate to participations purchased or sold.

19. There is some indication that payments on participations purchased are being made by the selling institution without reimbursement from the borrower.

Suggested Action

Where possible, determine the current status of participations at each participating institution. Make special note of any disputes between participating institutions and follow up. Review any debits or credits related to participations posted to the correspondent institution accounts just prior to or during the examination. Follow up on any exceptions. Attempt to determine if the participation has been adversely classified by examiners at any participating institution. Look for any indication of any informal repurchase agreements.

REAL ESTATE LENDING

Potential Problems

Real estate lending abuses have been given a lot of publicity due to the problems encountered by financial institutions that have suffered substantial losses from problem real estate loans. These problems have not been confined to any particular area of the country. Many of the problems revolve around inflated appraisals, land flips (interparty transactions), fraudulent sales contracts, forged title documents, misapplication of loan proceeds, financing of nonexistent properties, loans in the name of trustees, holding companies and offshore companies to disguise the true identity of the actual borrowers and fraudulent loan applications from purchasers, including false income statements, false employment verifications, false credit reports and false financial statements. In many cases, important documentation is missing or is intentionally deficient in an attempt to conceal material facts.

Warning Signs

1. An unusually large number of loans in the same development are exactly equal to the institution's maximum loan-to-value (LTV) ratio for real estate mortgages.

2. The institution has an unusually high percentage of "No Doc" loans. (A "No Doc" loan is one in which extensive documentation of income, credit history, deposits, etc., is not required because of the size of the downpayment, usually 25% or more. Theoretically, the value of the collateral will protect the lender.)

3. Borrower has never owned a home before and does not appear to have the financial ability to support the size of the downpayment made.

4. Property securing loan has changed ownership frequently in a short period of time. Related entities may be involved.

5. Insured value of improvements is considerably less than appraised value.

6. Appraiser is a heavy borrower at the institution.

7. Appraisal fee is based on a percentage of appraised value.

8. Borrower furnishes his/her own appraisal which is a photocopy of an appraisal signed by a reputable appraiser.

9. Use of "comparables" which are not comparable.

10. Appraisal is based on an estimated future value.

11. All comparables are new houses in the same development that were built by the same builder and appraised by the same appraiser.

12. An unusual number of "purchasers" are from out of the area or out of state.

13. Credit history, employment, etc., are not independently verified by the lender.

14. Large number of applicants have income from sources that cannot be verified, such as self-employment.

15. The value of the home the applicant desires to purchase is not in line with the applicant's income. For example, the applicant makes $90,000 per year and only wants to purchase a $90,000 home.

16. The applicant's credit history is incomplete. For example, the applicant is 45 years old, but credit history only dates back five years.

17. The institution's normal procedure is to accept photocopies of important documents rather than to make their own copies of the originals.

18. If copies of income tax returns are provided, columns are uneven and/or do not balance.

19. Appraiser is from out of the area and not likely to be familiar with local property values.

20. A close relationship exists between builder, broker, appraiser and lender.

21. Construction draws are made without visual inspections.

22. All "comparables" are from properties appraised by the same appraiser.

23. Generally, housing sales are slow, but this development seems unusually active in sales.

24. There seems to be an unusual number of foreclosures on 90% to 95% loans with Private Mortgage Insurance on homes in the same development built by the same builder. (Sometimes it is cheaper for the builder to arrange for a straw buyer to get the 95% loan and default than it is to market the home if the market is sluggish.)

25. Applications received through the same broker have numerous similarities.

26. Sales contracts have numerous crossed out and changed figures for sales price and downpayment.

27. Appraiser for the project owns property in the project.

28. Lending officer buys a home in a project financed by the institution.

29. Assessed value for tax purposes is not in line with appraised value.

30. The project is reportedly fully occupied, but the parking lot always appears to be nearly empty.

31. The parking lot is full, but the project appears empty. Nobody is around in the parking lot, pool, etc.

32. After a long period of inactivity, sales suddenly become brisk.

33. Sales contract is drawn up to fit the lender's LTV requirements. For example, the buyer wants an $80,000 home but has no down payment. The lender only lends 80% of appraised value or selling price. Contract is drawn up to show a selling price of $100,000 instead of the actual selling price of $80,000.

34. Builder claims a large number of presold units not yet under construction while many finished units remain unsold.

35. The borrower's interest in the property is not logical given the distance between the property and his/her place of employment and the supply of comparable housing near his/her employer. For example, employment of the prospective borrower/purchaser is 100 miles from the location of the property, while comparable housing is readily available within 10 miles of employment.

36. Applicant's stated income is not commensurate with his/her stated employment and/or years of experience.

37. Applicant's financial statement shows numerous assets that are self evaluated and cannot be readily verified through independent sources.

38. Applicant claims to own partial interests in many assets but not 100% of any asset, making verification difficult.

39. Appraised value of property is contingent upon the curing of some property defect such as drainage problems.

40. The applicant's financial statement reflects ownership of valuable items, such as jewelry and art work, but no insurance is carried on these items.

41. Applicant's tax return shows substantial interest deductions, but the financial statement shows little debt. For example, the borrower's tax return shows substantial mortgage interest deductions, but the self-prepared financial statement shows no mortgage or a very small mortgage.

42. Appraised value of a condominium complex is arrived at by using the asking price for one of the more desirable units and multiplying that by the total number of units.

43. Loans are unusual considering the size of the institution and the level of expertise of its lending officers.

44. There is a heavy concentration of loans to a single project or to individuals related to the project.

45. There is a heavy concentration of loans to local borrowers with the same or similar real estate collateral which is located outside the institution's trade area.

46. There are many loans in the names of trustees, holding companies, and/or offshore companies but the names of the individuals involved are not disclosed in the institution's files.

47. A loan is approved contingent upon an appraised value of at least a certain amount and the appraised value is exactly that amount.

48. Independent reviews of outside appraisals are never conducted.

49. The institution routinely accepts mortgages or other loans through brokers but makes no attempt to determine the financial condition of the broker or to obtain any references or other background information.

50. Borrower claims substantial income but his/her only credit experience has been with finance companies.

51. Borrower claims to own substantial assets, reportedly has an excellent credit history and above average income, but is being charged many points and a higher than average interest rate which is indicative of high risk loans.

52. The institution allows borrowers to assign mortgages as collateral without routinely performing the same analysis of the mortgage and mortgagor as they would perform if the institution were mortgagee.

53. Asset Swaps - Sale of other real estate or other distressed assets to a broker at an inflated price in return for favorable terms and conditions on a new loan to a borrower introduced to the institution by the broker. The new loan is usually secured by property of questionable value and the borrower is in weak financial condition. Borrower and collateral are often outside the institution's trade area.

Suggested Action

Review all real estate files and request any missing documents. Review appraisals to attempt to determine whether any land flips have been involved. Compare appraised value to other stated values such as assessed value or insured value. Attempt to identify any pattern or practice which appears to be suspicious such as a large number of borrowers having the same employer, a large number of properties appraised by the same appraiser, a large number of loans presented by the same broker, a large number of out-of-territory borrowers, etc. If possible, visit construction sites to see if activity is as represented.

SECURED LENDING

Potential Problems

Financial institutions are often lulled into a false sense of security when they believe that they have adequate collateral for their loans; however, many institutions fail to properly record their liens and/or fail to physically verify the existence of their collateral. In many cases, there are no independent appraisals to support collateral value. Out-of-territory collateral may be difficult to verify and monitor. Where fraud is suspected, it is often difficult to prove in cases where institutions have failed to follow generally accepted procedures for documenting collateral.

Warning Signs

1. Lack of independent appraisals of collateral.
2. Significant out-of-territory lending.
3. Loans with unusual terms or conditions.
4. Poor or incomplete documentation used to intentionally conceal material facts.
5. Loans that are unusual considering the size of the institution and the level of expertise of its lending officers.
6. Heavy concentration of loans secured by the same or similar types of collateral.
7. Financing of 100% of the value of any collateral that is subject to rapid depreciation or wide fluctuation in market value.
8. Appraisals which appear to be made to cover the borrower's loan request rather than to reflect the true value of the collateral.
9. Appraisal fee based on amount of loan or on appraised value of collateral may encourage inflated appraisals.
10. Review of records indicates numerous related party purchases and sales of the collateral which could be used to inflate the collateral price far beyond actual market value.
11. Loans in the names of trustees, holding companies, and offshore companies may disguise the identity of actual borrowers.
12. Assigned notes and mortgages are accepted as collateral without verifying all underlying documentation and conducting normal credit analysis on the obligor.

Suggested Action

Review collateral inspection records to determine if there are any exceptions. Review appraisals for similar types of collateral and reconcile any differences. Determine whether in-house appraisals are based on physical inspection of the collateral. If not, why not? Be sure that adequate collateral margins are required at the inception of loans and monitored throughout the term of the loans.

THIRD PARTY OBLIGATIONS

Potential Problems

A guaranty is only as good as the guarantor and a guaranty without adequate documentation to support its value to the institution may be worthless. A guaranty that is separate from the note may contain restrictions that could render it worthless unless the restrictions are closely followed and a guaranty signed in blank may be legally unenforceable if contested. A false third party obligation may be created for the sole purpose of obtaining a loan from the institution. It may have no actual value. This is particularly true where offshore "shell" institutions are involved.

Warning Signs

1. Documentation on guaranties is incomplete.
2. Loans are secured by obligations of offshore institutions.
3. Lack of credit information on third party guarantor.
4. Financial statements reflect concentrations of closely held companies or businesses that lack audited financial statements to support their value.
5. A guaranty signed in blank may be used indiscriminately by some dishonest individuals to cover weak loans. Guaranties signed in blank may also be legally unenforceable if contested.
6. Guaranties that are separate from the notes may contain restrictions that could render them worthless unless the restrictions are closely followed.
7. Third party obligor is not informed of the assignment of the obligation to an institution; this may allow payments to be diverted to some use other than payment of the loan.

8. Guaranties from insurance companies or letters of credit from insurance companies to guaranty payment are accepted without an evaluation of the financial soundness of the guarantors and their ability to honor the guaranties or letters of credit if necessary.

9. Guaranties or letters of credit from insurance companies are not directly verified with the issuer.

10. The institution's audit procedures do not include a request for acknowledgement of guaranties by guarantors.

11. Corporate guaranties are used, but there is no information in the institution's files to support the authority of the corporations to make the guaranties or to indicate that they are still in force.

12. The institution purchases substandard consumer contracts from a third party relying on recourse to the seller without performing proper analysis of seller's financial condition.

13. The institution purchases substandard consumer contracts for automobiles, home improvements, etc., while relying on some type of insurance to cover delinquencies, skips, etc., without verifying the financial condition of the insurer.

Suggested Action

All guaranties should be reviewed to determine that all documentation is complete and that each guarantor is financially sound and reputable. Corporate guaranties and letters of credit from insurance companies and financial institutions should be verified directly with the issuer. If a loan is collateralized by an obligation of an offshore bank, determine if the lender has attempted to verify the existence, reputation and financial stability of the offshore bank. Guaranties signed in blank should be reviewed to determine their validity.

LENDING TO BUY TAX SHELTER INVESTMENTS

Potential Problems

Be wary of deals where there is no economic purpose except to generate tax write-offs. If the Internal Revenue Service (IRS) successfully challenges the tax benefits claimed from the tax shelter, the investor would have to pay not only additional income tax on the amounts disallowed but also interest and possible penalties. Should this occur, investors might walk away from their loans, and institutions holding the loans would suffer losses.

Warning Signs

1. Block loans to individuals to buy tax shelters arranged by a tax shelter promoter.

2. Shelters which promise tax deductions that would not appear to withstand the scrutiny of the IRS.

3. Specific use of the invested funds cannot be ascertained.

4. Loan payments are to be made by a servicing company.

5. Investments reflect no economic purpose except to generate tax write-offs.

6. Financial "no cash" deals where transactions are structured to avoid any actual cash flow. For example, a long-term CD is matched against a loan payable from the proceeds of the CD at its maturity. Interest accumulates on the CD in an amount equal to or greater than the compounded interest owed on the corresponding loan. The depositor/borrower never provides or receives any cash but still gets the tax write-off.

Suggested Action

Try to determine if the tax shelter is legitimate. Section 465 of the Internal Revenue Code states that an investor can only use losses available from such at risk activity to the extent that the taxpayer is actually economically at risk in connection with the activity.

LINKED FINANCING /BROKERED DEPOSITS

Potential Problems

Linked financing and brokered deposit transactions have contributed to the failure of several banks and savings associations. Offers of large deposits in return for favorable treatment on loans to out-of-area borrowers or to other borrowers previously unknown to the institution should be handled with caution. Where the brokered deposits are not pledged to secure the associated loans, the institution is exposed to substantial risk since it must refund the deposits regardless of the collectability of the loans.

Warning Signs

1. Short-term volatile deposits are used to fund long-term loans of questionable credit quality.

2. A generous point spread exists between the loan interest rate and the interest rate on deposits, which are usually below prevailing market rates.

3. Out-of-territory lending to previously unknown borrowers.

4. Large dollar deposits are offered in consideration for favorable treatment on loan requests, but deposits are not pledged as collateral for the loans.

5. Brokered deposit transactions where the broker's fees are paid from the proceeds of related loans.

6. Institution is presented with a large loan request that cannot be funded without the use of brokered deposits.

7. An unsolicited offer to purchase the institution comes at about the same time as brokered deposits and related loans are processed.

8. Long term discounted certificates of deposit pledged or matched at face value and not actual book value and structured to repay the loan automatically.

Suggested Action

Loans and other transactions associated or connected with brokered deposits should be carefully reviewed. Special attention should be given to transactions where the broker's fee is paid out of loan proceeds or fees for other related transactions instead of being paid directly by the institution as a cost of obtaining the funds.

CREDIT CARDS AND ATM TRANSACTIONS

Potential Problems

Poor control by the issuing institution over unissued cards, PINs, returned mail, credit limit increases and name and address changes can contribute to credit card and ATM card fraud. Credit card merchant accounts can be used to defraud the institution, particularly where the institution does not exercise care in screening prospective accounts. If not handled properly, credit card programs secured by deposit accounts can create substantial liability to the institution for inadequate or improper disclosures of fees and interest charges to customers and can create losses where credit limits are not adequately monitored and/or controlled. Delay in payments to merchants and payments from cardholders could signal the beginning of problems with a third party servicer (generally an outside marketing firm).

Warning Signs

1. Lack of separation of duties between the card issuing function and issuance of personal identification number ("PIN").

2. Poor control of unissued cards and PINs.

3. Poor control of returned mail.

4. Customer complaints.

5. Poor control of credit limit increases.

6. Poor control of name and address changes.

7. Frequent malfunction of payment authorization system.

8. Unusual delays in receipt of cards and PINs by the customers.

9. The institution does not limit amount of cash that a customer can extract from an ATM in a given day.

10. Evidence that customer credit card purchases have been intentionally structured by a merchant to keep individual amounts below the "floor limit" to avoid the need for transaction approval.

11. Credit card merchant accounts are opened without obtaining any background information on the merchant.

12. Credit card merchant account activity reflects an increase in the number and size of chargebacks.

13. The institution's credit card merchant is depositing sales drafts made payable to a business or businesses other than the business named on the account.

14. Credit card merchant frequently requests the wire transfer of funds from the merchant account to other institutions in other parts of the country or to offshore institutions almost immediately after deposits are made.

15. Merchant is engaged in telemarketing activities and is the subject of frequent customer complaints.

16. The institution contracts with third party servicer to process credit card customer and merchant transactions without verifying the financial stability and reputation of the servicer.

17. The institution contracts with a third party to establish and market a secured credit card program without verifying the financial stability and reputation of the third party and without determining the institution's potential liability for participation in the program.

18. Credit card merchant account deposits appear to exceed the level of customer activity observed at the merchant's place of business.

19. Merchant has access to EDC (electronic data capture) equipment but frequently inputs credit card account numbers manually. Be especially alert if manually keyed transactions exceed 10% of total transactions.

20. Merchant has a sudden or unexplained increase in the level of authorization requests from a particular merchant location.

Suggested Action

Review customer complaints, no matter how insignificant they may appear to be, and review the institution's follow-up procedures. Be sure proper controls are in place at all points throughout the card issuing and transaction processing functions. Review possible causes of frequent malfunctions of the payment authorization system and follow-up on remedial actions taken by the institution. Monitor the level of authorization requests to spot potential problems before sales drafts are deposited. Conduct on-site inspections of merchant's operations. Review contracts and correspondence between the institution and Visa, MasterCard, etc. Review contracts with third party servicers, secured credit card programs and marketing agencies to determine possible exposure to liability.

ADVANCE FEE SCHEMES

Potential Problems

Advance fee schemes have been around for many years. They usually involve offers of sizable funds available for loans at below market rates, with the funds supposedly coming from some foreign interests who are seeking a safe haven in the United States. The targets are usually individuals or businesses experiencing financial difficulties. The goal of the perpetrator is to collect a fee in advance since the rest of the transaction is a sham and will never be consummated.

Although Institutions have been victimized by advance fee schemes, they are seldom the primary targets. However, institutions may be unwittingly used to lend false credibility to an advance fee scheme. Evidence of association with a reputable United States financial institution is critical to the success of the scheme. Institutions that act as agent, custodian, or in some other legal capacity face potential liability: (1) They have been sued by the perpetrators of the scheme for nonperformance under agency or escrow agreements, (2) They could be charged criminally for aiding and abetting a fraud, or (3) They may be civilly liable to the victims of the fraud.

Warning Signs

1. A person having no previous relationship with the institution suddenly appears and offers fantastic opportunities for the institution and/or its customers.

2. Broker claims to be part of a major financial organization, but this claim cannot be verified.

3. Broker claims to have access to huge sums of money from a secret, undisclosable or unverifiable source.

4. Broker becomes irritated if the institution suggests that references be checked.

5. Broker makes frequent references to such terms as "ICC Form 254, 290 or 322" and frequently uses the terms "emission rate", "prime bank notes", "tranches", "letters of commitment", "bank acceptances", "arbitrage", "hedge contracts" or "escrow agreements".

6. Broker initially requests an advance fee for his services but often "reluctantly" agrees to defer the fee until settlement of the transaction.

7. As the deadline for settlement nears, the broker urgently requests an advance on his fee to cover expenses such as travel, documentation, communication costs, etc.

8. Broker states that funds will be forthcoming from some offshore bank in the Caribbean or South Pacific.

9. Attempts to verify the broker's references are unsuccessful.

10. Broker's references include telephone numbers which are answered by machines and addresses which are mail drops, hotel rooms, etc.

11. Broker proposes a self-liquidating loan where earnings from a deposit or other investment will be such that they will pay the principal and interest of the loan with no additional funds needed from the borrower.

12. Broker conducts most of the negotiations by telephone or telex and appears to resist any meeting with the institution's counsel.

13. Broker repeatedly delays the settlement of the deal citing numerous "technical" problems.

14. The deal frequently falls through at the last minute while the broker searches for another source of funds.

15. Broker asks institution to serve as a transfer bank, middleman or agent in the transfer of funds between a sending institution and a receiving institution.

16. Broker who originally presents the deal may be known to the institution but other persons involved may be unknown to the institution and may have questionable backgrounds.

17. Broker asks for the institution's telex numbers and frequently, a long, instructional telex from the lender's agent is received by the institution.

18. The receiving institution may be asked to send a number of letters, contracts, or telex messages to the lender's agent or the lender's institution.

19. Broker expresses a great deal of urgency in completing the transaction so that the loan will not be lost.

20. Broker offers funds that the borrower can invest in U. S. Treasury Notes or similar instruments at a 4 or 5 point spread which will help the borrower to cover part of the fees, but offers only flimsy excuses as to why the lender does not directly invest in these instruments.

21. Broker does not allow borrower or institution any direct contact with the proposed lender, often citing confidentiality requirements by the lender or some sensitive political situation in the lender's home country.

22. Broker often requests that the borrower's institution issue a standby letter of credit to the foreign lender to guarantee payment.

23. Broker is often a name dropper, but the people named are either deceased or impossible to contact for reference because of political reasons.

Suggested Actions

The key to avoiding direct losses and/or potential legal liability in an advance fee scheme is to "know the customer" and carry out an extensive due diligence review. Each proposal involving any offer of large sums of money from previously unknown sources should be thoroughly investigated. No commitments should be made until all references are directly verified through some reputable and reliable source. Until references are verified, telex and written communications concerning the transactions should be avoided. Fees should not be paid until funds are verified and physically transferred. Suspicious transactions should be immediately reported to the FDIC and to the FBI. Remember, if the deal sounds too good to be true, it probably is.

OFFSHORE TRANSACTIONS

Potential Problems

Although there are legitimate and reputable institutions operating offshore offices, many are only "shell" institutions with little or no capitalization, no actual main office, no fixed asset investment, no actual staff and few other characteristics of a legitimate institution. Licenses for many offshore financial institutions are issued upon receipt of relatively nominal fees and minimal background verifications. The names of these offshore "shell" institutions are often similar to those of major legitimate financial institutions which are listed in international banking directories. There have been many instances of fraud involving obligations of offshore institutions, including certificates of deposit, letters of credit, drafts, commitments, etc. In some cases, these obligations have been purchased for a fraction of their face value for the sole purpose of defrauding legitimate institutions and other businesses.

Offshore companies, including financial institutions, are frequently established for the purpose of hiding the true identity of the principals, laundering money, inflating financial statements and issuing false documents to secure loans. Loans to offshore companies and loans secured by obligations of offshore institutions must be viewed with extreme caution.

Warning Signs

1. Loans made on the strength of a borrower's financial statement when the statement reflects major investments in and income from businesses incorporated in bank secrecy haven countries such as Panama, Cayman Islands, Netherlands Antilles, Montserrat and others.

2. Loans to companies domiciled in bank secrecy haven countries.

3. Loans secured by obligations of offshore institutions.

4. Transactions involving an offshore "shell" institution whose name may be very similar to the name of a major legitimate institution.

5. Frequent wire transfers of funds to and from bank secrecy haven countries such as Panama, Cayman Islands, Netherlands Antilles, Montserrat and others.

6. Offers of multi-million dollar deposits at below market rates from a confidential source to be sent from an offshore institution or somehow guaranteed by an offshore institution through a letter, telex, or other "official" communication.

7. Offshore companies are used to disguise the true identity of borrowers or guarantors.

8. No independent verification of the financial strength of the offshore institution is available from any source.

9. In order to make an offshore bank transaction appear legitimate, innocent third parties are brought into the scheme, unaware of its fraudulent nature.

Suggested Action

Offshore transactions should be closely examined to determine the legitimacy of the entities involved. Suspicious wire transfers to and from offshore institutions should be reviewed to determine the source and disposition of the funds. Obligations issued by questionable offshore institutions should not be accepted at face value unless the value can be substantiated through independent sources.

WIRE TRANSFERS

Potential Problems

Wire transfer fraud is often possible because of a breakdown in internal controls and/or system security measures at the financial institution. Transactions may be introduced by unauthorized persons who have obtained the proper procedures from an unsuspecting employee. Transactions may be altered in processing and posted to the wrong account, posted in the wrong amount or posted to the correct beneficiary but wrong account. Wire transfers are a popular form of laundering money, providing an easy way of sending funds to and from bank secrecy haven countries.

Warning Signs

1. Lack of separation between authority to initiate a wire transfer and authority to approve a wire transfer.

2. Indications of frequent overrides of established approval authority and other internal controls.

3. Intentional circumvention of approval authority by splitting transactions.

4. Wire transfers to and from bank secrecy haven countries.

5. Frequent or large wire transfers for persons who have no account relationship with the institution.

6. Large or frequent wire transfers against uncollected funds.

7. Frequent requests for immediate wire transfer of funds from a credit card merchant account to institutions in other parts of the U. S., offshore institutions or foreign institutions.

8. Frequent wire transfers from accounts with numerous cash deposits of just under $10,000 each.

9. Frequent errors in payment by authorized system officials.

10. Lack of security of the wire transfer system safeguards such as the password and other details of wire transfer transactions.

11. Unconfirmed wire transfer requests initiated by telephone.

12. Incoming wire transfers in which the account name and account number do not match.

13. Wire transfer or payment request that does not conform to established procedures.

14. Absence of written funds transfer agreements between the institution and its customers.

15. Large international funds transfer to or from the accounts of domestic customers in amounts and of a frequency that are not consistent with the nature of the customer's known business activities.

16. Receipt of funds in the form of multiple cashier's checks, money orders, traveler's checks, bank checks or personal checks that are drawn on or issued by U. S. financial institutions and made payable to the same individual or business, in U. S. dollar amounts that are below the $10,000 Bank Secrecy Act reporting threshold and which are then wire transferred to a financial institution outside the U. S.

17. The deposit of funds into several accounts and then aggregated into one account followed by the wire transfer of those funds from that account outside of the U. S. when such action is not consistent with the known business of the customer.

18. Any other unusual international funds transfer requests wherein the arrangements requested appear to be inconsistent with normal funds transfer practices, e.g., where the customer directs the institution to wire transfer funds to a foreign country and advises the institution to expect same day return of funds from sources different from the beneficiaries initially named, thereby changing the source of the funds.

19. A pattern of wire transfers of similar amounts both in and out of the customer's account on the same day or next day.

20. Wire transfers by customers operating a cash business, i.e., customers depositing large amounts of currency.

21. Wire transfer volume is extremely large in proportion to the asset size of the institution.

22. The institution's business strategy and financial statements are inconsistent with large volumes of wire transfers, particularly outside the United States.

Suggested Action

Review wire transfer procedures for possible circumvention of internal controls and system security measures. Follow-up on any exceptions. Verify source and disposition of suspicious wire transfers. Review accounts with frequent wire transfers to determine if the activity appears legitimate.

MONEY LAUNDERING

Potential Problems

An institution may be liable for civil or criminal penalties for willful participation in a money laundering scheme. The length of time involved in a money laundering investigation and the surrounding publicity can be disrupting and costly to an institution even if no formal charges are filed and no fines are levied. A money launderer usually needs the assistance of someone within the institution to whom he is often willing to pay a substantial fee. With the employee's assistance, money launderers are often able to hide their activities for an extended period of time.

Warning Signs

1. Increase in cash shipments that is not accompanied by a corresponding increase in number of accounts.

2. Cash on hand frequently exceeds limits established in security program and/or blanket bond coverage.

3. Large volume of cashier's checks, money orders, traveler's checks, etc., sold for cash to noncustomers

in amounts ranging from several hundred to just under $10,000 each.

4. Large volume of wire transfers to and from offshore institutions.

5. Large volume of wire transfers for noncustomers.

6. Accounts which have a large number of small deposits and a small number of large checks with the balances of the accounts remaining relatively low and constant. The accounts have many of the same characteristics as accounts used for check kiting.

7. A large volume of deposits to several different accounts with frequent transfer of major portions of the balances to a single account at the same institution or at another institution.

8. Loans to offshore companies and loans secured by obligations of offshore institutions.

9. Large volume of cashier's checks, money orders and/or wire transfers deposited to an account where the nature of the account holder's business would not appear to justify such activity.

10. Large volume of cash deposits from a business that is not normally cash intensive, such as a wholesaler.

11. Cash deposits to a correspondent account by any means other than through an armored carrier.

12. Large turnover in large bills that would appear uncharacteristic for the institution's location.

13. Cash shipments which appear large in comparison to the dollar volume of currency transaction reports filed.

14. Dollar limits on the list of customers exempt from currency transaction reporting requirements which appear unreasonably high considering the type and location of the businesses. No information is in the institution's files to support the limits.

15. Currency Transaction Reports, when filed, are often incorrect or lack important information.

16. List of exempted customers appears unusually long.

17. Customer expresses some urgent need to be included on the institution's list of customers exempt from currency transaction reporting requirements.

18. Customer requests information on how to avoid the filing of currency transaction reports on cash transactions involving amounts over $10,000.

19. Upon being informed of the currency transaction reporting requirements, customer withdraws all or part of the transaction to avoid the filing of the CTR.

20. Customer frequently conducts cash transactions in amounts just under $10,000 each.

21. Customer refuses to provide information required to complete a CTR.

22. Corporate customer makes frequent large cash deposits and maintains high balances but does not avail itself of other services such as loans, letters of credit, payroll services, etc.

23. Customer almost never comes to the institution but has numerous couriers making deposits to the account.

24. A large increase in small denomination bills and a corresponding decrease in large denomination bills with no corresponding CTR filings.

25. Customers who open accounts providing minimal or fictitious information or information which is difficult or expensive for the institution to verify.

26. Customers who decline to provide information that normal customers would provide to make them eligible for credit or other banking services that normal customers would regard as valuable.

27. Customers who appear to have accounts with several institutions within the same locality, especially when there is a regular consolidation of balances in the accounts and transfer of funds out of the accounts by wire transfer, or other means, to offshore institutions or to large domestic institutions.

28. Customers whose deposits frequently contain counterfeit bills or bills which appear musty or extremely dirty.

29. Customers who have deposit accounts at the institution but frequently purchase cashier's checks, money orders, etc., with large amounts of cash.

30. Retail customer which deposits a large volume of checks but seldom, if ever, requests currency for its daily operations.

31. Retail business has dramatically different patterns of cash deposits than other similar businesses in the same general location.

32. Exempted customer frequently requests increases in exemption limits.

33. Substantial increase in cash deposits of any business without any apparent cause.

34. Substantial increase in cash deposits by professional customers using client accounts or in-house company accounts such as trust accounts, escrow accounts, etc.

35. Customers who make or receive large transfers of funds to or from countries associated with production, processing and marketing of narcotics.

36. Size and frequency of cash deposits increases rapidly without any corresponding increase in non-cash deposits.

37. Size and frequency of cash deposits is not consistent with observed activity at the customer's place of business.

38. Customer makes large and frequent cash deposits but checks or other debits against the account are not consistent with the customer's stated line of business. For example, customer claims to be in the retail jewelry business, but checks are mostly to individuals and/or firms not normally associated with the jewelry business.

39. Customer frequently deposits large amounts of currency that is wrapped in currency straps that have been stamped by other financial institutions.

40. Customer frequently deposits strapped currency or currency wrapped in rubber bands that is disorganized and does not balance when counted.

41. Customer is often observed entering the safety deposit box area just prior to making cash deposits just under $10,000.

Suggested Action

Review results of the institution's independent testing for compliance with the Bank Secrecy Act. Perform Bank Secrecy Act examination procedures. Request verification of Currency Transaction Reports filed by the institution. Review all transactions involving offshore institutions to see if they appear to represent legitimate business activities.

SECURITIES TRADING ACTIVITIES

Potential Problems

Speculative securities trading activities may result in unsafe and unsound banking practices. Some bond salesman have made extensive use of the telephone to employ high pressure sales techniques, sometimes accompanied by oral guarantees which purport to limit an institution's exposure. Situations have been reported where an institution's board of directors and/or senior management have not monitored or controlled these practices and, in effect, have relinquished the management of their institution's investment portfolio to a broker.

Warning Signs

1. Management lacks the expertise needed to fully understand the ramifications of proposals made by brokers and/or they perceive an unrealistic opportunity to enhance income.

2. Investments bear no reasonable relationship to the institution's size or its capital accounts.

3. Overreliance is placed on the purported safety of the securities since they involve U. S. Government issues.

4. Little or no attention is given to "interest rate risk" prior to the transaction taking place.

5. Delayed settlements over unreasonable time periods sometimes allow management to make imprudent purchases and avoid booking the transaction on a timely basis.

6. The institution engages in reverse repurchase agreements with brokers which allows institutions to erroneously defer recognition of losses.

7. Securities held for short-term trading are not appropriately identified and segregated from those that are held primarily as a source of investment income.

8. Trading account securities are not revalued periodically and are not reported consistently at market value or the lower of cost or market value.

Suggested Action

Review the institution's investment policy to see if the board of directors has implemented prudent limits and comprehensive controls to suit their particular circumstances. Review the institution's files to determine if the institution has satisfied itself that it is dealing with a reputable and financially stable dealer. Ensure that management has sufficient expertise to analyze each transaction independently of the broker's sales pitch and recommendations.

MISCELLANEOUS

Potential Problems

Lack of proper supervision and lack of effective internal controls makes an institution especially vulnerable to fraud and insider abuse. Customer complaints, even seemingly insignificant ones, may be an indication of much greater problems.

Warning Signs

1. Lack of supervision of lending activities by officers of the institution.
2. Lack of lending policies or failure to enforce existing policies.
3. Lack of code of conduct or failure to enforce existing code.
4. Dominant figure allowed to exert influence without restraint.
5. Lack of separation of duties.
6. Lack of accountability.
7. Lack of written policies and/or internal controls.
8. Circumvention of established policies and/or controls.
9. Lack of independent members of management and/or Board.
10. Entering into transactions where the institution lacks expertise.
11. Excessive growth through low quality loans.
12. Unwarranted concentrations.
13. Volatile sources of funding such as short term deposits from out of area brokers.
14. Too much emphasis on earnings at the expense of safety and soundness.
15. Compromising credit policies.
16. High rate - high risk investments.
17. Underwriting criteria allows high risk loans.
18. Lack of documentation or poor documentation.
19. Lack of adequate credit analysis.
20. Failure to properly obtain and evaluate credit data, collateral, etc.
21. Failure to properly analyze and verify financial statement data.
22. Too much emphasis on character and collateral and not enough emphasis on credit.
23. Lack of balance in loan portfolio.
24. Poor loan administration after credit is granted.
25. Unresolved exceptions or frequently recurring exceptions on exception reports.
26. Out-of-balance conditions.
27. Purpose of loan is not recorded.
28. Proceeds of loan are used for a purpose other than the purpose recorded.
29. Lax policies on payment of checks against uncollected funds.
30. The institution is defendant in a number of lawsuits alleging improper handling of transactions.

Suggested Action

Out-of-balance conditions should be given proper attention and not merely charged off if their amount is small. Be alert to rumors and gossip inside and outside the institution because in many cases, embezzlers and perpetrators of other frauds are betrayed by jealous peers or subordinates. Review any loans that do not appear to conform to the written loan policy. Determine the circumstances under which they were approved and who approved them. Each attempt to circumvent existing policies, controls and/or regulations should be investigated. Be alert to any overrides or attempted overrides of internal controls and determine who is responsible and the reason.

INTRODUCTION

Criminal Conduct Undermines Public Confidence

The public's confidence in the banking system is undermined when insured institutions are the victim of fraudulent and dishonest conduct, which, through fidelity insurance premiums, raise overall costs in the banking system. Confidence is especially harmed by insider abuse and fraud, which have been major contributing factors in a significant number of bank failures. When this occurs, the FDIC deposit insurance fund can suffer significant losses.

If allegations of wrongdoing come to the Corporation's attention, a prompt response is warranted. The scope of the response will vary based upon the source and credibility of the information, as well as the specificity of the allegations and documentation provided. Therefore, discretion and judgment are needed when determining an appropriate response.

BANK MANAGEMENT'S ROLE

Bank Management is Responsible for Preventing and Detecting Fraud and Insider Abuse

The primary responsibility to prevent fraud and insider abuse rests with the board of directors and senior management. To properly execute their fiduciary duties, management must implement internal controls and other safeguards to prevent fraud and theft whether internally or externally perpetrated. But, even the best safeguards can be circumvented; therefore, systems also must be designed to detect suspicious activities. Once detected, suspicious activities must be reported.

Suspicious Activity Reports

Part 353 of the FDIC Rules and Regulations requires insured nonmember banks to report suspicious activities to the Financial Crimes Enforcement Network (FinCEN). The primary purpose of the reporting requirement is to assure that the information needed by investigators and prosecutors is provided in an orderly and timely fashion. Additionally, the reports enhance the FDIC's ability to monitor and act to reduce losses suffered by insured nonmember banks as a result of suspicious activity.

This report is to be made on a standard form used by all federally insured financial institutions called a Suspicious Activity Report (SAR). The SAR is designed to elicit the type of information deemed most important to law enforcement and bank regulatory agencies in assessing the activities and their effects.

Preparing and Filing the Suspicious Activity Report

Instructions for preparing the SAR are contained on the form itself and in Part 353. SARs shall be filed in the following situations:

- Insider abuse involving any amount.
- Transactions aggregating $5,000 or more where a suspect can be identified.
- Transactions aggregating $25,000 or more regardless of potential suspects.
- Transactions aggregating $5,000 or more that involve potential money laundering or violations of the Bank Secrecy Act.

Financial institutions are required to file the SAR within 30 days of detecting the criminal activity; however, if management is unable to identify a suspect within 30 days, reporting may be delayed an additional 30 days or until a suspect is identified, whichever is sooner. In no case shall the reporting of a known or suspected crime of an unidentified suspect exceed 60 days from the detection date.

Copies of related supporting documentation must be maintained by the institution and made available to law enforcement authorities upon request. A copy of the SAR and supporting documentation should be retained for five years.

Management must notify the board of directors of any SAR filed in accordance with Part 353. In addition, the Board must record such notification in the minutes of the directors' meetings.

"Safe Harbor" and Filing of Suspicious Activity Reports

Federal law (31 U.S.C. 5318(g)(3)), provides that a financial institution, and its directors, officers, employees, and agents are provided protection from civil liability for reports of suspicious activities (including supporting documentation) made to appropriate authorities, regardless of whether such reports are filed pursuant to the SAR requirements or are filed voluntary on an alternative basis. Once a bank has filed a SAR, the related documentation is deemed filed with the SAR and may be made available to law enforcement agencies upon request without the need for a subpoena.

THE EXAMINER'S ROLE

Examiners are responsible for evaluating the bank's internal controls and management systems. Therefore, it is essential that examiners remain alert for irregular or unusual activity. Explanations by bank officers that appear unreasonable should not be accepted without being fully investigated. The examiner should be concerned with suspicious activities involving insiders and others. (The Bank Fraud and Insider Abuse section contains warning signs of fraud and investigative alternatives.) Early detection of suspicious activities may reduce the potential for monetary loss, as well as other types of harm, such as the unauthorized disclosure of confidential customer information.

If suspicious activities surface during the course of an examination, the examiner should immediately notify the supervisory Regional Office. This is paramount when senior management is suspected, or when losses attributable to the activity imperils the continued bank operation. The Regional Office may instruct examiners to prepare and file suspicious activity reports directly with FinCEN if the financial institution's referral is deemed inadequate, or the activity discovered by the FDIC has not been reported by the bank. Otherwise, the examiner should submit the SAR directly to the Regional Office as soon as practicable. Following Regional Office review of the document, the SAR will be forwarded to FinCEN.

The fact that a SAR has been filed does not prevent the examiner from making a more detailed written report. If necessary, the examiner may need to gather the facts to support corrective actions, which may include recommendations for removal and prohibition.

Notifying Bank Officials

The examiner must consult with the supervisory Regional Office before informing the bank's board of directors or anyone associated with the bank of the suspicious activity. Generally, apparent criminal violations that are detected by examiners should be brought to management's attention; the examiner should present the facts but avoid any conclusions as to the particular individuals. Bank officials should be apprised of the requirements of Part 353. However, under certain circumstances, it may be unwise or inappropriate to notify management or other bank officials; for example, when senior bank officials are implicated in the suspicious activity or if the examiner has reason to believe that a bank official or officials might flee, warn the target, destroy evidence or otherwise jeopardize an investigation.

Disclosure Issues

An examiner may disclose confidential information obtained during the course of an examination to law enforcement authorities after obtaining permission from the DSC Director, or his designee, pursuant to Part 309 of the FDIC Rules and Regulations.

Additionally, details relating to customer financial records can be discussed with law enforcement officials after a FDIC official, (Regional Director or designee), has certified that there is reason to believe that the records may be relevant to a violation of Federal criminal law; and the records were obtained in the exercise of the FDIC's supervisory or regulatory functions. Refer to the Right to Financial Privacy Act for more information and specific requirements.

INTERAGENCY COOPERATION

The FDIC, the other Federal banking regulators, and various other agencies have agreed to cooperate and exchange information where necessary to address suspicious activity affecting insured financial institutions.

Fraud Section Assistance

Staff of the Fraud Section of the Department of Justice in Washington is available to assist the local prosecutor in handling significant cases. In unusual cases, such as a scheme to defraud several banks located in more than one jurisdiction. FDIC requests for assistance, however, should be made by the Washington Office upon request of the Regional Director. The staff of the Fraud Section and FBI can assist the U.S. Attorneys in their evaluation, investigation, and/or prosecution of significant cases and, where appropriate, will coordinate multi-jurisdictional cases. The Fraud Section also may supply prosecutorial staffing to aid the appropriate U. S. Attorney's office.

Communication and Points of Contact

After being authorized by the Regional Director, the examiner may communicate the SAR details directly to Federal law enforcement agents or the U.S. Attorney's office. Coordination and cooperation during the investigative stage between the local FDIC offices and prosecutors and local Federal law enforcement agents can have a positive effect on the outcome of the prosecution. Local working groups comprised of examiners, prosecutors, FBI agents and other Federal investigators have been organized in many areas to resolve communication problems and exchange information to assist in preventing crimes against banks.

Parallel Proceedings

The referral of suspicious activity to the Department of Justice (DOJ) does not restrict the FDIC from continuing its own examination or investigation into the same conduct in order to carry out its regulatory responsibilities, unless requested to cease or suspend such activity by the DOJ in connection with an ongoing criminal investigation or prosecution. Nevertheless, the U.S. Attorney should be kept informed of the progress of any parallel civil investigation with a view toward reaching a cooperative solution, as appropriate. This type of cooperation might lead to a demand for restitution and stipulation to a prohibition from future employment in the banking industry being included in a criminal plea agreement or pre-trial diversion arrangement.

Coordination with the Office of Inspector General (OIG)

Various procedures have been established for communications between DSC and the OIG with respect to investigations involving operating institutions. Refer to outstanding guidance for specific information, responsibilities, and action required.

EXAMINER ASSISTANCE TO FEDERAL LAW ENFORCEMENT AUTHORITIES

Examiners may be requested to provide expertise to law enforcement agents investigating suspicious activity or prosecuting a criminal case, usually in connection with bank fraud or money laundering cases. The assistance is most often needed for the following reasons:

- To interpret subpoenaed documents obtained from the bank;
- To explain document flow and processing;
- To determine whether the documents are relied upon by FDIC examiners, bank auditors, or managers to formulate business decisions or opinions as to the condition of the bank; or
- To provide information concerning banking policies and banking practices in general.

At other times, more specific assistance is desired; this may include testimony at trial or before a Federal grand jury.

DSC personnel will cooperate to the fullest extent possible in honoring reasonable requests for assistance. The Regional Office will supply the examiner with specific guidance governing each assignment. A written agreement may be necessary for long-term assignments. The following broad guidelines apply to most requests for examiner assistance.

- The request for assistance must be for a legitimate law enforcement purpose within the jurisdiction of the requesting agency;
- The information requested, or that which the examiner has been asked to review, must be relevant to a legitimate law enforcement inquiry;
- The suspicious activity should involve an FDIC insured bank, its directors, officers, employees, agents or customers;
- If the bank itself is not under investigation, the targets of the investigation should be specified and should be associated with the bank as directors, officers, employees, agents or customers;
- Compliance with all applicable provisions of the Right to Financial Privacy Act covering disclosures of information derived from bank customer records must be assured;
- The examiner should be instructed that while assisting the law enforcement authorities, he or she will be acting solely as a representative of the law enforcement authority, will not represent the FDIC in any way, and should not assert or exercise any authority as an FDIC examiner; and
- If the examiner accompanies law enforcement agents onto the bank's premises for the purpose of gathering records, bank management must be apprised that the examiner is assisting the law enforcement authority in an investigation and does not represent the FDIC in any supervisory or regulatory capacity.

FEDERAL GRAND JURY SUBPOENAS

A Federal grand jury subpoena is an important investigatory tool used to build the prosecution's case without compromising the privacy of investigation targets or prematurely revealing their investigatory directions. Rule 6(e) of the Federal Rules of Criminal Procedure requires that grand jury proceedings are to be kept secret to the fullest extent practicable. Grand jury secrecy is maintained principally:

- To encourage witnesses to come forward and to testify freely and confidentially;
- To minimize the risks that prospective defendants will flee or use corrupt means to thwart investigations and escape punishment;
- To safeguard the grand jurors themselves and the proceedings from extraneous pressures and influences;
- To avoid unnecessary disclosures that may make persons appear to be guilty of misconduct without their being afforded adequate opportunity to challenge the allegations; and
- To prevent information adduced under compulsion and for purposes of public justice from being used for insubstantial purposes, such as gossip, to the detriment of the criminal justice system.

An exception to Rule 6(e)(2) non-disclosure of grand jury information and provides that on the motion of an attorney for the government and a finding of substantial need, a court may direct disclosure of matters occurring before a grand jury concerning banking law violations to a Federal financial institution regulatory agency for use in relation to any matter within the jurisdiction of the agency. The possession of grand jury documents and/or testimony requires great care in order to comply with the secrecy requirements of Rule 6(e) of the Federal Rules of Criminal Procedure.

The Corporation’s General Counsel has the delegated authority to authorize an examiner to appear and testify before the grand jury or at a criminal trial. The examiner may be directed to contact the prosecutor or investigator either before or after a grand jury subpoena is issued to assist in identifying and gathering the documents that are pertinent to the investigation. The examiner will be provided with appropriate counsel before testifying.

SAFEGUARDING AND DOCUMENTING EVIDENCE

Copies of the SAR and all supporting evidentiary documents should be segregated and stored to ensure that they are readily retrievable and can be provided to law enforcement officials if needed.

Generally, copies of documents must be made during the examination. The copies should be initialed and dated by the examiner in case the originals are misplaced or destroyed.

In addition to photocopying documents, the examiner should document the flow of funds, approvals and employees responsible for handling each transaction. Flow charts or similar methods may be appropriate for documenting complex transactions. The following questions are provided as an example of the line of inquiry an examiner may follow in deciding how to review and document a particular circumstance:

- What is the bank's policy for handling this type of transaction?
- Was there deviation from the policy?
- Who handled this transaction?
- Who had knowledge?
- Who benefited ultimately from the transaction?
- What knowledge did the bank's directors have?
- What was the credit quality at the time of making a loan and what it is now?
- Was the documentation adequate at inception?
- Was collateral value adequate at inception?
- Are there presently any credit or legal problems?
- Is the bank facing possible risk or damage other than financial loss?

Examiners should consult the Regional Office regarding necessary documentation.

NOTIFICATION TO THE BONDING COMPANY

The FDIC has a mutual interest with management of each insured bank to be certain that all of a bank's employees are protected by a fidelity bond. When a bank files a SAR involving an employee, it normally will be required to notify its fidelity insurer of the subject activity. However, a bank may not provide a copy of the SAR to the insurer.

The notification requirement is usually among the terms of the insurance contract and is not dependent upon the filing of a claim against the insurance coverage. The standard financial institutions bond contains a termination clause which automatically cancels coverage of any employee as soon as there is knowledge of any dishonest or fraudulent act on the part of such employee. The insurer need not give notice of such termination; in fact, the decision of the insurer may be made at a subsequent date. In the rare case in which a bank official has knowledge of a suspicious act on the part of an employee and yet the bank wishes to continue to employ that person, it is very important for the bank to obtain either an assurance in writing from the main office (agents generally are not so empowered) of the insurer that such person is still covered under the bond, or a new bond covering that person. Also refer to the Fidelity and Other Indemnity Protection section of the Manual.

OTHER MATTERS OF IMPORTANCE

Examiners occasionally receive information about alleged misconduct by a bank, its officers, employees or directors and are requested to protect the informant's identity. When this happens, the examiner should advise the informant that the FDIC will try to protect the identity of the informant. However, prior to receiving the information, the examiner should advise the informant of the following facts:

- Mere inquiry into the situation may cause bank employees to deduce the informant's identity.
- The information may be referred to another agency, such as the Department of Justice, which may request the informant's identity to continue or complete an investigation.
- If the information becomes the basis for a criminal prosecution, the court may order disclosure of the informant's identity to the defendant.

CRIMINAL STATUTES

The Federal criminal statutes that an examiner might encounter are generally contained in Title 18 of the United States Code. Most of these laws are included in the Prentice-Hall volumes with only the major sections discussed below.

18 U.S.C. Section 215 - Bank Bribery

Anyone who corruptly gives, offers, or promises anything of value with intent to influence or reward an officer, director, employee, agent or attorney of a financial institution in connection with any business or transaction or any bank official who receives or corruptly solicits such things of value would violate this statute.

Banks are encouraged to prohibit bank officials from self-dealing or otherwise trading on their positions with the bank; or accepting from one doing or seeking to do business with the bank, a business opportunity not generally available to the public. In this regard, the bank's code of conduct or policies should require that its officials disclose all potential conflicts of interest, including those in which they have been inadvertently placed due to either business or personal relationships with customers, suppliers, business associates, or competitors of the bank.

18 U.S.C. Section 471 – Counterfeiting and Forgery

This statute applies to persons who falsely make, forge, counterfeit, or alter any obligation or other security of the United States with intent to defraud.

18 U.S.C. Section 472 – Counterfeiting and Forgery

This statute applies to persons who intentionally defraud, pass, utter, publish, or sell, the items contained in Section 471 above. It also includes those persons who attempt to do so, or those who keep in their possession or conceal any such items.

18 U.S.C Section 500 – Counterfeiting and Forgery

This statute applies to persons who intentionally defraud, falsely make, forge, counterfeit, engrave, or print any order in imitation of or purporting to be a blank money order. It also applies to those who receive or possess any such money order with the intent to convert it for their own use or gain, knowing that is had been embezzled, stolen or converted.

18 U.S.C. Section 656 - Theft, Embezzlement, and Misapplication of Funds

This statute prohibits the theft, embezzlement, or misapplication of bank funds, willfully by an officer, director, agent, or employee of a bank, with intent to injure or defraud the bank. Intent can be inferred from the fact of injury or from acts knowingly done in reckless disregard for the interests of the bank.

Three types of activity are proscribed: embezzlement, abstraction, and misapplication. Embezzlement is the unlawful taking of monies by a person or conversion to his or her own use. Embezzlement cannot be charged if funds have been converted to a third party. Abstraction is the wrongful taking or withdrawing of funds with the intent to injure or defraud the bank or some other person without the knowledge or consent of the bank or its board of directors. Misapplication means willful and unlawful misuse of bank funds to the benefit of the wrongdoer or some person other than the bank. Some examples are:

- Loans granted by a bank officer to fictitious borrowers;

- Bad loans granted on inadequate or valueless collateral if the loan officer benefited personally or acted in reckless disregard of the bank's interests;
- Brokered loans where deposits are provided for a fee to fund a loan that is worthless from its inception.

18 U.S.C. Section 657 - Theft, Embezzlement, and Misapplication of Funds

This statute requires that any officer, agent or employee of or connected in any capacity with the FDIC, et al, embezzles, abstracts, purloins or willfully misapplies any moneys, funds, credits, securities, or other things of value belonging to an insured institution will be fined.

18 U.S.C. Section 658 – Property Mortgaged or Pledged to Farm Credit Agencies

This statute applies to persons who intentionally defraud, knowingly conceal, remove, dispose of, or convert to their own use, or to that of another, any property mortgaged or pledged to, or held by, the Farm Credit agencies.

18 U.S.C. Section 664 – Theft or Embezzlement from Employee Benefit Plans

This statute applies to persons who intentionally embezzle, steal, or unlawfully and willfully abstract or convert to their own use or to the use of another, any of the monies, funds, securities, premiums, credits, property, or other assets of any employee welfare benefit plan or employee pension benefit plan, or of any fund connected therewith.

18 U.S.C. Section 709 - False Advertising or Misuse of FDIC Name

This statute covers false advertising or representations, misuse or unauthorized use of words such as national, reserve, Federal deposit, or deposit insurance, or misuse of names such as FDIC, to convey the impression of Federal agency affiliation.

18 U.S.C. Section 1001 - False Statements or Entries

This statute generally covers oral or written false statements that are knowingly or willingly made, or concealment of a material fact, for the purpose of influencing a determination of any Federal department or agency. It is not necessary to show that the governmental body was actually influenced thereby.

The following is an example of the application of Section 1001: A real estate broker who loaned to purchasers the down payment for obtaining an FHA loan and who submitted to a bank, which acted as agent for the FHA, forms disclosing that the purchaser had paid the down payment in cash, violated Section 1001.

18 U.S.C. Section 1005 - False Entries

This statute covers false entries and reports or statements, including material omissions, made by an officer, director, agent or employee of an insured bank with intent to injure or defraud the bank, or to deceive the FDIC or other individuals or companies. This section also prohibits any such person from issuing or putting forth in circulation any notes of the bank or making, drawing, issuing, or assigning any certificate of deposit, draft, order, bill of exchange, acceptance, note, debenture, bond or other obligation, or mortgage, judgment or decree. The crime may be committed personally or by direction (e.g., an officer directing the making of false entries).

Actions taken by a bank officer or employee to conceal delinquencies, disguise potential lending limit violations, or the recording of securities transactions at values adjusted to hide losses, rather than at the market price, would come under this statute. A false answer to a question on an FDIC Officer's Questionnaire has been held to violate this statute. Entries in minute books are also covered, and the making of unauthorized loans and other unauthorized transactions may come under this statute if the other elements of the statute are met.

18 U.S.C. Section 1007 - Federal Deposit Insurance Corporation Transactions

This statute covers false statements made for the purpose of influencing an action of the FDIC in any way. This includes willfully over-valuing any security for the purpose of obtaining, extending or renewing a loan and statements made to induce the payment of an insured deposit, the purchase of assets, or the payment of any claim by the FDIC. To establish a violation of this statute, it is not necessary to prove loss or damage to the FDIC caused by the falsification. Violations of this section occur when false statements are made to the FDIC in connection with an application for deposit insurance, notice to acquire control of an insured state nonmember bank, or other process in which FDIC is required to take action. False or misleading statements made to an FDIC examiner during an examination would also be covered.

18 U.S.C. Section 1014 - False Statements on a Loan or Credit Application

This statute covers oral or written false statements or misrepresentations made knowingly on a loan or credit application to an insured bank (e.g., willful over-valuing of land, property, securities or other assets or understatement of liabilities). Such statements or misrepresentations must have been capable of influencing the bank's credit decision. Actual damage or reliance on such information is not an essential element of the offense. The statute applies to credit renewals, continuations, extensions or deferments and includes willful omissions as well as affirmative false statements. Obsolete information in the original loan application is not covered unless the applicant reaffirms the information in connection with a renewal request. The application will trigger the statute even if the loan is not made.

18 U.S.C. Section 1028 - Fraud and Related Activity in Connection with Identification Documents, Authentication Features, and Information

This statute applies to persons who knowingly and without lawful authority produce, transfer, or possess with intent to use unlawfully, an identification document, authentication feature, or a false identification document.

18 U.S.C. Section 1029 - Fraud and Related Activity in Connection with Access Devices

This statute prohibits the production, use, and trafficking in counterfeit access devices (credit or debit cards), and the use of unauthorized access devices obtains anything of value aggregating $1,000 or more during a one-year period knowingly and with intent to defraud.

18 U.S.C. Section 1030 - Computer Fraud

This statute applies to persons who knowingly access a computer without authorization or who, having accessed a computer with authorization, use it for unauthorized purposes (e.g., obtaining information contained in records of financial institutions).

18 U.S.C. Section 1032 – Concealment of assets from FDIC

This statute applies to persons who knowingly conceal or endeavor to conceal an asset or property from the FDIC, acting as conservator or receiver.

18 U.S.C. Section 1341 - Mail Fraud

This statute covers use of the mails in furtherance of a fraudulent scheme. Commonly referred to as the "mail fraud statute," this law was used primarily in check kiting cases before the passage of the general bank fraud provision in Section 1344. Valid mailings which can be used in an indictment include opening the account by mail, mailing of check order forms by the bank to the check printers during the period in which the scheme was being operated, and making deposits by mail. Use of the mail after a scheme to defraud has been completed is not an offense under this statute.

18 U.S.C. Section 1343 - Wire Fraud

This statute applies to a scheme or an artifice to defraud or to obtain property or money through use of wire (telephone), radio or TV transmissions in interstate commerce. "Boiler room" operations and electronic funds transfer frauds are covered by this statute if the "wire" extends beyond the boundaries of one state.

18 U.S.C. Section 1344 - Bank Fraud

The bank fraud statute was modeled directly after the mail fraud statute (Section 1341). It covers the use of a scheme or artifice to defraud an insured bank or to obtain, through misrepresentations, any of the monies, funds, credits, assets, securities, or other property owned by, or under the control of, the institution. It clearly applies to check kites and would appear to apply when a financial institution's property is obtained under false pretenses, such as in advance fee scams and where fraudulent appraisals are used to obtain credit. Misrepresentation of the value of collateral or of third-party guarantees, misrepresentation of terms and conditions of participation loans, and other such devices may violate this statute. To convict, the prosecutor must show intent to defraud but it is not necessary that the scheme be successful or that anyone be actually defrauded by the scheme.

18 U.S.C. Section 1517 – Obstructing Examination of a Financial Institution

This statute applies to persons who corruptly obstruct or attempt to obstruct any examination of financial institution by an agency of the United States with jurisdiction to conduct an examination. The FDIC has agreed to report any such offense to the Office of the Inspector General (OIG).

18 U.S.C. Section 1708 – Theft or Receipt of Stolen Mail

This statute applies to persons who steal, take, or abstract, or by fraud or deception obtain, or attempts to obtain, from or out of any mail, post office, or station thereof, letter box, mail receptacle, or any mail route or other authorized depository.

18 U.S.C. Sections 1951-1961 - Racketeer Influenced and Corrupt Organizations (RICO)

These statutes are commonly referred to as "RICO" (Racketeer Influenced and Corrupt Organizations). They cover investments in any enterprise impacting interstate commerce if the funds are derived from a pattern of racketeering activity. These activities include murder, drug dealing, bribery, robbery, extortion, counterfeiting, mail fraud, embezzlement from pension funds, wire fraud, obstruction of criminal investigations, and fraud in the sale of securities.

18 U.S.C. Section 1956 - Laundering of Monetary Instruments

This statute makes it illegal to conduct or attempt to conduct a financial transaction knowing that the property involved in the transaction represents the proceeds of some form of illegal activity. There must be intent to promote the continuation of specified unlawful activity or knowledge that the transaction is designed in whole or in part to conceal or disguise the nature, location, source, ownership, or control of the proceeds of unlawful activity or to avoid a transaction reporting requirement under State or Federal law.

The statute also makes it illegal to transport or attempt to transport internationally a monetary instrument or funds with the intent to promote the carrying on of specified unlawful activity or knowing that the monetary instrument or funds constitute the proceeds of some form of illegal activity and knowing that the transportation is designed in whole or part to conceal the nature, location, source, ownership or control of the proceeds, or to avoid a transaction reporting requirement under State or Federal law.

18 U.S.C. Section 1957 - Engaging in Monetary Transactions in Property Derived from Specified Unlawful Activity

This statute makes it illegal to engage or attempt to engage in a monetary transaction in property constituting, or derived from, proceeds obtained from a criminal offense knowing that it is criminally derived property and has a value of over $10,000.

18 U.S.C. Section 2113 - Bank Robbery and Incidental Crimes

In addition to covering theft of bank property by force or violence, this section also covers the entry or attempted entry of a bank with intent to commit any felony affecting any bank and in violation of any statute of the United States, or any larceny. Although this statute has seldom been used to prosecute bank fraud, it has been used successfully in a few major fraud cases. Potential penalties are much stiffer than traditional fraud statutes.

18 U.S.C. Section 2339C – Prohibitions Against the Financing of Terrorism

This statute applies to persons who by any means, directly or indirectly, unlawfully and willfully provide or collect funds with the intention that such funds be used, or with the knowledge that such funds are to be used, in full or in part in order to carry out acts of “terrorism” as defined with this section. It also applies to those persons who knowingly conceal or disguise the nature, location, source, ownership, or control of any material support, resources, or funds used for such acts.

15 U.S.C. Section 78dd - Foreign Corrupt Practices Act of 1977

This statute covers payment of anything of value to any foreign official, foreign political party or candidate or any other person where an American corporation knows or has reason to know something of value was offered.

15 U.S.C. Sections 78ff and 78x - Securities Laws

These statutes covers criminal violations and penalties of securities laws.

31 U.S.C. Section 5311 - Currency Transactions/Bank Secrecy Act - Also 31 C.F.R. Part 103

Refer to the Bank Secrecy Act section of this Manual.

31 U.S.C. Section 5324 - Structuring Transactions to Evade Reporting Requirement

This statute makes it illegal to cause or attempt to cause a domestic financial institution to fail to file a Currency Transaction Report (CTR), cause or attempt to cause a domestic financial institution to file a CTR that contains a material omission or misstatement of fact, or structure or assist in structuring, attempt to structure or attempt to assist in structuring, any transaction with one or more domestic financial institutions for the purpose of evading the reporting requirements.

Applies only to transactions occurring after January 27, 1987. Intent to evade the reporting requirements is an important element of the criminal offense. Carelessness or oversight would more likely trigger civil penalties. Applies to all persons including financial institutions and their employees.

Other Criminal Statutes

<u>18 U.S.C. Section 2 - Aiding and Abetting</u>

Whoever aids, abets, counsels, commands, induces or procures the commission of a Federal offense is punishable as a principal.

<u>18 U.S.C. Section 4 - Misprison of Felony</u>

This statute covers the failure to report a felony. Requires anyone who has knowledge of the actual commission of a felony cognizable by a United States court to report it to any judge or other person in civil or military authority. A financial institution that fails to report an offense of which it is aware can be charged with violating this section.

<u>18 U.S.C. Section 201 - Bribery of Public Officials</u>

This statute proscribes the offering or soliciting of bribes to or by Federal officials, elected representatives, jurors or witnesses in official proceedings with the intent to influence that person's official functions.

<u>18 U.S.C. Section 371 - Conspiracy to Defraud</u>

This statute covers a conspiracy of two or more persons to commit a Federal offense or to defraud the United States or any agency thereof. This statute has been cited when two or more persons willfully ignored the notice requirements of the Change in Bank Control Act.

<u>18 U.S.C. Section 1342 - Fictitious Name or Address</u>

This statute covers the use of a false, assumed or fictitious name, address or title for the furtherance of a fraudulent scheme which is carried out by means of the postal service.

<u>18 U.S.C. Section 2314 - Transportation of Stolen Goods, Securities, etc.</u>

This statute prohibits transportation of stolen goods, securities, moneys or falsely made, forged, altered or counterfeited securities in interstate commerce. Obtaining money from a bank on either a forged check of any amount or a fraudulently obtained check of $5,000 or more, which is drawn on a bank in another state, comes under this section since it is transported in interstate commerce.

<u>18 U.S.C. Section 2315 - Sale or Receipt of Stolen Goods, Securities, etc.</u>

This statute prohibits receipt, concealment, storage, bartering or selling of stolen goods, securities, moneys, or fraudulent State tax stamps of $5,000 or more. It prohibits the pledge or acceptance as security for a loan, any such stolen item, $500 or more in value, moving as foreign or interstate commerce.

<u>2 U.S.C. 441b - Federal Election Campaign Act of 1971</u>

This statute prohibits national and insured state banks from making any contributions to or expenditures on behalf of any candidate for Federal elective office. Insured state nonmember banks may make contributions to or expenditures on behalf of candidates or committees for State or local elective offices so long as the contribution or expenditure is consistent with State or local law. It should be noted that, even where permitted by State law, the contribution or expenditure must satisfy requirements of safety and soundness. A loan is not a contribution if it is made in accordance with applicable banking laws and is made in the ordinary course of business (i.e.., on appropriate terms and conditions and on a basis that assures repayment, 11 CFR §100.7(b)(11)).

<u>Improper and Illegal Payments by Banks</u>

The Federal Election Campaign Act and the Foreign Corrupt Practices Act cover improper and illegal payments by banks and bank holding companies.

<u>42 U.S.C. Section 1490s(a) – Equity Skimming</u>

Whoever, as an owner, agent, employee, or manager, or is otherwise in custody, control, or possession of property that is security for a loan made or guaranteed, willfully uses, or authorizes the use, of any part of the rents, assets, proceeds, income, or other funds derived from such property, for any purpose other than to meet actual, reasonable, and necessary expenses of the property shall be fined or imprisoned.

Identity Theft Penalty Enhancement Act Public Law 108-275

This law enhances the penalties for individuals who knowingly transfer, possess, or use the means of identification of another person to commit a serious Federal predicate offense including various portions of United States Code relating to banking.

INTRODUCTION

This section of the Manual of Examination Policies looks at international banking from the broadest of perspectives. It begins by addressing the concept of country risk, including transfer risk, which is perhaps the single overarching risk of all international banking operations and impacts all international activities. This section then discusses international activities of U.S. banks, including foreign lending, investments, placements, funds management, and foreign exchange, which are the most significant international products and services offered by financial institutions. Within the foreign lending component, a significant amount of attention is given to trade finance, which is a particularly important segment of U.S. banks' international credit exposures and an especially important part of cross-border lending of state nonmember banks. Foreign exchange activities, on the other hand, are very specialized and only relatively few FDIC-supervised institutions engage in foreign exchange to a significant degree.

The section then turns to international banking from a different point of view. It discusses how U.S. banks may be owned by or otherwise associated with foreign entities, including foreign banks. Supervision of foreign banking organizations (FBOs) is a primary part of this latter discussion. Also discussed are parallel-owned banking organizations (PBOs), where there is common ownership of domestic and foreign banks outside of a bank holding company structure (i.e. similar to chain banks). This section concludes with discussions of certain laws relevant to international banking and a glossary of international banking terms.

This section has been geared to meet the basic needs of an FDIC examiner encountering international banking. Examiners needing more extensive guidance may wish to refer to examination manuals of the Federal Reserve or Comptroller of the Currency. The International Section in Washington may also have additional resources at its disposal to assist with unusual situations.

Overview of U.S. Bank International Activity

The last few decades have witnessed distinct growth in the ability of firms and countries to access the global capital markets. During this time span, access to capital (bank credit, equity and/or fixed income bond issuance) has become more abundant and competitive. However, failure to price, select, and manage international risks, both on- and off-balance sheet, has resulted in well publicized reductions in profitability, operating losses, and sizable capital charges, particularly during the late 1990s through 2001 (Asian Crisis 1997; as well as, Russian-1998, Ecuador -1999, and Argentine-2001 sovereign defaults).

While the number of U.S. banks significantly involved in international finance is relatively small, certain large banks have notable volumes. Moreover, smaller banks have also allocated significant capital and resources to international banking in select markets. Given the extent of risk introduced by a sovereign country, particularly an emerging market economy, it is necessary that the examiner understand and review international activities when assessing a bank's overall condition.

The international operation of a bank may be conducted in a separate division or department even though many of the activities parallel those performed elsewhere in the bank. Large banks typically operate an international division, which may include a network of foreign branches, subsidiaries, and affiliates. Smaller banks or those with limited international activity often use only a separate department in conjunction with a network of foreign correspondent banks. In either case, the international section will usually have its own management and staff, as well as distinct accounting systems and controls.

Examination Objectives

The objectives of examining an international department are basically the same as those of examining other areas of the bank. However, some modification of examination techniques and procedures may be required because of the specialized nature of international banking. Documentation and accounting procedures for international operations may differ from domestic banking, and the department may operate under separate laws and regulations.

The examination of the international department is usually conducted concurrently with the commercial examination of the bank. Pre-examination planning should be used to determine the scope of the examination and personnel requirements. A good starting point is to review a bank's most recent Uniform Bank Performance Report (UBPR), Reports of Condition (for information concerning on-balance sheet assets and liabilities - foreign debt securities RC-B(6b); bankers' acceptances RC 9&18; loans to foreign banks RC-C2; or off-balance sheet instruments, including letters of credit RC-L4 and OTC derivatives RC-L 12) and examination reports. These reports will indicate the existence of an international department, foreign branches or subsidiaries, the volume of international activity, and the nature of the bank's international business. Review of the bank's most current 009, 009a, and 019 Country Exposure Reports can also assist in determining the level of country exposure if the bank is required to file the reports.

The examination can usually be conducted at the bank's head office or some other centralized location. Banks that operate foreign branches or subsidiaries usually maintain sufficient duplicate records at home offices to permit a centralized international examination. In fact, Part 347 of the FDIC's Rules and Regulations imposes minimum recordkeeping standards upon state nonmember banks that operate foreign branches or subsidiaries. These standards require that a bank maintain at its head office duplicate records of offshore operations which will permit a centralized review of asset quality, funding operations, contingent liabilities, and internal controls. In most cases, it is expected that this duplicate information will be adequate for examination purposes.

On-site examinations of foreign branches will be necessary in some cases because of inadequate information at the head office or unusual features concerning the activities of the branch. Overseas examinations should be planned very carefully in order to use personnel effectively. It is important that the international examiner determine the availability and quality of information maintained at the head office before commencing a foreign branch examination. To do this it may be advisable to conduct a pre-examination visitation or begin the foreign branch examination after commencing the domestic examination.

Examiners will find many similarities between a bank's international and domestic operations. For example, a bank will extend credit, issue and confirm letters of credit, maintain cash and collection items, maintain foreign and domestic correspondent bank accounts, accept and place time deposits, accept customer deposit accounts, and borrow funds both domestically and internationally.

Other activities are unique to international banking. Creating acceptances and trading in foreign exchange are among these activities. Another element of international operations not found in domestic banking is country risk. This refers to the political, economic, and social conditions of countries in which a bank has exposure and it must be taken into consideration when evaluating a bank's international operation.

International banking is a dynamic field that embraces a wide spectrum of financial services and practices. This section of the Manual is not intended to provide exhaustive coverage of the subject; rather, the discussion is limited to the basic functional areas of international banking. Many of the activities of an international department parallel those conducted in other areas of the bank. In these instances treatment of the topic is limited largely to those features pertinent to international banking. For this reason the examiner will find it necessary to refer to other areas of the Manual. Also, there are a number of laws, regulations and Corporation policy statements which deal wholly or in part with international banking. These are discussed throughout the text of this section and several are reviewed under the Laws and Regulations section. Examiners should be familiar with these laws, regulations, and statements.

COUNTRY RISK MANAGEMENT

Underlying most, if not all, facets of international banking is a component of risk known as country risk. Because of the increasing volume of international lending and other activities at U.S. banks, the three Federal bank regulatory agencies have adopted a uniform policy against which they will assess a bank’s country risk management program. This policy is the March 2002 statement entitled “Sound Risk Management Practices for Country Risk” (March 2002 Statement). Examiners should assess a bank’s country risk management program by comparing its policies and processes to the standards set forth in this joint statement. The results of the examiner's evaluation should be included, in narrative form, on the report page entitled "Analysis of the Country Exposure Management System."

The remainder of this section briefly describes the concept of country risk; the elements of an effective country risk management process; and how the three Federal agencies evaluate transfer risk, which is a component of country risk, in bank examinations. The foundation for the discussion that follows is the March 2002 Statement and the 1998 Guide to the Interagency Country Exposure Review Committee (ICERC). Examiners should consult these primary documents for further information.

Concept of Country Risk

Along with the risks present in their domestic operations, institutions engaged in international activities are exposed to country risk – the risk that economic, social, and political conditions and events in a foreign country will adversely affect an institution’s financial interests. In addition to the adverse effect that deteriorating economic conditions and political and social unrest may have on the rate of default by obligors in a country, country risk includes the possibility of nationalization or expropriation of assets, government repudiation of external indebtedness, exchange controls, and currency depreciation or devaluation.

Country risk has an overarching effect on an institution’s international activities and should explicitly be taken into account in the risk assessment of all exposures (including off-balance sheet) to all public- and private-sector foreign-domiciled counterparties. The risk associated with even the strongest counterparties in a country will increase if, for example, political or macroeconomic conditions cause the exchange rate to depreciate and the cost of servicing external debt to rise.

The March 2002 Statement recognizes that country risk is not necessarily limited to an institution's exposures to foreign-domiciled counterparties. In some situations, the performance of domestic counterparties may also be adversely affected by conditions in foreign countries. Where appropriate, and to the extent practicable, country risk factors should be taken into account when assessing the creditworthiness of domestic counterparties.

Country risk is not limited solely to credit transactions. Investments in foreign subsidiaries, electronic banking agreements, and EDP servicing and other outsourcing arrangements with foreign providers all carry with them the risk that policies or conditions in a foreign country may have adverse consequences for an institution.

Country Risk Management Process

Although the details and complexity of the country risk management process will vary from one institution to the next, such management must be commensurate with the volume and complexity of the institution's international activities. Supervisory expectations will also take into consideration the institution's size and technological capabilities. As more fully described in the March 2002 Statement, a sound country risk management process includes the following nine components:

- Effective oversight by the board of directors;
- Adequate risk management policies and procedures;
- An accurate system for reporting country exposures;
- An effective process for analyzing country risk;
- A country risk rating system;
- Established country exposure limits;
- Regular monitoring of country conditions;
- Periodic stress testing of foreign exposures; and
- Adequate internal controls and audit function.

The March 2002 Statement notes that to effectively control the risk associated with international activities, institutions must have a risk management process that focuses on the broadly defined concept of country risk. A country risk program that is limited to an assessment of transfer risk and especially one that solely relies on transfer risk designations assigned by the ICERC is not acceptable. Transfer risk and the ICERC program are discussed in subsequent subsections.

Risk Management – Exit Strategies

With regard to regular monitoring of country conditions, external shocks and adverse market conditions during the 1990s, culminating with the Argentine sovereign default in 2001, have underscored the importance to further develop this risk management area. The effectiveness of a bank's monitoring of country conditions and ensuing action plans during episodes of increasing country risk are of paramount importance in ultimately mitigating credit risk and losses.

Inherent to satisfying this objective is the development of board-approved policy guidelines regarding exit strategies (action plans) with defined trigger points to effect the reduction of exposure in a given country portfolio when conditions warrant. The substance of an exit strategy should be commensurate with the degree of sophistication and exposure of a given institution. Items for consideration in the exit plan may include how a bank will reduce exposure to the following:

- ***Aggregate*** (total country exposures)
- **A*sset class*** (Loans, Placements, corporate EuroMTN, bonds, CP)
- **Issuer** (sovereign versus private sector for either a bank or corporate issuer),
- ***Product* risk** (Trade transaction versus Working Capital, Pre-export finance, or off-balance sheet item LCs/derivative), and by
- ***Tenor*** (generally, consensus should be towards reducing tenor or duration during periods of increasing country risk).

Management can also incorporate risk reduction strategies stemming from contagion risk or the likelihood of economic problems in one country, region or emerging market impacting another.

Trigger points to affect an exit strategy, either gradual or complete elimination of country exposure, will vary with the size and complexity of a given institution. Both quantitative and qualitative data should be used to define, substantiate, and initiate action to reduce risk. Regardless of the forms used, some measures should be formally incorporated into policy that will serve to alert management that risk has escalated beyond an acceptable threshold and that action is now necessary.

With regard to the type of data collected to initiate action, market intelligence garnered from the bank's internal country studies, representative office, officer visits to the home country central bank or correspondent bank, as well as nationally recognized statistical rating organizations (NRSRO) may be useful sources of information. For instance, Foreign/Local Currency Ceiling Ratings for the Sovereign, Foreign /Local Currency Deposit Ratings for Banks, and Bank Financial Strength Ratings (including credit watch events and outlook changes positive-negative) could be effectively employed.

Such information should serve to stimulate discussion and assessment at senior management levels as to the scope and nature of the bank's current exposure and whether reductions are necessary. Once exit strategies are employed, monthly or quarterly reporting should be provided to the bank's board of directors to update the board on the ongoing nature of exposure and progress towards reducing and/or limiting risk.

Transfer Risk

Transfer risk is a facet of country risk. Transfer risk is the possibility that an asset cannot be serviced in the currency of payment because the obligor's country lacks the necessary foreign exchange or has put restraints on its availability.

In general, transfer risk is relevant whenever a bank extends credit across international borders and the extension of credit is denominated in a currency external to the country of residence of the obligor. In these circumstances, an obligor must, in the absence of the ability to earn and/or borrow and retain foreign currency outside the country of residence, obtain the foreign currency needed to service an obligation from the central bank of the country. Where a country is beset by economic, political, or social turmoil leading to shortages of foreign currencies at the central bank, the borrower may be unable to obtain the foreign currency and thus default on the obligation to the lending bank or, alternatively, request a restructuring of the debt.

Although a bank's country risk management program must be based on the broadly defined concept of country risk, the Federal banking agencies use transfer risk as a tool to consistently assign classifications and other designations to cross-border exposures, determine minimum reserve requirements on cross-border exposures, and measure cross-border concentrations.

Interagency Country Exposure Review Committee

The ICERC is responsible for providing the uniform transfer risk designations to be used in the Federal banking agencies' reports of examination. Aided by balance of payments statistics, studies of country conditions and information from other sources, the committee reaches decisions on the extent of transfer risk posed by underlying economic, political and social circumstances in countries where U.S. bank exposure meets the committee's review criteria. Where appropriate, the committee prepares a standard narrative on the country to be used in reports of examination. Refer to the 1998 Guide to the Interagency Country Exposure Review Committee for a detailed explanation of the ICERC program.

Transfer Risk Classifications and Designations

When a country is experiencing political, social, or economic conditions leading to an interruption in debt servicing by obligors within the country or when an interruption in payments appears imminent, credits within the country will be designated as Other Transfer Risk Problems (OTRP), or will be adversely classified using the designation of Substandard, Value Impaired, or Loss. Lesser degrees of transfer risk are identified by the transfer risk designations Strong, Moderately Strong, and Weak. ICERC is responsible for providing the uniform transfer risk classifications and designations. The appropriate criteria for including transfer risk classifications and designations in the Report of Examination are discussed in the Report of Examination instructions. See the 1998 Guide to the Interagency Country Exposure Review Committee for the definitions of the classifications and designations. Examiners can find ICERC's transfer risk designations and write-ups on the International and Large Bank Branch website in the FDIC Intranet.

Contingent liabilities subject to transfer risk (including commercial and standby letters of credit as well as loan commitments) that will result in a concomitant increase in bank assets if the contingencies convert into an actual liability should also be considered for special comment or classification, as applicable. Contingent liabilities extended for classification should be classified according to the type and tenor of the bank asset which would result from conversion of the contingency into an actual liability. For example, commercial import/export letters of credit would be accorded the same classification as trade transactions, while commitments to fund long-term project loans would be accorded the same classification as long-term loans. In cases where type or tenor is not easily discernible and where exposure is accorded a split classification, the more severe classification should prevail.

Transfer Risk Reserve Requirements

The Federal banking agencies are directed by International Lending Supervision Act of 1983 (ILSA) to require banks to establish and maintain a special reserve when the value of international loans has been impaired by a protracted inability of the borrowers in a country to make payments on external indebtedness or no definite prospects exist for orderly restoration of debt service. ILSA requires that the special reserves established by a charge against current income be segregated from the bank's general Allowance for Loan and Lease Losses (ALLL), and not be included as a part of bank capital. ILSA also directs each appropriate Federal banking agency to require a banking institution to establish and maintain a special reserve whenever in the judgment of the appropriate Federal banking agency:

1. The quality of such banking institution's assets has been impaired by a protracted inability of public or private borrowers in a foreign country to make payments on their external indebtedness as indicated by such factors as: (i) a failure by such public or private borrowers to make full interest payments on external indebtedness; (ii) a failure to comply with the terms of any restructured indebtedness; or (iii) a failure by the foreign country to comply with any International Monetary Fund (IMF) or other suitable adjustment program; or

2. No definite prospects exist for the orderly restoration of debt service.

The banking agencies refer to this special reserve as the Allocated Transfer Risk Reserve (ATRR). ATRR requirements are established on an interagency basis through the ICERC program. When applicable, ICERC assigns ATRR requirements to country exposures classified as Value Impaired. Banks have also the option of charging off the required amount in lieu of establishing an ATRR. ATRR requirements are posted on the International Section website after each ICERC meeting. Examiners should refer to this website to determine if any of the bank's country exposures are subject to an ATRR.

Country Exposure Concentrations

The Federal banking agencies recognize that diversification is the primary method of moderating country risk. Diversification is especially relevant to international lending because the assessment of country risk involves major uncertainties and is subject to considerable margin for error. Diversification provides the best protection against a dramatic change in the economic and/or political fortunes of any particular country.

The adequacy of diversification within a bank's international portfolio is determined by comparing individual country exposure to the bank's capital. Depending on the economic and political situation within a country and the structure of the bank's portfolio within that country, different concentration levels are used to identify significant country exposures.

The March 2002 Statement notes that concentrations of exposures to individual countries that exceed 25 percent of the institution's Tier 1 capital plus the ALLL are considered significant; however, in the case of particularly troubled countries, lesser degrees of exposure may also be considered to be significant. Report of Examination instructions explain how to use this basic criterion for preparing report commentary and the concentrations schedule. In addition, similar to the March 2002 Statement advice for banks to consider limiting exposures on a broader (i.e. regional) basis, examiners may wish to identify in the Report of Examination concentrations of exposure to broader country groupings when bank or market analyses have identified linkages between countries to which the bank is exposed.

Other ILSA Provisions

In addition to transfer risk reserve requirements, as described above, ILSA and implementing regulations contained within Subpart C of Part 347 of the FDIC Rules and Regulations address several other requirements and matters relating to U.S. banks' international lending. For example, they set forth requirements for accounting for fees on international loans and reporting and public disclosure of international assets. As with other loan fees, Part 347 requires banks to follow generally accepted accounting principles (GAAP) for the amortization of fees on international loans. Regarding disclosures on international loans, Part 347 references reporting requirements for FFIEC Form 009 (see Country Risk Exposure Report below).

Country Risk Exposure Report

One of the tools used in monitoring a bank's country risk exposure is the FFIEC's Country Risk Exposure Report (Form 009), which must be filed quarterly by banks that meet certain conditions. Those conditions, as well as the detailed instructions for compiling the report, can be found on the FFIEC webpage under Instructions for Preparing the Country Exposure Report (FDIC Form 6502/03). The examination process should include assurances that banks adhere to reporting requirements, and that such reports are accurate. However, examiners may wish to note that a bank's internal measures of country exposure may be different from that required by the Form 009. This is acceptable. The bank should be able to explain the differences between internal country exposure reports and the Form 009.

INTERNATIONAL ACTIVITIES

Lending

Banks engaged in international lending are both geographically concentrated and numerically limited. A large percentage of international credits originate at New York City institutions, with most of the remainder are negotiated in secondary money-market centers including Chicago, Miami, and San Francisco.

A bank's major source of profit, both internationally and domestically, remains interest received from lending and securities instruments (either sovereign or corporate sector debentures). Other international department activities, such as cable and foreign exchange operations, are necessary adjuncts to international banking and are part of the capability to service correspondent relationships. However, few of these activities produce income after expenses, and if these were the only services of international banking, few banks would be attracted to the field.

Among those banks that have made a substantive commitment to international activity, international loans have increased considerably in size, complexity, and geographical scope in recent years. Such loans are variously extended to foreign governments, foreign banks, foreign companies, multinational corporations, and U.S. importers and exporters.

International Lending Risks

Few bank loans are completely without risk and bank lending officers must assess the degree of risk in each extension of credit. Foreign loans share most of the same characteristics of domestic credits but, in addition, include several other risks unique to international lending. For convenience, these risks are considered under three categories: credit risk, currency (foreign exchange) risk, and country risk.

Credit Risk refers to the potential inability of a borrower to comply with contractual credit terms and bears the closest resemblance to the primary risk in domestic lending. Evaluation of this risk is similar to any credit decision and involves analysis of appropriate factual information, including credit volume requested, loan purpose, anticipated term and proposed repayment source. In addition, standard credit file information such as financial statements covering several years and the borrower's performance history on previous loans would be reviewed. The difference in international lending is that applicable information is usually less readily available and less detailed. Foreign financial statements are more likely to be unaudited and their format varies from country to country. Moreover, there are often barriers to acquiring such information from foreign sources. Thus, in the financial evaluation of international loans, the credit decision must frequently be based on information inferior to that available in domestic applications.

Currency Risk pertains to the vulnerability of international lenders to variations in rates of currency exchange, and in every international extension of credit, someone has a currency conversion exposure. U.S. banks attempt to reduce the risk by lending and requiring repayment in U.S. dollars, but the effectiveness of this technique is limited. If a dollar loan is used in a foreign borrower's own country, it will be necessary to convert the proceeds into local currency. Subsequently, when the loan matures, U.S. dollars will be required for repayment. The problem arises when, even though the borrower may have sufficient local currency, the country may not have the dollars available to sell. Thus, the borrower would be at the mercy of the country's central bank and might not be able to make dollar remittance. (Basically, lending and requiring repayment in dollars gives rise to transfer risk, a specific component of country risk, which is covered later in this section.)

Currency risk may manifest itself in credit risk, should adverse currency movements ensue. In this scenario, a speculative attack on a foreign currency or other exogenous economic factors might precipitate foreign currency depreciation/weakness versus the U.S. dollar. This can lead to the inability of a foreign borrower to meet debt service requirements in U.S. dollars, even if U.S. dollars are available within the local financial system.

For example, say a foreign borrower, while generating revenue in local currency (Venezuelan Bolivar) must fulfill its debt service requirement to a U.S. bank in U.S. dollars. A gradual or protracted weakening of the Bolivar (all other factors remaining equal) will require a commensurate rise in revenue, profit margins, and/or reduction in costs to service the same amount of U.S. dollar debt upon currency conversion/translation.

This is considered a facet of the credit decision process that should be factored in under varying currency scenarios and loans should be priced accordingly given the inherent degree of uncertainty and risks with regard to currency movements.

Country Risk is the primary factor that differentiates international lending from domestic lending. In broad terms, country risk encompasses an entire spectrum of risks arising from economic, social, legal, and political conditions of a foreign country that may result in favorable or unfavorable consequences for borrowers in that country. Specifically, country risk analysis includes assessment of the likelihood of political or social upheaval, nationalization or expropriation, and government repudiation of external debts. A discussion of country risk and country risk management is provided elsewhere in this section.

Forms of International Lending

Trade Financing via Letters of Credit and Bankers' Acceptances

The most important single function of international banking departments is the financing of international trade. Several kinds of trade credit facilities are used, depending on circumstances, but the most prevalent are letters of credit and bankers' acceptance financing. In view of its widespread use, this credit procedure is discussed in some detail. Letters of credit are issued in many forms for many different circumstances and types of transactions, but the two most common types are the commercial documentary letter of credit and the unsecured standby letter of credit.

Commercial documentary letters of credit are instruments in which a bank (issuing bank) undertakes to pay a party (the beneficiary/seller/exporter) named in the instrument a sum of money on behalf of the bank's customer (account party/buyer/importer). The beneficiary will be paid when he submits to the issuing bank specific documents as required by the terms of the letter of credit.

Therefore, through a letter of credit, the bank substitutes its creditworthiness for that of the account party. Issuance and negotiation by banks of letters of credit are governed by the "Uniform Customs and Practice for Documentary Credits" of the International Chamber of Commerce presently in effect (currently version 500). All letters of credit must be issued in favor of a definite beneficiary; for a fixed or determinate amount; in a form clearly stating how payment to the beneficiary is to be made and under what conditions; and with a definite expiration date. The usual routing of a letter of credit is from the issuing bank, through its correspondent bank in the country of the exporter, to the exporter. The two basic forms in which the correspondent bank will receive the letter of credit are either the "revocable" or the "irrevocable" form.

The "revocable" form is, in principle, of little use to the exporter. As the term indicates, the importer's bank can revoke its credit if requested to do so by its principals (the buyers) or amend its terms, without the specific agreement of the beneficiary. Ordinarily an exporter would request an irrevocable letter of credit. In this case the buyer could not instruct his bank to rescind or change the letter of credit without first securing the consent of the exporter. When the exporter presents his documents exactly as described in the letter of credit to the correspondent bank, the latter will be able to secure payment from the importer's bank.

The advantages of financing exports by way of an "irrevocable" letter of credit are obvious. The buyer arranges issuance of the credit with his bank and by the terms of the credit, lists the proof of shipment needed for the merchandise for which he is paying. The exporter, by presenting documents in accordance with the letter of credit terms, will receive payment from a bank. An irrevocable letter of credit constitutes a definite commitment by the issuing bank to pay upon presentation of the documents. The letter of credit may be sent directly to the exporter by the issuing bank or through a local bank that is a correspondent of the issuer. In the latter case, the correspondent may merely "advise" the letter of credit. This means that it is acting as an agent of the importer's bank without any commitment on its part. This is evidenced by a printed clause appearing in these credits reading, "This advice is not an engagement on our part, but is simply for your guidance in preparing and presenting drafts and documents."

Some exporters, especially when not familiar with the issuing bank, require an undertaking from bankers in their own country. For this purpose the correspondent bank will "confirm" irrevocable credits by its correspondent (the issuing bank) upon the latter's authorization and the formers willingness to do so. Now the exporter has a definite undertaking from a bank in his country that it will pay upon presentation of documents in accordance with the terms of the letter of credit. This is evidenced by a printed clause by the confirming bank reading, "We undertake that all drafts drawn and presented as above specified will be honored by us."

Payment terms of a letter of credit usually vary from sight to 180 days, although special forms of letters of credit allowing for other terms exist. Usually the letter of credit will call for drafts to be drawn on the advising (and confirming) bank. If drawn at sight, the bank will effect payment immediately, provided the terms of the credit have been met. If drawn on a time basis, the bank will accept the draft, which thereafter can be held by the exporter or by the bank on his behalf until maturity. Alternatively, the accepted draft can usually be discounted or sold at going market rates. (Refer to the section on Bankers' Acceptances.)

The importance of documentation is paramount in all letter of credit transactions. The bank is required to examine all documents with care to determine that they conform to all of the terms and conditions of the letter of credit. Many letters of credit are part of continuous transactions evolving from letters of credit to sight drafts or acceptances or to notes and advances, collaterized by trust receipts or warehouse receipts. Letters of credit negotiations rarely occur without document discrepancies. Banks actually charge a fee to resolve the discrepancies. Ultimate repayment often depends upon the eventual sale of the goods involved. Although the transaction passes through various sections of the international department, the proper handling and accuracy of the documents required under the letter of credit is of primary concern.

All commercial documentary letters of credit are contingent liabilities and are included as such in Reports of Condition. Banks should also monitor the volume outstanding through a general ledger memorandum account or contra accounts.

Standby letter of credits guarantee payment to the beneficiary by the issuing bank in the event of default or nonperformance by the account party (the bank's customer). Whereas a commercial documentary letter of credit is normally payable against the presentation of documents conveying or securing title to goods, such as a bill of lading, a standby letter of credit is normally unsecured and payable against a simple statement of default or nonperformance. Some of the most common purposes for which this instrument may be used are listed below.

- Standby credit for the account party's performance under a contract award. In this case the beneficiary would present to the issuing bank a draft accompanied by a statement to the effect that the contract bidder (account party) did not perform under an awarded contract. The issuing bank would be obliged to pay the beneficiary and then look to the account party (customer) for reimbursement.
- Standby credit for the account party's borrowing or advances from another bank. This arrangement calls for the issuing bank to reimburse the lending bank if the account party (customer) does not repay his loan.
- Standby credit to back commercial paper or other obligations of the bank's customers.

A standby letter of credit transaction involves a higher potential risk for the issuing bank than a commercial documentary letter of credit. Unless the transaction is fully secured, the issuer of this instrument retains nothing of value to protect it against loss. A commercial documentary letter of credit provides the bank with title to the goods being shipped. Therefore, to reduce the unsecured credit risk of standby letters of credit, the issuing bank's credit analysis of the account party or customer should be equivalent to that applicable to a borrower in an ordinary loan. Unsecured standby letters of credit are included, along with loans, within a bank's unsecured legal lending limit to one borrower.

For reporting purposes, standby letters of credit are reflected as contingent liabilities in the issuer's Report of Condition. Once drawn upon, the amount of the standby letter of credit becomes a direct liability of the issuing bank.

Other direct liabilities by a bank may arise during the course of business. Court cases and interpretive rulings have held that banks may issue enforceable guarantees when a direct interest of the bank is served. An instance in which this authority is exercised is in the issuance of steamship guarantees and airway releases. These instruments request a transportation carrier to release merchandise shipped under a letter of credit, but before a bill of lading has been received, and provides indemnity protection against future liability. All such guarantees are to be combined with standby letters of credit for the purpose of determining a customer's legal lending limit.

Bankers' acceptances are a common method of financing international trade. These are used to finance all of the successive stages of the movement of goods through the channels of trade from the point of origin to the final destination.

A bankers' acceptance is an order in the form of a time draft (also referred to as a bill of exchange or an issuance draft) drawn by one party (the drawer) in favor of itself or another party (the payee), addressed to (drawn on) a bank (the drawee) and accepted by that bank to pay the holder a certain sum on or before a specified date. The bank's acceptance of this order from the drawer, by stamping across the face of the draft "ACCEPTED" and dating and signing the stamp, is a formal acknowledgment of the obligation and constitutes an unconditional promise by that bank to honor the time draft at maturity. The drawee bank creating the acceptance is primarily liable for the instrument, while the payee, as first endorser, is secondarily liable for paying the holder in due course. If the drawee (acceptor) is other than a bank, the instrument is a trade acceptance, not a bankers' acceptance.

Most bankers' acceptances are used to finance trade transactions. Accordingly, acceptances are most often created in connection with letters of credit, although they may arise in connection with collection or open account transactions (refer to Commercial Documentary Letters of Credit).

In general, acceptance credit is considered self- liquidating; i.e. it must provide the means for its own payment at maturity. In order to accomplish this, the acceptance must be based on an underlying business transaction in which goods are being shipped prior to entering the channels of trade. It is therefore reasonable to expect satisfactory evidence to be available indicating that the draft, when created, is based on an actual shipment or storage and that, at maturity of the draft, the proceeds from the sale of the goods will be used to settle the draft. To a lesser extent, acceptances also finance the domestic shipment of goods and domestic or foreign storage of readily marketable staples.

The payee of the acceptance may hold an acceptance until maturity, discount it with his bank, or sell it in the acceptance market. When a bank discounts (purchases) its own acceptance from the payee, its "Customers Liabilities on Acceptances Outstanding" (asset) and "Liability for Acceptances Executed and Outstanding" (liability) accounts are reduced and the discounted acceptance is recorded with other loans. If the accepting bank subsequently rediscounts (sells) the acceptance in the market, that acceptance should be rebooked in both the asset and liability accounts. The asset and liability accounts may differ on occasion when the asset account is reduced by the customer's prepayment (anticipation). In that case, the bank's liability, which exists so long as the draft is still outstanding in the market, is not reduced.

Creation of eligible bankers' acceptances is governed by Sections 12A, 13 and 14 of the Federal Reserve Act and Regulation A issued by the Board of Governors of the Federal Reserve System. Bankers' acceptances must meet certain criteria described in Regulation A and by the Federal Open Market Committee (FOMC) in order for the instrument to be eligible for either discount or purchase by Federal Reserve Banks. Federal Reserve Banks have not, however, "discounted" acceptances of member banks for many years. In addition, the Federal Reserve Bank of New York, which conducts acceptance operations for the Federal Reserve System under the direction of the FOMC, have discontinued "purchasing" acceptances for its own account.

Despite the fact that acceptances are currently not being either discounted or purchased by Federal Reserve Banks as a matter of policy, the rules governing whether an acceptance meets the eligibility requirements continue to be important for two major reasons. First, acceptances meeting the conditions of eligibility for discount or purchase are more readily salable in the market than are acceptances which do not satisfy these conditions. As such, they provide a greater degree of liquidity for the accepting bank. Second, ineligible acceptances are subject to reserves (eligible acceptances are not), which raises the cost to the borrower over that of an eligible acceptance.
Bankers' acceptances as a source of finance and investment offer significant advantages to borrowers, accepting banks, and investors alike. Over the years, the bankers' acceptance has often been a cheaper financing vehicle than a loan or advance since it is readily marketable and considered an important secondary reserve for the accepting bank and is a relatively secure instrument to the investor because of its two-name backing.

The market for bankers' acceptances is made by dealer firms recognized by the Federal Reserve System. Participants in the market, in addition to recognized dealers, are domestic and foreign accepting banks, nonrecognized dealers, Edge Act Corporations, and investors of all types, ranging from individuals to foreign central banks. Although most trading is now done on a negotiated basis, published bid and asked prices can be useful indicators of actual negotiated prices. Generally, secondary market activity in acceptances has not been substantial. Most investors who buy acceptances do not resell them, but hold them until maturity so that, once placed with the investor, relatively few find their way back into the market. Thus, accepting banks are the major source of supply to the acceptance market and their willingness to sell their acceptances varies significantly with changes in general money market conditions. Both accepting and non-accepting banks are also important buyers of other banks' acceptances as an investment when rates on acceptances are attractive compared with other short-term obligations. Since the banks' holdings of acceptances form part of their secondary reserves, it is important that the paper they buy be readily marketable by conforming to all the rules which make the acceptance eligible for discount by a Federal Reserve Bank.

Lending limits affecting bankers' acceptances in nonmember banks are controlled by State banking laws but most of the States which are oriented toward international banking have adopted the appropriate sections of the Federal statutes. Under Section 13 of the Federal Reserve Act, eligible acceptances for discount at the Federal Reserve (subject to specific criteria) are exempt from both reserve requirements and Federal lending limits. Bankers' acceptances that are ineligible for discount at the Federal Reserve (do not meet criteria) become an unsecured obligation of the accepting bank for the full amount of the draft and thus subject to prevailing unsecured lending limit requirements.

Trade Financing – Other Methods

While most bank trade financing is provided through letters of credit and bankers' acceptances, several other methods are used in various circumstances. Some of the more common are current account advances, foreign receivable financing, discounting trade acceptances, and forfaiting.

Current account advance is the American substitute for the European method of financing by overdraft. Current account advances are extensions of credit in which no instrument of specific indebtedness is used. Instead, a signed agreement is on file stating the conditions applicable for payment by the obligor.

Financing foreign receivables through advances against foreign collections, the exporter pledges his outward collections to the bank. The exporter may then borrow from the bank up to a stated maximum percentage of the total amount of receivables lodged with the bank at any one time. Besides having a pledge on the exporter's outward collections, the bank usually retains recourse to the exporter, whose credit strength and reputation are of prime consideration. The bank also maintains control of the merchandise by ensuring that the export bill of lading is "to the order of" the shipper and endorsed in blank or to order of the bank. The bill of lading must not be consigned to the buyer (importer) since this would give him control over the goods.

Discounting trade acceptances may also be used by a bank to finance foreign receivables. The exporter's draft accepted by the foreign buyer becomes a trade acceptance with the full credit obligation of the importer. The acceptance is returned to the exporter. If the exporter does not need bank receivable financing, he simply asks the collecting bank to present the draft to the acceptor (importer) for payment at maturity. If the exporter needs the funds before maturity of the trade acceptance, he may ask the bank to discount the draft with or without recourse to himself (exporter). For the most part, however, the lending bank retains the right of recourse to the exporter, if the primary obligor (importer) defaults.

Banks also finance foreign receivables by bankers' acceptances. To obtain acceptance financing against receivables, the exporter draws two drafts. The first is a time draft drawn on the foreign buyer (importer), which, along with the necessary documents, is sent for collection in the usual manner. The second, for the same or a lesser amount and for the same tenor as the first, is drawn on the exporter's bank. The bank accepts the second draft and discounts it, crediting the net amount to the exporter's account. The bank may hold the acceptance in its loan portfolio or may sell it in the market. When payment is received from the importer on the first draft, the bank applies the proceeds to pay its own acceptance. Should the importer default, the bank has recourse to the drawer (exporter) for payment.

Similar to factoring, *forfaiting* is discounted longer term financing for the importer on a non-recourse basis to the exporter. Forfaiting typically involves amounts over $250,000 for terms of 180 days to 8 years. Under forfaiting, notes, bills of exchange, receivables, or deferred payments under letter of credit guarantees are discounted to the forfaiter. The exporter arranges the transaction with the forfaiter subject to its credit approval. The importer must provide an irrevocable letter of credit or notes or bills of exchange to draw in favor of the exporter. The importer arranges for its bank to guarantee the notes or bills of exchange. The exporter arranges the terms of the agreement with the discounter (forfaiter) to determine the documents necessary to close the deal at a pre-determined price. After shipping the goods to the importer and by delivery of the proper documentation to the forfaiter, the exporter then receives cash. Exporters typically will use forfaiting because they may not want to maintain an open account with a counterparty in certain areas of the world, particularly when government export credits or credit guarantees are not available. The importer finds forfaiting attractive because expensive capital goods can be purchased and put to use generating income before the items have to be paid for.

Domestic Loans

Although some loans to domestic corporations are extended to facilitate international transactions, they are essentially domestic loans. A typical transaction would be a loan or other form of credit to a domestic customer to finance imports of inventory shipped on open account or under a letter of credit or bankers' acceptance facility. The credit is in U.S. dollars and repayment is expected through the sale of the inventory in the U.S.

Loans to overseas units of domestic corporations are sometimes guaranteed by the domestic corporation. The loans may be made for several purposes such as short-term working capital or long-term capital improvements. The domestic company guarantees generally play a much stronger role in international banking than in domestic lending, and their proper execution is a critical factor in granting the credit. On the other hand, loans to foreign affiliates of U.S. corporations not supported by a guarantee of the domestic corporation must be considered on their own merits. There may be a verbal agreement between the parent company and the bank or an informal commitment, such as a comfort letter, keepwell letter, or letter of assurance that is not legally binding. Therefore, such loans to overseas affiliates should be evaluated as loans to independent entities.

Loans to Foreign Governments

Loans to foreign governments and government- controlled entities cover not only government-controlled banks, financial institutions, and agencies, but also nationalized industries. Repayment of such loans depends ultimately upon the government of the country. The evaluation of risk inherent in such country exposure represented in the international loan portfolio is discussed within this section, under Country Risk Management.

Direct Credit to Foreign Banks

Direct credit to foreign commercial banks may be in the form of loans or deposit placements (discussed in more detail below under a separate heading). Loans are of the normal business type, similar to domestic loans made to local correspondent banks. In some cases, these loans may be used for trade-related transactions commonly referred to as pre-export financing. These trade-related lines of credit work like a working capital line for the foreign bank with advances requested to fund loans for local clients of the foreign bank. The lines are unsecured and based on the creditworthiness of the foreign bank, although repayment may be affected by the ability of the foreign bank's client to reimburse the foreign bank. However, the foreign bank certifies to the U.S. bank the nature of the transaction and the parties involved.

Indirect Loans to Foreign Banks

Indirect loans to foreign banks are loans extended to a foreign borrower based primarily on the foreign bank's guarantee of the loan. In fact, such credit extensions are often accommodations to the foreign bank, with little or no contact between the lending bank and the direct borrower. For all practical purposes, such loans are part of the credit extended to the foreign bank for funding purposes.

Loans to Foreign Business or Individuals

Direct loans to foreign businesses and individuals are based on the same credit principles as domestic commercial loans. However, the examiner must consider them in the special environment of international business that may influence their repayment. Country risk, foreign exchange risk, and reliability of financial statements are some of the factors that need to be considered in this environment.

Syndicated Project Loans

Project loans put together by international consortia and participations in syndications are specialized loans which are often managed by another bank and may or may not involve existing customers. Nevertheless, the bank under examination should have sufficient financial information and documentation on hand to ensure an adequate understanding of the transaction, the borrower, the risks involved, and the source of repayment.

International Lending Policy

Every bank engaged in international lending should be guided by a formal statement of policy approved by its board of directors. Content will vary depending on the size of the bank and the extent of its international commitment, but certain factors should be addressed in almost all situations. These would most often include a summary of management's basic credit standards, a statement of the bank's international lending objectives, a description of its system for credit approval, a recital of loan processing procedures, and establishment of specific personnel lending authorities. In addition, the policy should establish procedures that ensure that the board of directors will regularly be apprised of the condition of the international loan portfolio. It will be appropriate to indicate the major differences in international versus domestic lending. These differences have been summarized under the categories set forth below.

Credit Standards and Information

In the evaluation of international credit risk, special consideration must be given to a review of foreign financial statements, types of borrowers, and the forms of indirect support provided by parent companies, banks, and official financial institutions. Bank personnel should be alerted to the need of reviewing, with caution, financial statements prepared in other countries, since accounting practices vary widely and even some highly developed countries have surprisingly lax auditing standards compared to the U.S. Foreign financial statements may be prepared in either U.S. dollar equivalents or in a borrower's local currency. Most banks analyze the foreign currency statement, particularly if that currency is unstable and the comparability of figures stated in U.S. dollar equivalents at various dates would be distorted by the fluctuating exchange rates. Nevertheless, banks should also translate and spread the foreign financial statement into English, with the foreign currency converted to U.S. dollars and the applicable exchange rate indicated. Since financial information from foreign countries is not always reliable, the bank's policies should enable it to determine borrower capacity and reputation by other means. One of the most effective methods is a program of regular visitations to borrowers' countries by bank account officers, obtaining credit references, followed by preparation of candid reports which become significant parts of credit files.

Loans to Foreign Banks

Loans to foreign banks represent an important segment of international credit. Lending to these institutions involves the same uncertainties as other foreign borrowers, particularly regarding the usual absence of information concerning their asset quality. Within this framework, the key to evaluating a foreign bank is an accurate appraisal of its management. Other important factors are an understanding of the country's banking structure, including method of reporting problem assets, and supervisory program, the central bank's financial position, the economic and political condition of the country, and the position of comparable banks (peer group analysis). As with international borrowers, generally, there is no substitute for regular bank account officer visitations in developing this type of information. Banks may also consider World Bank and International Monetary Fund (IMF) Financial Sector Stability Assessments (FSSAs), which describe a country's adherence to sound financial sector principles such as the Core Principles of Banking Supervision prescribed by the Basel Committee on Banking Supervision (BCBS).

Another factor in international credit analysis is a consideration of the type of domestic borrowers with which international departments do business. Some domestic borrowers are major companies that enjoy excellent credit standings, while others may include sole proprietorship import/export companies operating on modest capital and narrow spreads. Loans to foreign borrowers are often directly or indirectly supported by a party of substantial financial strength such as a domestic parent or affiliate, a foreign correspondent bank guarantor, or foreign government. An evaluation of that support will be basic to a given credit's analysis.

Geographic Limits

Defining geographic loan limits is probably the most significant component in the establishment of an adequate international lending policy. It requires bank management to intelligently estimate where it can lend profitably in accordance with its strategic objectives, financial capacity, and personnel resources. Maximum credit lines should be established for each individual borrower, and maximum aggregate lines established for each political entity where credit is advanced, based on country risk analysis. Banks may also consider assigning limits based on the potential for contagion issues, meaning adverse events in one country may lead to similar adverse events in another. This may occur, for example, in the case of two or more countries with close trading ties, such as in the case of Mercosur countries in South America. Banks should also consider establishing country and credit sub-limits by transaction type (loans versus investments) and tenor (short-term versus long-term).

Detailed in a preceding paragraph is the notion of currency risk. This refers to the potential loss on loans made in foreign currencies that may decline relative to the U.S. dollar or to the impact of foreign currency devaluations. Aggregate country loan limits should include a currency sub-limit in order to control currency loss exposure.

Investments

In addition to international loans and deposit placements, U.S. banks may periodically allocate capital and risk to investments in foreign debt securities and/or debentures. The debentures may be issued by a foreign bank, corporation, or sovereign government for their respective capital needs. Banks with foreign offices might hold securities of foreign governmental entities to meet various local laws or reserve requirements, reduce tax liability, or as an expression of goodwill. As with domestic bond issues, duration and maturity of the instruments will vary and, in the case of debentures, represent an unsecured obligation of the issuer.

Foreign debt securities held by U.S. banks, typically U.S. dollar-denominated in the form of Eurobonds, Medium Term Notes (MTNs), or Yankee Bonds provide some liquidity in the secondary markets (during normal market conditions) and, depending on the country and circumstances of the issuer, may offer much higher yields than what would otherwise be feasible in the highly competitive trade finance market. Higher yields over comparable U.S. Treasury instruments are driven by a confluence of factors including credit quality, country risk (including transfer risk), as well as foreign currency fluctuations.

Examination Guidance

International investments may be internally reported within a bank's domestic bond portfolio, even though they are slotted differently for call report purposes. Banks with foreign branches are permitted a broader scope of investment activities, including investment services and underwriting of debt and equity securities. Limitation of international investments and definition of permissible activities are governed by the Federal Reserve Board's Regulation K which is incorporated into the FDIC Rules and Regulations through Part 347. As with the domestic investment portfolio, the purchase of foreign debt securities with speculative characteristics merely to generate higher short-term income is an unsuitable investment practice.

While policy considerations with respect to managing risk are very similar to those contained within the Securities section of this Manual, the foreign aspect of Eurobonds, notes, and debentures requires greater diligence, consideration, and monitoring than would otherwise be expected of a plain vanilla domestic bond portfolio. As with international loans or other credit products, foreign debt securities should be purchased under a board-approved country exposure line. Moreover, policy guidelines should prescribe permissible investments, minimum credit quality standards, and maximum duration. All investment selection activities should be consistent with the bank's broader strategic plan, including its risk appetite regarding transfer, credit, interest rate, liquidity, and price risks.

Before purchasing a foreign security, the institution should analyze the following factors relative to the investment: legal implications, credit soundness, marketability, exchange rate risk, and country risk. Credit soundness considerations for foreign debt instruments also include all the qualitative and quantitative considerations for domestic debt instruments (including, for example, credit measures that isolate the extent of leverage and cash flow of the debtor). For non-rated foreign debt issues, it is especially important to adopt conservative minimum thresholds for credit evaluation criteria (i.e. earnings coverage of debt service requirements). Particularly important is a bank assessment of the reasonableness of the risk-reward tradeoff, using, for example, an analysis of the credit spread between the issue and comparable U.S. Treasury instrument as a benchmark.

Regarding pre-purchase analyses of foreign debt securities in countries with a low sovereign rating ceiling (endemic within many emerging market instruments), enhanced diligence is necessary to preclude the introduction of higher risk securities into the portfolio. Examiners may wish to note that nationally recognized statistical rating organizations (NRSRO) have historically not rated certain debentures above the foreign currency rating for the sovereign (sovereign ceiling). However, a company's credit metrics (ability to repay) in an emerging market may have been better represented by a credit grade that was higher than its host government for a variety of factors, including:

- Foreign company's overall importance to the sovereign economy.
- Extent to which company has direct or indirect access to foreign exchange and/or ability to export product/services and realize U.S. currency within its operations.
- Company's access to the international capital markets.
- Extent of foreign ownership and implied support.

Supporting documentation of the pre-purchase analysis should be retained in the institution's files for examiner review. To ensure adherence to written policies and procedures, the international portfolio should be reviewed at least annually by the bank's board of directors and more frequently by its investment or asset/liability management committee. To properly determine overall country exposure, the instruments should also be incorporated within the bank's country exposure report under the appropriate country of risk.

Placements

Banks may maintain interest-bearing time deposits with foreign banks and overseas branches of U.S. banks. Referred to by various terms such as placements, interbank placements or redeposits, maturities of these instruments may range from overnight to several months or even years. Deposit placements are usually connected with foreign exchange markets and international money centers such as New York, London, Frankfurt, Singapore, and Nassau and carried in the account "Due From Foreign Banks-Time." They involve both foreign banks and overseas branches of U.S. banks and are made under a pre-approved placement line that, in essence, is a line of credit.

The bulk of due from time deposits consists of Eurodollar placements, with smaller amounts in other Eurocurrencies. Eurodollars and Eurocurrencies are simply dollars or foreign currencies domiciled outside the respective country of denomination. The Eurodollar market has grown significantly since 1960 with increased interbank activity stemming from the desire to put idle Eurodollar balances to work or to fund Eurodollar loan requests. Although treated as deposits in the Reports of Condition, due from bank time deposits contain the same credit and country risks as any extension of credit to a bank in a foreign country. Consequently, a prudently managed bank should place deposits only with sound and well-managed banks after a thorough investigation of their creditworthiness. Placement activity should be governed by a formal bank policy similar to that used for Federal funds transactions. The policy should define terms, designate acceptable levels of concentration in relation to credit and country risks, and identify those banks acceptable for placement activity. Lists of acceptable depositories with prescribed limits should be provided to the traders or placement officers and reviewed regularly by credit officers, particularly during periods of money market uncertainty or changing economic and political conditions.

The primary examination objective is to determine adequacy of bank policies. Examination procedures are similar to those performed in the domestic operations and should focus on a review of written policies, internal controls, and audit programs. In those instances where a formal policy has not been developed, or credit analysis is nonexistent or deficient, the matter should be discussed with management. Unless the depository institution clearly exhibits pronounced financial deficiencies, in which case the placement can be criticized for its poor credit quality, the examiner's objective is to advise the bank of the potential risks of its practices. The need for correction of any deficiencies should be reinforced through the examiner's comments and conclusions. In the case of due from bank time deposits or placements, prevailing procedures on interbank liabilities should be referenced as contained within Section 3.3 (Cash and Due from Banks) of the Manual of Examination Policies.

If the bank's total exposure with any one institution via Eurodollar placements, Federal funds sold, and demand or time balances with the U.S. offices meets the criteria for a concentration of credit, it should be listed on the appropriate examination report schedule. Also, in the case of placements with foreign banks, these amounts should be included with other foreign extensions of credit for purposes of evaluating country or transfer risk.

Funds Management

Cash Accounts

International departments, like their domestic counterparts, maintain cash accounts which may vary from nominal sums to large amounts depending on customer needs. These accounts will include U.S. and foreign currencies, collection items, and unposted debits. Examination objectives for these accounts are the same as those in domestic operations. Physical control over cash should be maintained and complemented with adequate accounting systems and controls. The department's accounting reports should include the U.S. dollar equivalent of foreign currency balances. Separate controls for cash items should be maintained in the general ledger, supported by subsidiary records which permit an evaluation of each item. Dealing in foreign notes and coins can involve more risk than engaging in foreign currency activity through a due-from account maintained at a correspondent bank because: 1) The institution may unknowingly accept counterfeit currency and 2) The physical movement of notes and coins is expensive and time-consuming. Appropriate internal controls should be instituted to compensate for these additional factors.

Some banks do not include foreign currency in their net position reports or monthly reevaluations. However, currencies of other countries are foreign currency assets as are loans or nostro accounts and should be included in position reports.

Due-From or Nostro Accounts

A bank must be prepared to make and receive payment in a foreign currency in order to meet the needs of its international customers. Since physical movement of currency is impractical, these transactions are accomplished by maintaining accounts or "inventories" of foreign currency in correspondent banks located in the countries where the bank and its customers conduct business. Nostro accounts or due from accounts are accounts established in correspondent banks located in the countries where the bank conducts business. The bank will maintain an inventory of currency, i.e. British Pound Sterling in London, in order to complete transactions requiring the receipt or payment of Pounds. Account transactions occur in the foreign currency, and normal procedure is to record deposits and withdrawals on the department's ledgers in both the foreign currency and its U. S. dollar equivalent. Conversely, “vostro” accounts are due-to demand deposit accounts maintained by a bank in a foreign country at a U.S. bank.

Close supervision of nostro accounts is required to provide adequate balances to service the needs of customers while avoiding excessive idle funds, or overdrawing the nostro account and incurring service charges. All foreign currency transactions, except over-the-counter cash trades, are settled through the nostro accounts. Therefore, the volume of activity may be substantial and must be adequately controlled. Incoming confirmations of transactions should be carefully reviewed by the institution to protect against fraud and error. Similarly, timely follow-up procedures should be in place for non-receipt of confirmations.

Examination objectives are similar to those of domestic correspondent accounts with the additional problem of exchange risk. Nostro account balances are included with other general ledger accounts to determine the department's "position" in each foreign currency. Spot and forward contracts taken to cover excessive nostro overages should be combined with all other exchange contracts to discover "gaps" or maturity mismatches. The institution's credit evaluation of foreign banks with which demand deposit accounts are maintained should also be carefully reviewed.

Borrowings

All international department transactions that constitute borrowings should be properly recorded on the general ledger, in reports to shareholders, and in published Reports of Condition. International borrowings exist in the same forms as in domestic banking and are commonly composed of direct borrowings from the Export-Import Bank of the U.S., short-term call money from foreign banks, and overdrawn nostro accounts. Other forms of borrowing include: notes and trade bills rediscounted with central banks of various countries; notes, acceptances, import drafts or trade bills sold with the bank's endorsement or guarantee; and, notes or other obligations sold subject to repurchase agreements.

Certificates of deposit and due-to foreign banks - time (takings) have not been defined as borrowings and continue to be reflected as deposits for reporting and borrowing limitation purposes. However, the fundamental distinction between these instruments as deposits or as borrowings is at best nebulous; in fact, they are widely recognized as borrowing vehicles for many banks.

Guidelines presented elsewhere in this Manual for evaluating domestic borrowing activity should be used for any borrowings found in the international department. Any unjustified borrowing policy being pursued in the international department should be reviewed with management and appropriate comments included in the Report of Examination.

Foreign Exchange

The Foreign Exchange Market

Foreign exchange is the exchange of money of one country for money of another. Foreign exchange transactions arise out of international trade or the movement of capital between countries. Foreign exchange transactions can be conducted between any business entity, government, or individual; but banks, by virtue of their position as financial intermediaries, have historically been ideal foreign exchange intermediaries, as well. Banks are on one side or the other of the majority of the transactions in the foreign exchange market worldwide.

Bank foreign exchange transactions take place between other banks (referred to as interbank trading) and between banks and their customers (generally referred to as corporate trading). The volume of foreign exchange activity varies widely among banks. The degree of a bank’s involvement is largely dictated by customer demand but increasingly is being driven by interbank trading for a bank’s own account. Multinational or global banks are the most active in terms of both trading volume and the number of currencies traded. These banks trade foreign exchange across virtually any currency. Other banks may trade actively in only a few currencies, while other banks will have only limited activity. While banks of any size can and do engage in foreign exchange transactions on behalf of their customers, generally only the world’s largest banks and certain smaller banks specializing in international business enter into transactions for their own account.

Foreign Exchange Trading

Foreign exchange trading is an integral part of international trade and can be an important activity and source of income for banks. However, only banks specializing in this complex and specialized field, particularly those banks which trade foreign exchange for their own account, will maintain a foreign exchange department with qualified dealers. It is these banks which present the most complex risks. Banks that only execute their customer’s instructions and do no business on their own account – essentially maintaining a “matched book” – will generally use the services of another bank or foreign exchange intermediary to place customer transactions. While these banks present less supervisory risk, examiners of these institutions should still be familiar with the fundamentals outlined in this section. This section is intended to present only the most basic fundamentals of foreign exchange in order to provide the examiner with a minimum understanding for evaluating the risks in this business. Examiners are encouraged to study the subject in more detail, especially when examining banks with more complex foreign exchange operations. A number of books about foreign exchange are available and several major U.S. banks have published books or pamphlets on the subject. In addition, the FFIEC has a Foreign Exchange section within the International Self Study Modules that provides useful guidance for examiners.

Exchange Rates

When currencies of different countries are exchanged, it is done at an exchange rate which is simply the price of one currency in terms of another. Many political and economic factors influence exchange rates. A government may attempt to fix the rate of exchange for its currency or allow it to fluctuate freely or within established limits. Trade and investment flows affect the supply and demand for currencies, which, in turn, influence exchange rates. Banks also quote different rates based upon the amount of time required to exchange currencies. For example, the British Pound Sterling is quoted at a certain rate for immediate (spot) transactions and another rate is quoted on the same day for future (forward) transactions. In general, rates vary depending on the agreed payment date (value date) of the transaction, i.e. overnight, one week, one month, etc. Also, banks quote a different exchange rate for a given transaction when they are buyers or sellers of currency. This applies to both spot and forward transactions and the two rates are usually referred to as bid (buy) and offer (sell). The spread between the bid and offered rates represents the bank's profit margin, if the bank is acting as dealer.

Exchange rates can be quoted either as direct rates or cross rates. Direct rates are simply the value of a currency in terms of another, i.e. the value of the Japanese Yen in U.S. dollar terms. A cross rate is defined as the price of one currency in terms of another currency in the market of a third country, i.e. a Japanese Yen rate in Sterling terms calculated from the respective U.S. dollar rates.

Spot and Forward Exchange

Customers buying or selling foreign exchange may ask their bank to provide that service for immediate delivery (spot transaction) or they might contract to buy or sell a specified amount of foreign currency for delivery at a future date (forward transaction). The date on which payment is effected is referred to as the value date. The value date for a spot transaction is generally two working days after the date the transaction originated. For example, a spot contract originating on Monday would have a value date of Wednesday.

The market for foreign exchange for future delivery is called the future or forward market as opposed to trading for two-day delivery which takes place in the spot market. A forward contract for foreign exchange is a transaction in which one currency is bought or sold against another for delivery at some future date. It differs from the spot market in that settlement occurs in the future, usually in increments of thirty days out to one year for most currencies. However, the liquidity in the market decreases beyond three months and differs across currency pairs, with small country currencies and currencies of emerging market countries having significantly less liquidity and wider spreads. Liquidity is important both for offsetting or hedging a transaction and replacing a transaction should there be a problem with settlement. The exchange rate for a specific currency will differ between spot and future transactions because of the time difference in settlement dates.

An exchange rate is fixed or agreed upon when the forward contract is entered into but no money is exchanged until the agreed future date (value date or settlement date) arrives. This type of contract enables a company or an individual who has a future commitment in a foreign currency to eliminate the risk of an adverse move in the rate of exchange prior to the maturity of the commitment. Forward exchange rates are usually quoted in terms of their premium or discount over the spot rate. As described above, there is a specific exchange rate for each forward contract and that rate will usually differ from the spot exchange rate. If the forward exchange rate for a currency is higher than the current spot rate for the same currency, the currency is said to be trading at a premium for the forward maturity. If the forward rate is below the spot rate, the currency is said to be trading at a discount. The amount of the premium or the discount is generally determined by the interest rate differential for similar money market instruments that exists between the two countries.

Swaps

One of the most widely used types of foreign exchange transaction is known as a financial swap or cross currency swap, which is a simultaneous purchase and sale of a certain amount of foreign currency for two different value dates. It is generally the combination of a spot contract and a forward contract. For example, an exchange trader buys a currency for spot value and at the same time sells it back for a value date in the future. The swap permits a temporary exchange of currencies and is often used to acquire a foreign currency that is then used to make a short-term investment. The maturity of the investment will coincide with the forward value date and the currency will be returned at that time. The exchange rate for the forward delivery is fixed at the outset, avoiding the risk of fluctuations in the exchange rate over the life of the investment, and the swap spread is the cost of this protection.

Forward Options

Another type of forward is the forward option contract. A forward exchange transaction is often based on expectations of payments involved in future trade or financial operations, where the exact date of payment is unknown. If the customer knows the approximate date when the currency will be received or needed he can enter into a forward option contract. The contract gives the purchaser the option of completing a transaction in the first ten days, the middle ten days, or the last ten days of the month. The bank agrees to deliver payment or receive delivery of payment of exchange on any day within the ten-day option period. The customer is charged a less favorable rate for the advantage of leeway or option in timing the execution of the contract than he would be for a regular forward contract. Swaptions, an option on a swap contract, works similarly.

Foreign Exchange Risk

Trading in foreign exchange (FX) or holding assets and liabilities denominated in foreign currency entail certain risks. These risks fall into five categories: exchange rate risk, interest rate risk, credit risk, operational risk, and country risk.

Exchange Rate Risk

Exchange Rate Risk occurs when a bank takes an open position in a currency. When a bank holds, buys, or agrees to buy more foreign currency than it sells, or agrees to sell more than it buys, an exposure is created which is known as an open position. Open positions are either long or short. When a bank buys more of a currency, either spot or forward, than it sells, it has a long position. Conversely, if more of a currency is sold than bought, a short position is created. Until an open position is covered by the purchase or sale of an equivalent amount of the same currency, the bank risks an adverse move in exchange rates. A long position in a depreciating currency results in exchange loss relative to book value. As the foreign currency depreciates, it is convertible into fewer units of local currency. Similarly, a short position in a currency that is appreciating results in an exchange loss relative to book value because, as the foreign currency increases in value it costs more units of local currency to close or square the position. To control exchange risk, bank management should establish limits for net open positions in each currency. See Trading Limits under the “Written Policies and Procedures” section.

To cover or match trade open positions, banks will generally hedge these positions with a forward contract, matching an expected requirement to deliver with a future contract to receive. The hedging of open positions can be very complex, sometimes using multiple contracts, different types of contracts, and even different currencies. Such hedging will not be detailed in this guidance. However, it is important to remember that the amount of exchange rate risk a bank is exposed to is not necessarily dependent on the volume of contracts to deliver or receive foreign currency, but rather the extent that these contracts are not hedged either individually or in aggregate. Also, while various types of forward contracts are typically used for hedging open positions resulting from commercial or financial transactions, forward contracts are also ideal for speculative purposes (called outright deals or single forward transactions) because often no funds are actually exchanged at the time the contract is entered into. All banks which engage in FX activity should monitor their open positions at least daily. Banks which actively trade FX will monitor their open positions constantly, closing out or matching exposures at various times during the day.

Maturity-Gap Risk

Maturity-Gap Risk is the foreign exchange term for interest rate risk. It arises whenever there are mismatches or gaps in a bank's total outstanding spot and forward contracts. Gaps result in days or longer periods of uneven cash inflows or outflows. For example, a maturity spread of a bank's assets, liabilities, and future contracts may reflect a prolonged period over which large amounts of a particular currency will be received in advance of any scheduled offsetting payments. The exposure to the bank is that of shifts in interest rates earned on funds provided by cash inflows or on interest rates paid on funds required to meet cash outflows. In this situation, the bank must decide whether: (1) to hold the currency in its "nostro" accounts (refer to the “International Activities" section for more details); (2) to invest it short term; (3) to sell it for delivery at the time the gap begins and repurchase it for delivery at the time the gap closes; or (4) to use any combination of the above. Banks control interest rate risk by establishing limits on the volume of mismatches in its total foreign exchange position. The problems of managing gaps are complex. The decision whether to close a gap when it is created, or to leave it until a later date, is based upon analysis of money market interest rates, and spot and forward exchange rates.

Credit Risk

When entering into a foreign exchange transaction, the bank must be confident that its customer or counterparty (individual, company, or bank) has the financial means to meet its obligations at maturity. Two types of credit risk exist in FX trading, one is called the 10-20 percent risk or the cost cover, the second is delivery or settlement risk. The 10-20 percent risk is that a customer might not be able to deliver the currency as promised in order to settle the contract. The bank's FX position is suddenly unbalanced and the bank is exposed to any movements in exchange rates. The bank must either dispose of the currency it had acquired for delivery under the contract, or it must purchase the currency it had expected to receive and probably had contracted to sell to a third party. In either case, the bank must enter into a new transaction and may suffer a loss if there has been an adverse change in exchange rates. Generally, exchange rates will fluctuate no more than 10-20 percent in the short-term and usually much less, hence the term 10-20 percent risk.

Delivery or settlement risk refers to the risk of a counterparty taking delivery of currency from the bank but not delivering the counterpart currency. In this situation the bank is exposed not just to currency fluctuations but for 100 percent of the transaction.

To limit both types of risk, a careful evaluation of the customer's creditworthiness is essential. The credit review should be used to establish an overall limit for exchange contracts for each customer. For example, after careful analysis of the customer's financial soundness, the bank may determine an overall limit for foreign exchange contracts for the customer in the equivalent amount of, say, $2 million.

With this total limit the bank might establish a settlement limit of no more than the equivalent of $200,000 in any one day. In this manner it has limited its 10-20 percent risk to 10 percent of any outstanding contracts to a maximum of $2 million. At the same time it has limited its delivery or settlement risk by imposing a $200,000 settlement limit. If the customer fails to deliver counterpart funds, the bank can cancel remaining contracts and limit its risk of loss.

Operational Risk

Banks that engage in foreign exchange transactions must have systems and personnel capable of controlling and reporting transactions. The absence of an effective operations department may result in unanticipated losses to the bank. Generally, the bank will have an Operations Manager whose responsibility is to ensure that systems are in place to record transactions, perform daily mark-to-market, reconcile currency positions daily, and assess compliance with limits. The Back Office or Operations Department should also ensure that all confirmations are received or sent to counterparties daily. In more sophisticated foreign exchange trading rooms, there may be a middle office as well that interacts with front office (traders) as well as back office personnel. Separation of duties is essential in managing operational risk, with the responsibilities of the traders and back office personnel being strictly segregated. While the form of trades and trade confirmations have changed with the advent of new technology, the independence of these functions remains of paramount importance irrespective of the extent of a bank's trading operations.

Country Risk

Political changes or adverse economic trends within a country are likely to be accompanied by changes in policies which could affect such factors as interest rates, balance of payments, foreign exchange reserves, and capital flows. These policies, whether based on economic necessity or changed attitudes, might affect the availability or transfer of currency to the bank's customers or to the bank itself, and could even affect the convertibility of that country's currency in foreign exchange markets. Exchange control regimes imposed by a county's central bank can limit the amount of currency that can be exchanged in any single transaction, by any given customer, or within a particular period. In any case, the exchange rate for the currency may be subject to additional supply and demand influences, and sources of covering the desired currency may vanish.

Examination Guidance

An examination of a bank's foreign exchange activities seeks to appraise the impact of the foreign exchange activities on the financial condition of the bank. Large, global banks with extensive foreign exchange trading operations earn substantial fee income from this activity, while banks which conduct trades entirely on behalf of their customers generally do not. However, the nature of foreign exchange trading wherein a single trader can commit a bank to huge forward commitments in a short time makes evaluation of risks important for banks of any size and perceived level of activity. At a minimum, examiners should:

- Determine the extent of the bank's FX activities in relation to the sophistication of their policies and strategies, expertise, operations, internal controls, management information systems, and internal audit coverage.
- Evaluate the overall FX risk position of the bank, its potential impact on future earnings, and management's ability to manage the risk.
- Determine the type of FX contracts in which the bank is engaged (spot, forward, swaps, options, futures) and the risks presented by the bank's FX activities (maturity gaps, financially weak counterparties, illiquid currency contracts, currencies with greater country risk).
- Evaluate the quality of personnel, risk controls, and operational systems in the context of the volume of the bank's activities and the complexity of transactions.

Guidance on Internal Control for Foreign Exchange Activities

The FDIC recognizes that most banks maintaining their own FX dealers already have adequate controls in place for foreign exchange trading. These internal policies and procedures, along with any relevant Federal Reserve and Office of the Comptroller of the Currency (OCC) examination guidance, may be used by FDIC examiners as a basis for evaluating a bank's FX practices in order to supplement the guidelines below. It should be noted that the Federal Reserve and OCC guidelines may not be all-encompassing and banks which are active in FX trading perhaps should have controls which exceed regulatory standards. Banks with limited foreign exchange activity and limited risk profiles (most state nonmember institutions) may not need all the systems and controls maintained by larger institutions or even all of the minimum FDIC standards. However, it is incumbent upon the management of these banks to demonstrate to examiners that their systems provide adequate protection for their level of risk.

Written Policies and Procedures

The bank's policies and procedures should, at a minimum, address the following:

- Scope of trading activity authorized and types of services offered.
- Trading and credit limits and limit exception approval and reporting process.
- Clear standards for trading with affiliated entities, members of the board of directors, and employees.
- Specific officer responsibility for and authority over functional trading desks (i.e. spot, forward, and options).
- Holdovers and after-hours transactions, accounting methods, and operational procedures.
- Trading Limits- Trading limits should be evaluated in light of current strategies, liquidity/volatility of individual currencies, trader qualifications, and loss exposure related to capital. At a minimum, the bank's policy should include limits with respect to:

    - Net positions by currency and in aggregate.
    - Maturity distribution of foreign currency assets, liabilities, and contracts.
    - Individual customer and bank lines.
    - Daily settlements with customers and banks.
    - Total FX contracts outstanding.
    - Overnight net FX positions by currency and in aggregate.
    - Maximum loss by trader/desk/branch.

- The process by which limits are allocated to branches and the process through which branches may borrow limits from other branches should be reviewed. In addition, policies governing the extension of limits and the approval and reporting procedures should also be evaluated.

- Credit Limits- The allocation of credit limits and the monitoring of such limits should be reviewed. The bank should establish the following:

    - FX counterparty and settlement limits, approved by a credit review process, that are established independently of other credit lines within the bank.
    - Daily reports generated by FX operations which indicate those customers or banks that have exceeded their limits (sometimes called an over-limit or exceptions report).
    - Daily report of limit excesses, including written approvals for excesses prepared by an officer not in the trading area.
    - Systems for allocating more risk to counterparties with long maturity positions.
    - On-line systems available to traders that detail credit line status.

Examiners should review the list of approved credit limits and note any unusual concentrations or lines to banks with known market problems. A current report of all outstanding FX contracts should be compared with approval limits to verify that there are no excesses other than those reported on the exceptions report.

Management Information Systems (MIS) and Operational Support

The bank's management information systems (MIS) and Operations Department should be capable of reporting and supporting the level of current and expected trading volumes on a daily basis. Specifically, with respect to MIS, examiners should review the reports generated and evaluate the systems' ability to monitor all FX positions, compliance with limits (both trading and credit), frequency of distribution (at least daily), and periodic testing for accuracy.

The personnel in the Operations Department should report to someone other than a member of the trading staff. The Operations Department should be adequately staffed to support the volume of transactions and duties of the department should be segregated, i.e. confirmations, trader positions, counterparty positions. There should be sufficient documentation of all transactions to ensure a proper audit trail. Documentation may be in the form of taped records of phone calls and trade tickets and confirmations received via telex, facsimile, recorded telephone calls or mail. The Operations Department should also review all trader and counterparty position reports and identify and report all excesses to the Operations Manager daily. Documentation for the approval of excesses must be obtained and reviewed each day.

The revaluation or mark-to-market of appropriate positions are calculated by operations personnel. Examiners should closely review these revaluations for accuracy and adherence to bank policy. Prices used by operations personnel should be obtained and verified from sources other than the bank's traders. Revaluations are recorded at least monthly.

Written confirmations should be sent no later than one business day after the transaction date. Incoming confirmations should be reviewed by a designated person in the back office or operations section. All confirmation discrepancies must be recorded in a log and promptly corrected.

Finally, the status of nostro and vostro accounts should be routinely reviewed to identify any outstanding items that may indicate settlement errors in those accounts.

Internal Accounting Controls

The bank's accounting systems and controls should be sufficient to provide reports on trading activities that are current and accurate and minimize the possibility of concealment of unauthorized transactions and misappropriation of funds. Documentation describing the accounting and other controls should be maintained by each trading office.

Internal control guidelines enumerate a number of specific recommendations for adequate internal controls of foreign exchange trading. In broad terms, the recommendations address the description of accounting systems and procedures, confirmation of contracts, reconciliation of trading positions, and reporting of exceptions. As a whole, the guidelines are considered minimum standards for the control of exchange activities. It is possible that the bank can control certain risks in a different manner. In such case, the bank must be able to justify its method of control.

Audit Documentation

The audit function is an important tool for management's use in determining that controls are functioning as intended and that employees are adhering to policy directives. The review of audit reports is a necessary part of an examination, particularly in specialized areas such as foreign exchange trading. The failure to extend adequate audit coverage to the bank's FX activity might be considered an important weakness in the bank's system of controls. In such case, the examiner should address the matter in the examination report and seek corrective action from senior management.

The guidelines do not describe how the audit program is to be performed. The development of an adequate audit program is a responsibility of senior management. The guidelines contain recommended minimum standards for documenting audit procedures and findings in a manner that facilitates an appraisal of the adequacy of the audit program.

The bank should maintain audit reports, workpapers, and related documentation at its head office or another centralized location and make them available to examiners. The auditor's files should indicate the extent to which the auditor tested the control and accounting entries, as well as compliance with bank policy. The auditor should also make a determination as to whether the bank's controls are adequate for the risks involved. The files should contain any recommendations by the auditor for additional controls, or the deletion of existing controls, and the underlying rationale. Any material deficiencies disclosed by the audit should be promptly reported in writing to the board of directors or a board committee.

SUPERVISION OF U.S. OPERATIONS OF FOREIGN BANKS AND OTHER INTERNATIONAL BANKING ENTITIES

Foreign Banking Organizations

Many foreign banks have operations in the U.S. These institutions are known in the U.S. bank regulatory community as foreign banking organizations (FBOs). The banking offices of FBOs can generally be divided into bank subsidiaries, branches, agencies, Edge and Agreement Corporations, commercial lending companies, and representative offices. The FDIC insures the FBOs' U.S. bank subsidiaries and a small number of the branches. As of June 30, 2004, U.S. banking operations of FBOs, insured and uninsured totaled about $3.4 trillion in assets. One hundred and eighty nine FBOs had 408 insured subsidiary banks, agencies, Edge and Agreement Corporations, and branches combined. FBO operations of national and state member and nonmember banks have assets totaling about $575 billion. Interestingly, FBOs also have U.S. non-banking offices (e.g. brokerage/dealers and real-estate companies) with assets totaling approximately $2 trillion.

U.S. Branches and Agencies of foreign banks are licensed at either the State or Federal level but have no separate legal status apart from the foreign bank. They are extensions of the foreign bank, much like a domestic branch of a U.S. bank is merely an office of that institution. The OCC supervises the federally licensed branches, and the Federal Reserve and State banking authorities supervise the State licensed branches. The Foreign Bank Supervision Enhancement Act of 1991 (FBSEA) effectively prohibits the FDIC from granting deposit insurance to U.S. branches of foreign banks except for those that were insured prior to FBSEA's enactment. The FDIC examines State licensed branches that are insured.

Examiners should consult the Federal Reserve Board's Examination Manual for U.S. Branches and Agencies of FBOs when conducting examinations of FDIC-insured branches of foreign banks. Branches (and agencies) are assigned a ROCA rating instead of a CAMELS rating. The ROCA components are: Risk management, Operational controls, Compliance, and Asset quality. Like the CAMELS rating, the ROCA rating determines the level of supervisory concern and the frequency of the examination schedule. An electronic version of the Uniform Report of Examination for Branches and Agencies is available for examiners on the International Section's website in MS Word format. The quarterly Report of Assets and Liabilities (Schedule RAL of the FFIEC 002) for branches and agencies is publicly available from the Federal Reserve Board's National Information Center at http://www.ffiec.gov/nic/.

Agencies also do not have a separate legal status and may have State or Federal licenses. An agency is like a branch; however, it is not allowed to accept deposits. Agencies are permitted to have occasional credit balances under certain conditions.

Edge or Agreement Corporations are subsidiaries of financial institutions organized for the purpose of engaging solely in certain types of international financial and investment activities. Edge Corporations are chartered at the Federal level, whereas Agreement Corporations are chartered at the State level. They may be organized by member or nonmember banks, or by foreign banks, and ownership can be held by one bank or several banks. They are located in the U.S. but often not in the same state in which the parent bank operates.

Edge and Agreement Corporations are useful vehicles for banks that wish to enter the international banking business. They may be located in any part of the U.S., can establish branches in this country or overseas, and are permitted to engage in a broad range of banking activities provided the transactions are international in nature or directly related to international transactions. Operations of Edge and Agreement Corporations are governed by Part 211.6 of Federal Reserve Regulation K and supervised by the Federal Reserve and/or the corresponding State banking authority. Deposit-taking activities of such entities are limited and uninsured.

A commercial lending office may not accept deposits but may borrow and lend on behalf of its parent company. These entities are State licensed and must receive approval from the Federal Reserve Board.

Representative offices are established under State law with the prior approval of the Federal Reserve Board. The representative office is a marketing facility and meeting place for conducting business of its parent foreign bank. The representative office cannot accept deposits or make any loan commitments for its parent company.

FBO Supervision Program

FBSEA mandated oversight of FBOs by the Federal Reserve Board. As part of its oversight responsibility, the Federal Reserve Board coordinates the examinations of FBOs with the other Federal agencies and with the various State banking authorities. In order to streamline FBO supervision, to enhance cooperation, and to reduce regulatory costs, the Federal regulatory agencies have entered into examination coordination agreements with the State banking agencies that protect the confidentiality of information shared by all participants. The information is shared through software known as the Banking Organization National Desktop (BOND). When planning an examination of an FBO, the examiner should contact the relevant case manager in the Regional Office or staff in the International Section as they may have access to more recent information that should be considered in the overall assessment of the FBO.

Part of the Federal Reserve Board's oversight requires a strength-of-support assessment (SOSA) ranking of the foreign bank, which strives to determine the ability of the parent institution to support the U.S. operations of the FBO. The purpose of this SOSA is to determine the FBO's overall risk profile and to develop an examination strategy and frequency that is commensurate with this profile. As part of the SOSA process, regulatory agencies will try to understand the FBO better by also reviewing its home-country financial system, supervisory practices, and accounting standards. A rating for the combined U.S. operations of the FBO is also assigned. For more information on FBO supervision and the SOSA process, examiners should refer to the Federal Reserve Board's SR 00-14, dated October 23, 2000, entitled, "Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations."

International Banking Facility

An International Banking Facility (IBF) is a set of asset and liability accounts, segregated on the books and records of the establishing entity, which reflect international transactions. An IBF is established in accordance with the terms of Federal Reserve Regulation D and after appropriate notification to the Federal Reserve. The establishing entity may be a U.S. depository institution, a U.S. office of an Edge or Agreement Corporation, or a U.S. branch or agency of a foreign bank pursuant to Federal Reserve Regulations D and Q. An IBF is permitted to hold only certain assets and liabilities. In general, IBF accounts are limited to residents of foreign countries, residents of Puerto Rico and U.S. territories and possessions, other IBFs, and U.S. and non-U.S. offices of the establishing entity. An IBF is an attractive tool for banks because its deposits are not subject to reserve requirements or deposit insurance premiums since they are not FDIC insured, thus providing a lower cost of funds to facilitate its international banking. Such funding may also serve to diversify the bank's liability mix and prove less volatile to changes in interest rates. This may be the case as foreign depositors often seek to mitigate country risk within their home country by transferring or diversifying their wealth into the U.S. market.

Parallel-owned Banking Organizations

A Parallel-Owned Banking Organization (PBO) exists when a depository institution[1] in the U.S. and a foreign bank[2] are **controlled**, either directly or indirectly, by an individual, family, or group of persons[3] with close business dealings or are otherwise acting in concert. PBOs do not include structures in a recognized financial group,[4] which are entities that are subject to comprehensive consolidated supervision via the Foreign Bank Organization (FBO) Supervision Program established as a result of the Foreign Bank Supervision Enhancement Act[5] (FBSEA).

PBOs are not included in the FBO Supervision Program because they do not have a foreign bank or holding company as the parent organization. PBOs, therefore, create unique supervisory concerns. A portion of the control of a PBO is located in foreign countries for which U.S. bank regulatory agencies may or may not be able to obtain sufficient, reliable information to accurately assess the risk the PBOs pose on a "top down" organization-wide basis. Therefore, this guidance addresses the lack of a "group-wide" supervisory approach by:

- Providing a supervisory definition of presumed control to identify a PBO,
- Clarifying that the entities that comprise a PBO may or may not be affiliated,
- Explaining how to determine whether intra-company transactions are subject to regulatory restrictions,
- Illustrating a complex PBO business structure,
- Describing the supervisory risks such relationships can pose to the associated bank in the U.S., and
- Discussing the methodology for conducting a risk assessment that analyzes a PBO on a "group-wide" basis.

Supervisory Control Definition

Identifying a PBO is difficult because control, based on common ownership, management, or decision-making authority, often is not clear. A review of applicable regulations and/or policies in the U.S. and abroad yielded several differing definitions of control. The lack of a globally-accepted and easily-understood definition of control complicates the identification of PBOs.

In April 2002, the U.S. banking agencies adopted the Joint Agency Statement on PBOs addressing inconsistencies in the definition of control specifically for PBOs and to facilitate their detection. It states, in part, that the U.S.

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1 References to "U.S. depository institution" are intended to be synonymous with U.S. bank; and it represents all banks and savings associations insured by the FDIC.

2 References to "foreign bank" include a holding company of the foreign bank and any foreign or U.S. non-bank affiliates of the foreign bank.

3 The term "persons" includes both business entities and natural persons, which may or may not be U.S. citizens.

4 A "recognized financial group" means a structure in which a bank is a subsidiary of another bank, or an entity that is controlled by a company subject to the Bank Holding Company Act (BHC Act) or the Savings and Loan Holding Company Act (S&L HC Act). Such companies would be subject to the application, notice and supervisory requirements in the BHC Act or the S&L HC Act and not the procedures described here. A BHC or a S&L HC, however, may be a component of a PBO. This situation may arise when a bank holding company or savings and loan holding company controls the U.S. depository institution, and the holding company, in turn, is controlled by a person or group of persons who also controls a foreign bank.

5 The FBSEA was enacted in 1991 to improve the degree of supervision of foreign banks operating in the U.S. As a result of FBSEA, an Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations (the FBO Supervision Program) was established and applied to all FBOs with a presence in the U.S.

banking agencies consider whether an individual, family, or group of persons acting in concert "control[6]" a depository institution if the individual, family, or group of persons controls 10 percent or more of any class of the voting shares of the bank.

A supervisory definition of presumed control is derived from applying the criteria in the April 2002 Joint Agency Statement on PBOs to the ownership structure of a foreign bank. Thus, if the individual, family, or group of persons acting in concert controls 10 percent or more of any class of the voting shares of both the U.S. bank and the foreign bank, then the individual, family, or group of persons is presumed to control both organizations. This approach provides an objective standard for ascertaining if a PBO relationship exists, which bank officials can rebut.

If the 10 percent or more stock ownership threshold is not met, the presence of certain other characteristics may nonetheless indicate that a PBO relationship exists. These criteria may include situations where the individual, family, or group of persons acting in concert:

- Constitutes a quorum or a significant presence on the Board of Directors of both the U.S. depository institution and the foreign bank;
- Controls, in any manner, the election of a majority of the directors of both the U.S. depository institution and the foreign bank;
- Constitutes a quorum or a significant portion of the executive management of both the U.S. depository institution and the foreign bank;
- Exercises a controlling influence over the policies and/or management of both the U.S. depository institution and the foreign bank;
- Engages in an unusually high level of reciprocal correspondent banking activities or other transactions or facilities between the U.S. depository institution and the foreign bank;
- Requires the U.S. depository institution to adopt particular/unique policies or strategies similar to those of the foreign bank, such as common or joint marketing campaigns, cross-selling of products, sharing customer information, or linked web sites;
- Obtains financing to purchase the stock of either the U.S. depository institution or the foreign bank from, or arranged through, the foreign bank, especially if the shares of the U.S. depository institution are collateral for the stock-purchase loan;
- Names the U.S. depository institution in a similar fashion to that of the foreign bank; or
- Presents any other factor(s) or attribute(s) that indicate that a PBO relationship exists.

While any one of the subjective characteristics, by itself, is unlikely to indicate that an individual, family, or group of persons exert sufficient influence to control the U.S. depository institution and the foreign bank, the presence of a combination of them may indicate that a PBO relationship does exist. For example, Mr. Jones owns 10 percent of a U.S. bank holding company, which, in turn, wholly-owns a U.S. depository institution. Separately, Mr. Jones owns/controls 4 percent of a foreign bank. Mr. Jones also either serves as a director or executive officer at both institutions and/or serves on a committee that establishes policy for both banks. This scenario strongly suggests that Mr. Jones exerts a controlling influence over both organizations even though he does not meet the 10 percent stock ownership threshold.

However, the individual, family, or group of persons acting in concert can rebut both the objective and subjective criteria considered in reaching this conclusion. Therefore, examiners must weigh each factor in relation to all of the other available information in determining whether a PBO relationship does or does not exist.

PBO versus Affiliate Relationships

A key issue with PBOs is that affiliation, either through common ownership or management, often is not clear. The preceding supervisory definition of presumed control is provided for identifying a PBO for supervisory monitoring purposes only. An individual, family, or group of persons acting in concert may exercise sufficient control to meet the supervisory definition of presumed control for establishing that a PBO exists; but, not meet the criteria to be considered affiliates, as specified in the Federal Reserve Act (FRA).

Thus, the entities that comprise a PBO may or may not be affiliates. In instances where a PBO relationship exists but an affiliate relationship does not exist, the transactions between the U.S. bank and the foreign bank would not be subject to the FRA. However, non-affiliated PBOs can not be disregarded because such relationships can pose the same or greater risks than those from affiliated PBOs.

The FRA[7] provides a definition of control that serves as a legal basis for determining if an affiliate relationship exists between a U.S. bank and a foreign institution. Section 23A(1)(C) defines an affiliate of a U.S. bank to include any company that is **controlled** directly or indirectly by

[6] A variety of presumptions and technical rules apply to determinations of control.

[7] See 12 U.S.C.§§ 371c, 371c-1.

shareholders who also directly or indirectly **control** the bank. Section 23A(b)(3) defines control as:

1. having the power to vote 25 percent or more of any class of voting securities of the U.S. bank;
2. controlling the election of a majority of the directors of the U.S. bank; **or**
3. receiving a determination that the shareholder or company exercises a controlling influence over management or policies of a U.S. bank from the Federal Reserve Board.

This definition differs from the supervisory definition of presumed control used to identify a PBO primarily in the percentage of stock the beneficial owner(s) controls. If an individual, family, or group of persons acting in concert collectively has the power to vote 25 percent or more of any class of stock of a U.S. bank and a foreign bank, then a PBO and an affiliate relationship exist. All transactions between the affiliated entities would be subject to the restrictions in the FRA. In addition, the affiliated entities in a PBO cannot take advantage of the sister-bank[8] exemption as it requires ownership by a holding company.

For example, Mr. Jones owns 51 percent of a U.S. depository institution and 30 percent of a foreign bank. This scenario reflects that these two entities are both PBOs and affiliates subject to the restrictions in the FRA. If Mr. Jones owned/controlled 12 percent of each institution's outstanding stock, then the two entities would not be affiliated per the FRA, but a PBO would exist.

If the beneficial owner(s)'s stock ownership or voting rights are less than 25 percent, then the next criteria must be reviewed. Item (2) considers whether the beneficial owner(s) controlled the election of a majority of the directors. Section 23A(b)(1)(C) further defines an affiliate as any company in which a majority of its directors constitute a majority of the persons holding any such office with the U.S. bank. If an individual, family, or group of persons acting in concert control the election of a majority of both institutions' boards; or, constitute a majority of both a U.S. bank's and a foreign bank's directorate, then a PBO and an affiliate relationship exist and the FRA is applicable.

For example, Mr. Jones, his son, and his brother each own 12 percent of a U.S. depository institution. Each person also owns 10 percent of a foreign bank. The minutes of the shareholders meeting of both the U.S. and the foreign bank reflect that these three individuals constitute a quorum of each institution's Board. This scenario reveals that these two entities are both PBOs and affiliates subject to the restrictions in the FRA. If these three individuals did not represent a quorum of each institution's board, then the two entities may not be affiliated per the FRA, but a PBO would still exist.

If neither the beneficial owner(s)'s stock ownership/voting rights percentage nor the board's election thresholds are met, then item (3) must be considered. If the Federal Reserve Board determined that the shareholder/company exercises a controlling influence over the management or policies of the bank, then a PBO and an affiliate relationship exist and the FRA applies. In addition, the FRA states a person is presumed to have control if the company or shareholder, directly or indirectly, or acting through one or more persons, owns or controls 15 percent or more of the equity capital of the company unless the company or shareholder provide information acceptable to the Board to rebut this presumption of control.

It is important to note, however, that any transaction by the U.S. bank with any person, where the proceeds of the transaction are used for the benefit, or are transferred to, an affiliated entity, it is considered a covered transaction for purposes of Section 23A(a)(2). Furthermore, despite the absence of regulations governing transactions between the U.S. bank and the foreign bank, transactions must nonetheless conform to reasonable business terms and practices. Any abuses or questionable practices are subject to criticism.

PBO versus Related Interests of Insiders

An individual, family, or group of persons acting in concert may exercise sufficient control to meet the preceding supervisory definition of presumed control for establishing that a PBO exists; but, not meet the criteria to be considered affiliates, as contemplated by the Federal Reserve Board's Regulation O.[9] Regulation O restricts extensions of credit to the related interests of executive officers, directors, and principal shareholders, collectively known as bank insiders. The FDIC made virtually all of these restrictions applicable to state nonmember banks in the FDI Act.[10] Thus, extensions of credit from a state nonmember bank to a domestic or foreign company commonly controlled, as defined by Regulation O, by a bank insider are generally subject to the limitations in Regulation O.

The definition of control is of great importance. Regulation O provides a similar but not identical definition of control as does the FRA as follows:

[8] See 12 U.S.C.§§ 371c, 371c-1, Section 23A(d).

[9] 12 CFR Part 215.

[10] See generally 12 CFR § 337.4, which implements Section 18(j)(2) of the FDI Act (12 U.S.C. § 1828(j)(2).

1. having the power to vote 25 percent or more of any class of voting securities of the U.S. bank;
2. controlling in any manner the election of a majority of the directors of the U.S. bank; **or**
3. exercising a controlling influence over the management or policies of the company or bank.

Please note that the first two items are very similar to those on the previous page from the FRA. Item three is different. Also, these criteria are not as expansive as the preceding supervisory definitions of control.

If an individual, family, or group of persons acting in concert collectively has the power to vote 25 percent or more of any class of stock of both the U.S. depository institution and the bank in the foreign country, then the same situation exists as under item (1) of the FRA and all transactions with related interests would be subject to the restrictions established in Regulation O.

If the beneficial owner(s)'s stock ownership/voting rights are less than 25 percent, the next criteria must be reviewed. Item (2) considers whether the beneficial owner(s) controlled the election of a majority of the directors. For example, Mr. Jones, his son, and his brother each own 20 percent of a U.S. depository institution. Each individual also owns 10 percent of a foreign bank. Minutes of the shareholders meetings of both the U.S. and the foreign bank reflect that these three individuals nominated the candidates for each institution's Board and voted their shares in a block. This scenario reveals that these two entities are PBOs and subject to the restrictions of Regulation O. If these three individuals had voted their shares independently or in a different manner from each other, then it would indicate that these two entities are not subject to Regulation O, but a PBO does exist.

If neither the beneficial owner(s)'s stock ownership/voting rights percentage nor control of the board's election thresholds are met, then item (3) must be reviewed. Regulation O also states that 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 the person:

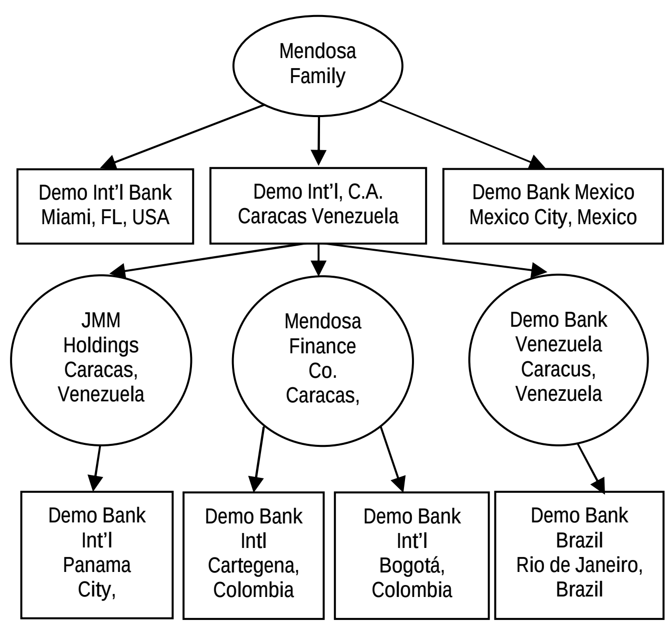
- Is an executive officer or director of the company or bank; **and** directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank; **or**
- Directly or indirectly owns, controls, or has the power to vote more than 10 percent 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.

Ascertaining whether an individual, family, or group of persons acting in concert exercises a controlling influence over the management or policies of the bank is difficult to determine. If the criteria in either item (a) or item (b) above are met, then a PBO exists and all transactions with related interests would be subject to the restrictions of Regulation O.

An individual, family, or group of persons acting in concert may exercise sufficient control to meet the supervisory definition of presumed control for establishing that a PBO exists; but, not meet the level of control required by Regulation O. In these instances, the transactions between the U.S. bank and the bank insiders' related interests would not be subject to the restrictions of Regulation O. Despite the absence of regulations governing these transactions, these dealings must nonetheless conform to reasonable business terms and practices. Any abuses or questionable practices are subject to criticism.

Business Structures

A PBO can have a simple or a complex business structure or organization chart. A simple PBO business structure consists of an individual who directly controls both a U.S. depository institution and a foreign bank. However, PBOs often exhibit a complex organizational structure that may include multiple domestic and foreign shareholders working in concert, who individually do not have direct control of the U.S. and the foreign bank, but who collectively exercise a controlling influence throughout the PBO. The following is an illustration of a complex PBO structure.



The existence of cross-border organizations compounds the difficulty of the supervisory oversight process because they generally are not as transparent as a U.S. company, and U.S. bank supervisors may be unable to evaluate their ownership structure or to conduct on-site evaluations of the foreign entities.

Complex PBOs also could be part of privately held multi-national conglomerates that service a particular business sector or geographic region. These privately held PBOs often are the most challenging to understand because public information on their ownership structure, operations, and affiliations is scarce. Conversely, PBOs can be part of large multi-national conglomerates that are publicly traded and where financial services are typically not a main activity of the enterprise. In these structures, information on ownership, operations, and affiliations is more readily obtainable.

Supervisory Risks

PBOs present supervisory risks similar to those arising from a chain banking organization (CBO) with the added dimension that part of the chain is in a foreign country. From a regulatory perspective, the risks presented by PBOs may be greater than those presented by domestic CBOs because a portion of the PBO structure is subject to the laws and jurisdiction of one or more foreign countries.
The fundamental risk posed by PBOs is that they may act in a de facto organizational structure that, because it is not formalized, is not subject to comprehensive consolidated supervision. The Core Principles[11] of the Basel Committee on Banking Supervision requires banks to be supervised on a consolidated basis to minimize the leveraging of capital, ensure that risks are managed on a group-wide basis, and mitigate the risk of contagion within a banking group.

However, the beneficial owner(s) of a PBO may be an individual, family, group of persons acting in concert, or a holding company[12] that is seeking entry into the U.S. market, but is not subject to comprehensive consolidated supervision by their home country supervisors before establishing a banking presence in the U.S.

The lack of a globally-accepted supervisory approach to evaluate risk on an organization-wide basis makes it more difficult to obtain information from foreign regulatory agencies; and, coordinated examinations of the U.S. depository institution and the foreign bank may not be a viable option. Therefore, relationships between the U.S. depository institution and the foreign bank may be harder to understand and monitor.

PBOs may foster other management and supervisory risks:

- Concentrations of risk on a group level may be inadequately monitored or managed, exposing the entire organization to excessive risk in the event of an external shock affecting a specific market or sector.
- Officers and directors of the U.S. depository institution may be unable or unwilling to exercise independent control to ensure that transactions with the foreign bank or affiliates are legitimate and comply with applicable laws and regulations. As a result, the U.S. depository institution may be the conduit or participant in a transaction that violates U.S. law or the laws of a foreign country; or, that is designed to prefer a foreign bank or non-bank entity in the group to the detriment of the U.S. depository institution.
- The home country of the foreign bank may have insufficient mechanisms or authority to monitor changes in ownership or to ensure arm's-length inter-company transactions between the foreign bank and other members of the group, including the U.S. depository institution, or monitor concentrations of loans or transactions with third parties that may present safety and soundness concerns to the group.
- Money-laundering concerns may be heightened due to the potential lack of arm's-length transactions between the U.S. depository institution and the foreign bank. Specifically, the flow of funds through wires, pouch activity, and correspondent accounts may be subject to less internal scrutiny by the U.S. depository institution than usually is warranted. This risk is greatly increased when the foreign bank is located in an offshore jurisdiction or other jurisdiction that limits exchange of information through bank secrecy laws, especially if the jurisdiction has been designated as a "non-cooperating country or territory" or the jurisdiction or the foreign bank has been found to be a money-laundering concern under the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001.
- Securities, custodial, and trust transactions may be preferential to the extent that assets, earnings, and losses are artificially allocated among the parallel banks. Similarly, low-quality assets and problem loans can be shifted among parallel banks to manipulate earnings or losses and avoid regulatory scrutiny. In addition, the common owners or the foreign bank might pressure the U.S. depository institution to provide liquidity or credit support in excess of legal limits to the foreign bank if it were experiencing financial difficulties.

[11] Basel Committee on Banking Supervision Core Principles, Cross-Sectoral Comparison. November 2001.
[12] A "holding company" excludes any entity that is part of a "recognized financial group."

- Political, legal, or economic events in a foreign country may affect the U.S. depository institution. For example, the intervention and assumption of control of the foreign bank by its supervisor may trigger a rapid inflow or outflow of deposits at the U.S. depository institution, thereby affecting liquidity. Foreign events could increase the U.S. depository institution's reputation risk. These events also may adversely affect the foreign bank owner's financial resources and decrease the ability of the foreign bank owner to provide financial support to the U.S. bank. In addition, foreign law(s) may change without the U.S. depository institution or banking agencies becoming aware of the effect of these legal changes on the U.S. bank.
- PBOs may seek to avoid legal lending limits or limitations imposed by securities or commodities exchanges or clearinghouses on transactions by one counterparty, thereby unduly increasing concentration and credit risk to the banking entities within the organization and others.
- Capital may be generated artificially through the use of international stock-purchase loans. Such loans can be funded by the U.S. depository institution directly to the foreign bank; or, to a non-bank affiliate with the purpose of shifting the funds back to the foreign bank, leveraging the U.S. depository institution or vice versa. As a result, capital for one of the parallel banks is increased even though there is no external capital injection into either bank. This concern is elevated if the foreign bank is not subject to comprehensive supervision.

To minimize these risks, the U.S. bank regulatory agencies collectively developed best practices for identifying these entities and supervising the risks that PBOs present, which were incorporated into industry guidance and examination programs In addition, the U.S. regulatory agencies will coordinate their supervision of a PBO's U.S. operations by:

- Working with appropriate U.S. and non-U.S. supervisors to better understand and monitor the activities of the foreign banks and the owners;
- Sharing information regarding material developments with foreign and domestic supervisory agencies that have supervisory responsibility over relevant parts of the PBO, as appropriate, feasible, and in accordance with applicable law; and
- Imposing special conditions or obtaining special commitments or representations related to an application or other supervisory action, when warranted.

Examination Guidance

Gaining a comprehensive understanding of a PBO's structure and any supervisory risk that it presents will be an examiner's main priority and greatest challenge inasmuch as these organizations are complex, and their ownership can be vested in cross-border, multi-tiered companies that can be difficult to analyze. To complicate matters, financial reporting in foreign countries often can be opaque and may not adhere to generally accepted accounting principles.

In developing the examination strategy for a U.S. bank that is part of a PBO, the examiner should consider any risks arising from the lack of consolidated supervision, especially if the U.S. bank actively engages in business activities with its foreign bank. The U.S. bank's board of directors and senior management are expected to be cognizant of the risks associated with being part of a parallel-owned banking structure, especially with respect to diversion of a depository institution's resources, conflicts of interest, and affiliate transactions. The depository institution's internal policies and procedures should provide guidance on how personnel should treat transactions between PBOs. The U.S. banking agencies will expect to have access to such policies, as well as to the results of any audits of compliance with the policies. The examiner may want to contact the International Section to obtain current information on the condition of the foreign bank and any supervisory concerns or developments in the home country that may adversely affect the U.S. bank.

It is important to recall that the companies that comprise the PBO may or may not be affiliates of the U.S. bank. Where an affiliate relationship exists, the Federal Reserve Act is applicable. If an affiliate relationship is absent, transactions should adhere to customary business and banking principles. Likewise, Regulation O may or may not be applicable to transactions between U.S. bank's insiders and the foreign bank. Examiners should scrutinize transactions between the entities in a PBO for adherence with applicable laws and prudent banking practices.

Examiners should evaluate the U.S. bank's relationship with the other companies within the PBO and determine whether the relationship has had, or is likely to have, a negative impact on the U.S. bank. Appropriate supervisory action should be taken to address any conditions or abusive practices that can adversely affect the U.S. bank. Regulatory authorities can also develop a strategy to work with home country supervisors to stay informed of developments associated with the organization and to share information.

If the examiners' review represents the initial identification of a PBO, the examiner should contact the International Section to discuss the facts and circumstances surrounding the bank. The examiner should contact the DSC Associate Director of the International and Large Bank Branch if the analysis determines that a modification to an existing parallel bank structure has occurred, i.e. the beneficial owner(s) sold its interest in the U.S. or foreign bank.

In all instances where a PBO relationship is possible, the examiner should complete the Parallel-owned Banking Organizations page. Examiners should consider all of the issues detailed in the Parallel-owned Banking Organizations page to ascertain whether a PBO exists. If the examiner determines that a PBO does not exist, the Parallel-Owned Banking Organizations page should be maintained in the examination workpapers to document the basis of the examiners' conclusion. If the examiner determines that a PBO does exist, the Parallel-Owned Banking Organizations page should be maintained in the examination workpapers unless an adverse trend is noted. The page should be included in the Report of Examination if any adverse trends are noted within the PBO relationship.

Upon the examination's completion, the region should forward the Parallel-Owned Banking Organizations page, whether it is included in the Report of Examination or not, with a cover letter to the DSC Associate Director of the International and Large Bank Branch. Refer to the Report of Examination Instructions and the International Section in ED Module for additional guidance.

LAWS AND REGULATIONS

Several laws and regulations govern certain international activities of banks and some are discussed briefly in this section. Examiners should be familiar with these laws and will find it useful to refer directly to them. They have been made available to the field staff either in the Prentice-Hall volumes or in memorandum form, both of which are accessible on the Examiner Reference CD.

Part 347 of the FDIC's Rules and Regulations covers international banking. Briefly, Subpart A of Part 347 (and corresponding sections of Part 303) implements Sections 18(d) and 18(l) Federal Deposit Insurance Act and outlines the application process by which State nonmember banks may be given permission to operate foreign branches or invest in foreign banks or other financial entities. The powers or permissible activities of overseas branches are defined by the regulations and, generally, these branches are allowed a wider range of financial activity than is permitted domestically. The regulations also establish minimum standards for accounting and internal controls in foreign branches or subsidiaries. In certain circumstances, state nonmember bank applicants may be granted expedited processing of their applications. The FDIC's external website identifies foreign countries where state nonmember banks have subsidiaries and branches. This site will specifically inform the applicant whether expedited processing is available or not.

Subpart B of Part 347 implements Section 6 of the International Banking Act of 1978 and governs FDIC insured branch operations of FBOs. This section establishes asset pledge and asset maintenance requirements for insured branches of foreign banks. Subpart B also provides for examinations of these branches and establishes minimum recordkeeping requirements.

Subpart C of Part 347 implements the provisions of the International Lending Supervision Act of 1983 (ILSA). The section deals with the establishment of an Allocated Transfer Risk Reserve (ATRR) and accounting for and reporting of international loans and assets.

The provisions of Part 347 are similar to those contained in Regulation K of the Board of Governors of the Federal Reserve System which is applicable to member banks. State nonmember banks which operate foreign branches or subsidiaries are regulated by Part 347. Regulation K applies primarily to member banks but it does govern Edge or Agreement Corporations operated by nonmember banks.

FinCEN Advisories and OFAC

The Financial Crimes Enforcement Network (FinCEN) occasionally issues advisories on countries that the Financial Action Task Force on Money Laundering (FATF) has determined to be noncooperative in the fight against money laundering. Upon receiving an advisory, banks are expected to closely scrutinize any transactions of their customers with these countries. A listing of FATF's Noncooperative Countries and Territories (NCCTs) can be found FATF's website. FinCEN advisories can be found on FinCEN's website.

The Department of Treasury's Office of Foreign Asset Control (OFAC) enforces embargoes and sanctions by the U.S. against foreign countries. Typically, the President initiates these actions through an executive order based upon authority granted to the Executive Branch by acts of Congress. In addition, a number of individuals and entities have been specifically designated as narcotics traffickers, terrorists, or engaged in the proliferation of weapons of mass destruction. Banks that identify a transaction dealing with one of these countries or specially designated nationals (SDNs) are to block the transaction or freeze the account and notify OFAC of their actions. Violations of OFAC regulations carry substantial civil and criminal penalties. Examiners typically review OFAC compliance as part of Bank Secrecy Act examinations. Current listings of OFAC regulations and SDNs can be obtained at OFAC's website. Additional information on OFAC is available in the various Financial Institution Letters to Chief Executive Officers, in the Bank Secrecy Act section of this Manual, or in the Examination Documentation (ED) module for Anti-Money Laundering/Bank Secrecy Act.

USA PATRIOT Act

On October 26, 2001, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act (USA PATRIOT Act) was signed. A number of implementing regulations deal with foreign shell banks and foreign correspondent banking relationships became effective on December 26, 2001.

The Department of the Treasury's Financial Recordkeeping rules prohibit *covered financial institutions* from maintaining correspondent accounts in the U.S. with a foreign shell bank that is not a regulated affiliate. A *covered financial institution* includes an agency or branch of a foreign bank operating in the U.S. and Edge and Agreement Corporations. A foreign bank is one that is organized under foreign law, or an agency, branch or office of a bank located outside the U.S. A *foreign shell bank* is defined as a foreign bank that does not have a *physical presence* in a country. A *physical presence* is defined as a place of business that is maintained by a foreign bank located at a physical address (not solely an electronic address or a post office box). The address must be in a country in which the foreign bank is authorized to conduct banking business, employs one or more individuals on a full-time basis, maintains operating records related to its banking activities, and is subject to inspection by the banking authority that licensed it to conduct banking business.

The Financial Recordkeeping rules also require covered financial institutions to take reasonable steps to obtain ownership information and a certification from foreign banks with which correspondent accounts are maintained that the account is not being used indirectly by a foreign shell bank. If the ownership information and certification by the foreign bank are not provided, covered financial institutions are required to close these correspondent accounts. Once every three years, the covered financial institution must obtain a recertification from the foreign bank providing ownership information and attesting the account is not being used indirectly by a foreign shell bank. Foreign banks are required to appoint an agent in the U.S. to accept service of legal process for foreign bank records concerning the correspondent account. Additional information on the USA Patriot Act is available in the Department of the Treasury's Financial Recordkeeping rules and regulations in the Prentice-Hall volumes or in various memorandum form (both on the Examiner Reference CD), in the Bank Secrecy Act section of this Manual, or in the ED module for Anti-Money Laundering/Bank Secrecy Act.

Foreign Corrupt Practices Act

Public disclosure of improper payments made by U.S. companies to foreign officials led Congress to enact the Foreign Corrupt Practices Act of 1977 (the Act). The Act is designed to prevent the use of corporate assets for corrupt purposes and applies to all U.S. companies, including banks, bank holding companies, and Edge Corporations.

The Act contains a number of provisions. First, companies subject to the jurisdiction of the Securities and Exchange Act of 1934 are required to maintain strict accounting standards and management control over their assets. The falsification of accounting records to conceal corrupt payments is prohibited. Second, the Act makes it a crime for a U.S. company, or individuals acting on behalf of a company, to bribe foreign officials or foreign political candidates or parties for the purpose of acquiring or retaining business. However, facilitating or so-called "grease" payments are not prohibited. Grease payments generally are those payments for expediting shipments through customs, securing required permits, or obtaining adequate police protection even though such payments may involve the payment of money for the proper performance of duties. The legislative history of the Act recognizes that, in some countries, payments to expedite or implement bureaucratic processing are customary practices.

The Act applies to all State nonmember insured banks, among other U.S. corporations, but does not apply directly to foreign subsidiaries. However, Congress has made it clear that any U.S. corporation which engages in bribery of foreign officials indirectly through any other person or entity, including a foreign subsidiary, would itself be liable under the Act. Since 1998, the Act also applies to foreign firms and persons who take any act in furtherance of corrupt payments while in the U.S.

All violations of the Act are criminal in nature and should be reported following the procedures for reporting apparent criminal violations. Violations of the Act may also result in civil fines and, in the case of private actions under the Racketeer Influenced and Corrupt Organizations (RICO) Act, treble damages.

GLOSSARY OF INTERNATIONAL BANKING TERMINOLOGY

The following glossary of international banking terminology will assist examiners during examinations of banks' international operations and in completing required reports.

Acceptance – A time draft (bill of exchange or usance draft) drawn by one party and acknowledged by a second party. The drawee, known as the "acceptor," stamps or writes the word "accepted" on the face of the draft and, above his or her signature, the place and date of payment. Once the draft is accepted, it carries an unconditional obligation on the part of the acceptor to pay the drawer the amount of the draft on the date specified. A "bank acceptance" is a draft drawn on and accepted by a bank. A "trade acceptance" is a draft drawn by the seller of goods on the buyer, and accepted by the buyer.

Account-account dealing – Foreign-exchange dealing that involves settlement from bank to bank in the due from accounts. No third party (bank) is involved.

Account Party – The party, usually the buyer, who instructs the bank to open a letter of credit and on whose behalf the bank agrees to make payment.

Ad Valorem – A term meaning ‘‘according to value,’’ used for assessing customs duties that are fixed as a percentage of the value stated on an invoice.

American Depository Receipt (ADR) – ADRs are depository receipts for shares of stock in a foreign company held in safekeeping by a U.S. bank. The ADRs are purchased and sold through listed exchanges.

Advance – A drawing or payout of funds representing the disbursement of a loan, including disbursement in stages. In international banking, an extension of credit usually recurring, when no instrument (other than a copy of the advice of an advance) is used as evidence of a specific indebtedness, except in special cases. A signed agreement must be on file in the department, stating the conditions applicable to payments made to the borrower. This loan category does not include commercial account overdrafts, but may be created to finance payments affected under a commercial letter of credit, to finance payments of collections or to refinance a maturing loan.

Advance Against Documents – An advance made on the security of the documents covering a shipment.

Advised Letter of Credit – See Letter of Credit Advised.

Advised Line – A credit authorization that will be made known to the customer. See also guidance line.

After Sight – When a draft bears this name, the time to maturity begins at its presentation or acceptance.

Agent Bank – The bank that leads and documents a syndicated loan.

Agreement Corporation – A company chartered or incorporated under State law that, like an Edge Act corporation, is principally engaged in international banking. See also Edge Act.

Allocated Transfer-risk Reserve (ATRR) – A special reserve established and maintained for specified international assets pursuant to the International Lending Supervision Act of 1983 to cover country risk. At least annually, the OCC, FRB, and FDIC determine which international assets are subject to transfer risk, the amount of ATRR for the special assts, and whether an ATRR previously established for specified assets may be reduced.

Anticipation – A deposit of funds to meet the payment of an acceptance prior to the maturity date. Should be applied to reduce customer's liability on acceptances.

Amortizing Swap – A transaction in which the notional value of the agreement declines over time.

Arbitrage – Simultaneous buying and selling of foreign currencies, or securities and commodities, to realize profits from discrepancies between exchange rates prevailing at the same time in different markets, between forward margins for different maturities, or between interest rates prevailing at the same time in different markets or currencies.

Article IV – To facilitate the exchange of goods, services, and capital between countries, members of the IMF signed the Articles of Agreement. Article IV identifies members' obligations regarding exchange arrangements. To promote stable exchange rates, members agree to foster orderly economic growth with reasonable price stability, to promote economic and financial conditions that do not tend to create erratic disruptions, to avoid exchange rate or international monetary system manipulation, and to follow exchange rates compatible with these goals. Under Article IV, an IMF member country notifies the IMF of its exchange arrangement. The member country has three exchange rate options. First, the country can select an exchange rate in terms of special drawing rights (SDRs), gold, or some other denominator. Second, the member can by cooperative arrangement peg the value of their currency to the currency of another member. Typically, the country will pick its major trading partner's currency. Third, the country can select another exchange arrangement of the member's choice. The member country must notify the IMF of its selected exchange arrangement. Article IV also allows the IMF to conduct surveillance of the member country's exchange rate policies and to offer suggestions for improvement under principles of guidance. Members agree to provide the information necessary to the IMF to conduct this surveillance.

Article IV Consultations – Under the Articles of Agreement, the IMF holds discussions with member countries at least once per year. The IMF typically sends a team of experts to collect various financial and economic information. The IMF staff then discusses its findings with the member country and prepares a consultation report for the IMF's Executive Board. The Article IV Consultation report is returned to the member country and certain aspects of these reports are made publicly available on the IMF's website.

At Sight – A term indicating that a negotiable instrument is payable upon presentation or demand.

At the Money – A term used to refer to a call or put option whose strike price is equal (or virtually equal) to the current price of the asset on which the option is written.

Authority to Pay – An advice from a buyer, sent by his or her bank to the seller's bank, authorizing the seller's bank to pay the seller's (exporter's) drafts up to a fixed amount. The seller has no protection against cancellation or modification of the instrument until the issuing bank pays the drafts drawn on it, in which case the seller is no longer liable to its bank. These instruments are usually not confirmed by the seller's U.S. bank.

Authority to Purchase – Similar to an authority to pay, except that drafts under an authority to purchase are drawn directly on the buyer. The correspondent bank purchases them with or without recourse against the drawer and, as in the case of the authority to pay; they are usually not confirmed by a U.S. bank. This type of transaction is unique to Far Eastern trade.

Baker Plan – Proposed in 1985, this initiative encouraged banks, the International Monetary Fund, and the World Bank to jointly increase lending to less developed countries that were having difficulty servicing their debt, provided the countries undertook prudent measures to increase productive growth.

Balance of Payments – The relationship between money flowing into and out of a country for a given period of time. Directly affected by the country's foreign trade position, capital inflows and outflows, remittances into and out of the country, grants and aid, and tourism. A deficit balance occurs when outflows exceed inflows with the converse situation reflecting a balance of payments surplus.

Balance of Trade – The difference between a country's total imports and total exports for a given period of time. A favorable balance of trade exists when exports exceed imports. An unfavorable trade balance is reflected when imports exceed exports.

Band – The maximum range that a currency may fluctuate from its parity with another currency or group of currencies by official agreement.

Bank for International Settlements (BIS) – Established in 1930 in Basel, Switzerland, the BIS is the oldest functioning international financial organization. It provides a forum for frequent consultation among central bankers on a wide range of issues. The BIS Board consists of representatives from the G-10 countries (defined below).

Bankers' Acceptance – A time draft that has been drawn on and accepted by a bank. The bank accepting the time bill becomes primarily liable for payment. See also acceptance.

Bankers' Acceptance Liability – The moment the draft is accepted by the bank, a direct liability is recorded in its "Acceptances Executed" account. The contra account on the asset side of the balance sheet is "Customer's Liability on Acceptances." On the date of maturity of the bankers' acceptance, the bank charges the customer's account and retires the acceptance by paying the beneficiary or drawee of the draft. The bank's liability records are liquidated at this point, and the transaction is completed.

Barter – The exchange of commodities using merchandise as consideration instead of money. This scheme has been employed in recent years by countries that have blocked currencies.

Base Rate – A rate used as the basis or foundation for determining the current interest rate to be charged to a borrower, such as the prime rate or London Interbank Offered Rate.

Basel Capital Accord – An agreement among the central banks of leading industrialized countries, including those of Western Europe, Canada, the U.S., and Japan, to impose common capital requirements on their internationally active banks to take into account bank risk exposure.

Basel Committee on Bank Supervision – The Committee was established by the central bank Governors of the G-10 countries in 1975. It consists of senior representatives from banking supervisory authorities and the central banks of Belgium, Canada, France, Germany, Italy, Japan, Luxemburg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the U.S. The Committee usually meets at the Bank for International Settlements (BIS) in Basel, where its permanent Secretariat is located.

Beneficiary – The person or company in whose favor a letter of credit is opened or a draft is drawn. In a documentary letter of credit or acceptance, beneficiary may also be referred to as exporter or seller of goods.

Bid-asked Spread – The difference between a bid and the asked price, for example, the difference between 0.4210 and 0.4215 would be a spread of 0.0005 or 5 points.

Bid Price – A buyer's quote for the purchase of a trading unit from a prospective seller.

Bid Rate – The price at which the quoting party is prepared to purchase a currency or accept a deposit. If the bid rate is accepted by the party to whom it was quoted, then that party will sell currency or place or lend money at that price. The opposite transaction takes place at the offer rate.

Bilateral Trade – Commerce between two countries, usually in accordance with specific agreements on amounts of commodities to be traded during a specific period of time. Balances due are remitted directly between the two nations.

Bill of Exchange – An instrument by which the drawer orders another party (the drawee) to pay a certain sum to a third party (the payee) at a definite future time. The terms "bill of exchange" and "draft" are generally used interchangeably.

Bill of Lading – A receipt issued by a carrier to a shipper for merchandise delivered to the carrier for transportation from one point to another. A bill of lading serves as a receipt for the goods, a document of title, and a contract between the carrier and the shipper, covering the delivery of the merchandise to a certain point or to a designated person. It is issued in two primary forms: an "order bill of lading", which provides for the delivery of goods to a named person or to his or her order (designee) but only on proper endorsement and surrender of a bill of lading to the carrier or its agents; and a "straight bill of lading", which provides for delivery of the goods to the person designated by the bill of lading and no other.

- **Clean bill of lading –** A bill of lading in which the described merchandise has been received in "apparent good order and condition'' and without qualification.
- **Ocean bill of lading –** A document signed by the captain, agents, or owners of a vessel furnishing written evidence for the conveyance and delivery of merchandise sent by sea. It is both a receipt for merchandise and a contract to deliver it as freight.
- **Order bill of lading** – A bill of lading, usually drawn to the order of the shipper that can be negotiated like any other negotiable instrument.
- **Order ''notify'' bill of lading –** A bill of lading usually drawn to the order of the shipper or a bank with the additional clause that the consignee is to be notified upon arrival of the merchandise. However, the mention of the consignee's name does not confer title to the merchandise.
- **Stale bill of lading –** A bill of lading that has not been presented under a letter of credit to the issuing bank within a reasonable time after its date, thus precluding its arrival at the port of discharge by the time the ship carrying the related shipment has arrived.
- **Straight bill of lading** – A bill of lading drawn directly to the consignee and therefore not negotiable.
- **Through bill of lading** – A bill of lading used when several carriers are used to transport merchandise, for example, from a train to a vessel or vice versa.
- **Unclean bill of lading** – A bill of lading across the face of which exceptions to the receipt of goods ''in apparent good order'' are noted. Examples of exceptions include burst bales, rusted goods, and smashed cases.

Black Market – A private market that operates in contravention of government restrictions.

Blocked Account – An account from which payments, transfers, withdrawals, or other dealings may not be made without Office of Foreign Asset Control (OFAC) or U.S. Treasury Department approval. Although the bank is prohibited from releasing funds from these accounts, deposits may be accepted. Banks are subject to significant fines for releasing funds from blocked accounts.

Blocked Currency – A currency that is prohibited by law from being converted into another foreign currency.

Blocked Exchange – Exchange which cannot be freely converted into other currencies.

Brady Plan – Proposed in 1989 and named after then U.S. Treasury Secretary Nicholas Brady, the Brady Plan sought to reduce the debt-service requirements of various developing countries and to provide new loans (Brady bonds) to service existing obligations.

Break-even Exchange Rate – The particular spot exchange rate that must prevail at the maturity of a deposit or debt in a foreign currency, which has not been covered in the forward market, so that there will be no advantage to any party from interest rate differentials.

Bulldog Bonds – British pound sterling denominated foreign bonds issued in London.

Boycott – An organized ban on the purchase of goods or services of a particular country or company for political or economic reasons. Bankers need to remain cognizant of the Export Administration regulations addressing restrictive trade and boycotts.

Buyer's Option Contract – When the buyer has the right to settle a forward contract at his or her option any time within a specified period.

Buying Rates – Rates at which foreign exchange dealers will buy a foreign currency from other dealers in the market and at which potential sellers are able to sell foreign exchange to those dealers.

Cable – A message sent and delivered by an international record carrier via satellite or cable connections to a foreign country. "Cable" also includes messages transmitted by bank telex. The terms "cable" and "telex" are generally used interchangeably.

Capital Controls – Governmental restrictions on the acquisition of foreign assets or foreign liabilities by domestic citizens or restrictions on the acquisitions of domestic assets or domestic liabilities by foreign citizens.

Capital Flight – A transfer of investors' funds from one country to another because of political or economic concerns about the safety of their capital.

Cedel – One of two main clearing systems in the Eurobond market, Cedel, based in Luxemburg, began operations in 1971 and established Cedel Bank, a clearing bank chartered in Luxemburg.

Central Bank Intervention – Direct action by a central bank to increase or decrease the supply of its currency to stabilize prices in the spot or forward market or move them in a desired direction to achieve broader economic objectives (i.e. weaken currency to a given point in order to boost export activity). On occasion the announcement of an intention to intervene might achieve the desired results.

Certificate of Inspection – A document often required for shipment of perishable goods in which certification is made as to the good condition of the merchandise immediately before shipment.

Certificate of Manufacture – A statement, sometimes notarized, by a producer who is usually also the seller of merchandise that manufacture has been completed and that goods are at the disposal of the buyer.

Certificate of Origin – A document issued by the exporter certifying the place of origin of the merchandise to be exported. The information contained in this document is needed primarily to comply with tariff laws that may extend more favorable treatment to products of certain countries.

Chain – A method of calculating cross rates. For example, if a foreign-exchange trader knows the exchange rate for German marks against U.S. dollars and for French francs against U.S. dollars, the "chain" makes possible the calculation of the cross rates for German marks against French francs.

Charter Party – A contract, expressed in writing on a special form, between the owner of a vessel and the one (the charterer) desiring to employ the vessel setting forth the terms of the arrangement such as freight rate and ports involved in the trip contemplated.

Clean Collection – A collection in which a draft or other demand for payment is presented without additional attached documentation.

Clean Draft – A sight or time draft to which no other documents such as shipping documents, bills of lading, or insurances certificates are attached. This is to be distinguished from a documentary draft.

Clean Risk at Liquidation – A type of credit risk that occurs when exchange contacts mature. They may be a brief interval (usually no more than a few hours) during which one of the parties to the contract has fulfilled its obligations, but the other party has not. During this period, the first party is subject to a 100 percent credit risk, on the chance that, in the interval, an event may prevent the second party from fulfilling its obligations under the contract.

Clearing Corporation – A clearinghouse that exists as an independent corporation rather than as a subdivision of an exchange.

Clearinghouse – A subdivision of an exchange or an independent corporation through which all trades must be confirmed, matched, and settled daily until offset.

Clearinghouse Funds – Funds used in settlement of a transaction that are available for use or that become good funds after one business day.

Clearing House Interbank Payments System (CHIPS) – A computerized telecommunications network provided by the New York Clearing House Association, which serves as an automated clearinghouse for interbank funds transfers.

Closing a Commitment – Allowing a covered foreign-exchange position to expire on maturity or reversing it before maturity by a swap operation.

Closing a Position – Covering open long or short positions by means of a spot operation and/or outright forward operation.

Combined Transport Document – A through bill of lading that applies to more than one mode of transport.

Commodity Credit Corporation – An agency of the U.S. Department of Agriculture that promotes the export of U.S. surplus agricultural commodities. It provides the necessary financial services to carry forward the public price-support activities, including government lending, purchasing, selling, storing, transporting, and subsidizing certain agricultural commodities.

Confirmation – Written communication to the counterparty in a foreign exchange transaction which recites all the relevant details agreed upon by phone or telex.

Consular Documents – Bills of lading, certificates of origin, or special forms of invoice which carry the official signature of the consul of the country of destination.

Consular Invoice – Detailed statement regarding the character of goods shipped which is duly certified by the consul at the port of shipment. Required by certain countries, including the U.S. Its principal function is to record accurately the types of goods and their quantity, grade and value for import duty, balance of payments, and other statistical purposes.

Convertibility – Freedom to exchange a currency, under certain circumstances, without government restrictions or controls.

Core Principles for Effective Bank Supervision (also known as the Core Principles Methodology) – A summary of 25 principles for prudential regulation and supervision prepared by the Basel Committee on Banking Supervision. This document benchmarks the best practices for effective bank supervision. Countries are expected to use the Core Principles Methodology to assess their current bank supervisory environments to identify weaknesses that need to be addressed. The IMF utilizes the Core Principles Methodology when assessing bank regulation and supervision during its Article IV surveillance.

Cost, Insurance, and Freight. (**C.I.F.)** – A price quotation under which the seller defrays all expenses involved in the delivery of goods.

Counterpart Funds – Local currencies deposited in a special account by recipient governments that represent grant aid extended by another government. Those funds, while remaining the property of the recipient government, can generally be used only by agreement of the donor government.

Countertrade – A system of trade, like bartering, when goods or services are accepted in lieu of payment in currency for the purchase of goods or services. Such trade schemes are attractive in developing countries to promote reciprocal trade in a nation’s local products as a precondition for consummating an international transaction. Countertrade was popular in East-West dealings during the Cold War and in defense and aerospace contracts. Countertrade may also be a useful where foreign exchange is limited or unavailable. The quality and marketability of the goods traded can be a real concern. Other risks involved in countertrade include government intervention, cancellation of contract, and seller insolvency**.**

Country Exposure – A measurement of the volume of assets and off-balance sheet items considered to be subject to the risk of a given country. This measurement is based, in part, on identifying the country of domicile of the entity ultimately responsible for the credit risk of a particular transaction.

Country Limit – The amount of money that a bank has established as the maximum it is willing to lend borrowers in a given country regardless of the type of borrower or the currencies involved.

Country Risk – Refers to the spectrum of risks arising from the economic, social, and political environment of a given foreign country, which could have favorable or adverse consequences for foreigners' debt and/or equity investments in that country.

Cover – The execution of an offsetting foreign exchange trade to close or eliminate an open exposure.

Covered Interest Arbitrage – The process of taking advantage of a disparity between the net accessible interest differential between two currencies and the forward exchange premium or discount on the two currencies against each other.

Crawling Peg System – An exchange rate system in which the exchange rate is adjusted every few weeks, usually to reflect prevailing inflation rates.

Credit Risk – The possibility that the buyer or seller of a foreign exchange or some other traded instrument may be unable to meet his or her obligation at maturity.

Cross-border Exposure – The risk that arises when an office of a bank, regardless of its location or currency, extends credit to a borrower that is located outside the booking unit's national border.

Cross-currency Risk – The risk associated with maintaining exchange positions in two foreign currencies as the result of one transaction. For example, if a U.S. operator borrows Swiss francs at 5 percent and invests the proceeds in British pounds at 12 percent, the cross-currency risk is the chance that the pounds will depreciate in values against the Swiss francs to such an extent that there will be a loss on the transactions in spite of the favorable interest-rate differential.

Cross Rate – The ratio between the exchange rate of two foreign currencies in terms of a third currency.

Current Account – Those items in the balance of payments involving imports and exports of goods and services as well as unilateral transfers. Includes trade, travel, military spending and other short-term financial flows. Short-term and long- term capital flows are excluded as they are included in the capital account balance.

Customs Union – An agreement between two or more countries in which they arrange to abolish tariffs and other import restrictions on each other's goods and to establish a common tariff for the imports of all other countries.

Date Draft – A draft drawn to mature on a fixed date, irrespective of acceptance.

Demand Draft – Draft payable immediately upon presentation to the drawee. Also called a "sight" or "presentation" draft.

Depth of the Market – The amount of currency that can be traded in the market at a given time without causing a price fluctuation. Thin markets are usually characterized by wide spreads and substantial price fluctuations during a short period of time. Strong markets tend to be characterized by relatively narrow spreads of stable prices.

Devaluation – An official act wherein the official parity of a country's currency is adjusted downward to the dollar, gold, Special Drawing Rights (SDRs), or a currency. After devaluation, there are more devalued currency units relative to the dollar, gold, SDRs, or other currency.

Direct Quote – The method of quoting fixed units of foreign exchange in variable numbers of the local currency unit. Also called a "fixed" or "certain" quotation.

Dirty Float – A floating exchange-rate system in which some government intervention still takes place. A government may announce that it will let its currency float, that is, it will let the currency's value be determined by the forces of supply and demand in the market. The government, however, may secretly allow its central bank to intervene in the exchange market to avoid too much appreciation or depreciation of the currency.

Discount – In foreign exchange, the amount by which the forward exchange rate of one currency against another currency is less than the spot exchange rate between the two currencies. If a dealer quotes $2.40 and $2.45 (bid and asked) for sterling and the discounts for six months forward are .0030 and .0275, the forward quotes would be adjusted to $2.3700 and $2.4225. This discount usually represents differences in interest rates in the U.S. and Britain. However, in periods of crisis for a currency, the discount can represent the market anticipation of a lower price.

Divergence Indicator System – One aspect of the European Monetary System that measures the departure of a country's economic policies from the European Union's "average." The measure of divergence is based exclusively on the movement of a country's exchange rate with respect to the European Currency Unit (ECU).

Documentary Credit – A commercial letter of credit providing for payment by a bank to the named beneficiary, who is usually the seller of the merchandise, against delivery of documents specified in the credit.

Documentary Draft – A draft with documents attached delivered to the drawee when it accepts or pays the draft, and which ordinarily controls title to the merchandise.

Documents – Shipping and other papers attached to foreign drafts, consisting of ocean bills of lading, marine insurance certificates, and commercial invoices. Certificates of origin and consular invoices may also be required.

Documents Against Acceptance (D/A) – Instructions given by an exporter to a bank that the documents attached to a draft for collection are deliverable to the drawee only against his or her acceptance of the draft.

Documents Against Payment (D/P) – Instructions given by an exporter to his or her bank that the documents attached to a draft for collection are deliverable to the drawee only against his or her payment of the draft.

Dollar Exchange Acceptance – Time draft drawn by central banks in specific foreign countries and accepted by banks in the U.S. for the purpose of furnishing foreign exchange. These instruments do not arise from specific commercial transactions, rather they are designed to alleviate shortages of dollar exchange for certain countries specified in a list published by the Federal Reserve System. It is anticipated that the acceptance will be liquidated subsequently from dollar funds acquired by the central bank. Limits are placed on initial maturity of drafts (three months). Member banks may not accept drafts in an amount exceeding 50 percent of paid-in and unimpaired capital and surplus.

Domicile – Place where a draft or acceptance is made payable.

Draft – A draft is an order in writing signed by one party (the drawer) requesting a second party (the drawee) to make payment in lawful money at a determinable future time to a third party (the payee). Drafts occasionally may be written to be non-negotiable, in that they will not meet all the requirements of the Uniform Negotiable Instruments Act. Drafts generally arise from a commercial transaction, whereby the seller makes an agreement with a buyer in advance for the transfer of goods. It may be accompanied by a bill of lading, which the bank will surrender to the buyer upon payment of the draft. The buyer may then claim the goods at the office of the carrier who transported them to the buyer's place of business. Drafts may be classified as to time element, such as sight or presentation drafts. A time draft is presented at sight, accepted, and then paid on the agreed upon date which may be 30, 60, 90 days or longer after presentation and acceptance.

Dragon Bond – A bond issue by a foreign borrower in an Asian or Pacific country excluding Japan.

Drawee – The addressee of a draft, that is, the person on whom the draft is drawn.

Drawer – The issuer or signer of a draft.

Edge Act – An act passed December 24, 1919, as Section 25A of the Federal Reserve Act, with the title "Banking Corporations Authorized to do Foreign Banking Business." Edge Act Corporations are chartered by the Board of Governors of the Federal Reserve System for 20 years with a minimum capital of $2,000,000. Edge Act Corporations finance international commerce, may operate interstate branches, accept deposits outside the U.S., and invest in non-U.S. firms. A nonbanking Edge Act Corporation makes equity investments under Federal Reserve Regulation K in foreign corporations, such as merchant banks or finance companies. A banking Edge buys and sells notes, drafts, and bills of exchange, and basically complements the international banking activities of its parent bank.

Eligible Acceptance – A bankers' acceptance that meets Federal Reserve requirements related to its financing purpose and term.

Embargo – A partial or total prohibition on trade initiated by the government of one country against another for political or economic reasons.

Eurobank – A bank that regularly accepts foreign currency denominated deposits and makes foreign currency loans.

Eurobond – A medium or long-term debenture underwritten by an international syndicate that is denominated in a currency other than that of the country of origin. Usually, a bond issued by a non-European entity (Sovereign, large multinational company, or bank) for sale in Europe. Instrument may also be called a global bond.

Eurocurrency – The nonresident ownership of one of the major western European currencies. Eurocurrencies, similar to Eurodollars, are frequently available for borrowing in the London Interbank Market.

Eurodollars – Dollar deposit claims on U.S. banks that are deposited in banks located outside the U.S., including foreign branches of U.S. banks. These claims, in turn, may be redeposited with banks or lent to companies, individuals, or governments outside the U.S.

Eurodollar Bond – A Eurobond denominated in U.S. dollars.

European Central Bank (ECB) – The ECB is the central bank of the 25-member European Union (EU). The Eurosystem consists of each member's national central banks (NCBs) headed by the ECB. The function of the Eurosystem is to maintain price stability while supporting the general economic practices of the EU members. Together the ECB and NCBs conduct monetary policy for the Euro area (not all members of the EU have opted for monetary integration), to conduct foreign exchange operations, and to maintain the EU payment systems. The ECB is headed by the Governing Council (composed of the Executive Board and the governors of each of the NCBs).

European Currency Unit (ECU) – A portfolio currency used in the European Monetary System as a community "average" exchange rate. It is also used in the private market as a means of payment and as a currency of denomination for lending, borrowing, and trade.

European Union (EU) – A free trade area consisting of 25 European nations with the ultimate goal of achieving political and economic integration. The ECB is the central bank of the EU. Effective January 2002, the euro is the currency of the EU for those member nations that have opted for the monetary union. The principal aspects of the EU are to establish a European citizenship; to ensure a common system of justice and security; to create a single European market and currency and increase jobs; to promote regional development; and to promote European interests in the world. Member nations give up certain aspects of their national sovereignty to institutions that represent the entire EU. In return, EU members achieve common law, freedom of movement, reduced barriers to trade, and strengthened external security. The original member countries are Belgium, Denmark, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal, Finland, Sweden, and the United Kingdom. In May 1, 2004, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia joined the EU.

Exchange Contracts – Documents issued by foreign exchange dealers, by banks dealing in foreign exchange, and by foreign exchange brokers confirming foreign exchange transactions.

Exchange Control or Restrictions – Limits on free dealings in foreign exchange or of free transfers of funds into other currencies and other countries.

Exchange Control Risk – The possibility of defaults on obligations by the imposition of exchange control or restrictions.

Exchange Rates – The price of a currency in terms of another.

Exchange Reserves – The total amount of Greeley convertible foreign currencies held by a country's central bank.

Exchange Risk – The risk of market fluctuation of an asset or liability denominated in a foreign currency, such as the ownership of a currency (spot or forward) or trade accounts payable in foreign currency.

Export Credit Insurance – A system to insure the collection of credits extended by exporters against various contingencies. In some countries only noncommercial risks can be insured.

Export-Import Bank of the United States (Ex-Im Bank) – Established in 1934 as an independent Federal agency, Ex-Im Bank provides intermediate and long-term non-recourse financing for U.S. exports when such facilities are not available from commercial banks. Ex-Im Bank guarantees working capital and other loans for U.S. exporters. Ex-Im Bank also offers a number of other useful programs such as export credit insurance. Further details about the Ex-Im Bank and their programs can be found at http://www.exim.gov.

Export Management Company – A domestic firm that provides marketing, distributing, and other international business services for exporters in overseas markets through established networks or contacts in the targeted country.

Export Trading Company (ETC) – A company organized under the Export Trading Company Act of 1982 that facilitates U.S. exports. An ETC may be an affiliate of a bank holding company. Subpart C of Regulation K of the Federal Reserve provides guidance and restrictions for these companies.

Financial Action Task Force (FATF) – Task Force on Money Laundering created by the leaders of the G-7 countries and the President of the European Communities in 1989. The FATF is overseeing international efforts to combat money laundering and terrorist financing. The FATF presently has 28 member countries. The FATF also supports the activities of other international organizations that share the same goals (i.e., the Asia/Pacific Group, Caribbean Financial Action Task Force, the Egmont Group of Financial Intelligence Units, and the Wolfsberg Group of Banks). As an international policy-making body, the FATF reviews country compliance with its Forty Recommendations: A Global Framework for Combating Money Laundering. Those countries determined to be noncooperative in the fight against money laundering are blacklisted. In the U.S., FinCEN advises banks to closely scrutinize any transaction with these noncooperative countries by their customers.

Financial Intelligence Unit (FIU) – FIUs are central repositories and clearing houses for reports of financial crimes to be used for disseminating information to law enforcement and regulatory agencies. FIUs also provide a country gateway for information sharing and international cooperation with the law enforcement and regulatory agencies in other countries. The FATF in its Forty Recommendations: A Global Approach for Combating Money Laundering encourages every country to establish a FIU. The Financial Crimes Enforcement Network (FinCEN) is the FIU for the U.S.

Fixed Exchange Rate System – A system in which the exchange rate of a country's currency is tied to one major currency, such as the U.S. dollar.

Fixed Rate of Exchange – A rate of exchange set by a foreign government relative to the dollar, gold, another currency, or perhaps Special Drawing Rights (SDRs). It remains in effect as long as that government is willing and/or able to buy or sell exchange at the set rates.

Flexible Rate of Exchange – A rate of exchange subject to relatively frequent changes. It is determined by market forces but subject to various floors or ceilings relative to the dollar, gold, SDR's or another currency when the rate fluctuates beyond certain parameters.

Floating Exchange Rate System – A system in which the values of the currencies of various countries relative to each other are established by supply and demand forces in the market without government intervention.

Floating Rate – A rate of exchange that is determined completely by market forces with no floor ceiling vis-a-vis the dollar, gold, SDR's or any other currency.

Force Majeure – A standard insurance clause in a marine contract that relieves the parties from nonfulfillment of their obligations due to circumstances beyond their control such as earthquakes, floods, or war.

Foreign Bank Supervision Enhancement Act (FBSEA) – Part of the FDIC Improvement Act of 1991, FBSEA mandated oversight of FBOs by the Federal Reserve. The Federal Reserve Board coordinates the examinations of FBOs with the other Federal agencies and with the various State banking authorities.

Foreign Bonds – Bonds issued by nonresidents but underwritten primarily by banks registered in the country where the issue is made.

Foreign Deposits – Those deposits that are payable at a financial institution outside the jurisdiction of the U.S. government and in the currency of the country in which the depository is located. See also Nostro Account.

Foreign Draft – An official bank order drawn on a foreign correspondent bank to pay on demand to a designated payee a specific sum of foreign money or U.S. dollars at the drawee's buying rate.

Foreign Exchange – The trading or exchange of a foreign currency in relation to another currency.

Foreign Exchange Market – Communications between dealers and brokers to transact wholesale business in foreign exchange and Eurocurrencies.

Foreign Exchange Rationing – A government requirement that all holders of bills of exchange relinquish them at a stipulated rate.

Foreign Exchange Reserves – The reserves maintained by a central bank which usually include gold and easily traded currencies of major industrial nations.

Foreign Exchange Risk – The risk associated with exposure to fluctuation in spot exchange rates.

Foreign Investment Advisory Service (FIAS) – Established in 1986, FIAS counsels developing countries on attracting foreign capital. FIAS operates under the aegis of the World Bank and its affiliates the International Finance Corporation and the Multilateral Investment Guarantee Agency.

Foreign Trade Zone – An area where goods may be received and stored without entering a country's customs jurisdiction and without paying duty. Sometimes called a "free trade zone."

Forward Book – The aggregated of all forward contracts for a given currency or all currencies.

Forward Exchange – Foreign currency traded for settlement beyond two working or business days from today.

Forward Exchange Position – The long or short position that a dealer may have in the forward market, as compared to spot dealing.

Forward Exchange Risk – The possibility of a loss on a covered position as a result of a change in the swap margin.

Forward-forward Dealing – The simultaneous purchase and sale of a currency for different forward dates.

Forward Premium – A phrase used to describe a currency whose forward price is more expensive than its spot price. Also referred as "at a forward premium."

Forward Purchase – An outright purchase of a forward contract.

Forward Rates – The rates at which foreign exchange for future delivery are quoted, bought, and sold.

Free Alongside Ship (F.A.S.) – A term for a price quotation under which the seller delivers merchandise free of charge to the steamer's side and pays shipping-related expenses up to that destination, if necessary.

Free On Board (F.O.B.) (destination) – A term for a price quotation under which the seller undertakes at his or her risk and expense to load the goods on a carrier at a specified location. Expenses subsequent thereto are for account of the buyer.

Free On Board (F.O.B.) (vessel) – A term for a price quotation under which the seller delivers the goods at his or her expense on board the steamer at the location named. Subsequent risks and expenses are for account of the buyer.

Free Port – A foreign trade zone open to all traders on equal terms where merchandise may be stored duty-free pending its reexport or sale within that country.

Free Trade Area – An arrangement between two or more countries for free trade among themselves, although each nation maintains its own independent tariffs toward nonmember nations. It should not be confused with "free trade zone," which is synonymous with "foreign trade zone."

Free Trade Area of the Americas (FTAA) – A movement by 34 member countries initiated in 1994 to integrate the Western Hemisphere into a single free trade area. The goal of the FTAA is to reduce trade and investment barriers between member countries. Negotiations to form the FTAA are still in process but are supposed to be finalized by January 2005. Implementation of the FTAA is to begin as soon possible thereafter with the ultimate goal of achieving the FTAA by December 2005.

Future (or Forward) Exchange Contract – A contract usually between a bank and its customer for the purchase or sale of foreign exchange at a fixed rate with delivery at a specified future time. A future contract is due later than a spot contract which is settled in one to ten days depending on the bank or market. Future exchange contracts are generally used by the customer to avoid the risk of fluctuations in rates of foreign exchange which he or she may need or may be due in the future.

G-7 (Group of Seven) – A group of industrialized countries comprising Canada, France, Germany, Great Britain, Italy, Japan, and the U.S.

G-10 Countries – The informal term for the Group of ten countries, which consists of Belgium, Canada, France, Germany, Italy, Japan, Luxemburg, the Netherlands, Sweden, the United Kingdom, and the U.S.. Switzerland joined in 1984, but the name remains as is.

Global Bond – A temporary debt certificate issued by a Eurobond borrower, representing the borrower's total indebtedness. The global bond will subsequently be replaced by individual bearer bonds.

Global Line – A bank-established aggregate limit that sets the maximum exposure the bank is willing to have to any one customer on a worldwide basis.

Guidance Line – An authorization, unknown to the customer, or a line of credit. If communicated to the customer, the guidance line becomes an advised line of credit commitment.

Hawalas – Informal exchangers and money transmitters commonly used in Arab and other Islamic countries and in India. The system relies on dealings with a trusted party who has financial connections with another individual in another country. Because of the discreteness and informality of the dealings between the parties, hawalas represent a high risk for money laundering. Furthermore, terrorists have used these networks to transfer funds around the world.

Heavily Indebted Poor Countries (HIPCs) – A designation by the IMF to identify nations targeted that need to reduce external debt to more sustainable levels. To determine sustainability, the net value of a country's debt burden is divided into its export earnings. An HIPC is identified as a nation that has a debt to export ratio one and one-half times the amount considered by the IMF to be sustainable. Under this debt reduction initiative for these poor developing countries, the IMF, the World Bank and other multilateral organizations will get together with all of the creditors of these HIPCs. The creditor group then develops a plan to reduce the HIPC's debt to a more sustainable level. To qualify for HIPC assistance, the country must have adopted a Poverty Reduction Strategy Paper and made progress in initiating this strategy for one year. Then the HIPC must adopt adjustment and reform programs supported by the IMF and the World Bank. The IMF and World Bank will conduct periodic debt sustainability analysis to determine ongoing qualification for assistance. As of August 2002, the IMF identified 41 countries as HIPCs, with most of the nations being in Africa.

Interagency Country Exposure Review Committee (ICERC) – A nine-member joint committee of three Federal regulatory agencies established to administer the country risk supervision program. ICERC determines the creditworthiness of individual countries and the proper Allocated Transfer Risk Reserve to be used by U.S. banks in mitigating cross-border exposure within a specific country.

International Banking Act of 1978 (IBA) – The principal legislation pertaining to the activities of foreign banks in the U.S. It established a policy of national treatment of foreign banks with regard to their operations in the U.S.

International Banking Facility (IBF) – A set of asset and liability accounts segregated on the books and records of a depository institution, U.S. branch or agency or a foreign bank, or an Edge Act or agreement corporation. IBF activities are essentially limited to accepting deposits from and extending credit to foreign residents (including banks), other IBFs, and the institutions establishing the IBF. IBFs are not required to maintain reserves against their time deposits or loans. IBFs may receive certain tax advantages from individual states.

International Lending Supervision Act (ILSA) – Enacted in 1983, the act requires U.S. banking agencies to consult with bank supervisory authorities in other countries to achieve consistent policies and practices in international lending.

International Monetary Fund (IMF) – A specialized agency of the United Nations. It encourages monetary cooperation, establishes international standards for a currency exchange policy, promotes stable foreign exchange rates among member nations, and makes short-term advances and standby credits to members experiencing temporary payments difficulties. In some cases, the IMF advances money subject to conditions that must be met by the borrowing country. Its resources come mainly from subscriptions of members.

International Money Market of the Chicago Mercantile Exchange (IMM) – The IMM is one of the world's largest markets for foreign currency and Eurodollar futures trading.

Intervention – The actions of a central bank designed to influence the foreign exchange rate of its currency. The bank can use its exchange reserves to buy its currency if it is under too much downward pressure or to sell its currency if it is under to much upward pressure.

Intracountry Foreign Currency Position – The risk that exists whenever a subsidiary or a branch lends, invests, places, or extends credit to entities that are located within the same country as the booking unit, but in a currency different from that of the country where the borrower and booking unit are located.

Intra-Day Position – The size of spot or forward positions allowed for a dealer during the business day, which may be larger than that allowed for the end of the day. Also called "daylight" limits.

Issuing Bank – Also known as the opening bank. The buyer's bank which issues a letter of credit.

Latin American Integration Association (**LAIA**) – Replaced LAFTA in 1981 and its purpose is to reduce tariff barriers between member countries. The member countries are Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay, and Venezuela. LAIA is also known under ALADI (its Spanish Acronym).

Letters of Credit - Advised – An export letter of credit issued by a bank that requests another bank to advise the beneficiary that the credit has been opened in its favor. This occurs when the issuing bank does not have an office in the country of the beneficiary and uses the facilities of the advising bank. The advising bank is potentially liable only for its own error in making the notification.

Letters of Credit - Back-to-back – A letter of credit issued on the strength (or "backing") of another letter of credit, involving a related transaction and nearly identical terms. For example, ABC company in the U.S. is designated as the beneficiary of an irrevocable letter of credit confirmed by a U.S. bank to supply XYZ company in Bolivia, whose bank issued the letter of credit, with goods to be purchased from a third company. The third company, however, will not fill ABC's order unless it receives prepayment for the goods either through cash or some other type of financing. If ABC is unable to prepay in cash, it will request its bank to issue a letter of credit in favor of the third company. If ABC's bank agrees, the domestic credit is then "backed" by the foreign letter of credit and a back-to-back letter of credit transaction exists.

Letter of Credit - Cash – A letter addressed from one bank to one or more correspondent banks making available to the party named in the letter a fixed sum of money up to a future specific date. The sum indicated in the letter is equal to an amount deposited in the issuing bank by the party before the letter is issued.

Letter of Credit - **Commercial** – A letter of credit addressed by a bank, on behalf of a buyer of merchandise, to a seller authorizing the seller to draw drafts up to a stipulated amount under specified terms and undertaking conditionally or unconditionally to provide payment for drafts drawn.

- **Confirmed Irrevocable Letter of Credit** – A letter of credit in which a bank in addition to the issuing bank is responsible for payment.
- **Irrevocable Letter of Credit** – A letter of credit in which the issuing bank waives all right to cancel or in any way amend without consent of the beneficiary or seller.
- **Revocable Letter of Credit** – A letter of credit in which the issuing bank reserves the right to cancel or amend that portion of the amount that has not been demanded before the actual payment or negotiation of drafts drawn.
- **Revolving Letter of Credit** – A letter of credit in which the issuing bank notifies a seller of merchandise that the amount of credit when used will again become available, usually under the same terms and without the issuance of another letter.

- **Special Clauses** –
  - **Green Clause** – Similar to the red clause letter of credit below, except that advance payment is made, generally upon presentation of warehouse receipts evidencing storage of the goods.
  - **Red Clause** – A clause permitting the beneficiary to obtain payment in advance of shipment so that the seller may procure the goods to be shipped.
  - **Telegraphic Transfer Clause** – A clause in which the issuing bank agrees to pay the invoice amount to the order of the negotiating bank upon receipt of an authenticated cablegram form the latter that the required documents have been received and are being forwarded.

Letter of Credit - **Confirmed** – A letter of credit issued by the local bank of the imported and to which a bank, usually in the country of the exporter, has added its commitment to honor drafts and documents presented in accordance with the terms of the credit. Thus, the beneficiary has the unconditional assurance that, if the issuing bank refuses to honor the draft against the credit, the confirming bank will pay (or accept) it. In many instances, the seller (exporter) may ask that the letter of credit be confirmed by another bank when the seller is not familiar with the foreign issuing bank or as a precaution against unfavorable exchange regulations, foreign currency shortages, political upheavals, or other situations.

Letter of Credit - **Deferred Payment** – A letter of credit under which the seller's draft specifies that the draft is payable at a later date, for example, 90 days after the bill-of-lading date or 90 days after presentation of the documents.

Letter of Credit - **Export** – A letter of credit opened by a bank, arising from the financing of exports from a country. The issuing bank may request another bank to confirm or advise the credit to the beneficiary. If confirmed, the credit becomes a confirmed letter of credit, and, if advised, it becomes an advised (unconfirmed) letter of credit.

Letter of Credit - **Guarantee** – A letter of credit guaranteed by the customer (applicant) and often backed by collateral security. In domestic banks, the payment of drafts drawn under this credit is recorded in the general ledger asset account "Customer Liability – Drafts Paid under Guaranteed L/C."

Letter of Credit - **Import** – A letter of credit issued by a bank on behalf of a customer who is importing merchandise into a country. Issuance of an import letter of credit carries a definite commitment by the bank to honor the beneficiary's drawings under the credit.

Letter of Credit - **Irrevocable** – A letter of credit that cannot be modified or revoked without the customer's consent or that cannot be modified or revoked without the beneficiary's consent.

Letter of Credit - **Negotiation** – A letter of credit requiring negotiation (usually in the locality of the beneficiary) on or before the expiration date. The engagement clause to honor drafts is in favor of the drawers, endorsers, or bona fide holders.

Letter of Credit - Nontransferable – A letter of credit that the beneficiary is not allowed to transfer in whole or in part to any party.

Letter of Credit - Reimbursement – A letter of credit issued by one bank and payable at a second bank that, in turn, draws on a third bank for reimbursement of the second bank's payment to the beneficiary. Those credits are generally expressed in a currency other than that of the buyer (issuing bank) or the seller, and, because of wide acceptability, many are settled in the U.S through yet another bank as the reimbursing agent. Upon issuance, the correspondent sends the reimbursing bank an authorization to honor drawings presented by the negotiating bank.

Letter of Credit - Revocable – A letter of credit that can be modified or revoked by the issuing bank up until the time payment is made.

Letter of Credit - Revolving – A letter of credit issued for a specific amount that renews itself for the same amount over a given period. Usually, the unused renewable portion of the credit is cumulative as long as drafts are drawn before the expiration of the credit.

Letter of Credit - Standby – A letter of credit or similar arrangement, however named or described, that represents an obligation to the beneficiary on the part of the issuer to:

- repay money borrowed by or advance to or for the account party,
- make payment on account of any indebtedness undertaken by the account party, or
- make payment on account of any default by the account party in the performance of an obligation.

Letter of Credit - Straight – A credit requiring presentation on or before the expiration date at the office of the paying bank. The engagement clause to honor drafts is in favor of the beneficiary only.

Letter of Credit - Transferable – A credit under which the beneficiary has the right to give instructions to the bank called upon to effect payment or acceptance to make the credit available in whole or in part to one or more third parties (second beneficiaries). The credit may be transferred only upon the express authority of the issuing bank and provided that it is expressly designated as transferable. It may be transferred in whole or in part, but may only be transferred once.

Letter of Credit - Traveler's – A letter of credit addressed to the issuing bank's correspondents, authorizing them to negotiate drafts drawn by the beneficiary named in the credit upon proper identification. The customer is furnished with a list of the bank's correspondents. Payments are endorsed on the reverse side of the letter of credit by the correspondent banks when they negotiate the drafts. This type of letter of credit is usually prepaid by the customer.

Letter of Credit - Usance – A letter of credit that calls for the payment against time drafts, or drafts calling for payment at some specified date in the future. Usance letters of credit allow buyers a grace period of a specified number of days, usually not longer than six months.

Limits – Maximum line amounts by bank name with other banks for forward exchange transactions; Eurocurrency and Eurodollar transactions, and payments arising from foreign exchange transactions on the same day.

Local Currency Exposure – The amount of assets and off-balance sheet items that are denominated in the local currency of that country.

Lock-up – The term used to refer to procedures followed in a Eurobond issue to prevent the sale of securities to U.S. investors during the period of initial distribution.

London Interbank Offered Rate (LIBOR) – Key rate in international bank lending. LIBOR is an average of the interest rates that major international banks charge each other to borrow U.S. dollars in the London money market. Like the U.S. Treasury the CD indexes, LIBOR tends to move and adjust quite rapidly to changes in interest rates.

London International Financial Futures Exchange (LIFFE) – A London exchange where foreign currency and Eurodollar futures, as well as foreign currency options, are traded.

Long Position – An excess of assets (and/or forward purchase contracts) over liabilities (and/or forward sales contracts) in the same currency. A dealer's position when net purchases and sales result in a net-purchased position.

Loro Accounts – Current accounts banks hold with foreign banks in a foreign currency on behalf of their customers.

Maquiladoras – A program where imports are shipped duty and license free to Mexican firms for assembly and then exported back to the U.S.

Marine Insurance – Insurance for losses arising from specified marine casualties. Marine insurance is more extensive than other types, because it may provide not merely for losses arising from fire, but also from piracy, wreck, and most injuries sustained at sea.

Matched – A forward purchase is matched when it is offset by a forward sale for the same date, or vice versa. However, as a practical necessity, when setting limits for unmatched positions, a bank may consider a contract matched if the covering contract falls within the same week or semi-monthly period.

Maturity Date – The settlement date or delivery date for a forward contract.

Maturity Gap (Gap) – Mismatched asset and liability maturities creating periods of uneven cash inflows and outflows. A substantial inflow of a particular currency over a prolonged period may result in excess idle funds for which no investment or sale has been arranged. This could mean a loss of income on the idle funds for that period and/or of be amount by which the value of that currency is expected to appreciate or depreciate. Conversely, substantial outflows prior to the maturities of offsetting assets may necessitate purchasing or borrowing the required currency for that period (gap) at substantially higher rates. Thus, the bank is exposed to the risk of rate changes between the time the gap was created and the date it is actually closed.

Mercosur – The Mercosur was created by Argentina, Brazil, Paraguay and Uruguay in March 1991 with the signing of the Treaty of Asuncion. It originally was set up with the ambitious goal of creating a common market/customs union between the participating countries on the basis of various forms of economic cooperation that had been taking place between Argentina and Brazil since 1986. The Treaty of Ouro Preto of 1994 added much to the institutional structure of Mercosur and initiated a new phase in the relationship between the countries, when they decided to start to implement/realize a common market. A transition phase was set to begin in 1995 and to last until 2006 with a view to constituting the common market. In 1996, association agreements were signed with Chile and Bolivia establishing free trade areas with these countries on the basis of a "4 + 1" formula. During this period, Mercosur also created a common mechanism for political consultations, which was formalized in 1998, in which the four countries plus Bolivia and Chile all participate as full members of the so-called "Political Mercosur."

Multi-currency Line – A line of credit giving the borrower the option of using any readily available major currency.

Multilateral Exchange Contract – An exchange contract involving two foreign currencies against each other, for example, a contract for U.S. dollars against French francs made in London or a contract for U.S. dollars against German marks made in New York. Also called an arbitrage exchange contract.

Nationalization – A process where a nation’s central government assumes ownership and operation of private enterprises within its territory.

Net Accessible Interest Differential – The difference between the interest rates that can actually be obtained on two currencies. This difference is usually the basis of the swap rate between the two currencies and, in most cases, is derived from external interest rates rather than domestic ones. These external rates or Euro-rates are free from reserve requirements, which would increase the interest rate, and from exchange controls, which would limit access to the money.

Net Exchange Position – An imbalance between all the assets and purchases of a currency, and all the liabilities and sales of that currency.

Net Position – A bank has a position in a foreign currency when its assets, including future contracts to sell, in that currency are not equal. An excess of assets over liabilities is called a net "long" position and liabilities in excess of assets result in a net "short" position. A long net position in a currency which is depreciating results in a loss because, with each day, that position (asset) is convertible into fewer units of local currency. A short position in a currency which is appreciating represents a loss because, with each day, satisfaction of that position (liability) costs more units of local currency.

Netting Arrangement – Arrangement by two counterparties to examine all contracts settling in the same currency on the same day and to agree to exchange only the net currency amounts. Also applies to the net market values of several contracts.

Non-tariff Trade Barriers – Barriers other than tariffs that tend to restrict trade. For example, setting higher inspection standards for imports than for domestically produced items, giving preference to domestic companies in bidding on contracts, import substitution programs, import licensing requirements, additional product labeling requirements, export subsidizing, inadequate protection of intellectual property rights, or limitations on services.

North American Free Trade Agreement (NAFTA) – A free trade area consisting of Canada, Mexico, and the U.S. The goal is to reduce trade barriers between the member countries thereby creating jobs and economic prosperity for the citizens of all three countries.

Nostro Accounts – Demand accounts of banks with their correspondents in foreign countries in the currency of that country. These accounts are used to make and receive payments in foreign currencies for a bank's customers and to settle maturing foreign exchange contracts. Also called due from foreign bank - demand accounts, our balances with them, or due from balances.

Odd Dates – Deals within the market are usually for spot, one month, two months, three months or six months forward. Other dates are odd dates, and prices for them are frequently adjusted with more than a mathematical difference. Hence, most market deals are for regular dates, although commercial deals for odd dates are common.

Offer Rate – The price at which a quoting party is prepared to sell or lend currency. This is the same price at which the party to whom the rate is quoted will buy or borrow if it desires to do business with the quoting party. The opposite transactions take place at the bid rate.

Office of Foreign Asset Control (OFAC) – An office within the U.S. Treasury Department that administers U.S, laws imposing economic sanctions against targeted hostile foreign countries. While OFAC is responsible for administration of these statutes, all of the bank regulatory agencies cooperate in ensuring compliance.

Official Rate – The rate established by a country at which it permits conversion of its currency into that of other countries.

Offshore Branch – Banking organization designed to take advantage of favorable regulatory or tax environments in another country. Many of these operations are shell branches with no physical presence.

Offshore Dollars – Same as Eurodollars, but encompassing the deposits held in banks and branches anywhere outside of the U.S., including Europe.

Open Contracts – The difference between long positions and short positions in a foreign currency or between the total of long and short positions in all foreign currencies. Open spot or open forward positions that have not been covered with offsetting transactions.

Open Market Operations – Purchases or sales of securities or other assets by a central bank on the open market.

Open Position Limit – A limit placed on the size of the open position in each currency to manage off-balance sheet items.

Opening Bank – The bank that draws up and opens the letter of credit and that makes payment according to the conditions stipulated.

Option Contracts – A contract giving the purchaser the right, but not the obligation, to buy (call option) or sell (put option) an asset at a stated price (strike or exercise price) on a stated date (European option) or at any time before a stated date (American option).

Organization for Economic Cooperation and Development (OECD) – An organization of 30 countries that fosters democracy and free market development throughout the world. The OECD also researches issues having international implications. The OECD publishes its research findings and international statistics on various countries at its website at http://www.oecd.org. The OECD also benchmarks best practices on economic, social, and governance issues. The OECD supports other international groups such as the FATF that have similar goals.

Other Transfer Risk Problems (OTRP) – A category assigned by ICERC for countries near default or in noncompliance with their debt requirements.

Outright – Forward exchange bought and sold independently from a simultaneous sale or purchase spot exchange.

Outright Forward Rate – A forward exchange rate that is expressed in terms of the actual price of one currency against another, rather than, as is customary, by the swap rate. The outright forward rate can be calculated by adding the swap premium to the spot rate or by subtracting the swap discount from the spot rate.

Override Limit – The total amount of money measured in terms of a bank's domestic currency that the bank is willing to commit to all foreign exchange net positions.

Parity – A term derived from par, meaning the equivalent price for a certain currency or security relative to another currency or security, or relative to another market for the currency or security after making adjustments for exchange rates, loss of interest, and other factors.

Parity Grid – The system of fixed bilateral par values in the European Monetary System. The central banks of the countries whose currencies are involved in an exchange rate are supposed to intervene in the foreign exchange market to maintain market rates within a set range defined by an upper and lower band around the par value.

Par Value – The official parity value of a currency relative to the dollar, gold, Special Drawing Rights, or another currency.

Placement Memorandum – A document in a syndicated Eurocredit that sets out details of the proposed loan and gives information about the borrower.

Political Risk – Political changes or trends often accompanied by shifts in economic policy which may affect the availability of foreign exchange to finance private and public external obligations. The banker must understand the subtleties of current exchange procedures and restrictions as well as the possibilities of war, revolution, or expropriation in each country with which the bank transacts business, regardless of the actual currencies involved.

Position – A situation created through foreign exchange contracts or money market contracts in which changes in exchange rates or interest rates could create profits or losses for the operator.

Position Book – A detailed, ongoing record of an institution's dealings in a particular foreign currency or money market instrument. Also known as position sheet.

Position Limits – The maximum net debit or credit foreign currency balance either during the day (daylight limits) or at close of business (overnight limits) as stipulated by bank management.

Premium – The adjustment to a spot price that is made in arriving at a quote for future delivery. If a dealer were to quote $2.00 and $2.05 (bid and asked) for sterling and the premiums for six months forward are .0275 and .0300, the forward quotes would be adjusted to $2.0275 and $2.0800. The premium usually represents differences in interest rates for comparable instruments in two countries. However, in periods of crisis for a currency, the premium may represent the market anticipation of a higher price.

Price Quotation System – A method of giving exchange rates in which a certain specified amount of a foreign currency (1 or 100, usually) is stated as the corresponding amount in local currency.

Privatization – The selling of a government owned business (power, gas, communications) to the public. Governments privatize businesses to raise money for fiscal operations or to improve the efficiency of a firm.

Quota – A government-imposed restriction on the quantity of a specific imported good.

Rate Risk – In the exchange market, the chance that the spot rate may rise when the trader has a net oversold position (a short position), or that the spot rate may go down when the operator has a net overbought position (a long position).

Reciprocal Rate – The price of one currency in terms of a second currency, when the price of the second currency is given in terms of the first.

Representative Office – A facility established in the U.S. or foreign markets by a bank to sell its services and assist clients. In the U.S., these offices cannot accept deposits or make loans.

Reserve Account – Those items in the balance of payments that measure changes in the central bank's holdings of foreign assets (such as gold, convertible securities, or Special Drawing Rights).

Reserve Currency – A foreign currency held by a central bank (or exchange authority) for the purposes of exchange intervention or the settlement of intergovernmental claims.

Reserve Requirements – Obligations imposed on commercial banks to maintain a certain percentage of deposits with the central bank or in the form of central bank liabilities.

Revaluation – An official act wherein the official parity of a currency is adjusted relative to the dollar, gold, Special Drawing Rights, or another currency, resulting in less revalued units relative to those currencies. Also, the periodic computations of the current values (reevaluations) of ledger accounts and unmatured future purchase and sales contracts.

Rollover – The process of extending a maturing forward foreign exchange contract.

Samurai Bonds – Yen-denominated bonds issued by a foreign borrower in Japan.

Sanctions – A coercive governmental action that restricts trade with a specific country (i.e. embargo) for a political purpose rather than for an economic need.

Seller's Option Contract – When the seller has the right to settle a forward contract at his or her option anytime within a specified period.

Shell Branch – See offshore branch.

Shogun Bonds – Foreign bonds issued in Tokyo and denominated in currencies other than the Japanese yen. The usual denomination is the U.S. dollar.

Short Position – An excess of liabilities (and/or forward sale contracts) over assets (and/or forward purchase contracts) in the same currency. A dealer's position when the net of purchases and sales leaves the trader in a net-sold or oversold position.

Sight Draft – A draft payable upon presentation to the drawee or within a brief period thereafter known as "days of grace."

Society for Worldwide Interbank Financial Telecommunications (SWIFT) – A telecommunications network established by major financial institutions to facilitate massages among SWIFT participants. These messages typically result in a monetary transaction between institutions. The network is based in Brussels.

Soft Currency – A currency that is not freely convertible into other currencies.

Soft Loans – Loans with exceptionally lenient repayment terms, such as low interest, extended amortization, or the right to repay in the currency of the borrower.

Sole of Exchange – A phrase appearing on a draft to indicate that no duplicate is being presented.

Sovereign Risk –The risk that the government of a country may interfere with the repayment of debt.

Space Arbitrage –The buying of a foreign currency in one market and the selling of it for a profit in another market.

Special Drawing Rights (SDRs) – International paper money created and distributed to governments by the IMF in quantities dictated by special agreements among its member countries. The value of SDRs is determined by the weighted value of a "basket" of major currencies.

Specially Designated Nationals – Persons or entities listed by OFAC. These persons or entities are typically front organizations and are subject to OFAC prohibitions.

Spot Contract – A foreign exchange contract traded in the interbank market in which the value date is two business days from the trade date.

Spot Exchange (or Spot Currency) – Foreign exchange purchased or sold for immediate delivery and paid for on the day of the delivery. Immediate delivery is usually considered delivery in one or two business days after the conclusion of the transaction. Many U.S. banks consider transactions maturing in as many as ten business days as spot exchange. Their reasons vary but are generally to facilitate reevaluation accounting policies and to initiate final confirmation and settlement verification procedures on future contracts nearing maturity.

Spot Transaction – A transaction for spot exchange or currency.

Spread – The difference between the bid rate and the offer rate in an exchange rate quotation or an interest quotation. This difference is not identical with the profit margin because traders seldom buy and sell at their bid and offer rates at the same time.

Square Exchange Position – To make the inflows of a given currency equal to the outflows of that currency for all maturity dates. This produces a square exchange position in that currency.

Sterilization – Intervention in the foreign exchange market by a central bank in which the change in the monetary base caused by the foreign exchange intervention is offset by open market operations involving domestic assets.

Subsidiary – In the context of banking, an entity in which a bank has a degree of control. Used to facilitate entry into foreign markets in which other operations are proscribed.

Sushi Bonds – Dollar-denominated Eurobonds issued by Japanese companies and purchased primarily by Japanese investors. These bond issues are typically managed by Japanese banks.

Swap – The combination of a spot purchase or sale against a forward sale or purchase of one currency in exchange for another; merely trading one currency (lending) for another currency (borrowing) for that period of time between which the spot exchange is made and the forward contract matures.

Swap Arrangement (Reciprocal) – A bilateral agreement between the central banks enabling each party to initiate swap transactions up to an agreed limit to gain temporary possession of the other party's currency.

Swap Cost or Profit – In a swap transaction, the cost of profit related to the temporary movement of funds into another currency and back again in a "swap" transaction. That exchange cost or profit must then be applied to the rate of interest earned on the loan or investment for which the exchange was used. Furthermore, the true trading profits or losses generated by the foreign exchange trader cannot be determined if swap profits or costs are charged to the exchange function rather than being allocated to the department whose loans or investments the swap actually funded.

Swap and Deposit – A combination of swap transactions that enables the borrower to have use of both currencies for the duration of the transaction.

Swap Position – A situation where the scheduled inflows of a given currency are equal to the scheduled outflows, but the maturities of those flows are purposely mismatched. The expectation in a swap position is that the swap rate will change and that the gap can be closed at a profit.

Swap Rate – The difference between the spot exchange rate of a given currency and its forward exchange rate.

Swap Swap – A swap transaction involving one forward maturity date against another forward maturity date.

Swaption – An option on a swap. It gives the buyer the right, but not the obligation, to enter into an interest-rate swap at a future time period.

Tariff – A duty or tax on imports of goods or services that can be either a percentage of cost or a specific amount per unit of import.

Telegraphic Transfer (TT) Rate – The basic rate at which banks buy and sell foreign exchange. Buying rates for mail transfers, foreign currency drafts, traveler's checks, and similar instruments are all based on the TT rate. The TT rate may be slightly less favorable that other rates because of the time required for collection. Foreign currency time (usance) drafts are also bought at the TT rate, but interest to maturity is deducted for the time which must elapse until maturity.

Telex – Direct communication between two banks or companies and organizations via satellite or underwater cable.

Tenor – Designation of payment of a draft as being due at sight, a given number of days after sight, or a given number of days after the date of the draft.

Terms of Trade – Relative price levels of goods exported and imported by a country.

Test Key – A code used in transferring funds by cable or telephone so that the recipient may authenticate the message. A test key generally consists of a series of numbers, including a fixed number for each correspondent bank; a number for the type of currency, a number for the total amount; and, possibly, numbers for the day of the month and day of the week. A single number code indicates whether the total amount is in thousands, hundreds, tens, or digits. To arrive at a test number, the indicated numbers are totaled, and the total amount usually precedes the text of the message.

Third Country Bills – Banker's acceptances issued by banks in one country that finance the transport or storage of goods traded between two other countries.

Tied Loan – A loan made by a governmental agency that requires the borrower to spend the proceeds in the lender's country.

Time Draft – A draft drawn to mature at a fixed time after presentation or acceptance.

Tomorrow Next – The simultaneous purchase and sale of a currency for receipt and payment on the next and second business day, respectively, or vice versa.

Tradable Amount – The minimum amount accepted by a foreign exchange broker for the interbank market, for example, 100,000 Canadian dollars or 50,000 pounds sterling.

Trade Acceptance – A draft drawn by the seller (drawer) on the buyer (drawee) and accepted by the buyer. Also called a trade bill, customer acceptance, and two-name trade paper.

Trade Accounts – Those parts of the balance of payments that reflect money spent abroad by the citizens of a country on goods and services and the money spent by foreigners in the given country for goods and services.

Trader's Ticket or Dealer's Slip – The handwritten record of a foreign exchange trade and/or placing and taking of deposits that is written by the dealer who executed the transaction.

Trading Position Worksheet – A record of incomplete transactions in a particular currency.

Tranche – A term sometimes used when referring to the number of drawings of funds by a borrower under a term loan.

Transfer Risk – The risk arising when a borrower incurs a liability in a currency that is not the currency in which revenues are generated. The borrower may not be able to convert its local currency to service an international loan if foreign exchange is not generated.

Trust Receipt – Used extensively in letter of credit financing, this is a document or receipt in which the buyer promises to hold the property received in the name of the releasing bank, although the bank retains title to the goods. The merchant is called the trustee and the bank the entruster. Trust receipts are used primarily to allow an importer to take possession of the goods for resale before paying the issuing bank.

Two-way Quotation – A simultaneous quotation of foreign exchange buying and selling rates implying the willingness of the bank to deal either way.

Two-way Rate – An exchange rate or an interest rate quotation that contains both a bid rate and an offer rate. The size of the spread between the two rates indicates the relative quality of the quotation.

Undervalued – Decline in the spot rate below purchasing power parities, so that goods of one country are cheaper than in another country. In relation to foreign exchange, "undervalued" means that forward premiums are narrower or forward discounts are wider than the interest parities between the two financial centers.

Uniform Customs and Practices for Documentary Credits – Sets of rules governing documentary letters of credit formulated by the International Chamber of Commerce. Includes general provisions, definitions, forms, responsibilities, documents, and the transfer of documentary letters of credit.

Unmatched – A forward purchase is unmatched when a forward sale for the same date has not been executed or vice versa.

Usance – The period of time between presentation of a draft and its maturity. See also tenor.

Value Date – The date on which foreign exchange bought and sold must be delivered and on which the price for them in local currency must be paid.

Value-impaired – A category assigned by ICERC that indicates a country has protracted debt problems.

Value Today – An arrangement by which spot exchange must be delivered and paid for on the day of the transaction instead of two business days later.

Value Tomorrow – An arrangement by which spot exchange must be delivered and paid for on the business day following the transaction instead of two business days later.

Volume Quotation System – A method of giving exchange rates in which a certain specified amount of local currency (usually 1 or 100) is stated as the corresponding amount in foreign currency.

Vostro Account – A demand account maintained for a bank by a correspondent bank in a foreign country. The nostro account of one bank is the vostro account of the other bank. See also nostro account.

Warehouse Receipt – An instrument that lists and is a receipt for goods or commodities deposited in the warehouse which issues the receipt. These receipts may be negotiable or non-negotiable. A negotiable warehouse receipt is made to the "bearer," and a non- negotiable warehouse receipt specifies precisely to whom the goods shall be delivered. There are several alternatives for releasing goods held under warehouse receipts: (1) the delivery of goods may be allowed only against cash payment or substitution of similar collateral; (2) some or all of the goods may be released against trust receipt without payment; or (3) a warehouseman may release a stipulated quantity of goods without a specific delivery order. Banks will accept a warehouse receipt as collateral for a loan only if the issuer of a receipt is a bonded warehouseman. The bank must have protected assurances for the authenticity of the receipt and the fact that the commodities pledged are fully available as listed on the warehouse receipt.

Withholding Tax – A tax imposed by a country on the gross amount of payments to a foreign lender from an in-country borrower.

Within-line Facility – Subfacilities of the line of credit that establish parameters, terms, and conditions of various other facilities available for specific additional purposes or transactions. The aggregate sum of all outstandings under within-line facilities must not exceed the total of the overall line of credit.

World Bank – An international financial organization whose purpose is to aid the development of productive facilities in member countries, particularly in developing countries. The chief source of funds is capital contributions made by member countries, which vary with the financial strength of the country. Another funding source is the sale of long-term bonds.

Yankee Bond – A U.S. dollar-denominated foreign bond issued in the U.S. market.

Zero Coupon – A bond that pays no interest but that is redeemed at its face value at maturity.

Effective October 1, 1998, the FDIC made substantial revisions to Part 303 of the FDIC's Rules and Regulations, which governs the filing and processing of various applications. One of the most significant features of this revised regulation is that of expedited processing that is now available for "eligible depository institutions."

Eligible depository institutions are defined in the regulation as those which meet the following criteria:

- Received a composite rating of 1 or 2 under the Uniform Financial Institutions Rating System (UFIRS) as a result of its most recent federal or state examination.
- Received a satisfactory or better Community Reinvestment Act (CRA) rating from its primary federal regulator at its most recent examination, if subject to CRA
- Received a compliance rating of 1 or 2 from its primary federal regulator at its most recent examination
- Is well-capitalized as defined in the appropriate capital regulation and guidance of the institution's primary federal regulator; and
- Is not subject to a cease and desist order, consent order, prompt corrective action directive, written agreement, memorandum of understanding, or other administrative agreement with its primary federal regulator or chartering authority.

APPLICATIONS FOR DEPOSIT INSURANCE

Introduction

The granting of deposit insurance confers a valuable status on an applicant institution; its denial, on the other hand, may have seriously adverse competitive consequences, and, in the case of a new institution, may effectively preclude entrance into the banking/thrift business. Obviously, the role of the FDIC, in acting upon such applications, involves important responsibilities and the exercise of sound discretion in the public interest.

Sections 5 and 6 of the Federal Deposit Insurance Act specifically deal with deposit insurance. Under Section 5, the FDIC must determine as a threshold matter that an applicant is a "depository institution which is engaged in the business of receiving deposits other than trust funds. If an institution does not satisfy that threshold requirement as codified under Part 303 of the FDIC Rules and Regulations. Additionally, Section 5 states that before approving an application, consideration shall be given to the factors enumerated in Section 6. Those factors are: the financial history and condition of the bank, the adequacy of its capital structure, its future earnings prospects, the general character of its management, the risk presented to the insurance fund, the convenience and needs of the community to be served, and whether or not its corporate powers are consistent with the purposes of the Act.

Subpart B of Part 303 of the FDIC's Rules and Regulations implements the basic statutory provisions and governs the administrative processing of applications for deposit insurance. For those filings subject to a public notice requirement, any person may inspect or request a copy of the non-confidential portions of a filing (the public file) until 180 days following the final disposition of the filing.

Rights of Applicants

An applicant has a statutory right to apply for deposit insurance and to obtain full consideration of its application by the FDIC in light of all relevant facts and without prejudice. If all of the seven statutory factors are resolved favorably, the applicant is entitled to receive deposit insurance coverage. In the event an application is disapproved, an applicant has a right to be informed by the FDIC of the reasons for disapproval.

Obligations of the FDIC

Under applicable law, the FDIC is obligated to consider the seven factors enumerated in Section 6 of the FDI Act in connection with every application for deposit insurance. As a measure of protection against unwarranted and unjustified risks, a full and thorough examination or investigation of each application is conducted. The FDIC has formulated certain guidelines for admission, which are designed to ease administrative problems, aid in preventing arbitrary judgment, and assist in assuring uniform and fair treatment to all applicants. These guidelines must, however, be administered in a manner consistent with the spirit of the Act, and the maintenance of a competitive and free enterprise banking/thrift system. Although applicants are largely required to satisfy criteria under each of the seven statutory factors, in a newly organized institution the FDIC views management and capital adequacy as the most important. The FDIC believes active competition between banks, thrifts and other financial institutions, when conducted within applicable law and in a safe and sound manner, is in the public interest.

Examiner's Responsibility

Whether the applicant is a proposed or newly organized institution or an existing institution, a formal application for deposit insurance coverage must be filed with the FDIC. A copy of the formal application will be made available to an examiner for use in the investigation. Although the application contains data on each of the seven factors enumerated under Section 6 of the Act, reports of investigation are not to be limited to material supplied by the applicant. Reports should be factual as to necessary information and represent the independent and unbiased findings of the examiner. The examiner should in no way indicate to an applicant the probable nature of his recommendations or discuss the applicant's chance of gaining admission to the insurance system unless specifically authorized to do so by the Regional Director. Considerable reliance is placed upon impartial reports by examiners in connection with admission procedures.

The report should detail the relevant facts and data pertinent to each of the seven statutory factors, and under a separate topical heading, an opinion as to whether the FDIC's criteria under each of the statutory factors have been met. A negative opinion on one or more of the statutory factors must be fully explained and supported and, where possible, it should be indicated whether and how the situation may be corrected. The report should also include a general recommendation relative to admission and, if appropriate, a list of conditions which should be imposed. As a rule, the FDIC requires applicants to satisfy all criteria under each of the seven statutory factors. In some cases, however, minor deficiencies in certain factors may be excused when they are more than balanced by conspicuous merits in others.

The seven factors enumerated in Section 6 of the FDI Act which are the criteria used by the FDIC to determine eligibility for deposit insurance are discussed below. The FDIC's admission criteria for proposed or newly organized institutions and existing institutions are generally the same; however, pertinent aspects specifically applicable to admission of existing institutions are covered later in this Section.

Statutory Factors, Proposed or Newly Organized Institutions

Financial History and Condition - Proposed and newly organized institutions have no financial history to serve as a basis for determining qualification for deposit insurance. Some consideration may be given to the history of other institutions presently and formerly operating in the area of the applicant, if pertinent. The ability of the proponents to provide financial support to the new institution should be evaluated under this factor. Past institution failures in a community should not be a prominent consideration in acting upon the application of a new institution. New institution applications are to be judged as far as possible upon their own merits relative to capital, management, and the other factors enumerated in Section 6 of the Act.

The investigation report should include a pro forma statement of the proposed institution for the first three years of operation. The asset and liability projections and composition should be reasonable in relation to the proposed market. Major assets with which the proposed institution intends to begin business, should be fairly valued and supported with appraisals.

Fixed assets are of primary concern in analyzing the asset condition of a proposed or newly organized financial institution. The applicant’s aggregate direct and indirect fixed asset investment, must be reasonable in relation to its projected earnings capacity, capital and other pertinent matters of consideration. Significant assets should be described in detail. For example, the following elements are pertinent to an adequate description and evaluation of applicant's realty interests: the original cost of the premises at time of construction with a breakdown between land and building, original cost to applicant, date of construction, reasonableness of purchase price, from whom purchased, insurance to be carried, assessed value, prospective or immediate repairs or alterations, estimated useful life of the building as of the beginning of business, outstanding liens, tax status, completeness of title papers, desirability of the location, and prospective annual income and expenses if the building is to be other than a one-purpose structure.

The relationship between the applicant's total investment in fixed assets and capital structure should receive comment.

If the leasing of premises is contemplated either through a real estate subsidiary of the proposed institution or otherwise, the terms of the lease are to be outlined in some detail, including a description and estimated cost of any leasehold improvements. In such cases, the lease agreement should contain a termination clause, acceptable to the FDIC. Lease transactions shall be reported in accordance with Financial Accounting Standards Board Statement 13 (Accounting for Leases). Applicants are cautioned against purchasing any fixed assets or entering into any noncancelable construction contracts, leases, or other binding arrangements related to the proposal unless and until the FDIC approves the application.

Any financial arrangement or transaction involving the applicant, its organizers, directors, officers, 10% or more shareholders, or their associates (insiders) should be avoided. If there are any such arrangements or transactions, it must be determined that they are fair and on substantially the same terms as those prevailing at the time for comparable transactions with noninsiders and must not involve more than normal risk or present unfavorable features. Full disclosure of any arrangements with insiders must be made to all proposed directors and prospective shareholders.

An evaluation and comment should be made as to whether the new institution will provide procedures, security devices, and safeguards which will at least be equivalent to the minimum requirements of the Bank Protection Act of 1968 and Part 326 of the Rules and Regulations of the FDIC. In addition, if the new institution plans to utilize electronic data processing services for some or all of its accounting functions, proponents should be apprised of the need to furnish notification in the form prescribed in Part 304.

In applications anticipating the use of temporary quarters pending construction or renovation of permanent facilities, details should be provided regarding the location of the site in relation to the permanent location, the exact address, the rental arrangement, the leasehold improvements, and estimated nonrecoverable costs upon abandonment.

Considerations required by the National Historic Preservation Act and the National Environmental Policy Act of 1969 must also be favorably resolved and the applicant is generally requested to submit data in this regard for evaluation.

Applicants often employ professional assistance, such as attorneys, economic researchers, and other specialists to assist in the preparation and filing of an application for deposit insurance coverage. The revised Statement of Policy on "Applications for Deposit Insurance" was adopted by the Board of Directors of the FDIC effective October 1, 1998, requires that legal fees and all other organizational expenses be reasonable and fully supportable. Expenses for professional or other services rendered by insiders will receive special review for any indication of self-dealing to the detriment of the institution and its other shareholders. The FDIC expects full disclosure to all directors and shareholders of any arrangement with an insider. In no case will a deposit insurance application be approved where the payment of a fee, in whole or in part is contingent upon any act or forbearance by the FDIC or by any other state or federal agency.

Adequacy of the Capital Structure – Normally, the initial capital of a proposed depository institution should be sufficient to provide a Tier 1 capital to assets leverage ratio (as defined in the appropriate capital regulation of the institution's primary federal regulator) of not less than 8.0% throughout the first three years of operation. Initial capital should normally be in excess of $2 million net of any pre-opening expenses that will be charged to the institution's capital after it commences business. In addition, the depository institution must maintain an adequate allowance for loan and lease losses.

If the applicant is being established as a wholly owned subsidiary of an eligible holding company (as defined in Part 303), the FDIC will consider the financial resources of the parent organization as a factor in assessing the adequacy of the proposed initial capital injection. In such cases, the appropriate regional director (DOS) may find favorably with respect to the adequacy of capital factor when the initial capital injection is sufficient to provide for a Tier 1 leverage capital ratio of at least 8% at the end of the first year of operation, based on a realistic business plan, or the initial capital injection meets the $2 million minimum capital standard set forth in the FDIC Statement of Policy on Applications for Deposit Insurance, or any minimum standards established by the chartering authority, whichever is greater. The holding company shall also provide a written commitment to maintain the proposed institution's Tier 1 leverage capital ratio at not less than 8% throughout the first three years of operation.

The adequacy of the capital structure of a newly organized financial institution is closely related to its risk appetite, deposit volume, fixed asset investment, and the anticipated future growth in liabilities. Deposit projections made by the applicant must, therefore, be fully supported and documented. Projections should be based on established growth patterns in the specific market, and initial capitalization should be provided accordingly. Special purpose depository institutions (such as credit card banks) should provide projections based on the type of business to be conducted and the potential for growth of that business.

In most cases, the first three years of operation is a reasonable time frame for measuring deposit growth in newly organized institutions. Accordingly, in assessing the adequacy of initial capital as related to prospective deposit volume, the examiner should develop a reasonable estimate of the deposit volume a new financial institution may generate in each of the first three years of operation, which may differ considerably from the estimates provided in the proponents' application, feasibility study, or economic survey. It is not unusual to find that the proponents' deposit projections and feasibility study are influenced by the proposed capital structure. The proponents' deposit projections may also be out-of-date or not fully supportable due to lack of adequate information and documentation. The best sources of information to assist in formulating reasonable estimates are local economic indicators, population data, deposit and loan growth in other financial institutions in the area, comments and observations of

depository institution managers in the area, the competitive impact of other financial institutions, and the ability of the proponents to generate business in the trade area. In the final analysis, the estimated deposit volume for a new institution's third year of operation is highly significant because it serves the dual purpose of measuring earnings capability as well as capital adequacy after projecting a reasonable operating period.
The number of shares of stock and its par value as of the commencement of business should be scheduled. The per share price of the stock should be stated, and, in cases where an additional amount per share is assessed to cover organizational and preopening expenses, that amount should also be identified. The components of the beginning capital structure can then be allocated to capital stock, surplus, other segregations, and the organizational expense fund. It should be ascertained whether or not the State or Office of Thrift Supervision statutory minimum capital requirements are met and how evidence will be provided to the FDIC that capital funds are fully paid in prior to opening for business. If it appears the proposed capital structure will not meet the FDIC's criteria, the investigation report should reflect fully the extent of and reasons for the inadequacy and recommend to the FDIC an amount which would be acceptable. Should the attitude of the proponents be receptive to a request for supplying additional capital, it should be so indicated.

All stock of a particular class in the initial offering should be sold at the same price, and have the same voting rights. Proposals which allow the insiders to acquire a separate class of stock with greater voting rights are generally unacceptable. Insiders should not be offered stock at a price more favorable than the price for other subscribers. Price disparities provide insiders with a means to gain control disproportionate to their investments.

When securities are sold to the public, the disclosure of all material facts is essential. The FDIC's Statement of Policy regarding use of Offering Circulars in connection with Public Distribution of Bank Securities (dated September 5, 1996) provides additional guidance. A copy of the offering circular prepared by the applicant, the stock solicitation material, and the subscription agreement should be submitted to the FDIC when they become available.

Future Earnings Prospects - Allowing a new institution to commence operations without some indication that it can be operated profitably not only creates a potentially unsatisfactory situation, but could also have a detrimental effect on other competing financial institutions. Usually the operations of a new institution are not profitable for at least the first year. Estimates of operating income and expenses for the first three years of operation should be made using, among other things, the projections of loan and deposit volume made in connection with the "Adequacy of the Capital Structure" factor.

In determining future earnings prospects, the probable income from loans and discounts, bonds and securities, service charges and commissions, and other sources of income must be estimated. Assistance in this task may be obtained from evaluating the applicant's projections, the demand for loans in the area and types thereof, the probable nature of the institution's investment policy, the amount of time and demand deposits likely to be acquired, the probable competitive reaction from existing depository institutions, the economic conditions in the community, the possibility of future development or retrogression in the area, the apparent moneymaking ability of the institution's management, and the FDIC's statistical data for depository institutions operating in the same general area. In addition, estimates must be made for expenses such as salaries and other employee benefits, interest, occupancy and equipment outlays, electronic data processing service costs, and other current operating expenses. Assistance in making these projections may generally be obtained from the same sources used in projecting the various income categories. A review and comparison of original projections and actual data for other recently organized operating financial institutions in the same or comparable areas may be of assistance in projecting earnings and expense data. Applicants need to demonstrate through realistic and supportable estimates that, within a reasonable period (normally three years); the earnings will be sufficient to provide an adequate profit.

The report of investigation should pinpoint any marked divergence between the examiner's findings and those presented in the application and the reasons for such variances. Comment should also be made on the proponents' plans for payment of cash dividends, bonuses, directors' fees, retainer fees, etc, and the accounting system to be used. During the first three years, dividends shall be paid only from net operating income after tax and not until an appropriate allowance for loan and lease losses has been established and overall capital is adequate. In regard to accounting systems, the FDIC requires use of the accrual method from the outset of operations.

As indicated previously, this portion of the investigation report is, by reason of Part 303 of the FDIC's Rules and Regulations, available for public inspection.

General Character of the Management - The quality of an institution's management is vital and perhaps the single most important element in determining the applicant's acceptability for deposit insurance. To satisfy the FDIC's criteria under this factor, the evidence must support a management rating which in an operating institution would be tantamount to a rating of "2" or better. In most instances, the management of a proposed or newly organized institution will not have an operating record as a functioning unit to assist in forming a judgment; therefore, the management rating essentially becomes a question of directly evaluating the individual directors and officers and then making a composite overall rating premised upon the individual analyses.

In general, the individual directors and officers will be evaluated largely on the basis of the following:

- Financial institution and other business experience;
- Duties and responsibilities in the proposed depository institution;
- Personal and professional financial responsibility;
- Reputation for honesty and integrity; and
- Familiarity with the economy, financial needs, and general character of the community in which the depository institution will operate.

The report of investigation should, therefore, contain a schedule giving the name, address, approximate age, total liabilities, and net worth of each director and officer. In addition, for each proposed member of the management team comments should be included that detail present occupation or profession and past banking, thrift, business, farming, or other experience; including observations as to how successful the individuals have been in their present and past activities and whether they have been asked to resign from a position or positions held or have been associated with serious business failures or debt compromises. As a rule of thumb, success of the majority of an applicant's management in their present business endeavors is some evidence of their ability to manage successfully the affairs of the proposed institution.

In addition, all firms, companies, corporations, and organizations in which a given director or officer is substantially interested should be indicated. If the facts denote that the institution is being organized primarily to finance the businesses or personal interests of certain officers and directors, particularly when the assets related thereto are likely to be of dubious quality, the relevant facts should be fully covered.

Duties and responsibilities as well as the title of each proposed officer and director should be outlined. If the proposed duties and responsibilities are regarded as beyond the capabilities of a particular officer or some other distribution of duties and responsibilities among officers would be more effective than that contemplated, the opinions and reasons therefore should be indicated.

Net worth figures on each director and officer will be available from financial reports filed with the application. In listing net worth figures in the report of investigation, an opinion as to the validity of the figures and any pertinent information relating to sizable liabilities may be made.

Stock holdings of each director and officer are to be indicated. Successful operation of a financial institution requires a real interest in its welfare as well as a willingness to devote a substantial amount of time to its affairs. When directors and officers have a significant financial investment, genuine and continuing interest is more likely.

Section 19 of the FDI Act prohibits, without the prior written consent of the FDIC, a person convicted of criminal offense involving dishonesty, breach of trust, money laundering, or who has entered into a pretrial diversion or similar program in connection with a prosecution for such offense, from becoming or continuing as an institution-affiliated party, owning or controlling, directly or indirectly an insured institution, or otherwise participating, directly or indirectly, in the conduct of the affairs of an insured depository institution. If an employee, officer, or director is involved in a criminal conviction, or fidelity insurance has been denied with respect to any employee, officer, or director, a thorough investigation of the circumstances should be conducted. If the facts of the investigation dictate, the institution may be required to file an application pursuant to Section 19 of the FDI Act.

Length of residence in the community or trade area of the proposed institution and degree of familiarity with the major activities of the locale should be indicated with respect to each director and officer.

The above information should be particularly complete with respect to individuals who are likely to dominate the policies and operations of the institution. In addition, comparable information should be included on any shareholder (other than a proposed director or officer) who is subscribing to 10% or more of the aggregate par value of stock to be issued. Examiners should also include in their report any information that may come to their attention concerning possible changes that may be made in the institution's management after commencement of operations. In addition, the FDIC has found that on occasion, subsequent to approval of an application for deposit insurance and prior to the actual opening of a proposed new institution, changes have occurred in the management or ownership. In order to monitor such changes, the FDIC requires that the prospective incorporators advise the Regional Director in writing if changes in the directorate, active management, or in the ownership of stock of 10% or more of the total are made prior to opening. When conducting investigations, this notification should be stressed in any discussions with the proponents.

Certain other information relative to the sale and purchase of the proposed institution's stock and the exercise of voting rights may also reflect on the general quality and character of management. While these matters may also relate to the "Adequacy of Capital Structure" factor, on balance they are more appropriately treated herein. Stock financing arrangements by proposed officers, directors and 10% shareholders of their investments in stock of the proposed depository institution will be carefully reviewed. Such financing will be considered acceptable only if the party financing the stock can demonstrate the ability to service the debt without reliance on dividends or other forms of compensation from the applicant. When stock financing arrangements are anticipated, information should be submitted with the application demonstrating that adequate alternative independent sources of debt serving are available. Direct or indirect financing by proposed officers, directors and 10% shareholders of more than 75% of the purchase price of the stock subscribed by any individual, or more than 50% of the purchase price of the aggregates stock subscribed by the proposed officers, directors and 10% shareholders as a group, will require supporting justification in the application regarding the reason that the financing arrangements should be considered acceptable. If the proposed financing arrangements are not considered appropriate, the FDIC may find unfavorably on the adequacy of the capital structure.

It should be determined whether any commissions are to be paid in connection with the sale of the stock and confirmed that no loans representing applicant stock purchases will be refinanced by the institution. Any evidence that the institution is being organized on a promotional basis should also be covered. Ownership control by several individuals or groups of shareholders as well as any contemplated or existing buy-sell, voting trust, or proxy agreements between various individuals or other entities, such as holding companies, should also receive comment and copies of any such agreements obtained from the applicant or proponents involved.

Stock Benefit Plans – Stock benefit plans, including stock options, stock warrants and other similar stock based compensation plans will be reviewed by the FDIC and must be fully disclosed to all potential subscribers. Participants in stock benefit plans may include incorporators, directors and officers. A description of any such plans proposed must be included in the application submitted to the appropriate regional director. The structure of stock benefit plans should encourage the continued involvement of the participants and serve as an incentive for the successful operation of the institution. Stock benefit plans should contain no feature that would encourage speculative or high-risk activities or serve as an obstacle to or otherwise impede the sale of additional stock to the general public. The following are the factors to use to evaluate stock benefit plans:

- The duration of rights granted should be limited and in no event should the exercise period exceed ten years;
- Rights granted should encourage the recipient to remain involved in the proposed depository institution
- Rights granted should not be transferable by the participant;
- The exercise price of stock rights shall not be less than the fair market value of the stock at the time that the rights are granted;
- Rights under the plan must be exercised or expire within a reasonable time after termination as an active officer, employee or director; and
- Stock benefit plans should contain a provision allowing the institution’s primary federal regulator to direct the institution to require plan participants to exercise or forfeit their stock rights if the institution’s capital falls below the minimum requirements, as determined by its state or primary federal regulator.

Stock benefit plans provided to directors and officers will be reviewed as part of the total compensation package offered to such individuals.

Stock benefit plans provided to incorporators will also be closely scrutinized. In reviewing such plans, the FDIC will consider the individual’s time, expertise, financial commitment and continuing involvement in the management of the proposed institution. The FDIC will also consider the amount and basis of any cash payments which will be made to the incorporator for services rendered or as a return on funds placed at risk. Plans to compensate incorporators that provide for more than one option or warrant for each share subscribed will generally be considered excessive. It is further expected that incorporators granted options or warrants at or near this level will actively participate in the management of the depository institution as an executive officer or director. On a case-by-case basis, the FDIC may not object to additional options being granted to an incorporator who will also be a senior executive officer.

The FDIC recognizes that there will be limited instances where individuals who substantially contribute to organization of a new depository institution do not intend to serve as an active officer or director after the institution opens for business. The FDIC will generally not object to awarding warrants or options to incorporators who agree to accept shares of stock in lieu of cash payment for funds placed at risk or for professional services rendered. In such instances, the FDIC defines funds placed at risk to include seed money actually paid into the organizational fund and the value of professional services rendered as the market value of legal, accounting and other professional services rendered. Generally, warrants or options for organizers who will not participate in the management of the institution will be considered excessive if the amount of options or warrants to be granted exceeds the number of shares of stock at risk and/or for professional services rendered. The granting of options to incorporators who guarantee loans to finance an institution's organization generally would not be objectionable, but options granted should be limited so that the market value of the stock subject to option does not exceed the amount of the loan guarantees (although guarantees exceeding the amount drawn or expected to be drawn will not be considered.) When continuing service is not contemplated, the FDIC will not require vesting or restrictions on transferability, but will review the duration of the rights, exercise price and exercise or forfeiture clauses in the same manner as discussed above.

In evaluating benefit and compensation plans for insiders, the FDIC will look to the substance of the proposal. Those proposals that are determined to be substantially stock based plans will be evaluated on the above stock benefit plan criteria. Stock appreciation rights and similar plans that include a cash payment to the recipient based directly on the market value of the depository institution's stock are unacceptable.

If the proposal involves the formation of a de novo holding company and a stock benefit plan is being proposed at the holding company level, that stock benefit plan will be reviewed by the FDIC in the same manner as a plan involving stock issued by the proposed depository institution.

Proponents should be made aware of the prohibition against interlocking management relations applicable to depository institutions (banks, savings and loan associations, mutual savings banks, and credit unions) and depository holding companies (banks, and savings and loan holding companies) contained in Title 11 of FIRIRCA and Part 348 of the FDIC's Rules and Regulations. The FDIC adheres to a fixed policy requiring that all applicants provide at least a five-member board of directors, even though the State law may, in some cases, permit a lesser number.

On the basis of the facts and considerations detailed in the report of investigation, examiners should state, and factually support to the greatest extent possible, their conclusions as to the management rating. A notation as to the type and amount of the insurance (fidelity, burglary, robbery, etc.) to be carried by the institution should be included in the report under the management heading. With respect to fidelity coverage, the FDIC's position is that applicants should subscribe to and maintain adequate coverage and have in force at all times a $1 million excess bank employee dishonesty bond, if primary blanket bond coverage is less than $1 million.

Applicants are expected to develop appropriate written investment, loan, funds management and liquidity policies. Establishment of an acceptable audit program is required for proposed depository institutions. Applicants are expected to commit the depository institution to obtain an audit by an independent public accountant for at least the first three years of operation.

An applicant bank or an applicant branch of a foreign bank that expects to operate an international loan department or conduct international lending and investment activities is expected to address country risk and related concentrations of credit with respect to these activities in their written policies. These factors should be segregated from other lending and investment risk criteria and addressed separately in the policies. Policy coverage should not be limited to just loans, but should also encompass securities, deposit balances, acceptances, and other activities that are expected to be included in the bank's or branch's operations. If an applicant does not intend to engage in such activity, they should specifically so state.

Risk Presented to the Insurance Fund - This factor is to be broadly interpreted and may be the most relevant in the unusual circumstance where none of the other factors is clearly identifiable as unfavorable. For example, "risk to the fund" might be resolved unfavorably and the application denied based on the applicant's unsound business plan even though all the other factors might be favorably resolved. The FDIC expects that an applicant will submit a business plan commensurate with the capabilities of its management and the financial commitment of the incorporators. Any significant deviation from the business plan within the first three years of operation must be reported by the insured depository institution to the primary federal regulator before consummation of the change. An applicant's business plan should demonstrate the following:

- Adequate policies, procedures, and management expertise to operate the proposed depository institution in a safe and sound manner;
- Ability to achieve a reasonable market share;
- Reasonable earnings prospects;
- Ability to attract and maintain adequate capital; and

- Responsiveness to community needs.

Operating plans that rely on high risk lending, a special purpose market, significant funding from other sources other than core deposits, or that otherwise diverge from conventional bank related financial services will require specific documentation as to the suitability of the proposed activities for an insured institution. Similarly, additional documentation of plans is required where markets to be entered are intensely competitive or economic conditions are marginal. Like a recommendation based on any other factor, an unfavorable finding based on "risk to the fund" must be clearly articulated.

Convenience and Needs of the Community to be Served - Generally, there is a presumptive indication of need if the directors or organizers of the applicant are a responsible group of persons willing and able to supply a substantial and adequate amount of money to back up their judgment, and if the management of the proposed institution is competent, honest, and familiar with the problems of the area to be served. However, consideration should be given to the adequacy of existing depository institution facilities in the community and in nearby rival communities, for a financial institution is unlikely to fulfill a need if it is unable to command sufficient volume to maintain profitable operations. In this connection, the Examiner should endeavor to ascertain whether or not the services rendered by existing depository institutions are satisfactory, and whether or not such institutions are meeting the legitimate credit needs of the community.

It should be noted that the provisions of the Community Reinvestment Act are especially relevant in evaluating this statutory factor.

In considering the question of need, it is important that the examiner not adopt the viewpoint of depository institutions located in the community, to the exclusion of other, equally persuasive viewpoints. As in the other lines of business, existing financial institutions may regard any new institutions as unnecessary and a potentially "harmful competitor". An unbiased conclusion in this connection requires impartial consideration of the opinions of the organizers of the applicant as well as those of the management of existing institutions. In addition, it is sometimes necessary to solicit the views of representative business and professional persons in the community, together with those of citizens of more modest means. The results of canvasses and surveys of local individual or business persons should be set forth in the report in order to assist in evaluating support for the proposed institution, the adequacy of present depository institution facilities, whether the legitimate banking needs of the community are being met, whether and to what extent the new facility would be used, and the knowledge these persons have of the proponents. In the final analysis, the value of any information so obtained will depend largely on the examiner's ability to discriminate between those views which proceed from intelligent and rational consideration of the real needs of the community and those which are mainly inspired by a false sense of community pride or selfish personal interest.

A clear definition of the proposed institution's trade area is essential in determining convenience and needs. A brief description of the general area in which the proposed institution is to be situated and its location in relation to other prominent nearby communities, developments, or other important landmarks should be initially presented. The primary trade area as described in the application should then be discussed along with an opinion as to the validity of the applicant's definition of the trade area. In some instances, the applicant may artificially draw its trade area boundaries so as to exclude factors which would be unfavorable to the proposal (nearby depository institutions, depressed areas, etc.) and include others which would increase the attractiveness of the proposed location (significant residential or commercial developments, highly concentrated population area, etc.). Any differences between the examiner's conception of the trade area and that of the proponents should be discussed fully in the report together with a description of the trade area as the examiner perceives it. Once the trade area has been defined, information regarding the following should be set forth.

The principal industrial, trade, or agricultural activity should be described and, if considered relevant, annual values of principal products indicated. The presence and source of large payrolls in the area may also be an important consideration. The number and value of residential and commercial building permits can often be of considerable value in determining the vitality of the area. Figures regarding retail sales from public sources or trade organizations are useful; however, if they are not available, it may be possible to obtain some estimates of volume in the course of conducting a survey of the locale's business establishments. Information regarding medical facilities and other professional services can be a useful indicator of the self- sufficiency of the community or trade area. Statistical information on governmental units such as; assessed valuations, tax levies, bonded indebtedness, and tax delinquencies, and data on the educational environment of the area are also valuable indicators. Reports of investigation should not, however, be filled with pages of statistics unless the figures are relevant.

Demographic figures within the trade area as well as the general surrounding areas are significant determinants in considering convenience and needs. While population as of the date of investigation is important, data which establishes population trends as well as projections for the future should be presented. In some cases it is difficult to obtain accurate population data for a particular trade area, as statistics combine portions of several census tracts. In some instances, data showing the number of household units in the area may be a more appropriate basis for assessing reasonable population estimates.

The examiner should assess the competitive dynamics of the proposed market and how the institution will compete for market share. Officials of area depository institutions should be contacted during the investigation and given an opportunity to express their attitudes on the proposal. Any formal objections to the proposal should be investigated and comments relative to discussions with the objector(s) set forth in the investigation report. The probable competitive effects of a new institution proposal should be fully weighed by the examiner. While the number of depository institutions operating in the city or area to be served is important in determining whether the addition of a new institution may result in an overbanked condition, consideration should also be given to possible procompetitive consequences flowing from the new institution proposal, such as increased customer services and banking options to residents of the area. Therefore, it is necessary to furnish complete factual data with respect to the probable impact of the proposal on existing financial institutions in the community.

The extent of new or proposed residential, commercial, and industrial development and construction is a significant secondary consideration in resolving the convenience and needs factor. Plans for the development of shopping centers, apartment complexes and other residential subdivisions, factories, or other major facilities near the proposed site should, therefore, receive comment. In certain instances, inclusion of maps may be desirable to clarify comments, showing location of competing depository institutions or branches, important buildings, offices, shopping centers, industrial parks, and the like in relation to the office site. As in the case of the "Future Earnings Prospects' factor, this portion of the investigation report is also available for public inspection under Part 303 of the FDIC's Rules and Regulations.

Consistency of Corporate Powers – Generally, the FDIC will presume that a proposed national bank’s or federal savings association’s corporate powers are consistent with the purposes of the Act. Pursuant to section 24 of the Act, no insured state bank may engage as principal in any type of activity that is not permissible for a national bank unless the FDIC has determined that the activity would pose no significant risk to the appropriate deposit insurance fund and the state bank is, and continues to be, in compliance with applicable capital standards prescribed by its primary federal regulator. Similarly, section 28 of the Act provides that a state chartered savings association may not engage in any type of activity that is not permissible for a federal savings association, unless the FDIC has determined that the activity would pose no significant risk to the affected deposit insurance fund and the savings association is and continues to be, in compliance with the capital standards for the association. Since the applicant will have agreed in its application not to exercise nonbanking powers whether granted by charter or statute, the examiner need only refer to this previously obtained agreement. Additional comments may be included if the terms of the agreement are not generally understood by the applicant or if they regard the agreement as being incomplete or amendment to the Articles of Association or Charter is necessary or desirable.

Miscellaneous - The existence of any conflicting applications to establish depository facilities in the immediate area should be indicated and receive appropriate comment in the examiner's report of investigation. If operation of a trust department is contemplated, applicant must also file with the FDIC the appropriate form covering "Application for Consent to Exercise Trust Powers". This form will provide much of the information necessary for the completion of the report of investigation with respect to this phase of the applicant's operations. If the proposed trust functions will materially affect the examiner's findings in making a recommendation on anyone of the seven factors contained in Section 6 of the Federal Deposit Insurance Act, it may be advisable to analyze the prospects for the operation of the commercial and trust departments under separate subheadings for any factor so affected.

If any of the documents essential for full consideration of the application have not been submitted to the FDIC, the proponents should be instructed to transmit such documents at the earliest practical date and a notation to that effect included in the report.

Statutory Factors, Existing Institutions

As indicated previously, the FDIC's admission criteria for proposed or newly organized institutions and for existing institutions are generally the same. Consequently, principles previously discussed in this section of the Manual are not repeated herein. Prior to processing applications for existing institutions for deposit insurance coverage, examiners should familiarize themselves not only with the following provisions but also those set forth under "Statutory Factors, Proposed or Newly Organized Institutions". In the case of an existing institution, the FDIC will conduct an examination of the ongoing institution or its predecessor institution and a report prepared on the regular printed FDIC form, with appropriate notation on the cover indicating the special purpose of the examination. Under Examiner's Comments and Conclusions of the Supervisory Section of the Report of Examination, the examiner is required to discuss separately each of the seven statutory factors.

Financial History and Condition - While the financial history of an operating institution is usually reflected in its present condition, the basic cause or causes for an institution's condition, whether satisfactory or unsatisfactory, should be analyzed and the reasons therefor ascertained. Accordingly, where the financial history of an operating institution has not been successful or is questionable, the FDIC generally requires reasonable assurance that the cause or causes of any past difficulties of a serious nature have in large measure either been overcome or ceased to exist.

Date of primary organization should be indicated. Another important feature in the financial history of an existing institution is its past attitude on the prompt recognition and current charge-off of losses and the administration of dividend policies. In addition, mergers, consolidations, recapitalizations, reorganizations, liability assumptions, deposit waivers, deposit deferments, and similar events, which are not recent, should be covered in the Report of Examination, but in less detail.

With respect to an operating institution's financial condition, the FDIC customarily requires that the general quality of its net assets be satisfactory and on a par with that of peer institutions. In appraising the value and quality of an applicant operating institution's assets, the same appraisal and classification procedures and criteria are to be followed as in regular FDIC examinations. The "Items Subject to Adverse Classification" as well as the "Items Listed for Special Mention" pages in the Report of Examination as well as the "Summary Analysis of Examination Report" (SAER) should include data on the quality of an institution's net assets. This information should be summarized in the "Examination Conclusions and Findings" under an appropriate caption. General comments on asset condition and problems should also be included, as well as a summary of "Violations of Laws and Regulations", contingent liabilities, existing litigation against the institution, dividend and remuneration policies, and other matters which could affect the institution's condition.

Adequacy of the Capital Structure - An existing institution applying for deposit insurance should have sufficient capital to support the volume, type, and character of its business, provide for losses, and meet the reasonable credit needs of the community which it serves. The process of determining the adequacy of an institution's existing capital as well as that after three years of operation (considering estimated deposit growth) begins with a qualitative evaluation of critical variables that directly bear on the institution's overall financial condition. These variables as well as all the principles set forth in the FDIC Statement of Policy on Capital (Appendix B to Part 325), are applicable here. The Statement, setting forth various levels for adjusted equity capital, only provides a benchmark for evaluating capital adequacy. Although it establishes uniform standards for capital levels among depository institutions regardless of size, the ratios set forth therein are, however, only starting points since such ratios are not in themselves determinative and must be integrated with all other relevant factors such as character of management, quality of assets, and so on. In the final analysis, each case must be judged on its own merits. It should be recognized that various State banking departments may impose more stringent capital requirements than those set forth in the FDIC Statement of Policy on Capital.

The Report of Examination should include some of the data necessary for determining whether the applicant's capital is adequate. The data should also be summarized and augmented in the Examiner's Conclusions and Recommendations of the Supervisory Section under the caption "Adequacy of Capital Structure". If for any reason a substantial increase in deposits is anticipated, or any plans of the applicant with respect to the institution's capital structure are contemplated, or if the proponents appear receptive to a request for supplying additional capital, it should be so indicated in the Report of Examination. It is desirable to include under this caption, or as a supplemental page to the Report of Examination, a complete or reasonably complete list of all shareholders, their holdings, and related interests.

Future Earnings Prospects - The earnings capability of an existing institution is reflected in its earnings record. Ordinarily, an operating institution's earnings record should indicate ability to pay all operating expenses with a safe margin for the absorption of losses and for the payment of reasonable dividends. For comparative purposes, current earnings ratios may be obtained from various data prepared by the FDIC. If earnings have not been sufficient, areas where income may be improved or expenses reduced should be noted. The principles described in the Earnings Section of this Manual are applicable here. The income and expense figures reflected in the Report of Examination are book figures. If the examiner regards these figures as incorrect or misleading because of improper accounting for unearned discounts, failure to charge off losses, failure to properly depreciate fixed assets, or similar deviations from accepted practices, the matter should be fully discussed in the presentation of earnings data in the Supervisory Section. The examiner should also comment on the effect deposit insurance coverage might have on the institution's income and expenses in the future.

General Character of Management - In the case of an existing institution, management may be evaluated both from the standpoint of the institution's condition and the vantage point of management's past performance as reflected in the books and records of the institution, previous Reports of Examination and correspondence from other regulators, and internal records, such as committee and board of directors' minutes. A management rating of "2" or better is necessary to satisfy the requirements of this statutory factor. The rating of management is discussed in the Management Supervision, Administration and Control Section of this Manual.

Complete information on management will be included in the report. In addition, a summary discussion of important aspects of this information, together with information on director and officer indebtedness to the institution, should be included under this caption in the "Examiner's Conclusions and Recommendations" of the Supervisory Section. If management is not regarded as warranting a rating of "2" or better, it should be indicated what changes are believed essential to warrant such a rating. Fidelity insurance on active officers and employees and other indemnity protection should receive comment to the extent necessary under this captioned statutory factor.

Risk Presented to the Insurance Fund - Analysis of this factor is the same as previously described for proposed new institutions.

Convenience and Needs of the Community - The FDIC's criteria under this statutory factor are closely related to those outlined with respect to the "Future Earnings Prospects" factor. A going institution which is being successfully and profitably operated, and which has a recognized place and established customer relationships in its community, is for self-evident reasons convenient to and fulfilling the needs of the community it serves. An institution may, however, have had inferior earnings in the past and nevertheless qualify under this statutory factor. Any pertinent information with respect to local economic conditions, population trends, or unusual circumstances which have affected or may affect the community and the applicant should be commented on under this caption. It should be noted that the provisions of the Community Reinvestment Act are relevant in evaluating this statutory factor.

Consistency of Corporate Powers - Nonbanking powers and certain saving associations activities, other than trust powers, are regarded by the FDIC as inconsistent with the purposes of the Act. In some states, institutions have been granted the right under their charters or by statute to engage in certain nonbanking activities. Section 24 of the Act limits the powers of insured state banks and section 28 of the Act limits the powers of state chartered savings associations. If the institution is exercising any powers not authorized under the applicable statute, the application should contain an agreement and plan for eliminating the activity as soon as possible, or a separate application should be submitted seeking the FDIC's consent to continue the activity.

Miscellaneous - If the applicant operates a trust department, an examination will be conducted and a Report of Examination compiled. The examiner should consider the condition and the prospects of the trust department in developing the conclusion for each factor enumerated under Section 6 of the Act. Should trust department operations be of sufficient influence in the final determination of the examiner's findings on any of the factors, it may be advisable to analyze the commercial and the trust operations under appropriate subheadings. The examiner should indicate the number of tellers' windows at which insured deposits will be received. If any of the documents essential for full consideration of the application have not been submitted to the FDIC, the proponents should be instructed to transmit such documents at the earliest practical date and a notation to that effect included in the report.

Examiners should indicate in their reports the sources of information on significant points covered in their comments. During the examination, the examiner should review reports of examination of other supervisory authorities and correspondence from these authorities.

Deposit Insurance Applications from Proposed Publicly Owned Depository Institutions

An application for deposit insurance from a depository institution which would be owned or controlled by a domestic governmental entity (such as, for example, a state, county or a municipality) will be reviewed very closely. The FDIC is of the opinion that due to their public ownership, such depository institutions present unique supervisory concerns that do not exist with privately owned depository institutions. For example, because of the ultimate control by the political process, such institutions could raise special concerns relating to management stability, their business purpose, and their ability and willingness to raise capital. On the other hand, such institutions may be particularly likely to meet the convenience and need of their local community, particularly if the local community is currently un- or under- served by depository institutions.

APPLICATIONS TO ESTABLISH A BRANCH OR TO MOVE MAIN OFFICE OR BRANCH

Provisions of Law

Under the provisions of Section 18(d) of the Federal Deposit Insurance Act (the "Act"), no State nonmember insured bank may establish and operate any new branch, or change the location of any existing branch, or move its main office, unless it obtains the prior written consent of the FDIC. The factors to be considered in granting or withholding such consent are those enumerated in Section 6 of the Act. Also included in Section 18(d) of the Act, no state nonmember insured bank shall establish or operate any foreign branch, except with the prior written consent of the FDIC. There are further restrictions detailed below concerning either establishment or relocation of branches in states other than the applicant's home state. Subpart C of Part 303 of the FDIC's Rules and Regulations governs the administrative handling of applications to establish a branch or to relocate an office.

Filing Procedures for Branch Applications

In applying to establish a branch or to relocate an existing office, State nonmember insured banks must file an application in letter form with the FDIC. A complete letter application shall include:
(1) a statement of intent to establish a branch or to relocate the main office or a branch;
(2) the exact location of the proposed site including the street address; and
(3) details concerning any involvement in the proposal by an insider of the bank;
(4) a statement on the impact of the proposal on the human environment, including information on compliance with the provisions of the NEPA (National Environmental Protection Act);
(5) a statement as to whether or not the site is eligible for inclusion in the National Register of Historic Places for purposes of complying with the applicable portions of NHPA (National Historic Preservation Act);
(6) comments on any changes in services to be offered, the community to be served, or any other effect the proposal may have on the applicant's compliance with the Community Reinvestment Act;
(7) a copy of each newspaper publication required; and
(8) when an application is submitted to relocate the main office of the applicant from one state to another, a statement of the applicant's intent regarding retention of branches in the state where the main office exists prior to relocation.

Expedited processing per Part 303 is available for eligible depository institutions. For those applications which are not processed pursuant to the expedited procedures, preliminary consideration will be given in the Regional Office to applications to determine whether an examination of the applicant bank should be ordered. In all cases, however, a Summary of Investigation Form for Branch Applications will be completed. Please refer to the Case Managers Procedures Manual for additional processing and filing information.

Interstate Banking Branch Applications

For applications to establish a de novo branch that is not in the applicant's home state and in which the applicant does not already maintain a branch, the application must comply with the state's filing requirements. The FDIC needs to determine that the applicant is adequately capitalized as of the date of the filing and will continue to be adequately capitalized and adequately managed upon consummation of the transaction; and confirmation that the host state has a law permitting state "opt-in" elections to enable interstate branching, pursuant to the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994.

For applications where the applicant already has one or more existing branches in a state other than the applicant's home state, a determination needs to be made that the application has not failed the host state's credit needs test and that it is reasonably helping to meet the credit needs of the communities which the branches serve.

Other Considerations for Branch Applications

As in the case of applications for deposit insurance, the provisions of the Community Reinvestment Act, the National Historic Preservation Act, and the National Environmental Policy Act of 1969, must be favorably resolved.

APPLICATIONS FOR CONSENT TO EXERCISE TRUST POWERS

Introduction

1. FDIC Section 333

The FDIC does not grant trust powers, but only gives its consent to exercise such powers as granted by state authorities. Section 333.2 of the FDIC's Rules and Regulations prohibits an insured state nonmember bank from changing the general character of its business without the FDIC's prior written consent. The test to determine when a change in character of business has occurred is left to the discretion of the FDIC. For trust powers, this normally occurs when a fiduciary relationship is created under the laws of the governing state authority. Therefore, it is general policy that unless a bank is exempted through the circumstances described in the Background section below, it must file a formal application with the FDIC to obtain prior written consent before it may exercise trust powers. It should also be noted that the statute applies only to banks. Separately chartered and capitalized uninsured trust company subsidiaries of banks need not apply for FDIC consent to exercise trust powers.

2. Background

In 1958 the FDIC articulated its basis for requiring consent to exercise trust powers (refer to page C-41 of the FDIC Trust Examination Manual), and established conditions for grandfathering consent. Banks granted trust powers by state statute or charter prior to December 1, 1950, regardless of whether or not such powers have ever been exercised, are not required to file an application with the FDIC for consent to exercise trust powers. Such consent is grandfathered with the approval for Federal deposit insurance.

Banks approved for Federal deposit insurance after December 1, 1950, are required to file an application to exercise trust powers, unless such filing was made simultaneously with the application for Federal deposit insurance.

3. Applications for Consent

Part 303 of the FDIC's Rules and Regulations governs the administrative handling of applications for consent to exercise trust powers. Application procedures are set forth in both Part 303 and the Case Managers Procedures Manual. Banks eligible for expedited processing under Part 303 (as defined therein) may file an abbreviated application. Application forms for both expedited and non-expedited processing are available at Regional Offices. Applications are reviewed in the context of the financial institution's ability to satisfactorily perform trust activities. In reviewing any such application, the statutory factors set forth in Section 6 of the Federal Deposit Insurance Act are also considered. Other factors which examiners should be aware of include:

a. Statement of Principles of Trust Department Management

The FDIC's "Statement of Principles of Trust Department Management" outlines minimum requirements for the sound operation of a trust department. Before final approval of any application for consent to exercise trust powers may be given, the applicant's board of directors is required to adopt the minimum requirements set forth in the "Statement".

b. Management Adequacy

To approve any application for consent to exercise trust powers, it must be concluded that management of the contemplated trust operation is capable. By adopting the "Statement of Principles of Trust Department Management", the applicant bank resolves to provide sufficient staff and facilities to meet minimum standards of competency in trust matters. Applications submitted for consent to exercise full trust powers by banks having inexperienced trust management, or management which is considered incapable of administering trust activities other than routine matters, should not be approved. Such applications should not be accepted for processing, but returned to the bank for resubmission at a later time. Where limited powers will suffice, the bank should be encouraged to amend its application for specified limited powers. Otherwise, the board of directors should be requested to seek qualified trust management if it wishes to obtain consent to exercise full trust powers. Nevertheless, Regional Directors may, when warranted, approve an application conditioned on the bank's hiring of qualified trust management which is acceptable to the FDIC.

c. Limited Trust Powers

Banks will sometimes be granted limited trust powers, usually confined to a few specific functions such as agent for employee benefit accounts, guardian of the property of minors, or capacities not requiring extensive expertise. In processing an application for consent to exercise limited trust powers, applicants should be required to specify the exact functions to be performed. At
examinations of banks having limited trust powers, the examiner should determine that only authorized activities are being performed.

d. Unauthorized Trust Activities

Commercial banks may be found performing fiduciary services without having obtained full or limited trust powers, or the FDIC’s consent to exercise such powers. In these cases, the examiner should determine what services are being performed, and review all written customer agreements. If a bank is acting in any capacity requiring trust powers, the examiner should:

(1) cite a violation of state law for performing fiduciary services without trust powers (if applicable);

(2) cite a violation of FDIC Section 333.2 for changing the character of its business without the FDIC's prior written consent;

(3) advise management:

(a) it must discontinue accepting any additional appointments;

(b) it should (upon advice of counsel) discontinue performing fiduciary services, if it can do so without jeopardizing its accounts or incurring additional liability upon itself;

(c) that it must apply to its state authority for trust powers (if applicable); and

(d) that it must also apply to the FDIC for consent to exercise the powers.

If a bank is acting in an agency capacity, the examiner should make a determination of the bank's duties and responsibilities.

Particular attention should be given to the degree of discretionary authority exercised. It should also be determined whether the bank is required to manage the assets, or to simply hold them subject to customer direction. If the bank's duties are those which require trust powers, the examiner should follow the procedures outlined in the preceding paragraph. Applications for consent to exercise trust powers subsequent to the discovery of unauthorized activities do not merit expedited processing. Such applications warrant consideration for approval subject to prior written conditions with management.

e. "Customer Service" versus "Fiduciary Activity"

It is not unusual for a bank to hold securities, notes, mortgages, or similar instruments in a "Customer Collections" department, collecting income and remitting it to customers. This could be considered a normal banking function not requiring trust powers. However, there have been instances where banks have entered into arrangements to make investment recommendations, buy and sell securities on their own authority, vote proxies, and otherwise deal with securities in the manner of a fiduciary. Banks have also entered into discretionary arrangements to execute repurchase agreements, or make other short-term investments using demand deposit accounts to settle transactions. Some escrow departments may hold, manage, rent, or otherwise administer real property in a manner, which reaches beyond conventional escrow relationships. All these activities constitute discretionary agencies typically requiring trust powers. Normally, the most important determining factor is the degree of discretionary authority exercised over funds and assets, with resulting exposure to contingent liabilities. Questionable cases should be submitted by the examiner to the Regional Office for determination.

f. Additional Information

Whether or not additional information is necessary to approve or recommend denial of an application for consent to exercise trust powers, is generally left to the discretion of the Regional Director. Additional information may be obtained by correspondence, telephone, or personal visit. Matters, which may be relevant in considering applications which, are not eligible for expedited processing include:

(1) Competition - If the lack of sufficient trust services in the trade area is of importance in determining a recommendation, competitive information should be secured from the Annual Report of Trust Assets of area banks.

(2) Trust Business Development - The size and scope of the proposed operation may be influenced considerably by the extent to which the applicant plans to use advertising, personal solicitation, and other public relations activities.

(3) Amount and Kind of Property and Potential Volume of Business - The sources of such data will vary. Any information as to trade area demographics, and the types of assets or property by which it is principally represented would, in some instances, prove beneficial.

(4) Deposit Structure - If collateral benefits to the bank, such as a substantial volume of new deposits in the banking department, are anticipated from the establishment of trust services, the bank may be required to provide full details. Caution is suggested in allowing too much weight in consideration for claims of collateral benefits, as these are often short-lived while the obligations of the trust services continue.

(5) Fixed Assets - If establishment of the trust department results in a significant increase in an already heavy fixed asset investment, full details should be requested.

(6) Deposit Insurance - As noted in FDIC Section 330.12, depending on the institution's Prompt Corrective Action capital category, pass-through deposit insurance may not be available on deposits of retirement and

employee benefit plans. This applies to deposits, which may obviously be made in the bank without regard to whether it has trust powers.

However, the likelihood of such deposits being made increases when banks acquire trust powers. The applicability of this section to applicants seeking consent should be ascertained. To the extent that deposits of such plans exist in the bank, or are contemplated, and pass-through deposit insurance is not available, care should be taken to ensure that procedures in both Parts 325 (Capital Maintenance) and 330 (Deposit Insurance Coverage) are being followed, and that corrective plans are in place.

C. CORPORATE STRUCTURE AND ORGANIZATION OF FIDUCIARY ACTIVITIES

1. General

The offering of trust services has long been regarded as an ancillary customer service, primarily the dominion of banks. However, toward the end of the twentieth century a number of forces have combined, with the result that fiduciary services are a dynamic and sought-after product line with significant profit potential. In the U. S., population trends have been a significant factor as the large post-World War II "baby boom" generation matures and accumulates wealth. The large size and consumer influence of this group has created much emphasis on wealth management and transfer. While this has presented trust service providers with more opportunity, it has also attracted competition from banking and non-banking industries. New delivery systems, new products, advances in technology, and consolidation within the financial industry, have all contributed to changes in how banks offer trust services. To properly evaluate these delivery systems the examiner needs an understanding of both the legal and functional organization of the bank's trust services.

The trust department, as a separate and visually distinct department of the bank, remains the most prevalent method for banks to deliver fiduciary services. However, the recent trend toward consolidation within the financial services sector has led to diverse restructuring and merger activity. In some instances, banks previously lacking trust product lines may have acquired them through mergers. In other cases, the "trust" line of business may have been purchased or sold by a bank. In some cases, trust services being provided by several individual banks owned by the same holding company may have been consolidated within one bank, or within a separately chartered trust company. In still other instances, a bank may have contracted with an unrelated outside party, to provide such services on-premises. Or conversely, the bank under examination may provide such services to other banks. In all cases, the examiner should seek to understand the organization, and review the structure of the delivery system for legality, reasonableness, and adequacy of compensation to the bank.

CHANGE IN BANK CONTROL ACT

Introduction

The Change in Bank Control Act of 1978, Title VI of the Financial Institutions Regulatory and Interest Rate Control Act of 1978, amended Section 7(j) of the Federal Deposit Insurance Act. The amendments gave Federal banking agencies authority to disapprove changes in control of insured banks and bank holding companies. The appropriate agencies for changes in control are: the FDIC for insured nonmember banks, The Board of Governors of the Federal Reserve System for member banks and bank holding companies, the Comptroller of the Currency for national banks, and the Director of the Office of Thrift Supervision for savings associations and savings and loan holding companies. Previous reporting requirements relating to loans by banks secured by stock of other banks and management changes occurring after a change in control were retained with some modification and these requirements were extended to bank holding companies and loans secured by bank holding company stock. The FDIC's objectives in its administration of the Change in Bank Control Act are to enhance and maintain public confidence in the banking system by preventing identifiable serious adverse effects resulting from anticompetitive combinations of interest, inadequate financial support, and unsuitable management in these institutions. The FDIC will review each notice to acquire control of an insured State nonmember bank and disapprove transactions likely to have serious harmful effects.

Provisions of Law

Section 7(j) of the FDI Act; Subpart E, Section 303.80 of the FDIC's Rules and Regulations and the FDIC Statement of Policy, "Changes in Control in Nonmember Banks," set forth in detail all necessary requisites and instructions.

Procedures

Any person (broadly defined) seeking to acquire control (power to vote 25% or more of any class of voting securities) of any insured bank or bank holding company, is required to provide sixty days prior written notice to the appropriate agency. A person means an individual or a corporation, partnership, trust, association, joint venture, pool, syndicate, sole proprietorship, unincorporated organization, or any other form of entity. A Notice of Acquisition of Control form is required to be filed with the appropriate Regional Office, accompanied by a completed and signed Financial Report and Biographical Information form for each of the acquiring parties to the extent known. Certain newspaper publication requirements are also required as indicated in Part 303.

The FDIC reviews the information reported in a Notice to assess any anticompetitive or monopolistic effects of the proposed acquisition, to determine if the financial condition of any acquiring person is such as might jeopardize the financial stability of the bank or prejudice the interests of the depositors of the bank, and to determine whether the competence, experience, or integrity of any inquiring person, or any of the proposed management personnel, indicates that it would not be in the interest of the depositors of the bank, or in the interests of the public, to permit such person to control the bank.

While processing and handling of Notices may parallel the procedures related to applications for deposit insurance, new branches, relocations, etc., at least one fundamental difference is present. In the case of statutory applications, the burden of making a case in support of a proposal falls on the applicant; in considering Notices, the FDIC exercises a veto, with a burden of sustaining a disapproval falling on the FDIC. Accordingly, in evaluating Notices, the FDIC need not find favorably on the various factors; the absence of unfavorable findings approximates tacit approval.

Regional Directors are delegated, with certain exceptions, authority to issue a written notice of the FDIC's intent not to disapprove an acquisition of control. Authority to disapprove has been delegated to the Director and Deputy Director (DOS) and where confirmed in writing by the Director to an associate director. If written views of the State authority recommend disapproval, or if an acquiring party discloses a conviction or a plea of no contest to a criminal charge involving dishonesty or breach of trust, the Regional Director makes a recommendation to Washington based on the findings under the factors.

The factors considered in evaluating Notices and the basis for disapproval are, in brief: whether the proposed acquisition of control would result in a monopoly; whether the effect the proposed acquisition of control in any section of the country may be substantially to lessen competition or to tend to create a monopoly, or would in any other manner be in restraint of trade; the financial condition of the acquiring party and its potential impact on the financial stability of the bank or prejudice the interests of depositors; the competence, experience or integrity of any acquiring person or proposed management; if any acquiring party neglects, fails, or refuses to furnish all the information required by the FDIC; or the effect on the Bank Insurance Fund or Savings Association Insurance Fund is adverse.

A transaction triggering the notice requirements may not result in the acquiring party actually gaining effective control of an institution. For example, a person acquiring 25% of voting control would not gain effective control if there were an existing shareholder with 50% of voting control. Nonetheless, the transaction triggers the notice requirement and a Notice should be evaluated as if it were an actual change in effective control. After once complying, further acquisitions by the same person in the same bank do not require filing of notices. An acquiring party who continuously remains within the definition of control needs to file only one notice per bank to be in compliance.

Certain types of transactions are exempt from prior notice requirements, such as those subject to Section 3 of the Bank Holding Company Act, Section 10 of the Home Owner's Loan Act, or Section 18 of the FDI Act, since they are covered by existing regulatory approval procedures. Accordingly, changes in control due to acquisitions by bank holding companies and those resulting from mergers, consolidations, or other similar transactions are not covered. Acquisition of shares of foreign banks are exempt, however, foreign banks with insured domestic branches are subject to the after-the-fact reporting requirements. Transactions resulting in voting control of 10% or more of any class of voting securities of banks whose securities are subject to the regulation requirements of Part 335 of the FDIC's Rules and Regulations are presumed to be acquisitions of control as are similar transactions of unregistered banks resulting in 10% or more control whereby the acquiring party would become the largest shareholder. These latter two are rebuttable presumptions of control. In addition, the following types of transactions are also exempt: a foreclosure of a debt previously contracted in good faith; testate or intestate successions; a bona fide gift; and; a transaction described in Section 2(a)(5) or 3(a)(5)(A) or (B) of the Bank Holding Company Act by a person there described.

Persons acquiring control by exempt transactions while not required to give prior notice, are required to provide after-the-fact information on the transaction and other information regarding changes in management or policies of the bank. Personal financial and biographical information may be requested subsequent to changes in control of these types at the discretion of the Regional Director. Affected banks are required to report changes or replacement of chief executive officers or directors occurring within twelve months after change in control, including a statement of the past and current business and professional affiliations of the new chief executive officer or director.

Section 7(j) of the FDI Act also requires the chief executive officer of an insured bank that makes a loan secured or to be secured by 25% or more of the voting stock of another insured bank to report the facts to the appropriate regulatory agency. No report need be made where the stock is that of a newly organized bank prior to its opening. Through the definition of insured bank, the reporting requirement is extended to include loans secured by bank holding company stock.

Effective enforcement of Section 7(j) of the FDI Act requires examiners to review stockholder ledgers and records and review correspondence files to determine whether any nonexempt stock transactions have occurred which would constitute an acquisition of control, whether prior notice has been provided to the FDIC where required, and, if bank management has complied with the after-the-fact reporting requirements relating to bank stock loan reports and changes or replacement of the chief executive or directors. Review of stockholder records must be conducted with particular attention to the statutory definition of control, including the presumptions of control established in Part 303 of the FDIC's Rules and Regulations. All substantial change in ownership transactions between examinations should be reviewed, however, a relatively small transaction may trigger the notice requirements and the statutory definition of control does not necessarily imply effective control. Examiners should also be alert to the formation of voting trusts, assignments of proxies of duration beyond the customary annual meeting solicitations, and other similar arrangements which effectively transfer voting control and which may require prior notice. The statute and implementing regulations do not elaborate on what constitutes a group acting in concert. A series of transactions which are individually insignificant, but significant when aggregated, may indicate a subterfuge, particularly if the individuals or entities involved have other business or professional relationships. Consultation with the Regional Office would appear prudent should such a situation of this type be encountered.

Apparent violations regarding acquisitions consummated without filing of a prior notice should be communicated to the Regional Office by telephone and reported in the Supervisory Section of the Report of Examination. Apparent violations for failure to comply with the after-the-fact reporting requirements should be detailed in the open section of the report under Violations of Laws and Regulations since civil money penalties may be invoked (refer to the Civil Money Penalties Section of this Manual).

APPLICATIONS FOR RETIREMENT OF CAPITAL

Introduction

Refer to the current FDIC Statement of Policy on Capital in the Capital Section of this Manual. Section 303.241 of the FDIC Rules and Regulations contains the procedures to be followed when an institution seeks the FDIC's prior approval to reduce the amount or retire any part of its common or preferred stock, or to retire any part of its capital notes or debentures.

There is concern that approval of a request to retire subordinated notes by a bank which is in danger of failure may in effect be granting preferred creditor status to the note holder. Consequently, unless a bank is in a condition which indicates it might fail within a reasonable time, the Regional Director should exercise delegated authority and approve the request.

Applicants should submit a letter application containing the following: type and amount of the proposed change to the capital structure and the reason for the change; a schedule detailing the present and proposed capital structure; the time period that the proposal will encompass; if the proposal involves a series of transactions affecting Tier 1 capital components which will be consummated in twelve months or less, the application shall certify that the insured depository institution will maintain itself as a well-capitalized institution as defined in Part 325 of the FDIC Rules and Regulations, both before and after each of the proposed transactions; if the proposal involves the repurchase of capital instruments, the amount of the repurchase price and the basis for establishing the fair market value of the repurchase price; a statement that the proposal will be available to all holders of a particular class of outstanding capital instruments on an equal basis, and if not, the details of any restrictions; and the date that the applicant's board of directors approved the proposal. Expedited processing is available for eligible depository institutions as defined in Part 303.

Adequacy of the remaining capital is the chief factor considered in acting upon applications for capital retirement or reduction. In granting or withholding consent, the FDIC must consider the six statutory factors: the financial history and condition of the bank; the adequacy of its capital structure; its future earnings prospects; the general character of its management; the convenience and needs of the community to be served and whether or not its corporate powers are consistent with the purposes of the FDI Act.

Section 18(i) of the FDI Act deals specifically with the subject of capital retirement. The FDIC's Legal Division has ruled that the provisions of this section also apply to capital retirements or reductions relative to the following: retirements or reductions which are part of another proposal for which a current application has been filed for FDIC approval; conversion of capital notes or debentures to an equivalent amount of common stock or preferred stock; conversion of preferred stock to an equivalent amount of common stock; and repurchase and retention by a bank of its own capital as part of a stock option plan.

Capital Notes and Debentures

Insured State nonmember banks customarily seek the FDIC's consent to retire subordinated notes or debentures at the time of proposed issuance of such obligations. The Legal Division is of the opinion that where a replacement of capital issues is clearly of a formalistic nature only, without an effective reduction in the amount of the bank's capital and with no change to the governing terms and conditions of the instruments themselves, the replacement should not be deemed to come within Section 18(i)(1) of the FDI Act.

All new subordinated note and debenture agreements must contain a statement to the effect that the prior consent of the FDIC is required before any portion of the debt can be retired. The purpose of including the statement is to assure that all parties involved, including future holders of the notes, are aware of the requirements of Section 18(i)(1). Where periodic mandatory payments are required, the agreement and the notes may include the additional statement that these particular mandatory payments have already been consented to by the FDIC, if such advance consent has, in fact, been given.

APPLICATIONS FOR MERGERS

Introduction

It is the policy of the FDIC to preserve the soundness of the banking system and promote market structures conducive to competition. A proposed merger, consolidation, and purchase of assets and assumption of liabilities are all hereafter referred to collectively as "mergers."

Provisions of Law

Section 18(c) of the FDI Act (the "Act"), popularly known as the Bank Merger Act, provides that, except with the prior written approval of the FDIC, no insured depository institution may merge with any other insured depository institution, if the acquiring, assuming or resulting institution is to be a nonmember insured bank. The section also requires approval before an insured depository institution may merge with a noninsured bank or institution. The section contains special provisions for interstate merger transactions. These are subject to section 44 of the FDI Act. In addition, the FDIC will consider in evaluating merger applications the requirements of the Community Reinvestment Act. The factors to be considered in granting or withholding approval are those enumerated in Section 18(c) of the "Act". Subpart D of Part 303 of the FDIC Rules and Regulations governs the administrative handling of "merger" applications.

Paragraph (4) of Section 18(c) of the "Act" provides that, before acting on an application, the FDIC must request reports on the competitive factors involved from the Attorney General, the Comptroller of the Currency and the Board of Governors of the Federal Reserve System. These reports must ordinarily be furnished within 30 days, and the applicant will, if it so requests, be given an opportunity to submit comments to the FDIC respecting the contents of the competitive factor reports.

Paragraph (5) of Section 18(c) prohibits the FDIC from approving anticompetitive mergers. To establish that any anticompetitive effect is clearly outweighed in the public interest, the proponents must show that probable effect of the transaction in meeting convenience and needs is likely to benefit all seekers of banking services in the areas of competitive impact, rather than merely those who seek, for example, large loan and trust services, and that the expected benefit cannot reasonably be achieved through other, less anticompetitive means. The statute also requires the FDIC to consider in every case the financial and managerial resources, future prospects of the existing and proposed institutions, as well as the convenience and needs of the community to be served.

Under Section 8(q) of the "Act," whenever the liabilities of an insured depository institution are assumed by another insured depository institution; the insured status of the institution whose liabilities are assumed terminates on the date of receipt by the FDIC of satisfactory evidence of the assumptions, and separate insurance of all assumed deposits terminates at the end of six months from the date the assumption takes effect or, in the case of any time deposit, the earliest maturity after the sixth-month period.

Branch closings in connection with a merger transaction are subject to the notice requirements of Section 42 of the FDI Act, including requirements of notification to customers.

Statement of Policy - Bank Merger Transactions

The FDIC Statement of Policy on Bank Merger Transactions was revised effective October 1, 1998. The FDIC is prohibited by law from approving any merger that would tend to create or result in a monopoly, or which would further a combination, conspiracy or attempt to monopolize the business of banking in any part of the United States. Similarly, the FDIC may not approve a transaction whose effect in any section of the country may be to lessen competition substantially, or which in any other manner would be in restraint of trade. The FDIC may, however, approve any such transaction if it finds that the anticompetitive effects of the proposed transaction are clearly outweighed in the public interest by its probable effect in meeting the convenience and needs of the community to be served, for example, where approval of the merger may prevent the probable failure of one of the banks involved. In every case, the FDIC must also consider the financial and management resources and future prospects of the existing and proposed institutions, and the convenience and needs of the community to be served.

In evaluating the various factors prescribed and making the necessary judgments on proposed merger transactions, it is the intent and purpose of the FDIC to foster and maintain a safe, efficient and competitive banking system that meets the needs of all elements of the communities served. With these broad goals in mind, the FDIC will apply the specific standards listed in the Policy Statement in evaluating and deciding proposed bank merger transactions.

Procedures

Banks seeking the FDIC's consent to engage in a merger transaction must file a formal application with the FDIC on the appropriate form. The FDIC will not take final action on an application until notice of the proposed transaction is published in a newspaper or newspapers of general circulation in the appropriate community or communities, in accordance with the requirements of Section 303.65 of the FDIC's Rules and Regulations.

Section 303.64 of the FDIC Rules and Regulations provides for expedited processing to eligible applications. In evaluating a merger application, the FDIC considers the following factors: the extent of existing competition between and among the merging institutions, other depository institutions, and other providers of similar or equivalent services in the relevant product markets within the relevant geographic markets. In its analysis of the competitive effects of a proposed merger transactions, the FDIC will focus particularly on the type and extent of competition that exists and that will be eliminated, reduced or enhanced by the proposed merger transaction.

In order to determine the effect of the proposed merger on competition, it is necessary to identify the relevant geographic market. The delineation of such market can seldom be precise, but realistic limits should be established so the effect of the merger upon competition can be properly analyzed. The FDIC recognizes that different banking services may have different relevant geographic markets. However, the market should not be drawn so expansively as to cause the competitive effect of the merger to seem insignificant. Conversely, the market should not be drawn so narrowly as to place competitors in entirely different markets. After the relevant geographic market has been identified, the competitive effect of the proposed merger can be analyzed. A merger not having a substantially adverse competitive effect may nevertheless be disapproved if, after considering the banking factors, the FDIC concludes that the resultant bank will have inadequate capital, unsatisfactory management, or poor earnings prospects. Refer to the policy statement for further competitive effects analytical explanation.

In addition to the competitive analysis, the FDIC will consider prudential factors. These include the existing institutions overall condition, including capital, management and earnings. Apart from competitive considerations, the FDIC normally will not approve a proposed merger transaction where the resulting institution would fail to meet existing capital standards, continue with weak or unsatisfactory management, or whose earnings prospects, both in terms of quantity and quality are weak, suspect or doubtful. In assessing capital adequacy and earnings prospects, particular attention will be paid to the adequacy of the allowance for loan and lease losses. In evaluating management, the FDIC will rely to a great extent on the supervisory histories of the institutions involved and of the executive officers and directors that are proposed for the resultant institution.

The Convenience and Needs factor is also evaluated. Under this factor, the FDIC will consider the extent to which the proposed merger transaction is likely to benefit the general public through higher lending limits, new or expanded services, reduced prices, increased convenience in utilizing the services and facilities of the resulting institution, or other means. The FDIC, as required by the Community Reinvestment Act, will also note and consider each institution's CRA performance evaluation record. An unsatisfactory record may form the basis for denial or conditional approval of an application.

The commitment to pay or payment of unreasonable or excessive fees and other expenses incident to an application reflects adversely upon the management of the applicant institution. The FDIC will closely review expenses for professional or other services rendered by present or prospective board members, major shareholders or other insiders for any indication of self-dealing to the detriment of the institution. As a matter of practice, the FDIC expects full disclosure to all directors and shareholders of any arrangement with an insider. In no case will the FDIC approve an application where the payment of a fee, in whole or part, is contingent upon any act or forbearance by the FDIC or by any other federal or state agency or official.

Where banking offices are to be closed in connection with the proposed merger transaction, the FDIC will review the merging institution's conformance to any applicable requirements of section 42 of the FDI Act concerning notice of branch closing as reflected in the interagency Policy Statement Concerning Branch Closing Notices and Policies. Although the appropriate application must be filed with the FDIC and statutory factors are considered in the case of "interim" (mergers or other transactions involving an existing bank and a newly chartered bank or corporation for the purpose of corporate reorganization) and other corporate reorganizations (transactions involving banks controlled by the same holding company or transactions involving banks or their subsidiaries), these types of transactions normally do not have any effect on competition or otherwise have significance under relevant statutory standards set forth in Section 18(c) of the FDI Act. The guidelines set forth above for "mergers" have only general applicability and may have no applicability depending on the specific circumstances involved in individual transactions.

APPLICATIONS BY UNDERCAPITALIZED DEPOSITORY INSTITUTIONS FOR A WAIVER TO ACCEPT, RENEW OR ROLLOVER BROKERED DEPOSITS

Provisions of Law

Section 224 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 added Section 29 to the FDI Act, prohibiting the acceptance, renewal or rollover of brokered deposits by any undercapitalized insured depository institution (bank or savings association) except on specific application to and waiver of the prohibition by the FDIC.

Section 337.6 of the FDIC's Rules and Regulations provides guidance and detail on when an institution is considered undercapitalized, when certain deposits are considered "brokered" for purposes of the prohibition, and the circumstances under which a waiver from the prohibition may be obtained. Section 303.243 contains the procedures to follow to file with the FDIC for a brokered deposit waiver. Expedited processing of these filings is extended to eligible depository institutions with the caveat that for purposes of this filing, eligible depository institutions may be adequately capitalized, according to the definition found in Section 325.103 of the FDIC's Rules and Regulations, rather than well-capitalized as is required for other filings.

The regulation takes a broad view of when an institution is considered undercapitalized and a narrow view of the circumstances under which a waiver may be obtained with the result and expectation that such institutions will not accept new brokered deposits and over some reasonable time frame all undercapitalized depository institutions utilizing brokered deposits will have to either meet applicable capital standards or eliminate brokered deposits from their books.

Procedures

Undercapitalized insured depository institutions may file waiver applications under section 337.6 with the Regional Office where they are headquartered. Institutions may apply for a waiver in letter form or on an optional application form. Applications should contain: the time period for which the waiver is requested, a statement of the policy governing the use of brokered deposits in the institution's overall funding and liquidity management program; the volume, rates and maturities of the brokered deposits held currently and anticipated during the waiver period sought, including any internal limits placed on the terms, solicitation and use of brokered deposits; how brokered deposits are costed and compared to other funding alternatives and how they are used in the institution's lending and investment activities, including a detailed discussion of asset growth plans; procedures and practices used to solicit brokered deposits, including an identification of the principal sources of such deposits; management systems overseeing the solicitation, acceptance and use of brokered deposits; a recent consolidated financial statement with balance sheet and income statements; and the reasons the institution believes its acceptance, renewal or rollover of brokered deposits would pose no undue risk.

Authority is delegated to Regional Directors or Deputy Regional Directors to approve or deny brokered deposit waiver applications. Based upon a preliminary review, any delegate may grant a temporary waiver for a short period in order to facilitate the orderly processing of a filing for a waiver. A waiver should be for a fixed period, generally no longer than two years, and may be revoked by the FDIC at any time by written notice to the institution.

POLICY STATEMENT ON ENCOURAGEMENT AND PRESERVATION OF MINORITY OWNERSHIP OF FINANCIAL INSTITUTIONS

Introduction

In recognition of the unique status of minority-owned depository institutions in the financial system, it is the policy of the DOS to proactively preserve minority ownership of financial institutions and to encourage minority participation in the management of financial institutions. This policy is intended to be consistent with the FDIC's broader mission of preserving the soundness of the banking system and promoting fair market structures conducive to competition and community service.

For the purposes of this policy statement, the term minority-owned institution means an FDIC-insured depository institution where more than 50% of the voting stock is owned or controlled by minority individuals or organizations, or in the case of a mutual depository institution, the majority of the Board of Directors, account holders and the community which it serves are members of a minority group. The term "minority" means any Black American, Native American, Hispanic American, or Asian American.

Statutory Requirements

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) contains several provisions relating to the preservation of minority ownership of financial institutions. These statutes provide a framework for this policy statement.

Section 13(k) of the FDI Act deals with emergency acquisitions of distressed savings associations. Section 13(k)(2)(B) addresses the acquisition of minority-controlled depository institutions by stating: "the FDIC shall seek an offer from other minority-controlled depository institutions before seeking an offer from other persons or entities.

Section 13(f)(12) of the FDI Act eliminates the $500,000,000 asset cut-off for acquisition of a distressed minority-controlled bank by an out-of-state minority-controlled depository institution or depository institution holding company.

Section 308 of FIRREA sets goals to preserve minority ownership of financial institutions. These goals are set out as:

1. Preserving the number of minority depository institutions;
2. Preserving the minority character in cases of merger or acquisition;
3. Providing technical assistance to prevent insolvency of institutions not now insolvent;
4. Promoting and encouraging creation of new depository institutions; and
5. Providing for training, technical assistance, and education programs.

Discussion

The Division of Supervision becomes involved in the creation of new minority ownership through its responsibility for acting on applications for federal deposit insurance and mergers and reviewing notices of acquisition of control. For those minority applicants who are not familiar with the required laws, procedures or forms, technical expertise and assistance should be made available through DOS Regional Offices.

One very effective method of preserving minority ownership is to maintain the health of existing minority-owned depository institutions. In this regard, DOS is committed to a program of regular examination of all banks for which it has primary supervisory responsibility. This examination program is intended to detect deteriorating trends and to work with management to correct them. Correction of any adverse trends in institutions normally is handled through regular supervisory channels. In the event that management is unable to effect correction because of a lack of resources or technical expertise, DOS will provide assistance where practical. Additionally, DOS encourages other depository institutions to be available to provide technical expertise to minority-owned institutions.

Training, education and technical assistance are available through the FDIC in such areas as call report preparation, consumer affairs and civil rights, and accounting. FDIC personnel generally are available for attendance at conferences or seminars dealing with issues of concern to minority groups.

Procedures and Related Matters

Applications - Notices of acquisition of control and applications for deposit insurance and merger from minority-owned institutions will be submitted to the appropriate regional office and processed under established procedures. Those applications which involve creation or preservation of minority ownership also will be considered in the context of the effect of the transaction on the goal of preserving minority ownership. Technical assistance in the completion of the documentation of these applications is available upon request from the regional office.

Operating Institutions in Need of Assistance - Through its normal supervision, the FDIC will be aware of institutions in need of remedial or preventative attention. Field examiners and regional office staff will make suggestions and offer assistance, which an institution is free to accept. Institutions are also urged to make their needs known to the Regional Director who will do all they can to help. To the extent possible, the FDIC will consider invitations to participate in seminars, conferences and workshops directed to minority audiences.

Request for Financial Assistance - Requests from minority groups for assistance in resolving a failing minority-owned depository institution will be considered at the same time as assistance requests or failing bank bids received from non-minority groups; however, preference generally will be given to a minority group proposal. Technical assistance in preparing these applications is available upon request.

Failing Banks - In the event a minority-owned bank deteriorates into a failing condition, a list of eligible bidders is compiled. Generally, preference will be given to qualified minority bidders located 1) in the same local market area, 2) in the same state, and 3) nationwide. Trade associations will be contacted for names of possible interested parties which may be contacted. Groups interested in becoming bidders must have appropriate clearance from other responsible regulatory agencies.

APPLICATIONS PURSUANT TO SECTION 19 OF THE FDI ACT – CRIMES INVOLVING DISHONESTY OR BREACH OF TRUST OR MONEY LAUNDERING, OR PRETRIAL DIVERSION PROGRAMS FOR SUCH OFFENSES

Provisions of Law

Section 19 of the FDI Act prohibits, without the prior written consent of the FDIC, a person convicted of any criminal offense involving dishonesty, breach of trust, money laundering, or who has agreed to enter into a pretrial diversion or similar program for such offense, from becoming or continuing as an institution-affiliated party, owning or controlling, directly or indirectly an insured depository institution, or otherwise participating, directly or indirectly, in the conduct of the affairs of an insured institution.

Section 19 imposes a duty upon the insured institution to make a reasonable inquiry regarding an applicant's history, which consists of taking steps appropriate under the circumstances, consistent with applicable law, to avoid hiring or permitting participation in its affairs by a person who has a conviction or program entry for a covered offense. The FDIC believes that, at a minimum, each insured institution should establish a screening process that provides the insured institution with information concerning any convictions or program entry pertaining to a job applicant. This would include, for example, the completion of a written employment application (although other alternatives may be appropriate) that requires a list of all convictions and program entries. The FDIC will look to the circumstances of each situation to determine whether the inquiry is reasonable.

Upon notice of a conviction or program entry, the institution should obtain forms and instructions from, and file an application with, the appropriate FDIC Regional Director. The application must be filed by an insured depository institution on behalf of a person, unless the FDIC grants a waiver of that requirement. The FDIC will consider such waivers on a case-by-case basis where the institution shows substantial good cause for granting a waiver.

The above information represents a partial summary of the requirements of Section 19. For definitions of terms and additional guidance, examiners should refer to the FDIC Statement of Policy on Section 19 of the FDI Act.

Examiner Responsibilities

Examiners should review conformance with the FDIC Statement of Policy for Section 19 of the FDI Act during examinations of institutions where risk-scoping activities indicate a material degree of risk with respect to this area. The scope or depth of these reviews should comply with the guidelines detailed in the risk-focused supervision examination modules.

APPLICATIONS PURSUANT TO PART 362 OF THE FDIC's RULES AND REGULATIONS – ACTIVITIES AND INVESTMENTS OF INSURED DEPOSITORY INSTITUIONS

Revised Part 362 and related amendments to Part 303 became effective January 1, 1999. The revised rule provides the framework for which certain state-chartered banks or their majority-owned subsidiaries may engage in activities that are not permissible for national banks or their subsidiaries. The institution's chartering authority must permit all contemplated activities.

Under Part 362, well-capitalized, state-chartered banks or their subsidiaries may engage in certain otherwise impermissible activities without seeking specific FDIC consent if the bank complies with any limits or conditions restricting those activities. Other activities require depository institutions to submit either a notice or application to the FDIC.

The notice procedure is designed to expedite the processing of requests from banks meeting various eligibility requirements. Activities to which notice processing has been extended include securities underwriting and real estate investment activities.

OTHER APPLICATIONS

Subpart F of Part 303 – Change of Director or Senior Executive Officer

Insured state nonmember banks are to give the FDIC written notice at least 30 days prior to adding or replacing any member of its board of directors, employing any person as a senior executive officer of the bank, or changing the responsibilities of any senior executive officer so that the person would assume a different senior executive officer position if:

(1) The bank is not in compliance with all minimum capital requirements applicable to the bank

(2) The bank is in troubled condition, or

(3) The FDIC determines, in connection with its review of a capital restoration plan that such notice is appropriate

Waivers to the pre-filing requirement may be applied for and granted if delay would threaten the safety or soundness of the bank or not be in the public interest. In the case of the election of a new director not proposed by management at a meeting of the shareholders, the prior 30-day notice is automatically waived provided that a complete notice is filed with the appropriate regional director within two business days after the individual's election.

Subpart I – Mutual-to-Stock Conversions

An insured state chartered mutually owned savings bank that proposes to convert from mutual to stock form shall file with the FDIC a notice of intent to convert to stock form.

At a minimum, such notice shall contain:

- The plan of conversion with specific information concerning the record date used for determining eligible depositors and the subscription offering priority;
- Certified board resolutions relating to the conversion;
- A business plan including a discussion of how the capital acquired in the conversion will be used, expected earnings for at least a three year period following the conversion and a justification for any proposed stock repurchase;
- The charter and bylaws of the converted institution
- The bylaws and operating plans of any other entities formed in connection with the conversion transaction such as a holding company or charitable foundation;
- A full appraisal report, prepared by an independent appraiser of the value of the converting institution and the pricing of the stock to be sold in the conversion transaction;
- Detailed descriptions of any proposed management or employee stock benefit plans or employment agreements and a discussion of the rationale for the level of benefits proposed;
- Indemnification agreements;
- A preliminary proxy statement and sample proxy;
- Offering circular(s);
- All contracts or agreements relating to solicitation, underwriting, market-making or listing of conversion stock and any agreements among members of a group regarding the purchase of unsubscribed shares;
- A tax opinion concerning the federal income tax consequences of the proposed conversion;
- Consent from experts to use their opinions as part of the notice; and
- An estimate of conversion-related expenses.

The FDIC shall review the notice and other materials for considerations such as: the proposed use of the proceeds, the adequacy of the disclosure materials, the participation of depositors in approving the transaction, the appropriateness of any proposed increased compensation and other remuneration to be granted to officers and directors, the adequacy and independence of the appraisal of the value of the mutual savings bank for purposes of determining the price of the shares of stock to be sold and the extent to which the proposed conversion transaction conforms with the various provisions of the mutual-to-stock conversion regulations of the Office of Thrift Supervision.

The FDIC will issue either a letter of non-objection if the FDIC determines that the proposed conversion transaction would not pose a risk to the institution's safety or soundness, or a letter of objection. In the latter case, if the FDIC determines either that the proposed conversion transaction poses a risk to the institution's safety or soundness, violates a law or regulation, or presents a breach of fiduciary duty, the objection letter would instruct the institution not to consummate the transaction until such point as the objection letter is rescinded.

Other Filings

Golden Parachute and severance plan payments – Pursuant to section 18(k) of the FDI Act and Part 359 of the FDIC Rules and Regulations, an insured depository institution or depository institution holding company may not make golden parachute payments or excess nondiscriminatory severance plan payments unless permission is obtained.

For additional information and guidance on the various applications, please also refer to:

- The Division of Supervision and Consumer Affairs **Formal and Informal Action Procedures Manual**, and
- The Division of Supervision and Consumer Protection **Case Managers Procedures Manual**.

INTRODUCTION

By definition, institutions which have been assigned a composite 3 rating pursuant to the Uniform Financial Institutions Rating System have overall strength and financial capacity sufficient to make failure only a remote possibility. However, their weaknesses are such that if not properly addressed and corrected, deterioration could concur. The memorandum of understanding is a means of seeking informal corrective administrative action from institutions considered to be of supervisory concern, but which have not deteriorated to the point where they warrant formal administrative action. It is the policy of the Division of Supervision that matters in need of corrective action within such institutions should be addressed in the form of a memorandum of understanding. This is in lieu of the use of letter agreements, board resolutions passed at the request of the Regional Director, or other forms of bilateral or unilateral agreements. As a general rule, and as a minimum, this informal administrative action is to be considered for all institutions rated a composite 3. General use of a memorandum of understanding for composite 3 rated institutions does not rule out recourse to formal enforcement action when it is believed management is unwilling to take necessary corrective action, nor does it prohibit use of a memorandum of understanding in situations where other than a composite 3 rating is assigned.

A memorandum of understanding is usually drafted at the Regional level and jointly signed by the Regional Director, Deputy Regional Director, or an Assistant Regional Director and the institution's board of directors. In all instances, the State authority should be invited to join in these actions. Contents of a memorandum of understanding should be uniquely fashioned to address the specific problems of an individual institution. It is important that the language used in the memorandum of understanding be precise so that all parties fully understand exactly what is agreed to and expected. Use of a memorandum of understanding, as opposed to more formal action, is particularly appropriate where the Regional Office believes the problems discussed with management and the board of directors of the institution has been adequately detailed and the institution, in good faith, will move to eliminate the problems. An institution's failure to comply with the provisions of a memorandum of understanding, or continued deterioration in the areas addressed in the memorandum of understanding, may facilitate implementation of more formal administrative action in the future. After consultation with the Regional Office, examiners should discuss fully with management and the directorate the probable use of a memorandum of understanding at all examinations where a composite 3 rating is recommended. Examiners should also inform management in these cases that, should the memorandum of understanding prove ineffective in correcting the deficiencies, consideration may be given to initiation of formal administrative action at a later date.

Exceptions, which are defined as not obtaining at least a memorandum of understanding from institutions rated a composite 3, will be considered by the Regional Director when the condition of the institution clearly reflects significant improvements or individual circumstances strongly mitigate the appropriateness or feasibility of this supervisory tool. For example, an acceptable action by the State authority might preempt the need for FDIC action. Mere belief that management has recognized its error and will improve is not generally a sufficient basis for granting an exception.

At the Regional Director's discretion, the memorandum of understanding may be drafted in the field and signatures of the directors obtained at the board meeting held at the conclusion of the examination. Termination of an outstanding memorandum of understanding should be considered when the institution's overall condition has improved significantly and the institution has substantially complied with its terms. The Regional Office will coordinate any terminations with the State authority if the latter is a party to the action. Flexibility is the keynote of this action. The goal is to obtain correction by sharply focusing on the institution's problem areas and defining responsibilities for ensuring that deficiencies are addressed.

Monitoring of adherence to an outstanding memorandum of understanding may be done by any combination of progress reports, visitations or examinations. The examiner should detail each provision of the memorandum of understanding and provide sufficient details regarding the institution's action (or inaction) to allow for meaningful conclusions concerning the extent of compliance. Such statements as "Compliance indicated" or "Not in compliance", without sufficient details, are to be avoided.

Please also refer to the **Formal and Informal Actions Procedures Manual** and the Division of Supervision and Consumer Protection **Case Managers Procedures Manual** for more information concerning policies, procedures and criteria for the issuance of these memoranda.

INTRODUCTION

The Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRIRCA) gave the FDIC authority to prospectively assess civil money penalties (CMPs) against both banks and individuals. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) significantly increased the penalties for both banks and individuals and broadened the applicability of civil money penalties. Civil money penalties may be assessed for the violation of any law or regulation, any final order or temporary order issued, any condition imposed in writing by the appropriate Federal banking agency in connection with the approval of any application, and any written agreement between a depository institution and Federal banking agency. For example, civil money penalties may be assessed in the following instances:

1. Violations involving changes in control of banks. Refer to Section 7(j) of the FDI Act, Parts 303 and 308 of the FDIC Rules and Regulations, and the Applications Section of this Manual.
2. Violations involving participation by a convicted individual in the affairs of an insured depository institution. Refer to Section 19 of the FDI Act and the Applications Section of this Manual.
3. Violations of cease-and-desist orders that have become final. Refer to Section 8(i)(2) of the FDI Act, Part 308 of the FDIC Rules and Regulations, and the Formal Administrative Actions Section of this Manual.
4. Violations of Section 23A of the Federal Reserve Act (loans to affiliates). Refer to Section 18(j)(1) and 18(j)(3) of the FDI Act, Part 308 of the FDIC Rules and Regulations, and the Related Organizations Section of this Manual.
5. Violations of Section 22(h) of the Federal Reserve Act (loans to directors, officers, and principal stockholders). Refer to Section 18(j)(2) and 18(j)(3) of the FDI Act, Part 308 of the FDIC Rules and Regulations, and the Management Section of this Manual.
6. Violations of Section 106(b) of the Bank Holding Company Act (tying arrangements - official family loans and linked correspondent accounts). Refer to Section 106(b)(2)(F) of the Bank Holding Company Act Amendments of 1970, Part 308 of the FDIC Rules and Regulations, and the Related Organizations Section of this Manual.
7. Violations of Section 3907 of the International Lending Supervision Act of 1983 involving an issued Capital Directive. Refer to Sections 3907 and 3909 of ILSA, Part 325 of the FDIC Rules and Regulations, the Capital Section and the Formal Administrative Actions Section of this Manual.

VIOLATIONS

The previously mentioned statutes and regulations, with the exception of those relating to changes in bank control, define "violations" as including, but not limited to, "any action (alone or with another) for or towards causing, bringing about, participating in, counseling, or aiding or abetting a violation." The definition is exceptionally broad and will likely encompass any violation of the applicable statutes.

ASSESSMENT OF CIVIL MONEY PENALTIES

Civil money penalties are assessed not only to punish the violator according to the degree of culpability and severity of the violation, but also to deter future violations. Although relevant to the FDIC's interests, the primary purpose for utilizing civil money penalties is not to effect remedial action. Such action, in the form of restitution or other corrective measures, should be separately pursued.

In 1998, the FDIC adopted a revised interagency statement of policy regarding the assessment of civil money penalties. To facilitate evaluation of the gravity of such violation(s), the policy statement sets forth the following factors which must be considered in determining whether civil money penalties should be imposed:

1. Evidence that the violation or practice or breach of fiduciary duty was intentional or was committed with a disregard of the law or with a disregard of the consequences to the institution;
2. The duration and frequency of the violations, practices, or breaches of fiduciary duty;
3. The continuation of the violations, practices, or breach of fiduciary duty after the respondent was notified or, alternatively, its immediate cessation and correction;
4. The failure to cooperate with the agency in effecting early resolution of the problem;
5. Evidence of concealment of the violation, practice, or breach of fiduciary duty or, alternatively, voluntary disclosure of the violation, practice or breach of fiduciary duty;
6. Any threat of loss, actual loss, or other harm to the institution, including harm to the public confidence in the institution, and the degree of such harm;
7. Evidence that a participant or his or her associates received financial gain or other benefit as a result of the violation, practice, or breach of fiduciary duty;

8. Evidence of any restitution paid by a participant of losses resulting from the violation, practice, or breach of fiduciary duty;
9. History of prior violation, practice, or breach of fiduciary duty, particularly where they are similar to the actions under consideration;
10. Previous criticism of the institution or individual for similar actions;
11. Presence or absence of a compliance program and its effectiveness;
12. Tendency to engage in violations of law, unsafe or unsound banking practices, or breaches of fiduciary duty; and
13. The existence of agreements, commitments orders, or conditions imposed in writing intended to prevent the violation, practice, or breach of fiduciary duty.

FDIC policy provides that civil money penalty recommendations should only be initiated when the fineable violation is believed to meet the test of gravity as required by FIRIRCA including consideration of the 13 relevant factors found in the interagency statement of policy and the existence of any one of the following criteria:

1. The violation causes the bank to suffer a substantial financial loss;
2. The violation is willful, flagrant, or otherwise evidences bad faith on the part of the bank or individual(s) involved in the violation (including repeated and/or multiple violations, if applicable);
3. The violation directly or indirectly involves an insider, or an associate of an insider, who benefits from the transaction in a material or substantial way; or
4. Previous supervisory means (i.e., specific supervisory comment or correspondence, Memorandum of Understanding, previous civil money penalty assessment, or Cease-and-Desist Order) have not been effective in eliminating or deterring violations.

The aforementioned policy delineates the circumstances under which civil money penalty action may possibly be initiated, but is not intended to preclude consideration of any other matters relevant to a possible civil money penalty assessment. In addition, other fineable violations will be evaluated for recommendation of civil money penalties based on the 13 factors listed above. Where assessment of a civil money penalty is not considered appropriate in these cases, corrective action may be sought by means of a Supervisory Letter sent by the Regional Office to the bank's board of directors. The letter should request adoption of a resolution indicating the directorate's intent to correct the violation(s) and request that procedures be implemented to prevent future infractions. The bank should also be advised to notify the Regional Director when and how the violation(s) have been remedied. An insufficient response from the bank/individual to the Regional Office on the issues covered in the Supervisory Letter may constitute grounds for recommending initiation of civil money penalties.

With regard to a violation of a Cease-and-Desist Order which has become final or an issued Capital Directive, at the discretion of the Regional Director, a recommendation may be made (1) for court enforcement under Section 8(i)(1) of the FDI Act or (2) for initiation of assessment of a civil money penalty, as authorized. The determination should be based on which appears to be most appropriate for the given situation, will most likely result in correction of deficiencies giving rise to the penalty and will achieve the FDIC's objectives.

Penalties

It is the FDIC's policy that, whenever a violation committed by an individual results in personal financial or economic gain and/or financial loss to the bank, the amount involved shall be repaid as a portion of the penalty assessment or, preferably, through restitution to the bank if the bank suffered a loss. More specifically, an attempt should be made to have the individual make restitution to the injured bank for all losses suffered, or absent restitution, repay the personal gain or bank loss through the recommended assessment, plus pay a penalty over and above these amounts for violating the law. If the bank has suffered a loss, willingness and promptness in making restitution should have a bearing on the amount of penalty recommended. If the size of the bank's loss is such that restitution to the bank is desirable and there is no response to informal action, Section 8(b) action should be considered. If the size of the bank's loss is of little consequence in relation to the bank's financial resources, then the amount of loss should be incorporated into the recommended assessment.

Tiered penalty levels have been established. Tier 1 penalties of up to $5,500 per day may be assessed for most violations. If a party commits a violation, recklessly engages in an unsafe or unsound practice or breaches a fiduciary duty which is part of a pattern of misconduct, causes more than minimal loss to the institution or results in a pecuniary gain to such party, then the potential maximum penalty (Tier 2 penalty) increases to $27,500 per day. A Tier 3 penalty of the lessor of $1,100,000 or 1% of total assets may be assessed if a violation, unsafe or unsound practice, or breach of fiduciary duty is knowingly committed and causes a substantial loss to the institution or a substantial pecuniary gain to the violator.

Examiners should recommend a specific money penalty and, as stated in the policy statement, the financial or economic benefit received by the violator should be given significant consideration. In this regard, details of any such benefits must be adequately documented. Depending on the circumstances, the proposed penalty may be:

1. A multiple of the benefit when a strong deterrent on future actions is believed warranted;
2. A fraction when credible assurance of future compliance is received and, where applicable, restitution has been made; or
3. Simply the benefit itself.

To determine an appropriate penalty amount, each case must be considered on its own merits in light of the factors in the law and the policy statement. Consideration should be given to the maximum amount (which must not be exceeded) that can be assessed under the statutes; however, in many cases the amount is so large as to be considered unreasonable and the penalty should be tempered through judgment as to the seriousness of the violation. Prime factors to be considered are the amount of loss to the bank and/or gain to the individual charged, if any. Restitution to the bank of the amount lost should be determined and might be used in reducing the amount of the penalty that otherwise might be assessed. If restitution does not occur, the amount may be included as a portion of the penalty. The financial resources of the individual charged must also be weighed, which may cause a recommended penalty below that which would appear appropriate. Finally, the gravity of the violation and the involvement in the violation of the individual charged should be considered. A determination that the violation was particularly egregious and/or that the individual was directly involved in causing the violation or benefited from it would result in a larger recommended penalty than would a mere technical violation or one in which the individual was not directly involved.

Specific recommendations for assessment of penalties should be forwarded to the Regional Office and not communicated to the bank, its officers, or directors.

EXAMINATION PROCEDURES

The following procedures should be followed whenever fineable violations of laws or regulations are encountered:

1. When fineable violations, unsafe or unsound banking practices, or breaches of fiduciary duty of the type detailed in Section 8(i), 7(j) or 18(j) of the FDI Act are discovered and it is contemplated that CMPs may be an appropriate administrative action, examiners should complete the Civil Money Penalty Matrix. The CMP Matrix will aid the examiner in supporting the appropriateness and/or level of CMPs. The thirteen factors contained in the FFIEC policy statement regarding CMPs are built into the matrix and provide the bases for recommended actions or assessments. Although the CMP Matrix is generally most useful in Tier 1 penalty cases, it should be prepared whenever a penalty is being considered. The CMP Matrix is included at the end of this section.
2. When other fineable violations of statute (such as those detailed in Sections 7(a) and 7(c) of the FDI Act regarding late or inaccurate Reports of Condition and inaccurate certification statements or late payment of deposit insurance assessments) are encountered, the examiner should seek guidance from the Regional Office if the violation is severe and flagrant in nature.
3. Examination comments on the Violations of Laws and Regulations schedule generally should not contain references to the FDIC's power to impose civil money penalties or the maximum dollar amount of CMPs that may be imposed; comments of this nature should be included in only the most serious situations.
4. Reference on the Examination Conclusions and Comments schedule to apparent violations of laws and regulations depends on the seriousness of the situation and the examiner's intentions regarding recommendation of penalties and/or enforcement actions.
5. Examiners should fully discuss violations of law with management; however, discussion of the civil money penalty process should be limited. Unless the examiner intends to recommend the imposition of CMPs, there is minimal need to raise the issue with bank officers or directors. If the issue is raised, examiners may discuss the criteria used by the FDIC to determine whether to assess a penalty and the process involved.
6. The home mailing address for all directors and any other individuals involved in a fineable violation should be included in the Confidential Section of the examination report when it is contemplated that CMPs may be assessed.
7. When a violation involves financial gain to an insider and/or financial loss to the bank (in most instances, the insider's gain will be the bank's loss), the examiner should attempt to determine a monetary value. If management is cooperative, the amount should be determined with the assistance of bank personnel and indicated on the violations page. Otherwise, the examiner should estimate the amount and include it in the violation write-up along with the method of calculation. If the examiner cannot estimate the

monetary value with any degree of confidence, he/she should so state and include the reason why.

8. The Regional Office should be consulted to determine the supporting evidence needed in connection with scheduling a violation where a fine is contemplated. Regional Counsel should be consulted regarding determination of the violation and sufficiency of evidence.
9. Examiners should not discuss penalty matters relating to Section 8 matters; examiners may only confirm to bank management that CMPs may be assessed for noncompliance with terms of the order. This precaution is necessary because determination of noncompliance with a Section 8 Order is made by the Regional Director.
10. Evidence in support of a likely action should be copied and retained in field office files. This evidence should be segregated in a labeled envelope and kept apart from regular workpapers.

OTHER CONSIDERATIONS

If a fineable violation, for which prompt action appears warranted, is cited in a state report of examination, the Regional Office should schedule a visitation. The assigned examiner should be instructed to investigate the violation and, if appropriate, gather sufficient documentation to support a civil money penalty recommendation and/or request for restitution. If a flagrant violation does not appear to be involved, the Regional Director may postpone an investigation until the next scheduled FDIC examination or visitation. A state report of examination should generally not be utilized to support a civil money penalty recommendation or request for restitution, however, the Regional Director does have discretion to utilize it if it is deemed adequate.

Examiners involved in recommending civil money penalties should be mindful that such actions are covered under the Equal Access to Justice Act. The Act provides that certain parties who prevail in contested administrative or judicial proceedings against an agency of the Federal government may be able to recover their litigation expenses from the agency, if the position of the agency in the proceeding was not substantially justified. Examiners should use special care not to charge any practice or violation on inadequate grounds. Examiners should also be mindful that Confidential Section comments will be a matter of record at any required hearing. Comments and observations in the Confidential Section must be well supported and able to withstand cross-examination in a hearing.

GUIDELINES FOR USING THE CMP MATRIX

1. The CMP Matrix contains factors identified by the FFIEC as those which are relevant in determining the appropriateness of initiating a civil money penalty assessment. These factors, along with those statutorily provided, are also used in determining the assessed amount of a civil money penalty. However, these factors and this Matrix are provided solely as guides and do not replace sound supervisory judgment. As a general rule, it is recommended to use the following guidelines in determining how many matrices should be filled out:

   a. One Matrix per person for all violations, reckless unsafe and unsound practices or breaches of fiduciary duty; where there are several violations, practices, or breaches of duty included in one matrix, the highest severity level applicable to any of the violations, practices or breaches of duty should be recorded for each factor on the Matrix. Thus, if a single director approved a loan in violation of Regulation O, another loan in violation of State lending limitations, and engaged in reckless unsafe practices, only 1 Matrix should be completed for that director, with the highest severity level applicable to either of the violations and any of the unsafe practices recorded for each Matrix factor.

   b. One Matrix for a group of persons with similar culpability. Thus, if 6 directors approved a loan in violation of Regulation O, another loan in violation of State lending limitations, and engaged in reckless unsafe practices, and all were equally culpable, only 1 Matrix should be completed for the 6 directors. However, if 2 directors were more culpable than the other 4 directors, a separate Matrix should be completed for those 2 directors.

2. The Matrix generally applies to tier 1 penalties of up to $5,500 per day against institutions and institution-affiliated parties (IAP's) who engage in violations of law, regulations, final or temporary orders, formal agreements, and conditions imposed in writing in connection with the grant of any application or other request by the institution. The FDIC may also assess tier 2 penalties of up to $27,500 per day for the above violations, unsafe and unsound banking practices recklessly engaged in, and breaches of fiduciary duty, which are part of a pattern of misconduct, or cause or are likely to cause more than a minimal loss to the institution, or result in a pecuniary gain to the institution or individual. In addition, the FDIC may assess tier 3 penalties of up to $1.1 million per day for knowing violations, unsafe and unsound practices, and breaches of duty, which knowingly or recklessly cause a substantial loss to the institution, or a substantial pecuniary gain to the institution or individual. If the recommendation is to assess a penalty in excess of $5,500 per day, or if penalties for unsafe practices or breaches of duty are recommended, the examiner should consult with Regional Counsel to determine whether the criteria are met for a tier 2 or tier 3 penalty.

3. One may use the following definitions as a guide in using the Matrix:

   b. An ***Institution-affiliated party (IAP)*** is (1) any director, officer, employee or controlling shareholder (other than a bank holding company) of an insured depository institution, (2) any person who has filed or is required to file a change-in-control, (3) any shareholder, consultant, joint venture partner, or other person who participates in the institution's affairs, or (4) any independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly participates in violations of law or regulation, breaches of fiduciary duty, or unsafe or unsound practices, which caused or are likely to cause more than a minimal financial loss to, or a significant adverse effect on, the institution.

   c. An ***unsafe and unsound practice*** is one in which there has been some conduct, whether act or omission, which is contrary to accepted standards of prudent banking operation, and which might result in exposure of the bank or its shareholders to abnormal risk or loss. An unsafe or unsound practice may be considered reckless if it evidences disregard of, or indifference to, the consequences of the practice, even though no harm may be intended.

   d. A ***fiduciary duty*** is a duty of great confidence and trust, which includes a high degree of good faith. For example, bank officers and directors have a fiduciary duty to protect the bank's assets, further the best interests of the bank, and not place their interests above those of the bank.

4. ***Pecuniary Gain or Other Benefit to IAP***: In assessing this factor, the monetary gain or other benefit may be to the IAP who committed the violation, recklessly engaged in an unsafe or unsound practice, or who

breached any fiduciary duty, or to any other IAP or their related interests.

5. ***Previous Administrative Action or Criticism***: Under severity level #1, the reference to "similar violation" could refer to prior criticisms for violations under the same statute or regulation, e.g., a previous violation of a Section 23A provision and currently a violation of a different 23A provision. This could also refer to violations similar in nature, e.g., a previous violation of state law regarding lending limit and currently a violation of the aggregate lending limit provision of Regulation O.

6. ***History***: Under severity level #2, the reference to "similar violation" has the same meaning as the reference to "similar violation" used in the ***Previous Administrative Action or Criticism*** factor explained above.

7. ***Loss***: In assessing this factor, "potential loss" refers to any time at which the bank was in danger of sustaining a loss. Accordingly, if the violation caused a possible loss in its first month, but posed no risk of loss in the second month, the bank experienced a potential loss which falls with this category.

8. ***Continuation***: The reference to "notification" in this factor includes notice of the violation, practice or breach by the FDIC, other regulatory agencies, external auditors, internal auditors or other parties whose responsibilities include providing the bank and/or its subsidiaries with information about its operations.

9. ***Concealment***: This factor pertains to the concealment of a violation, practice or breach from the FDIC, the bank's board of directors or internal and external auditors.

10. ***Impact***: In assessing this factor, it is appropriate to consider any possible negative impact or harm to the bank, other than loss.

11. ***Loss or Harm to Securities Holders or Consumers***: This factor only applies in cases involving violations of securities laws, rules, or regulations applicable to state nonmember banks (where securities holders incur loss or are otherwise harmed) or consumer banking laws, orders, agreements or conditions, unsafe or unsound practices, or breaches of duty.

12. ***Good Faith***: In assessing a person's good faith, the examiner should generally focus on facts and circumstances which occurred prior to notification of the violation, practice or breach by the FDIC, other regulatory agencies, external auditors, internal auditors or other parties whose responsibilities include providing the bank and/or its subsidiaries with information about its operations.

13. ***Full Cooperation***: In assessing this factor, the examiner should generally focus on facts and circumstances which occurred after notification of the violation, practice or breach by the FDIC, other regulatory agencies, external auditors, internal auditors or other parties whose responsibilities include providing the bank and/or its subsidiaries with information about its operations.

For additional information and guidance, please also refer to:

- The **Formal and Informal Action Procedures Manual**, and
- The Division of Supervision and Consumer Protection **Case Managers Procedures Manual**.

CMP Matrix

Boxes on the Matrix (including the empty boxes) should be used to reflect progressive levels of severity. As used in the Matrix, the term "violations" also refers to reckless unsafe and unsound practices and breaches of fiduciary duty.

	0	1	2	3	4	WGT.	POINTS
Intent	No		Should Have Known		Clear Intent	5	
Pecuniary Gain or Other Benefit to Institution Affiliated Party (IAP) or Related Interest	No			Indirect Benefit to IAP or Related Interest	Direct Benefit to IAP or Related Interest	4	
Previous Administrative Action or Criticism	None	Previous Criticism for Similar Violation	Violation or Criticism on Point Cited in Exam or Visit Report	MOU or Supervisory Letter on Point	8(a), C&D, Agreement, Condition in Writing or Prior Assessment on Point	3	
History	None	Unrelated Prior Violations	At least One Similar Violation	Several Similar Violations	Frequent Similar Violations	2	
Loss or Risk of Loss to Bank	No Loss and No Risk of Loss	No Loss or Minimal Risk	Minimal Loss or Moderate Risk		Substantial Actual or Potential Loss	6	
Number of Violations at Issue					Numerous Violations	2	
Duration of Violations Prior to Notification					Violations Outstanding for Long Time	2	
Continuation after Notification	Violation(s) Ceased Prior to Notification	Violation(s) Ceased Immediately Upon Notification		Violation(s) Continued for Period of Time After Notification	Violation(s) Still Continuing	3	
Concealment	None			Purposely Complicated Transaction to Make it Difficult to Uncover	Active Concealment	5	
Impact Other Than Loss	No Impact on Bank or Banking Industry		Substantial Impact on Bank. No Impact on Banking Industry	Moderate Impact on Banking Industry or on Public Perception of Banking Industry	Substantial Impact on Banking Industry or on Public Perception of Banking Industry	6	
Loss or Harm to Securities Holders or Consumers (Securities or Consumer Laws Only)	No Loss and No Harm	No Loss or Minimal Harm	Minimal Loss or Moderate Harm		Substantial Loss or Harm	5	
Subtotal 1							
Restitution	No Restitution	Complete Restitution Under Compulsion	Partial Restitution	Complete Restitution Immediately After Loss or Violation Brought to Attention	Complete Restitution Voluntarily, Before Bank or Examiner Uncovered Loss	2	
Good Faith (prior to Notification)	None				Unintentional Violation	3	
Full Cooperation (after Notification)	None				Forthcoming in Interviews	2	
Subtotal 2							
Total (subtract 2 from 1)							

CMP MATRIX (Continued)

Points	Suggested Action	Responsibility
0-30	Consider not making referral.	Examiner reviews fineable offense(s) and applies Matrix. Workpapers should support decision to not refer.
31-40	Consider sending supervisory letter.	Examiner reviews fineable offense(s) and applies Matrix. Prepares referral to Regional Office. Regional Director considers sending 15-day letter. After consideration of response and referral, Regional Office applies Matrix. Regional Director considers sending a supervisory letter which would inform that, while a penalty assessment will not be pursued, policies which will prevent recurrence of the fineable offense(s) must be adopted and implemented. If decision is made to send a supervisory letter, such letter is sent by the Regional Director.
41-50	Consider assessment of $1M up to $5M.	Examiner reviews fineable offense(s), applies Matrix, and prepares referral to Regional Office. Regional Director sends 15-day letter. After consideration of response and referral, Regional Office applies Matrix. If recommendation is to assess a penalty, case should be submitted to the Washington Office. Prior to submission to Washington Office, Regional Office should determine that recommended penalty does not exceed maximum penalty permitted. Washington Office reviews recommendation and takes appropriate action.
51-60	Consider assessment of greater than $5M up to $10M.	Same as immediately above.
61-80	Consider assessment of greater than $10M up to $25M.	Same as above.
81-100	Consider assessment of greater than $25M up to $75M.	Same as above.
101-120	Consider assessment of greater than $75M up to $125M.	Same as above.
120+	Consider assessment of greater than $125M.	Same as above.

INTRODUCTION

While the use of reason and moral suasion remain the primary corrective tools of the FDIC, the Board of Directors has been given broad enforcement powers under Section 8 of the FDI Act. The Board has the power to terminate insurance (Section 8(a)), to issue Cease and Desist Actions (Section 8(b)) and, if deemed necessary, to immediately invoke a temporary Cease and Desist Action (Section 8(c)). In addition, the Board has been given the power to suspend or remove a bank officer or director or prohibit participation by others in bank affairs when certain criteria can be established (Sections 8(e) and (g)). Each of these powers and their scope and limitations are more fully discussed below.

The Board of Directors has delegated certain Section 8 actions, in accordance with Part 303 of the FDIC Rules and Regulations, to various levels within the Division of Supervision and has retained certain authorities for itself.

To assure greater uniformity of action and help assure that supervisory efforts are directed to banks most in need of them, the Division of Supervision has adopted a policy that presumes either a formal or informal administrative action will be taken on banks with Composite Uniform Bank Ratings of 3, 4 or 5 unless specific circumstances argue strongly to the contrary.

The composite 3 rating implies that a bank has weaknesses which, if not corrected, could worsen into a more severe situation. Remedial action is therefore appropriate. The Division's policy is that if formal administrative action under Section 8 of the FDI Act is not taken against insured State nonmember banks rated 3, the Regional Director shall generally (exceptions are allowed under certain circumstances) take action through use of a memorandum of understanding, an informal administrative action which is discussed in its own section of this Manual.

Banks with composite ratings of 4 or 5 will, by definition, have problems of sufficient severity to warrant formal action. Therefore, the policy of the Division of Supervision is that it shall take formal action pursuant to Section 8 of the FDI Act against all insured State nonmember banks rated 4 or 5, where evidence of unsafe or unsound practices is present. Such formal action will normally consist of either a Cease and Desist Order under either Section 8(b) or 8(c) or initiation of insurance termination proceedings under Section 8(a). Exceptions to the policy may be considered when the condition of the bank clearly reflects significant improvement resulting from an effective corrective program or where individual circumstances strongly mitigate the appropriateness or feasibility of this supervisory tool. For example, acceptable action by the State authority might preempt the need for FDIC action, or qualified new management might allow the use of an informal memorandum of understanding instead of a Cease and Desist Order. Mere belief that bank management has recognized the problems and will implement corrective action is not a sufficient basis to preclude action if the bank is still deemed to warrant a composite rating of 3, 4 or 5.

REPORTS OF EXAMINATION CONTAINING A BASIS FOR SECTION 8 CHARGES

Because of the seriousness of making Section 8 charges against a bank, it is mandatory that an examiner consult with the Regional Office before submitting a report of examination containing the basis for possible Section 8 charges. In preparation of a report where the examiner believes Section 8 action is or may be warranted, the following guidelines should be observed:

1. Only the FDIC's Board of Directors is authorized to make a finding of "unsafe or unsound". Therefore, examiners should avoid the use of the statutory words "unsafe or unsound" in the examination report. Synonyms and other descriptive terms such as "undesirable, unacceptable and objectionable practices" are permissible.

2. Examiners should present their findings in the report on the Examination Conclusions and Comments schedule in a manner and format consistent with the guidelines and instructions found in the Report of Examination Instructions. In a separate memorandum to the Regional Director, examiners should detail each specific "Undesirable and Objectionable Practice" regarded as unsafe or unsound, and the facts upon which that conclusion is based should be listed and discussed in the order of importance under appropriately descriptive subheadings and captions. Where violations of law or regulations are also present, they should be discussed under a separate subheading. All relevant facts concerning these areas should be addressed, and reference should be made to specific schedules in the report where full details are presented. In addition, the memorandum should include any statement made by the bank's directors and/or officers either supporting any charge made by the examiner or showing any corrective action. It is also valuable to quote the facts and circumstances from previous examination reports, letters from the Supervisory Authority to the bank, and letters of

inquiry regarding correction of criticisms from the Regional Director, so that examiners call attention to incomplete corrective promises of management. Examiners should also comment when the "Undesirable and Objectionable Practices" violate the provisions of the bank's board established formal policies.

3. Examiners should detail in the memorandum to the Regional Director their suggested measures to correct the "Undesirable and Objectionable Practices". Examples of corrective measures are offered under "UNSAFE OR UNSOUND PRACTICES" in this section. Such measures should be tailored to the situation and not impossible to perform within the given time frame. Care should be taken to ensure that recommended corrective actions are detailed for each "Undesirable or Objectionable Practice" reflected in the memorandum. Conversely, corrective measures which do not relate to the specific "Undesirable or Objectionable Practice" should not be recommended for inclusion in a corrective order.

4. The memorandum to the Regional Director should contain specific comments and recommendations relative to the existing management situation. In some cases, existing management may be considered adequate to solve the problems facing the institution, although a redirection or a clarification of authority may be necessary. If present management is not considered satisfactory, the examiner should comment upon such matters as

   a. the addition of independent outside directors and a chief executive officer, senior lending officer, or other appropriate senior officer with defined authority;
   b. the establishment of appropriate lines of authority, suitable board committees with outside director representation, and additional board policies for guidance of bank management;
   c. the implementation of board follow-up procedures to assure compliance with directives and established policies;
   d. the restriction of particular authorities of specific officers;
   e. the potential need for the directorate or an outside consultant to assess active management and/or the board; or
   f. any other managerial situations particular to the institution's circumstances.

5. The memorandum to the Regional Director should include the names and home addresses of any individuals the examiner believes should be named in a formal action to facilitate service on such individuals. The facts supporting the examiner's opinion should be provided in the memorandum as well as the Report of Examination.

6. If information needed to fully support the examiner's recommendations cannot be obtained through customary examination techniques, the Regional Office should be apprised of the situation as soon as possible; if the matter remains unresolved, the examiner should so indicate in the memorandum, and the Regional Director may consider possible use of the more formal investigative procedures under Section 10(c) of the FDI Act.

7. Examiners recommending Section 8 actions should be mindful that these proceedings are within the purview of the Equal Access to Justice Act. The Act provides that certain parties who prevail in contested administrative or judicial proceedings against an agency of the Federal government may be able to recover their litigation expenses from the agency if the position of the agency in the proceeding was not substantially justified. Examiners should use special care not to charge any practice or violation on inadequate grounds. Examiners should also be mindful that the memorandum comments may be a matter of record at any required hearing. Comments and observations in the memorandum must be well-supported by substantial evidence and be able to stand up under cross-examination in a hearing.

8. The report of examination generally serves as the FDIC's primary evidentiary exhibit in Section 8 proceedings. Therefore, it should be both factually and statistically correct, free of inconsistencies, and should not contain inflammatory remarks nor personal comments or observations not pertinent to evaluation of the bank or its management. Gratuitous remarks are to be avoided. Criticisms and comments set forth in Examination Conclusions and Comments should be realistic and must be well-supported. Classifications should be reasonable, not arbitrary, and likewise well-supported. Classifications of related lines or lines dependent upon the same source of repayment or strength should be consistent. The same is true where action is recommended against related banks with participations in the same loans. Reports of examination containing the basis for Section 8 recommendations should receive special priority in terms of field examination work and Regional and Washington Office processing.

9. When it is anticipated Section 8(b) cease and desist action against a bank will be recommended, the

examiner should consult with the Regional Office prior to discussing the possibility with the bank's board. Documentation of notification to the bank's board of directors should be included in the memorandum to the Regional Director.

10. When it is anticipated Section 8(e) removal action may be taken, the examiner should consult with the Regional Office, including Regional Counsel, as directed. It is especially important that the report or other documentary evidence support the charges issuing the Notice, particularly as they pertain to actions of the respondents.

Upon receipt in the Regional Office of an examination report containing the basis for Section 8 charges, the Regional Director, if in agreement after giving consideration to the surrounding circumstances and the merits of the examiner's contentions, may take certain actions under delegated authority. If delegated authority does not exist, the Regional Director should forward the report, and the applicable memorandum from the examiner to the Washington Office with a separate letter or memorandum containing the Regional Director's recommendation and pertinent legal documents (Notice and Order).

UNSAFE OR UNSOUND PRACTICES

General

The concept of unsafe or unsound practices is one of general application which touches upon the entire field of operations of a banking institution. It would, therefore, be virtually impossible to catalog with a single all-inclusive or rigid definition, the broad spectrum of activities which are included by the term. Thus, an activity not necessarily unsafe or unsound in every instance may be so in a particular instance when considered in light of all relevant facts pertaining to that situation.

Like many other generic terms widely used in the law, such as "fraud", "negligence", "probable cause", or "good faith", the term "unsafe or unsound practices" has a central meaning which can and must be applied to constantly changing factual circumstances. Generally speaking, an unsafe or unsound practice embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would result in abnormal risk of loss or damage to an institution, its shareholders, or the insurance fund administered by the FDIC.

Practices Deemed "Unsafe or Unsound"

"Unsafe or unsound practices" can result from either action or lack of action by management. The FDI Act does not define the term "unsafe or unsound practices," but the FDIC's Board of Directors, in previous Section 8 proceedings, has established examples of such practices, some of which are listed below.

Lack of Action Deemed "Unsafe or Unsound"

1. Failure to provide adequate supervision and direction over the officers of the bank to prevent unsafe or unsound practices, and violation(s) of laws, rules and regulations.
2. Failure to make provision for an adequate allowance for loan losses.
3. Failure to post the general ledger promptly.
4. Failure to keep accurate books and records.
5. Failure to account properly for transactions.
6. Failure to enforce programs for repayment of loans.
7. Failure to obtain or maintain on premises evidence of priority of liens on loans secured by real estate.

Actions Deemed "Unsafe or Unsound"

1. Operating with an inadequate level of capital for the kind and quality of assets held.
2. Engaging in hazardous lending and lax collection practices which include, but are not limited to, extending credit which is inadequately secured; extending credit without first obtaining complete and current financial information; extending credit in the form of overdrafts without adequate controls; and extending credit with inadequate diversification of risk.
3. Operating without adequate liquidity, in light of the bank's asset and liability mix.
4. Operating without adequate internal controls including failing to maintain controls on official checks and unissued certificates of deposit, failing to segregate duties of bank personnel, and failing to reconcile differences in correspondent bank accounts.
5. Engaging in speculative or hazardous investment policies.
6. Paying excessive dividends in relation to the bank's capital position, earnings capacity and asset quality.

Conditions Considered "Unsafe or Unsound"

As in the case of unsafe or unsound practices, it is impossible to define precisely what constitutes an unsafe or unsound condition because the condition of the bank is dependent upon an analysis of virtually every aspect of the bank's operation and position within a given time frame. At a minimum, the bank's capital position, asset condition, management, earnings posture and liquidity position must be carefully evaluated. While precise definition of unsafe or unsound condition is not possible, it is certain that a bank's condition need not deteriorate to a point where it is on the brink of insolvency before its condition may be found to be unsafe or unsound.

The following have been found to evidence unsafe or unsound conditions by the FDIC's Board of Directors:

1. Maintenance of unduly low net interest margins.
2. Excessive overhead expenses.
3. Excessive volume of loans subject to adverse classification.
4. Excessive net loan losses.
5. Excessive volume of overdue loans.
6. Excessive volume of nonearning assets.
7. Excessive large liability dependence.

Violations of Law, Regulation, Condition, or Order

Charges arising from violations of law, regulation, a written condition imposed by the FDIC in connection with a request by the bank or applicable Order are, as a general rule, definite and ascertainable and, therefore, generally more readily proven than charges based on unsafe or unsound practices.

Many violations are subject to legal interpretation, therefore, the term "apparent violation" is necessary to describe action or inaction which the examiner believes to be in contravention of law or regulation. Great care should be exercised in listing violations. The erroneous designation of conduct as a violation tends to discredit the report of examination and detract from its value as evidence. It may also tend to discredit the examiner on cross-examination at a hearing. If examiners are not reasonably certain a violation exists, they should promptly report the facts to the Regional Office and be guided by the advice received therefrom in the preparation of the report of examination.

Corrective Actions

In addition to setting forth the unsafe or unsound practices, conditions, and violations, the examiner should also detail in the memorandum to the Regional Director suggested measures, including appropriate time frames, to correct such practices, violations and conditions. These steps and the measurement of compliance therewith should be able to be accomplished within the time frames established. The requirements for compliance must be stated in unambiguous terms. Only those weaknesses requiring corrective action should be detailed in the memorandum to the Regional Director. It is generally not desirable to include provisions which require the Regional Director to make subjective judgments regarding correction. The following examples illustrate corrective measures for various unsafe and unsound practices, conditions, and violations:

1. If inadequate capital is evident, the amount of capital needed will be stated. This amount can be a ratio, e.g., Restore a ____% capital-to-asset ratio, or a dollar amount of new capital funds or a capital level, e.g., Increase capital and reserves to not less than _____and maintain. This particular corrective measure is one where precision in terminology mentioned immediately above may be illustrated. That is, should it be the desire to preclude the sale of preferred stock in an Order to sell new capital, the Order should indicate "sell new common stock" if that is what is actually intended.

2. If the bank has provided an inadequate allowance for loan losses, a requirement that the bank review the current balance of its allowance and make such entries as are necessary to provide an allowance that is adequate in light of the condition of the loan portfolio at that time will be included. The Board further requires that, in reviewing the adequacy of the allowance, consideration be given to the volume and severity of adverse loan classifications at the most recent examination. The bank's basis for adjustment to the allowance should be reduced to writing and provided to the regulatory authorities for review. Quarterly reevaluations are generally required. Except in unusual circumstances, Section 8(b) Orders should include some provision that the bank establish and maintain an adequate allowance for loan losses and that such allowance be established by charges to current operating income. In addition, a requirement that the bank provide accurate financial reporting prospectively and/or submit amended Reports of Condition or Income to correct previous inaccuracies should be included.

3. If the bank has operated with hazardous lending and collection policies, a requirement to cease and desist from such practices should be included. Such a requirement would normally establish a listing of conditions for extending credit. These might include: obtaining documents necessary to perfect the bank's lien and evaluate its priority; obtaining and maintaining current financial information on unsecured credits; and establishing a repayment

program consistent with the loan's purpose, security and source of repayment. In addition, development and implementation of formal lending policies have been required as have mandated reductions in the volume of classified assets.

4. If the bank was extending credit with inadequate diversification of risk, a requirement that credit extensions to any person or related interests of such person, be limited to % of the bank's Tier 1 capital should be included.

5. If the bank is operating without adequate liquidity, an order should contain a prohibition on the extension of credit, as defined in Section 215.3 of Federal Reserve Regulation O, during any month in total amounts exceeding __% of the total reduction in principal of outstanding loans during the month prior, unless the bank's total loans (exclusive of unearned income) are less than ______% of total deposits and the net cash, short-term and marketable assets exceed % of net deposits and short-term liabilities, calculated in accordance with current FDIC procedures. Establishment of formal asset-liability management policies has also been required.

6. If inadequate internal controls are evident, affirmative action to correct the specific weaknesses, hiring of a qualified operations officer, and contracting for an outside audit to include direct verification may be required.

7. If the bank is operating at a deficit, formulation and implementation of a comprehensive budget for two years for all categories of income and expense will be necessary. Also, appointment of a committee to supervise adherence to budgetary requirements and review items of bank expense has been directed.

8. If the institution is paying excessive dividends, prior written approval of the Regional Director before payment of dividends should be included. Similar prohibitions have frequently been established when a dollar amount of new capital funds is required.

9. If the board of directors is dominated by related individuals, officer directors, or directors whose dependence on the bank for credit compromises their effectiveness as directors, a requirement to change the composition of the board to a point which will reduce the impact of such individuals on the policies of the bank should be included. Each situation is unique; however, changes in the board to bring outside directors to at least 50% of the total board should be a goal. Furthermore, representation on influential committees should include a majority of outside directors.

As previously indicated, action under Section 8 constitutes a formal adversarial administrative action against the bank. The burden of proof for all charges rests with the FDIC. Examiners should be aware that lengthy time periods can elapse from completion of the examination to the date of a formal hearing. The examination report must contain all pertinent facts in support of each charge in order to better serve examiners should they be called as witnesses at a hearing. Examination workpapers may be used as evidence or to refresh the examiner's memory prior to giving testimony. Particular care should be taken to ensure that those workpapers are legible and consistent with the report. They should be stored under appropriate safeguards until the Order is lifted or the proceeding otherwise terminated.

SECTION 8(a) - TERMINATION OF INSURANCE

General

Section 8(a) provides an effective method by which the FDIC's Board of Directors can require insured banks to cease unsafe or unsound practices and violations and restore the bank to a safe and sound condition. The consequence of non-compliance, namely termination of insured status, is severe. The principal objective of Section 8(a), however, is to secure necessary corrections and not to terminate a bank's deposit insurance.

Authority to terminate a bank's insured status under Section 8(a) carries with it a grave responsibility. Deposit insurance is valuable and its loss would have serious adverse effects on any bank. National banks which lose their insured status must be closed, and many State banking codes contain similar provisions. Equity as well as logic mandate that, in any case, Section 8(a) be applied judiciously, with fairness, without haste or prejudice, and only after all other means for accomplishing correction have proven unsuccessful or where the condition of the institution is so severe as to preclude an attempt at correction through other means.

Outline of Section 8(a) and FDIC Procedure

In order for examiners to have a clear understanding of their part in cases involving Section 8(a), the applicable provisions of the FDI Act and an outline of the FDIC's procedures are offered.

Initiation of Proceedings - Section 8(a) provides that when the FDIC finds (1) an insured bank or its directors or trustees have engaged or are engaging in unsafe or unsound practices; (2) an insured bank or its directors or trustees have violated an applicable law, rule, regulation, order, or any condition imposed in writing by the FDIC in connection with the granting of any request by the bank, or any written agreement entered into with the FDIC; or (3) an insured bank is in an unsafe or unsound condition to continue operations as an insured bank, the FDIC, for the purposes of securing correction thereof, gives a notification regarding such practices, condition, or violations to the appropriate supervisory authority. Notification is provided to the Comptroller of the Currency in the case of a National or District bank, the relevant state authority having supervision over a bank or savings association in the case of a State-chartered institution, the Federal Reserve System in the case of a State member bank, and the Office of Thrift Supervision in the case of a savings association.

This "notification" specifies the violations, the unsafe and unsound practices, and conditions complained of in the form of findings; these are generally drawn from the reports of examination or a Report of Condition.

Such reports and the testimony of the examiners concerned constitute the bulk of evidence upon which the FDIC must rely to sustain the validity of the findings or charges made. Consequently, it is of the utmost importance that examination reports be accurate and that the facts are set out in detail and in clear, unambiguous form.

Should the decision be made that circumstances warrant termination of insurance, the FDIC gives the institution not less than 30 days written notice of its intention to terminate the institution's insured status and fixes a time and place for a hearing.

Hearing

Any hearing under Section 8(a) is a formal adversarial proceeding and held pursuant to the applicable provisions of the Administrative Procedures Act and Part 308 of FDIC Rules and Regulations. Failure of the bank to appear at the hearing is deemed as consent to the termination of its insured status. The hearing is presided over by an Administrative Law Judge and is comparable to a trial without a jury in U.S. District Court. Unless the bank chooses not to litigate the matter, the FDIC has the burden of proving the allegations made in the Findings through the production of evidence at the hearing. The FDIC's evidence generally consists of the reports of examination mentioned previously and the testimony of examiner personnel. However, any and all relevant evidence, such as the examiner's memorandum to the Regional Director, pertinent bank records and admissions made by directors, officers and other personnel of the bank, may be used as appropriate. The bank may be represented by counsel who has the right to cross-examine FDIC witnesses and present evidence in rebuttal or in mitigation of the FDIC's allegations. From the evidence adduced, the Administrative Law Judge recommends a decision to the Board of Directors. The Board of Directors then makes its final written findings and Order of disposition based upon the entire record of the evidence produced at the hearing. It should be noted this same procedure is utilized as regards hearings held under Section 8(b) of the FDI Act.

Bases for Section 8(a) Action

An institution's insured status may be terminated on the following grounds:

1. the institution or its directors or trustees have committed unsafe or unsound practices;
2. the institution or its directors or trustees have violated a law or regulation to which the bank was subject, a written condition imposed by the FDIC in connection with the granting of an application or other request of bank, or any written agreement entered into with the FDIC;
3. the institution is in an unsafe or unsound condition to continue operations.

Limiting the use of Section 8(a) powers as indicated is especially appropriate in light of the FDIC's intermediary enforcement powers now available under its cease and desist authority contained in Sections 8(b) and (c) of the Act.

Although the statutory language does not require it, Section 8(a) actions primarily occur when other available administrative remedies have proven unsuccessful in obtaining needed correction and/or when the bank's condition is unsafe or unsound. Section 8(a) charges are generally limited to those where immediate action is needed for the bank to continue as a viable entity. Other "unsafe or unsound practices" may be corrected through use of other administrative actions. Therefore, the Findings and Order for Section 8(a) actions are generally far more brief than those for Sections 8(b) or (c) actions.

CEASE AND DESIST PROCEEDINGS

General

As stated above, commencement of a proceeding to terminate the insured status of a bank should generally be used only after all other avenues have failed to induce an insured bank to discontinue unsafe or unsound practices or violations of law or regulation and restore the bank to a safe and sound condition. The severity of the ultimate penalty implicit in any 8(a) action limits its use as a remedial supervisory instrument.

Congress has given the FDIC and the other Federal bank supervisory agencies additional and intermediary powers with respect to banks engaging in or about to engage in, among other things, unsafe or unsound practices or violations of laws or regulations. This authority permits the use of "Cease and Desist" orders in situations where available facts and evidence reasonably support the conclusion that a bank is engaging in or about to engage in, an unsafe or unsound practice or violation of law. By ordering it to cease and desist from such practices and/or take affirmative action to remedy the conditions resulting therefrom, a bank's condition may be prevented from reaching such serious proportions as to require the more severe measures imposed by Section 8(a).

Section 8(b) Cease and Desist Proceedings

Section 8(b) provides that the FDIC may issue and serve a Notice of Charges upon a State nonmember insured bank in the following instances:

1. The bank is engaging, or has engaged, in unsafe or unsound practices;
2. The bank is violating, or has violated, a law, rule, or regulation, or any condition imposed in writing by the FDIC with regard to the approval of a request or application, or a written agreement entered into with the FDIC; or
3. There is reasonable cause to believe the bank is about to do either of the above.

The Notice contains a statement of facts relating to the practices or violations and fixes a time and place for a hearing to determine whether a Cease and Desist Order shall be issued.

A Cease and Desist Order is issued after the hearing, if one is held. The Order becomes effective 30 days after it is served upon the bank, or at the time indicated if issued upon consent of the bank. It remains in effect, as issued, until modified or terminated by the FDIC, or stayed or set aside by a reviewing court. Such an Order can be issued against the bank or any director, officer, employee, agent or other person participating in the conduct of the affairs of such bank.

Section 8(b) permits the FDIC to order an insured bank and its directors, officers, employees, and agents to cease and desist from certain practices and violations and take affirmative action to correct the conditions resulting therefrom. The failure of a bank to comply with any Cease and Desist Order which has become final can be the basis for subsequent Section 8(a) termination of insurance action. Such failure also can be the basis for the FDIC petitioning the U.S. District Court to enforce the Order. Civil money penalties may also be imposed against the bank or any officer, director, employee or other person participating in the conduct of the affairs of such bank. (Refer to the Civil Money Penalties section of this Manual).

In preparing recommendations for Section 8(b) or Section 8(c) proceeding, notification should be made to the State authority and the other Federal regulatory agencies. The views of the State authority regarding the need for the action and the appropriateness of the corrective actions should be sought. Such a contact may be made telephonically; however, a written reply should be requested. Failure to advise the State authority does not affect the legality of action taken under either Section 8(b) or 8(c).

Evidence Required - Section 8(b) provides that the FDIC need only be of the opinion that an insured bank is engaging in, or has engaged in, any of the aforementioned practices or violations, or has reasonable cause to believe that the bank is about to engage in such activities. However, mere suspicion is not sufficient grounds to institute this enforcement proceeding. Any such action must rationally be based on facts and evidence, as the FDIC has the burden of proving formal charges set out in a Notice of Charges. Consequently, documentation in the files of requests made of management, promises by bank officials, and conferences with bank directors and/or officers is a primary necessity. Furthermore, if bank records are needed to establish any of the charges, copies of those records should be made and retained as part of the necessary documentation in the case. When used in connection with any Section 8(b) proceeding, the report of examination should be prepared in accordance with the instructions detailed under Section II.

Actual Commission of an Unsafe Act Not Required - An important aspect of the use of Section 8(b) proceedings is that it permits the FDIC to prevent the commission of an unsafe or unsound practice or violation. It may thus be used to prevent a developing situation from reaching serious proportions. Assume for example that four banks are owned or controlled by the same group of individuals and that the owners have, through various self-dealing transactions, misused three of these banks but have not yet similarly abused the fourth bank. The FDIC in this situation could, through a Cease and Desist Order, likely ban all loans and fees to the ownership or controlling interest. This prohibition would apply not only to the three abused banks but also the fourth, even though no self-dealing had as yet transpired with regard to that institution. The basis for the Order against the fourth bank would rest on reasonably held belief by the FDIC that, because of the abusive self-dealing transactions committed by the owners with regard to the other related banks, similar unsafe or unsound practices would occur at the remaining bank.

Enforcement of Affirmative Corrective Acts - Under Section 8(b), the FDIC may both prohibit unsafe or unsound practices or violations of law and also require that affirmative steps be taken to correct the conditions resulting from previous violations or unsafe or unsound practices. For example, if the bank is being operated with an excessive amount of Substandard loans as a result of unsafe or unsound lending policies, a Cease and Desist Order issued pursuant to Section 8(b) could require the bank to take affirmative action to reduce the dollar volume of such loans to an amount specified in the Order.

Consent Cease and Desist Orders - Under Section 8(b), the FDIC attempts to obtain a Consent Cease and Desist Order in an effort to eliminate the need for time-consuming administrative hearings. The Consent Cease and Desist procedure is premised upon agreement to a stipulation between the representatives of the FDIC and the bank's board of directors whereby the bank agrees to the issuance of a Cease and Desist Order without admitting or denying that any unsafe or unsound practices and/or violations of law or regulation have occurred. The effect of this procedure is to reduce the time period between initial review of the case and the date on which an enforceable and binding Cease and Desist Order is issued. Concurrence of the State supervisor is sought; however, failure to obtain such concurrence is no reason to discontinue the pursuit of Section 8(b) action. The responsibility for negotiating a stipulation with the bank's board of directors is that of the Regional Counsel and other Regional Office representatives. The stipulation provides for waiver by the bank of its rights to a hearing and its consent to an agreed-upon Consent Cease and Desist Order. Once a stipulation is obtained, the Regional Counsel certifies in writing that the bank has been advised of its rights to a Notice of Charges and the directors or their chosen representative sign the stipulation. The Legal Division is responsible for certifying the legal sufficiency or for notifying the Division of Supervision of the legal insufficiency of the documents relating to Consent Cease and Desist Orders. After finalization of a stipulation, the FDIC issues the Order. If a satisfactory stipulation cannot be agreed upon, the FDIC gives notice of the time and place for a hearing.

Recommendation for Action - Recommendation for institution of Section 8(b) action is not necessarily dependent upon an examination of the bank or, if a bank is being examined, upon completion of a report of examination. If sufficient evidence is otherwise available, there is little or no reason to wait for an examination of the bank or completion of a report of examination before institution of Cease and Desist action. Care should be taken, however, to ensure that all unsafe or unsound practices evident have been addressed and are fully documented. Any report of examination and/or memorandum to the Regional Director should include as many detailed facts pertaining to the alleged practices or violations as is reasonably possible.

Determination of Compliance - The periods for compliance with the various provisions of a Cease and Desist Order are determined individually and may range from 30 days to 12 months, or more from the effective date of the Order. Virtually every Cease and Desist Order specifies intervals setting forth the form and manner of compliance with the substantive requirements of the Order. While reports prepared by the institution assist in monitoring progress with provisions, examinations will serve to determine compliance with the Order.

In the Compliance With Enforcement Actions schedule in the report of examination, the examiner must document in a factual manner and without statement of opinion the steps taken to comply with the Order. However, the examiner does not draw conclusions regarding the institution's compliance or noncompliance with the provisions of the Order. Refer to the Report of Examination Instructions for additional guidance.

Section 8(c) Temporary Cease and Desist Proceeding

The discussion of Section 8(b) actions reflects the FDIC's desire to obtain a Consent Cease and Desist Order to eliminate the need for time-consuming administrative hearings. The time frames involved in obtaining even a Consent Cease and Desist Order can be lengthy and may allow additional damage to be suffered by the bank from "unsafe or unsound practices". Section 8(c), however, provides the FDIC with the power to act with the utmost speed when the facts so dictate.

This portion of the Act provides that the FDIC may issue a Temporary Cease and Desist Order whenever the FDIC determines the violations or threatened violations or unsafe or unsound practices specified in the Notice of Charges are likely to cause insolvency or substantial dissipation of assets or earnings of the bank, or otherwise seriously prejudice the interests of the depositors prior to the completion of action under Section 8(b).

Such an Order, accompanied by a Notice of Charges, can be issued against the bank or any director, officer, agent or other person participating in the conduct of the affairs of such bank. The Order becomes effective upon service and, unless set aside or limited by court proceedings, remains effective and enforceable pending completion of the administrative proceedings pursuant to Section 8(b) action.

Within 10 days after service of a Temporary Cease and Desist Order, the bank or such director, officer, employee, agent, or other person named may apply for an injunction setting aside, limiting or suspending the enforcement, operation or effectiveness of such Order. These actions will generally be held in U.S. District Court for the judicial district in which the home office of the bank is located or U.S. District Court for the District of Columbia.

Because of the nature of the action, recommendations for such actions and support thereof are frequently developed without benefit of a completed report of examination. In those cases, a visitation report, memorandum or letter will discuss the practices and violations and their probable effect on the bank. An examiner should immediately contact the Regional Office to discuss the possible need for Section 8(c) action when a situation is discovered in which a violation of law or unsafe or unsound banking practice is likely to cause insolvency or substantial dissipation of assets prior to the completion of proceedings under Section 8(b).

SUSPENSION AND REMOVAL PROCEDURES

Section 8(e)

Examiners should be alert for situations where Section 8(e) may be applicable and promptly communicate with the Regional Office for guidance. It is vital that the examiner, the Regional Director or designee, and the Regional Counsel communicate with each other so that the decision on whether to proceed with a Section 8(e) action can be made while the examiner is still in the bank. It is especially important that the report or other documentary evidence be supportive of charges, particularly as they may pertain to the actions of the respondent.

Section 8(e) gives the FDIC the power to order the removal of an institution-affiliated party (director, officer, employee, controlling stockholder, independent contractor, etc.) from office. It also allows the FDIC to prohibit the party from participating in the conduct of the affairs of any insured depository institution. Section 8(e) action may be taken only when it is determined, after notice and hearing, that

1. The institution-affiliated party has violated any law or regulation, any final cease and desist order, any condition imposed in writing in connection with the granting of an application or other request, or any written agreement; participated in any unsafe or unsound practice in connection with the institution; OR engaged in an act, omission or practice which constitutes a breach of fiduciary duty; AND
2. By reason of the violation, practice, or breach, the insured depository institution has suffered or will probably suffer financial loss or other damage; the interests of the depositors have been or could be prejudiced; OR the party has received financial gain or other benefit; AND
3. The violation, practice or breach involves personal dishonesty on the part of the institution-affiliated party OR demonstrates willful or continuing disregard for the safety and soundness of the institution.

This section of the statute further permits removal or prohibition of an institution-affiliated party based on actions or consequences in connection with a business institution. More specifically, Section 8(e) proceedings may be based, in part, on participation of such party in an unsafe or unsound practice in connection with a business institution, actual or probable financial loss or other damage suffered by a business institution, or willful or continuing disregard by such party for the safety and soundness of a business institution. In addition, an institution-affiliated party can be immediately suspended or prohibited from participation in any manner in the conduct and affairs of the bank pending completion of proceedings regarding removal if the FDIC deems it necessary for the protection of the bank or the interests of the bank's depositors. Similar to proceedings under Section 8(c), an emergency suspension or order of prohibition remains effective pending completion of proceedings unless the person affected applies within 10 days for stay of such suspension and/or prohibition. Notification of anticipated Section 8(e) action should be made to the State authority and the opinion of the State authority regarding the appropriateness of the action should be sought. Failure to notify the State authority, however, does not affect the legality of the action taken under Section 8(e).

A notice of intention to remove a director, officer, or other person from office or to prohibit participation in the conduct of affairs of an insured bank contains a statement of the facts constituting grounds therefore and fixes a time and place for a hearing. This hearing must be held not earlier than 30 days nor later than 60 days after the date of service of such notice. Copies of the notice should also be served upon the bank of which the individual is a director, officer or associated person.

Within 10 days after any director, officer or other person has been suspended from office and/or prohibited from participation in the conduct of the affairs of an insured bank under Section 8(e)(3) (emergency suspension or order of prohibition), such director, officer, or other person may apply to the U.S. District Court for the judicial district in which the home office of the bank is located or the U.S. District Court for the District of Columbia for stay of such suspension and/or prohibition pending completion of the administrative proceedings.

For the purpose of enforcing any law, rule, regulation, or Cease and Desist Order in connection with an interlocking relationship, the term "officer" as used in this section has been defined as an employee or officer with management functions. The term "director" includes an advisory or honorary director, a trustee of a bank under the control of trustees, or any person who has a representative or nominee serving in such capacity.

Section 8(g)

Under Section 8(g), the FDIC may suspend an institution-affiliated party from office or prohibit that individual from participating in the conduct of the institution's affairs if such party is: (1) charged in any information, indictment or complaint authorized by a United States Attorney, with the commission of or participation in a crime involving dishonesty or breach of trust which is punishable by imprisonment for a term exceeding one year under State or Federal law; and (2) if continued service by the individual may pose a threat to the interests of the bank's depositors or may threaten to impair public confidence in the bank. The policy of the Division of Supervision regarding such actions is that the desirability of seeking removal or suspension will be considered on a case-by-case basis. Voluntary suspensions shall not be sought pending a decision that the FDIC is prepared to pursue formal suspension or removal under Section 8(g).

Examiners should notify the Regional Office immediately upon learning of the indictment of any director, officer, or other person participating the conduct of the affairs of an insured State nonmember bank. A copy of the indictment should be obtained and a determination made by Regional Counsel (or the Legal Division in Washington) that the indictment concerns a crime involving dishonesty or breach of trust punishable by imprisonment for a term exceeding one year under State or Federal law.

If the above determination is made, the Regional Director should review the threat posed by the individual's continued service. Relevant criteria may include the publicity expected to be generated by the case, the identification which exists between the individual and the bank, the nature of charges made in the indictment, or other relevant factors. It should be kept in mind that the FDIC must show only that an individual's continued service may threaten depositors or public confidence, but this finding must be supportable. Where the indictment relates to alleged crimes against a bank or other financial institution, it is expected that, except in rare instances, the second element of Section 8(g) will be met. Care should be taken to avoid any presumption of guilt or innocence in relation to the charges.

If it is determined that the relevant tests of Section 8(g) have been met, the individual(s) will be notified of the Region's contemplated recommendation for Section 8(g) action and offered the option of voluntary suspension. In those instances where there is voluntary suspension of the individual prior to the FDIC's learning of the indictment, the Regional Director will request a letter from the individual indicating resignation from office and/or a pledge of nonparticipation in any manner in the affairs of the bank.

Should formal action prove necessary, the FDIC will serve a written notice of the action upon the party and a copy of the notice upon the bank. The notice will suspend from office and/or prohibit the individual from further participation in bank affairs. Such suspension or prohibition will remain in effect until the indictment, etc., is finally disposed of or until the Order is terminated.

In the event of conviction and unavailability of further appellate review, the FDIC may serve an order removing the individual from office or prohibiting the individual from further participation in the conduct of bank affairs without the consent of the FDIC. A finding of not guilty, however, will not preclude the FDIC from removal proceedings under Section 8(e).

Within 30 days from service of any notice of suspension or order of removal, the involved person may request an opportunity to appear before the FDIC to show that continued service to the bank or participation in its affairs is not likely to pose a threat to the interests of a bank's depositors or threaten to impair public confidence in the bank. Upon receipt, the FDIC shall establish a time for a hearing before agency personnel (not more than 30 days after receipt of the request). Within 60 days after such hearing, the party will be notified of the FDIC's decision as to whether the prohibition or suspension will be continued, terminated or modified, or whether an order of removal will be rescinded or modified.

USE OF WRITTEN AGREEMENTS AND CAPITAL DIRECTIVES

The following are guidelines for implementing the requirements of the FDIC's capital regulation, Part 325 of the Rules and Regulation. In these guidelines, references to the "minimum capital requirements" for a bank mean either (a) a Tier 1 capital ratio of not less than 3.0% of total assets if the FDIC determines that the institution is not anticipating or experiencing significant growth and has well-diversified risk, excellent asset quality, high liquidity, good earnings, and, in general, is considered a strong banking organization, rated a composite 1 under the Uniform Financial Institutions Rating System or (b) a Tier 1 capital ratio of 3.0% of total assets plus an additional cushion of 100 to 200 basis points (a Tier 1 capital ratio of not less than 4% of total assets).

In addition to the minimum leverage capital standards, state nonmember banks are expected to maintain a minimum risk-based capital ratio of 8 percent, with at least one-half of that total capital amount consisting of Tier 1 capital.

Written Agreements

Part 325 states that any insured bank with a Tier 1 leverage capital ratio of less than 2% is operating in an unsafe or unsound condition. In such a case, the FDIC may, but is not required to, bring a Section 8(a) action against the bank. A bank with less than a 2% capital ratio will not be subject to Section 8(a) action because of its Tier 1 leverage capital ratio if it has entered into and is in compliance with a written agreement to increase its Tier 1 leverage capital ratio to the level deemed appropriate by the FDIC and to take whatever other action is necessary for the bank to be operated in a safe and sound condition. For an insured depository institution which is not a State nonmember bank, the written agreement must be between the bank and its primary Federal regulator with the FDIC a party to the agreement.

The use of a written agreement should normally be reserved for a bank whose problems are limited essentially to a capital deficiency that has not been caused by the unsafe and unsound practices of its management. Hence, within this narrow meaning of the term, a written agreement is not a substitute for other forms of enforcement action, but is intended to be used only when Section 8(a) or Section 8(b) action or a capital directive against a particular bank is not justified or practical. Thus, if the condition of a bank is so unsatisfactory that a termination of insurance action should be initiated, the FDIC should not seek to have the bank enter into a written agreement in lieu of taking a Section 8(a) action. Similarly, if Section 8(b) action and/or capital directive action would be called for on the basis of a bank's condition (including its capital ratios), it should be instituted by the primary Federal regulator against the bank.

When a bank's Tier 1 leverage capital ratio is less than the minimum levels and no Section 8 enforcement action or capital directive action is to be taken against the bank by its primary Federal regulator or the FDIC, as appropriate, the FDIC Regional Director should seek to cause the bank to enter into an acceptable written agreement between itself and its primary Federal regulator (with the FDIC as a party to it) or between itself and the FDIC. In the case of a State-chartered bank, the State authority should be invited to be a party to the written agreement.

Capital Directives

A capital directive is a final order issued by the FDIC to a State nonmember bank that fails to maintain capital at or above its minimum capital requirements. The FDIC does not have the authority to issue a directive to a national bank, a State member bank, or an FDIC insured Federal savings bank. The FDIC can issue a directive to a State nonmember bank. Such action can be taken in conjunction with a formal enforcement action or a memorandum of understanding or independent of other types of corrective action. A directive is to be used solely to correct a capital deficiency and it is not intended to address other weaknesses that may be present in a bank. Correction of such other weaknesses must be handled through some other form of action. Hence, in cases where it is possible to obtain a consent Cease and Desist Order that includes an appropriate capital provision, it is preferable to take Section 8(b) action instead of capital directive action. When a bank will be contesting the FDIC's Section 8(b) action, the Regional Directive may choose to also pursue a directive.

Upon determining that a directive should be issued to a State nonmember bank, the Regional Director should send a written notification of the intent to the bank. The State authority should be invited to join in this action. The written notification to the bank should indicate the capital ratios that the bank will be required to attain and thereafter maintain and the dollar amount of capital the bank will be required to raise. The notice should also state the time period within which the bank should achieve the prescribed capital levels, a period which should generally not exceed 180 days following the issuance of the directive. After the bank has received the written notification, it has 14 days in which to mail a written response to the Regional Director indicating why the proposed directive should be modified or not issued. Within 30 days of receipt of this response and after the Region's analysis of it, the Regional Director should decide whether to proceed with the directive. If such action is to be taken, the Regional Director or Deputy Regional Director may issue the Directive.

If the bank does not respond to the written notification from the Regional Director within the prescribed 14 day period, it is deemed to have consented to the issuance of a directive. However, sufficient time should be allowed for the mailing of the notice to the bank and a response from the bank before concluding that the bank will not file a written response. The granting by Regional Directors of requests for extensions of the 14-day period for filing a response to a notice of intent is generally not contemplated. Such requests should be approved only for good cause and only when there are extenuating circumstances.

When circumstances warrant, the time period for achieving the capital requirement in a directive may be formally extended by the Regional Director or additional time to comply with a directive can be informally provided by postponing further enforcement action. The FDIC does have authority to seek enforcement of a directive in district court when appropriate.

PROMPT CORRECTIVE ACTION DIRECTIVE

Prompt corrective action is a framework of supervisory actions for insured depository institutions which are not adequately capitalized. These actions become increasing severe as an institution falls within lower capital categories. Some supervisory actions associated with prompt corrective action are mandatory; that is, the actions immediately apply to the institution as it classified in a particular category. Other supervisory actions associated with prompt corrective action are discretionary; in other words, they may be imposed by the FDIC. If the FDIC pursues discretionary supervisory action, administrative procedures defined in Section 308.2 of the FDIC Rules and Regulations must be followed.

Part 325 of the FDIC regulations automatically makes institutions subject to certain of the restrictions of the prompt corrective action provisions immediately upon receiving notice, or being deemed to have notice, that the institution falls into a particular PCA capital category. In addition, the FDIC may take further discretionary supervisory actions under PCA where such actions appear necessary to carry out the purpose of PCA.

Section 38(f)(2) of the FDI Act requires the appropriate Federal banking agency to take one or more of the actions listed in that section against institutions which are significantly undercapitalized or undercapitalized institutions which have failed to file or implement a capital restoration plan. The mandatory restrictions may be embodied in an action taken pursuant to section 8 of the FDI Act or in a PCA Directive. Regardless of the enforcement tool used to achieve the desired result, every Critically Undercapitalized institution, Significantly Undercapitalized institution, or Undercapitalized institution which has failed to file or implement an acceptable capital restoration plan, for which the FDIC is the appropriate Federal banking agency, must have a formal action in place or in process which covers the mandatory restrictions. Such formal action can only be avoided if the FDIC Board is able to make a determination that the action would not further the purpose of section 38.

ORDERS TO CORRECT SAFETY AND SOUNDNESS DEFICIENCIES

Section 39 of the FDI Act establishes a corrective program for banks that do not meet the safety and soundness standards set forth in Appendix A to Part 364 of the FDIC Rules and Regulations. Specific rules and procedures for initiating corrective action in banks that do not conform to the standards are delineated in Part 308, Subpart R of the rules and Regulations.

The FDIC may request a bank to submit a compliance plan describing the steps the bank will take to correct identified deficiencies. Banks that fail to submit a requested plan, or fail to adhere to the submitted plan, will be subject to an Order requiring correction of the deficiencies noted. In addition, the FDIC has the discretion to employ other corrective measures which are similar to those imposed by PCA provisions. These include growth restrictions, capital calls, limits on the rate of interest paid on deposits, or any other measure deemed necessary by the FDIC to effect corrective action.

The power to initiate supervisory action under Section 39 is discretionary; however, the discretion becomes limited once a supervisory response has been introduced. Therefore, considerable care must be exercised so as not to begin a program that will result in overly harsh response to problems correctable by other means. Corrective programs for safety and soundness standards should normally be incorporated into formal and informal actions pursued against problem institutions. Such programs may also be considered for non-problem institutions having clearly inadequate safety and soundness practices and policies; however, this response will normally be limited to situations that could result in material loss to the bank, and/or where management has not responded effectively to similar criticisms in prior examinations.

CAPITAL PLANS

When a bank subject to FDIC supervision is determined to have capital ratios lower than those appropriate for the bank, the manner in which a capital plan is developed and submitted to the FDIC will depend largely on the nature of any other corrective measures (Section 8 action, capital directive, PCA directive, or memorandum of understanding) that will be taken. The Statement of Policy on Capital Adequacy, included in the Prentice-Hall volumes, provides interpretational and definitional guidance on how these corrective measures will be administered and enforced by the FDIC.

Those institutions which are deemed undercapitalized, significantly undercapitalized, or critically undercapitalized, as defined in Subpart B of Part 325 of the FDIC Rules and Regulations - Prompt Corrective Action, must submit a capital restoration plan to the appropriate Regional Director. This capital restoration plan must contain the following information:

- the steps the insured depository institution will take to become adequately capitalized;
- the levels of capital to be attained during each year the plan will be in effect;
- how the institution will comply with the restrictions in effect under prompt corrective action;
- the types and levels of activities in which the institution will engage; and
- other information as required.

Further, the FDIC may not accept a capital restoration plan unless the company having control of the institution has:

- guaranteed that the institution will comply with the plan until the institution has been adequately capitalized on average during each of four consecutive calendar quarters; and
- has provided appropriate assurances of performance.

This restoration plan must be filed within 45 days of the institution becoming undercapitalized.

Capital plans developed for any reason may describe the means and timing by which the institution will achieve its minimum capital requirements and may address one or more of the following areas: earnings, dividend policy, controlled growth, elimination of excessive risk, sale of common stock, sale of other forms of stock or debt, acquisition by new owners, merger, sale of branch offices, and other asset dispositions that do not reduce liquidity or increase risk.

Approved plans are expected to reflect a return to adequate capitalization within a reasonable time period. The time frame is to be determined on a case-by-case basis, taking into account the overall reasonableness of the plan and relevant factors such as the viability of the institution and whether it is fundamentally sound and well managed.

Institutions should be asked to submit capital restoration plans which are not merely a budget of projected operations, but the culmination of in-depth strategic planning on the part of the institution's directorate. Detailed information on the potential capital sources upon which the institution is relying should be provided. Plans which rely on an overly optimistic projected ability to sell stock may be rejected if not supported by objective data or reasonable assumptions. Institutions should provide an assessment of the likelihood of success of the plan and an explanation as to why particular strategies were selected over other alternatives. It may be appropriate to request an analysis of the effect of the capital restoration plan on the institution's risk profile, particularly in light of any planned sale of liquid assets, branch offices or other asset dispositions.

For additional information and guidance for all formal enforcement actions, please also refer to:

- The Division of Supervision and Consumer Protection **Formal and Informal Action Procedures Manual**, and
- The Division of Supervision and Consumer Protection **Case Managers Procedures Manual**.

GENERAL INSTRUCTIONS

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These instructions apply to all safety and soundness Reports of Examination (ROE), except those targeted reviews of banks included in the Large State Nonmember Bank Onsite Supervision Program.

References

Examiners should also apply the guidance detailed in the following directives:

- Federal Deposit Insurance Act, FDIC Rules and Regulations, and related statutes and regulations,
- FDIC and other applicable Statements of Policy,
- Instructions for the Preparation of Reports of Condition and Income (Call Reports),
- The User's Guide for the Uniform Bank Performance Report (UBPR),
- RMS Manual of Examination Policies (Manual),
- State Statutes and Regulations,
- FFIEC Information Technology Examination Handbooks,
- Outstanding Memoranda
- Financial Institution Letters,
- Uniform Financial Institutions Rating System,
- Uniform Rating System for Information Technology, and
- Uniform Interagency Trust Rating System.

Unless otherwise specified, complete Report financial schedules according to Call Report Instructions.

Reminder: Reports may be affected by changes to definitions, laws, regulations, Call Report Instructions, and regulatory policies within the aforementioned references. When significant Report changes occurred since the previous examination, use footnotes on the applicable report pages to explain the difference(s). Do not footnote minor changes.

Report Comments

Examiners should ensure all comments conform to The Plain Writing Act (Public Law 111-274), which was signed into law on October 13, 2010. The Act improves the effectiveness of Federal agencies by promoting clear written communication. For additional information, refer to the Plain Writing Act.

Report comments should clearly and concisely support component and composite ratings. Comments should:

- Focus on assessments, rather than simple descriptions, of a policy, practice, or condition,
- Reflect a complete analysis that forms a conclusion,
- Explain an examiner's reasoning for assigning a particular rating or making a particular recommendation,
- Present issues factually and in order of significance,
- Reflect an appropriate tone,
- Avoid matters not subject to criticism and lengthy discussions of relatively minor items, and
- Include descriptive subheadings, bulleted lists, tables, etc. as needed to improve readability.

Peer Group Information - Examiners may use UBPR or user-derived ratios and peer group comparisons to support comments. However, examiners should avoid over reliance on peer group comparisons.

Apparent Criminal Violations - Examiners must not discuss criminal referrals or apparent criminal violations in the open section of the ROE. All comments in confidential report pages or workpapers should be limited to clear-cut statements of fact. Examiners must not include opinions about the probability of indictment, conviction, or related matters. Comments should be as specific as possible and identify who reported an issue and how it occurred. Do not use language such as, "It is reported...," or, "Management indicated...." Instead, use language such as, "President Scott reported...."

Consolidated and Institution Only Schedules

Examiners should complete ROE schedules on a consolidated basis in accordance with Call Report instructions and generally accepted accounting practices. Institution-only schedules, or a list of an institution's investments in subsidiaries, may be included in ROEs when they add meaningful information. Institution-only schedules may be meaningful when:

- A material volume of a subsidiary's assets is adversely classified and inclusion of institution-only schedules highlight a concentration of risk in a subsidiary,
- A material amount of an institution's assets or capital is invested in a subsidiary and inclusion of institution-only schedules helps explain an examination concern (such as weak core earnings), or
- An institution is at risk of failing and inclusion of institution-only schedules might help the bank's board or regulatory authorities develop recovery or resolution strategies.

Examiners should create institution-only pages on continuation pages. Often, simple lists of investments in each subsidiary are adequate.

Report Dates

The Report uses four different dates:

- ***Examination as of Date*** - This is the date of the financial information analyzed throughout the Report, generally the most recent quarter-end Call Report data available. For example, if an examination commences on August 31, and June 30 financial data is available, the Examination as of Date would likely be June 30.
- ***Examination Start Date*** - This is the date the examination commenced, typically, the date when the examination team begins formal on-site examination of the institution. It is used to monitor ROE completion times and the length of time between examinations.
- ***Date Examination Completed*** - This is the date the examiner formally completes the examination and submits the ROE for review. The date is used to monitor ROE completion and processing times.
- ***Asset Review Date*** - This is the date of the asset data analyzed in the loan review, and often the investment portfolio and other real estate reviews. Although the date could be the same as the Examination as of Date, often examiners are able to obtain more current information. For example, if an examination commences on August 31, and July 31 loan data is available, the Asset Review Date might be July 31. Note the Asset Review Date on the Confidential-Supervisory Section page and within the Asset Quality comment on the Examination Conclusions and Comments (ECC) page.

Selection of the Examination as of Date and the Asset Review Date - When selecting these dates, examiners should consider the availability of the information (quarter-end Call Report data is generally not available until 45 days after the quarter end), the amount of time institutions need to compile requested information, and any material changes that occurred between the dates.

Note: When significant changes in the composition of the balance sheet occur between the Examination as of Date and the Asset Review Date, make appropriate comments in the Report. There may be circumstances when a more recent month-end date would better serve as the Examination as of Date (rather than the most recent quarter-end).

Page Order And Numbering

Page order is addressed in the Inventory of Report Pages section.

All pages in the open section are sequentially numbered. Sequential numbering continues through the confidential section, but the pages are not listed in the Table of Contents. The Table of Contents lists the titles and page numbers of all open section pages. The sequence of pages should generally follow the pages listed in the Inventory of Report Pages. When user-defined pages are included, they should be included where most appropriate, but not before the Risk Management Assessment (RMA) page.

Generally, do not number the Officer's Questionnaire. However, if the Officer's Questionnaire is included in the Report, numbering may be appropriate when the Officer's Questionnaire is lengthy. In such instances, the letters OQ should precede the number (for example, OQ.1, OQ.2, and OQ.3).

Supplemental Pages

Supplemental (non-mandatory) pages should be used to support the conclusions, recommendations, and ratings on the ECC page. The Bank of Anytown ROE includes many supplemental pages that provide guidance for formatting the pages. The sample pages do not necessarily provide examples of comments that support ECC page conclusions.

Rounding

Numbers/Dollar Amounts - Examiners may round dollar amounts to the nearest thousand and omit "000." In narrative comments, "M" is the acceptable abbreviation for thousands. Examiners should round amounts consistently throughout the Report and not use abbreviations like $2.5MM, $2,500M, and $2,500,000 interchangeably.

In the Items Subject to Adverse Classification and the Items Listed for Special Mention pages, round to the nearest thousand and omit "000" in both the heading and the extended criticized amount (refer to the Bank of Anytown). In narrative comments, the numbers and dollar amounts may be rounded and abbreviated; however, it is acceptable to use precise dollar or numerical amounts to avoid confusion. *Example:* The $25,000 loan is secured by a mortgage on a 1,800 square-foot condominium valued at $31,500, or $17.50 per square foot.

Note: When rounding, minor adjustments may be necessary to balance related totals in the Report.

Ratios

Generally, round percentages to the nearest hundredth of a percent, especially critical ratios such as Prompt Corrective Action capital ratios in problem institutions. Round noncritical or imprecise ratios to the nearest whole number.

Note: Avoid being overly precise in narrative comments.

Abbreviations

Matters Requiring Board Attention (MRBA), ECC, and Compliance with Enforcement Actions pages - An abbreviated term must be spelled out the first time it is used, with the abbreviation enclosed in parentheses following the term.

Other Report Pages - A list of standardized abbreviations for use on the other Report pages is provided on the back cover of the Report (shown in Appendix A).

Note: The effectiveness of Report comments is significantly diminished if the overuse of abbreviations makes a document harder for readers to understand by forcing them to refer to the list of approved abbreviations too often.

Writing Style and Grammar

Examiners should ensure all ROE comments conform to the guidelines in the Plain Writing Act. As noted above, the Act improves the effectiveness of Federal agencies by promoting clear written communication. Examiners should write clear, concise comments that are free from jargon and technical terms whenever possible. Refer to the Plain Writing Act, Appendix B of this document, and references such as dictionaries and writer's handbooks for specific guidance.

Footnotes - For ROE pages that have a section titled Footnotes, use the section for footnotes and not for comments.

Dollar signs - Use dollar signs in narrative comments, but not tables.

Commas - Use commas in amounts of 1,000 or more.

Spaces - Use two spaces between sentences.

Negative figures - Consistently enclose negative figures in parentheses or refer to them as negative values. Reminder: Do not write double negative numbers.

> *Examples:*
> *Correct:* The borrower reports a negative NW of $25M.
> *Or*
> The borrower reports a NW of ($25M).
>
> *Incorrect:* The borrower reports a negative NW of ($25M).

Names - On the first reference to a person in the Report, generally use the complete title, first name, middle initial, and last name (for example, Senior Vice President (SVP) John A. Doe). After the initial reference, an abbreviated name may be used (SVP Doe), if confusion with other officers is unlikely. Use references consistently throughout the Report.

Financial Ratios - Typically, UBPR financial ratios are uploaded into the ROE through the Genesys application. The most current information should be in the left column on all pages. Manually calculated ratios should conform to UBPR Users Guide definitions and be footnoted as having been manually calculated.

INVENTORY OF REPORT PAGES

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Report of Examination Page Order

Page	Section	Mandatory
Cover	**Open**	**Yes**
Table of Contents	**Open**	**Yes**
Matters Requiring Board Attention (MRBA)	Open	No
Examination Conclusions and Comments	**Open**	**Yes**
Compliance with Enforcement Actions	Open	No
Risk Management Assessment (RMA)	Open	No
Violations of Laws and Regulations	Open	No
Information Technology Assessment (ITA)	Open	No
Fiduciary Activities Assessment (FAA)	Open	No
Examination Data and Ratios (EDR)	**Open**	**Yes**
Comparative Statements of Financial Condition	Open	No
Loans and Lease Financing Receivables	Open	No
Recapitulation of Securities	Open	No
Items Subject to Adverse Classification	Open	No
Items Listed for Special Mention	Open	No
Analysis of Loans Subject to Adverse Classification	Open	No
Analysis of ORE Owned Subject to Adverse Classification	Open	No
Assets with Credit Data or Collateral Documentation Exceptions	Open	No
Concentrations	Open	No
Capital Calculations	Open	No
Analysis of Earnings	Open	No
Comparative Statements of Income and Changes in Equity Capital Accounts	Open	No
Relationships with Affiliates and Holding Companies	Open	No
Extensions of Credit to Directors/Trustees, Officers, Principal Shareholders, and Their Related Interests	Open	No
Internal Routines and Controls	Open	No
Composite Rating Definitions	**Open**	**Yes**
Signatures of Directors/Trustees	**Open**	**Yes**
Officer's Questionnaire	Open	No
Confidential – Supervisory Section	**Confidential**	**Yes**
Directors/Trustees and Officers	Confidential	No*

*Page must be completed at each examination (to collect data), but inclusion in ROEs is optional.

International Report Page Order

Examination Data and Ratios (International)	Open	Yes, when applicable
Transfer Risks Subject to Classification or Comment	Open	Yes, when applicable
Analysis of the Country Exposure Management System	Open	Yes, when applicable
Selected Concentrations of Country Exposure	Open	Yes, when applicable

Note: Use the EDR (International) page, in lieu of the standard EDR page, in the core section of the Report. Place International Report Pages immediately after the Items Subject to Adverse Classification and Items Listed for Special Mention pages.

EXAMINATION CONCLUSIONS AND COMMENTS (ECC)

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Purpose

The ECC page is the primary schedule examiners use to summarize examination findings, inform directors of undue risks, and guide corrective actions. Examiners should convey all significant examination findings on this page, including those relating to risk management, specialty areas, and, when material and relevant, Compliance/ Community Reinvestment Act (CRA) examinations. Examiners must document management's response to each significant recommendation and include an assessment of each CAMELS component on this page.

Comment Structure

Examiners must have a clear understanding of an institution's overall condition to prepare comments properly for this page. Comments should be sufficiently detailed to support all examination findings, ratings, and recommendations. Generally, commentary for a stable 1-rated component should be concise, while commentary for 2- through 5-rated components should be progressively more detailed.

In general, comments on the ECC page should not be duplicated on other ROE pages. However, some duplication is acceptable as certain types of examination issues can affect multiple UFIRS components.

Page Structure

Numerical Ratings

Uniform Financial Institutions Rating System – The top of the ECC page includes a grid to display the component and composite ratings for the current and two prior examinations. Previous examination dates should correspond to those noted elsewhere in the Report. Identify state examinations with "S" following the date, and designate other agency examinations with appropriate abbreviations. Composite ratings for the current and two prior specialty examinations, and the most recent Compliance and CRA examinations should be included at the bottom of the rating grid. Footnote any examination dates that do not correspond with the current or previous risk management examination dates.

Composite rating definitions for risk management and specialty examinations should be included on the Composite Rating Definitions page. Definitions of component ratings are publicly available in the FDIC Statement of Policy on the Uniform Financial Institutions Rating System and can be provided to management upon request.

Overall Condition Summary

The first narrative comments on this page should summarize the overall condition of the bank and briefly describe each component area. While this comment should be concise (often, two or three sentences), more extensive comments may be necessary for institutions with elevated risks. In all cases, the focus should be on providing a concise description of a bank’s overall condition. Often, bulleted comments can provide brief, yet effective, summaries of key conclusions. Examiners should include brief assessments of specialty areas in this section, but avoid significant duplication of comments included in other sections of the ECC page.

Matters Requiring Board Attention

Examiners should use this section of the ECC page (or the optional MRBA page), to highlight material issues and recommendations needing expeditious consideration by the directorate and between-examination follow-up by regulators. If the optional MRBA page is included in a Report, place it before the ECC page.

Examiners should include MRBA comments to highlight areas that require a board's prompt attention. The MRBA comments should prompt the board to evaluate risks and implement corrections before conditions deteriorate. In cases where conditions have already deteriorated, comments should prompt the board to take immediate action to correct deficiencies. Recommendations that management can address in the normal course of business without supervisory involvement can be included in the ECC or RMA pages.

Comment Structure **-** If MRBA comments are included on the ECC page, the comments should follow immediately after the Summary paragraph. Examiners may also use the optional MRBA page to highlight issues that are detailed on the ECC page. The MRBA section should consist of, at a minimum, a three-part comment that includes:

- An introductory sentence to explain the purpose of the MRBA comment,
- Brief comments highlighting the specific issues that require the directorate's attention, and
- A statement reminding the directorate of their responsibility to address issues appropriately and expediently.

Compliance with Enforcement Actions

Examiners should include a summary of outstanding formal or informal enforcement actions on the ECC page. Detailed analysis of outstanding actions should be presented on the Compliance with Enforcement Actions page. Generally, the summary should be included after the Overall Condition or MRBA summaries; however, placement of the comment depends on its significance in relation to other examination issues. Regardless of the type of action (formal or informal), the summary should discuss any unsafe or unsound practices or apparent violation of law that precipitated the enforcement action. Examiners should conclude comments by indicating if each practice, condition, or apparent violation was discontinued or still exists.

Note: Only the FDIC's Board of Directors is authorized to make a finding of unsafe or unsound banking practices. Therefore, do not use the statutorily significant phrase, "unsafe or unsound" in ROE comments. However, examiners should describe the facts that relate to unsafe and unsound conditions, and can use terms such as undesirable, unacceptable, or objectionable when commenting on unsafe and unsound practices.

Prompt Corrective Action **-** When applicable, present a summary of the Prompt Corrective Action (PCA) provisions included on the Compliance with Enforcement Actions page**.**

CAMELS Components

Each CAMELS component must be addressed on the ECC page. Components should be addressed in order of risk, although some latitude is allowed to facilitate effective communication. Include the assigned rating after each component heading (for example, Capital - 1). The narrative for each component must include an assessment of pertinent factors and support the assigned rating. If applicable, recommendations and management responses should also be detailed. When recommendations are included, the rationale for the recommendation should be provided. Refer to the Addendum to Section 1.1 (Basic Examination Concepts and Guidelines), of the RMS Risk Management Manual of Examination Policies for rating definitions and specific items to consider when evaluating each component.

The length of comments and level of detail should be consistent with assigned ratings. Generally, comments should be brief for 1- and 2-rated components and progressively more detailed for 3-, 4-, and 5-rated components. As commentary expands, it is important to use effective organization and presentation techniques. Subheadings and bullet points are encouraged to improve readability. Generally, lengthy comments should begin with a concise summary of the major issues being covered.

Violations of Law

If apparent violations of law or contraventions of statements of policy are cited in the ROE, the ECC page must include, at a minimum, a brief summary comment and reference to the Violations of Laws and Regulations page. References to other report pages may also be necessary if related issues, such as internal control or policy weaknesses, are detailed elsewhere in the ROE. Based on the significance of the violations, examiners may place the comments under a subheading in the appropriate CAMELS or specialty examination sections, or in a separate section on the ECC page. The amount of detail provided on the ECC page should be based on the materiality of a violation, management's response, and supervisory intentions regarding civil money penalties and enforcement actions.

Disposition of Assets Classified Loss

When applicable, management's response to examination Loss classifications should be discussed within the Asset Quality segment of the ECC page. For example, "President Smith indicated he will charge off all assets classified Loss prior to filing the June 30, xxxx Call Report."

Note: Except in formal cases under Section 8 of the FDI Act, examiners should not suggest management charge off a portion of loans classified Doubtful except when required by state law. Follow guidance contained in Section 3.3 (Securities and Derivatives), of the Manual when securities are adversely classified Doubtful or Loss. Other asset categories against which valuation reserves are not normally maintained require a judgment regarding a recommendation for charge-off.

Note: Comments should not include recommendations regarding the acquisition or disposition of specific assets.

Specialty Examinations

Concurrent specialty examinations <u>submitted under separate cover</u> (Information Technology (IT), Trust, Municipal/Government Securities Dealers (MSD/RSD), or Registered Transfer Agent RTA)) - In some situations, it may be necessary for specialty examination reports to be completed separately from Risk Management examinations. In these rare cases, separate cover specialty examinations should be prepared consistent with specialty examination guidance. Separate cover specialty ROEs require the approval of the regional director or designee.

Specialty examination findings for separate cover reports should be summarized in the ECC section of the risk management ROE. The placement and length of specialty examination comments should be commensurate with the risk profile of the specialty area.

Concurrent specialty examinations <u>embedded in the Risk Management ROE</u> - Specialty examination findings must be summarized in the ECC pages of the ROE. The placement and length of the comments should be commensurate with identified risks. When structuring comments, examiners should consider a department's risk profile, control environment, and risk management practices. Generally, comments should:

- Summarize the examination scope and key findings,
- Detail material recommendations and violations,
- Include management's response (including the timing of promised corrective actions) to material recommendations and violations, and
- Identify bank officials with whom examination findings were discussed.

There are no mandatory specialty examination pages. However, examiners may include specialty examination pages in the ROE to communicate findings, or to facilitate forwarding of information to other regulators or serviced institutions.

Note: Comments on the ECC page relating to RTA/MSD/GSD examinations should specifically state whether any apparent violations of laws or regulations were discovered. If apparent violations were discovered, but management disagrees with the violation, the apparent violation(s) should be cited and discussed in the ROE. If apparent violations were discovered and management agrees the violation occurred, examiners can list the violations associated with the applicable specialty examination in the ROE or include a statement indicating a list of violations was left with management. In either case, an ECC comment must be included detailing management's commitment, or lack of commitment, to correct the violations cited at the examination.

Note: Summary comments for IT examinations must include an ECC page comment assessing an institution's compliance with Appendix B to Part 364, Interagency Guidelines Establishing Information Security Standards (Security Guidelines). The length of the comment should vary based on the size and complexity of the institution and the significance of any weaknesses noted. Where programs are in compliance, comments need only state that compliance with the Security Guidelines was reviewed and the bank was found in compliance with the requirements. Comments should also address the overall adequacy of identity-theft prevention programs for the first examination cycle and on subsequent examination cycles until noted deficiencies (if any) are addressed.

Bank Secrecy Act (BSA)

Examiners must describe the adequacy of BSA and Office of Foreign Assets Control (OFAC) programs on the ECC page and factor their assessment into the Management component. The placement and length of comments should relate to the adequacy of the program and any outstanding regional guidance.

- Programs deemed satisfactory should be briefly discussed within a subsection of the Management component.
- Programs with moderate deficiencies should be discussed within a subsection under Management, with details of noted deficiencies and related recommendations included, as deemed appropriate, on the RMA or ECC page.
- Programs with significant deficiencies or violations of BSA related regulations should be presented, as deemed appropriate, in subsections under Management or as a separate section on the ECC page. Details of noted deficiencies and related recommendations should be included on the RMA or ECC pages.

Meetings with Management and the Board of Directors

If a meeting with the board of directors is held, the ECC page should include a concise presentation of the topics discussed and any related board responses and commitments. Specific management actions, commitments, or responses that are included in preceding comments need not be repeated. However, examiners should include enough detail to make the comment informative and to document commitments for corrective actions. The date of the meeting and a listing of attendees should be included. If a board meeting was not held, examiners should summarize the exit meeting held with senior management. This comment should precede the Board of Directors Reminder described below.

Board of Directors Reminder

This comment should be under a separate heading and the last narrative item on the ECC page. The comment should remind the directorate of their responsibility to review the entire ROE and sign the Signatures of Directors/Trustees page.

Examiner's Signature and Reviewing Official's Signature and Title

The examiner's signature (signatures if joint), and the reviewing official's signature and title should be the last items on the ECC page.

COMPLIANCE WITH ENFORCEMENT ACTIONS

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Purpose

This schedule presents facts relating to an institution's adherence to formal and informal administrative actions and to Prompt Corrective Actions. As noted below, examiners should address continuing conditions related to applications, notices, or other written requests on a separate schedule.

Formal enforcement actions are notices or orders issued by the FDIC against insured financial institutions and/or individuals. The purpose of formal actions is to correct noted safety and soundness deficiencies, ensure compliance with Federal and State banking laws, assess civil money penalties, and pursue removal or prohibition proceedings. Formal actions are legally enforceable and final orders are available to the public after issuance.

Informal enforcement actions are voluntary commitments made by an institution’s board of directors. They are designed to correct noted safety and soundness deficiencies or ensure compliance with Federal and State laws. Informal actions are not legally enforceable and are not available to the public.

When To Include This Schedule

Include this schedule when an institution has one of the following outstanding actions:

Formal Action

- Consent Order
- Capital Directive
- Continuing Condition
- Other formal administrative action of a state authority or other regulatory agency

Informal Action

- Board Resolution
- Memorandum of Understanding
- Other informal administrative action of a state authority or other regulatory agency

Prompt Corrective Actions

When an institution is subject to Prompt Corrective Action (PCA), summarize the applicable provisions of the PCA and follow each provision with an examiner assessment. Carry forward a summary of the institution's adherence to PCA requirements/restrictions to the ECC page.

Continuing Conditions

Create a separate schedule titled "Compliance with Ongoing Conditions" to discuss an institution’s adherence to conditions imposed by the FDIC or other relevant banking agency in connection with an application, notice, or other request made in writing. Address continuing conditions, including any conditions or requirements imposed through orders approving deposit insurance, mergers, or other applications, as well as continuing conditions or requirements imposed through a non-objection to a change in bank control notice or other filing. Continuing conditions or requirements to be addressed may also be included in various agreements relating to an application, notice, or filing such as operating agreements, parent company agreements, capital and liquidity maintenance agreements, and passivity agreements. The schedule should follow the Compliance with Enforcement Actions page (if formal or informal actions are in place) or the ECC page.

Page Structure

Examiners should begin comments with a brief overview of the facts leading to the issuance of an action. (For example, "Based on deficiencies noted at the xx/xx/xx examination, ...") Comments should detail the type of action, effective date, and affected parties. At the first examination after the issuance of a formal or informal administrative action, the action should generally appear verbatim on this page. If the action is lengthy and no court action is contemplated, it may be paraphrased if permitted by regional office policy.

Note: Use bold print, indentation, or similar techniques to differentiate between action provisions and examiner assessments.

Each provision should be followed with an assessment of the adequacy of the steps taken by the institution to comply with each provision of the action. For example, an assessment of a new policy might say, "The updated Liquidity Policy appears to adequately address the requirements of provision X." Examiners should not use conclusory statements of opinion such as, "The institution is in compliance/partial compliance/substantial compliance/noncompliance with this provision." Comments should also indicate whether or not agreed upon time limits have expired.

At subsequent examinations, provisions may be paraphrased or summarized. Address only those points of the action that the institution had not complied with at the previous examination and requirements of a continuing nature. When all provisions have been satisfied, and the only remaining provisions are those of a continuing nature having no expiration date, remarks may be limited to a short paragraph concerning the continuing requirements of the action.

Note: In all cases, carry forward a summary of the institution's adherence to any outstanding formal or informal actions to the ECC page.

RISK MANAGEMENT ASSESSMENT

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Purpose

The purpose of this schedule is to provide additional details that support conclusions and recommendations included on the ECC page.

When To Include This Schedule

Examiners should use the Risk Management Assessment (RMA) page to concisely detail risk management deficiencies, recommendations, and management responses that are material enough to be included in the ROE, but not on the ECC page. When determining where to place comments (ECC vs. RMA), consider the materiality of an issue, the impact an issue has on CAMELS ratings, and how placement of a comment most effectively supports recommendations and ratings.

General

Examiners should answer each RMA question by responding: "Yes," "No," or "Generally, yes." Responses at most 1 and 2 rated institutions will likely be answered: "Yes", or "Generally, yes."

"Yes" answers do not require ROE comments.

"Generally, yes" answers, which may be appropriate for moderate weaknesses, require comment on the RMA page, but may not require ECC page comments. Related comments should be concise and address management's response.

Answers of "No" normally require ECC page comments. To the extent possible, examiners should not duplicate comments on the ECC and RMA pages; however, RMA page comments may be used to address less significant issues or to provide additional details about weaknesses that are addressed on the ECC page.

In some cases, coverage of related issues may be split between the ECC and RMA pages. For example, a bank's loan policy is inadequate for several significant reasons. In addition, a number of less significant policy related weaknesses are identified that alone would not justify considering the policy inadequate. In this scenario, an appropriate RMA Question No. 2 response may be:

No. As indicated on the Examination Conclusions and Comments page, underwriting and credit administration practices relating to acquisition and development lending are deficient. Additionally, management should strengthen the Loan Administration Policy by:

- Addressing minimum documentation requirements relating to home lending,
- Developing minimum liquidity and net worth requirements for unsecured borrowers, and
- Modifying accounts receivable lending guidance to be consistent with actual practices.

President Smith agreed to modify the Loan Policy by the end of the year.

Risk Management Questions

Notes:
- The list of items under each question is for illustrative purposes and is not all-inclusive.
- In responding to these questions, examiners should consider the institution's existing and projected risk profile.

1) Are risk management processes adequate in relation to economic conditions and asset concentrations?

Consider issues such as:
- Local economic conditions and trends (including real estate markets),
- Trade area demographics,
- Loan demand and diversification strategies, and
- Industry or economic-sector concentrations.

Note: The level of formality in risk management processes should be consistent with the existing and projected size and complexity of an institution's activities. For example, written policies relating to monitoring economic conditions may not be needed in a stable 1 or 2 rated community bank.

2) Are risk management policies and practices for the credit function adequate?

Consider the adequacy of policies and practices relating to issues such as:
- Credit administration,
- Underwriting standards,
- Credit grading system,
- ALLL methodology,
- Real estate appraisals,
- Internal and external loan review programs,
- Documentation standards,
- Lending authorities,
- Loan approval processes,
- Loan committee structures,
- Nonaccruals and chargeoffs,
- Environmental risk controls,
- Out-of-area lending,
- Loan participations,
- Subprime lending programs,
- Credit card lending programs, and
- Renewals and extensions.

Additional guidance regarding this area is included in Section 3.2 (Loans), of the Manual.

3) Are risk management policies and practices for asset/liability management and the investment function adequate?

Consider the adequacy of policies and practices relating to issues such as:
- Asset/Liability management,
- Liquidity strategies,
- Investment strategies,
- Hedging strategies,
- Investment authorities,
- Committee structures, and
- Outside advisory services.

Additional guidance regarding this area is included in Sections 3.3 (Securities and Derivatives), 6.1 (Liquidity and Funds Management), and 7.1 (Sensitivity to Market Risk), of the Manual.

4) Are risk management processes adequate in relation to, and consistent with, the institution's business plan, competitive conditions, and proposed new activities or products?

Consider the adequacy of policies and processes relating to issues such as:
- Strategic and capital planning,
- Management depth and succession,
- New activities or products,
- Competitive environment,
- Feasibility and budgeting analysis,
- Fidelity insurance coverage,
- Consistency of present business plan with that provided with the Application for Federal Deposit Insurance (de novo institutions), and
- Consistency of proposed new activities or products with the business plan provided with the Application for Federal Deposit Insurance (de novo institutions).

5) Are internal controls, audit procedures, and compliance with laws and regulations adequate (includes compliance with the Bank Secrecy Act [BSA] and related regulations)?

Consider the adequacy of practices, as well as policy coverage and implementation, relating to issues such as:
- Independence, scope, and frequency of internal/external audit programs,
- Internal control standards,
- Management information systems,
- Audit committee composition,
- Management's responses to previous regulatory and audit recommendations,
- Accounting issues/Call Report errors,
- Fidelity insurance coverage,
- Compliance with the Bank Secrecy Act and Financial Recordkeeping regulations, and
- Compliance with laws and regulations, including continuing conditions other than orders granting approval for deposit insurance (which should be covered on the Compliance with Enforcement Actions Page).

Note: RMA page comments should only briefly address cited violations. Primary commentary regarding apparent violations should be included on the ECC and Violations of Laws and Regulations pages.

Note: BSA and OFAC comments are not required on the RMA page if there are no concerns. However, moderate deficiencies or recommendations for program enhancements that do not require ECC comments may be detailed on this page. (In all cases, scope comments for BSA and OFAC should be included on the Confidential - Supervisory Section page.)

6) Is board supervision adequate; and are controls over insider transactions, conflicts of interest, and parent/affiliate relationships acceptable?

Consider issues such as:
- Ownership/Control of the institution,
- Quality and completeness of Board reporting,
- Committee structure adequacy to the extent not addressed in prior questions,
- Directorate attendance,
- Transactions with insiders, affiliates, holding companies, and parallel-owned banking organizations,
- Unusual or nontraditional activities conducted through affiliates,
- Policies and procedures regarding conflicts of interest and ethical conduct,
- Affiliate/subsidiary relationships,
- Excessive compensation and director's fees, and
- Key man life insurance/deferred compensation arrangements.

VIOLATIONS OF LAWS AND REGULATIONS

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Purpose

Examiners use this page to communicate details regarding apparent violations of laws and regulations, as well as contraventions of statements of policy or non-conformance with other guidelines.

General

The ECC page must include a reference to this page whenever violations or contraventions are cited. References to this page on other report pages may also be necessary if related issues, such as internal control or policy weaknesses, are detailed elsewhere in the ROE.

Because of possible administrative or judicial reviews, all violations must be described as "apparent violations."

Examiners should list violations in order of importance, with consideration given to the materiality of violations, adequacy of management's response, and supervisory intentions regarding civil money penalties and enforcement actions.

Formatting Write-ups

Headings - A descriptive heading should precede each scheduled violation or group of violations.

Citation of Violation - When scheduling apparent violations of laws or regulations:

- Refer to general regulations by part number (for example, Part 329),
- Refer to specific parts of regulations by section number (for example, Section 328.2 or Section 329.1(e)), and
- Quote or paraphrase the requirements of violated statutes. Ensure summarized comments accurately reflect the key aspects of any paraphrased statutes. For example, "Section 337.3(b) prohibits banks from making loans exceeding defined amounts to directors without prior board approval."

Description of Violation - Describe the specific actions or circumstances that caused an apparent violation. For example, "The $3 million loan to Director Smith funded on 12/2/11 is in apparent violation of Part 337 because it was extended without prior board approval." Lengthy descriptions of violations may be unnecessary, especially if details are included in other schedules. In such cases, include references to the other schedules.

Management Response - Comments should include:

- Management's explanation for violations and their commitments for corrective action, or lack thereof,
- The name and title of any officers or directors who provided explanations and commitments, and
- Details of any promises of restitution (when applicable).

Director Approval - To reflect director responsibility, include the names of directors who approved assets held in nonconformance with applicable State or Federal laws, regulations, or similar transactions. While this is not necessary in all violation write-ups, it is essential when violations may result in civil money penalties. In such cases, show the date approval was granted and include the names of any dissenting directors. Follow this procedure even if approval consisted merely of ratifying a group of loans identified only by numbers. Generally, also include director approval information when the apparent violation(s) involves insider transactions, whether or not civil money penalties are being recommended.

Summary of Technical Violations – Generally, when citing technical violations involving numerous accounts or credits, examiners may include lists of sample violations in the ROE. If sample lists are included, examiners should give complete lists to management and retain a copy in the workpapers. Refer to specialty examination guidance when citing apparent violations relating to specialty examinations.

Legal Lending Limit Violations

Generally, courts have held that only the loan(s) that cause a borrower's debt to exceed the legal limit is illegal. Therefore, consider only the advance(s) that cause the excess over the legal limit a violation. However, the state law or practices regarding this matter should prevail.

Uncorrectable Vs. Repeat Violations

After violations are first cited at an examination, refrain from citing the violations at subsequent examinations if they cannot be corrected. For example, violations of Regulation O prior approval requirements are not correctable and should not be cited at subsequent examinations. However, examiners should cite repeat violations (new infractions of previously cited violations), and violations that could have been corrected but were not.

Civil Money Penalties

Examiners must not refer to the FDIC's ability to impose Civil Money Penalties (CMPs) except in the most serious circumstances. If institutions repeat or fail to correct serious violations, comments can indicate that violations may be subject to CMPs.

Reminder: Examiners must determine if an insured depository institution should be considered for a CMP referral when significant violations of the BSA/AML Compliance Program have been cited.

Note: When CMPs are being recommended, the home mailing addresses of all directors and any other individuals involved in the violation should be included in the Confidential-Supervisory Section.

Contraventions Of Statements Of Policy

List contraventions of statements of policy after cited violations under the subheading Contraventions of Statements of Policy.

Violations Of Part 325 vs. Contraventions Of FDIC Statements Of Policy

- Violations of Part 325 leverage capital standards are violations of a regulation.
- Failure to meet Risk-Based Capital guidelines is a contravention of an FDIC Statement of Policy, not a violation of Part 325.

Reference: Violations of Laws and Regulations section of the Manual

INFORMATION TECHNOLOGY ASSESSMENT (ITA)

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Purpose

The purpose of the ITA page is to convey supporting comments for embedded IT examination findings, which must be summarized on the ECC page. Significant findings from separate cover IT reports completed during the risk management examination cycle must also be summarized on the ECC page.

When to Include

Examiners have the option to include the ITA page when necessary to provide additional support for significant examination findings. In cases where a composite 3, 4, or 5 URSIT rating is contemplated, IT comments may have a higher priority on the ECC page, but should generally be formatted as a summary of overall IT conditions, with detailed findings included on the ITA page if necessary.

Page Structure and Order

Numerical Ratings

The ITA page, as formatted by Genesys, includes a grid at the top of the page to display the composite and component ratings for the current and two prior IT examinations. To enhance readability, examiners may wish to include composite IT ratings in the grid (but must still include the ratings in the ECC ratings grid). Rows for component ratings, which are generally not included in embedded IT examinations, should be deleted, or completed as NA and footnoted as Not Assigned.

Supporting Comments

Examiners should focus comments on the overall strengths and weaknesses of information security programs, risk management programs, and IT operations. Comments should be presented in order of importance and provide support for the conclusions and recommendations summarized on the ECC page. Use descriptive subheadings, bulleted lists, and other such devices to promote readability.

FIDUCIARY ACTIVITIES ASSESSMENT (FAA)

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Purpose

The purpose of the FAA page is to convey supporting comments for embedded trust examination findings that are summarized on the ECC page.

When to Include

Examiners have the option to include an FAA page when additional information regarding embedded trust examination findings, recommendations, or management responses is necessary to support ECC page comments.

Supporting comments on an FAA page may relate to apparent violations, contingent liabilities, potential losses, estimated losses, or other issues subject to comment or criticism.

Page Structure and Order

Numerical Ratings

The FAA page includes a grid at the top of the page to display the component and composite ratings for the current and two prior trust examinations. At a minimum, examiners must include composite trust ratings and a summary comment on the ECC page. However, if deemed appropriate, examiners may also include composite and component trust ratings on the FAA page. The definition of the assigned composite rating must be included on the Composite Rating Definitions page.

Supporting Comments

Examiners should prepare comments on an exception-only basis as much as possible. Comments should be presented in order of importance and provide support for the conclusions and recommendations summarized on the ECC page. Descriptive subheadings, bulleted lists, and other such devices should be used to promote readability.

EXAMINATION DATA AND RATIOS (EDR)

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Purpose

The EDR page includes various data that details trends in key financial components and supplements examination assessments of capital, asset quality, earnings, and liquidity. Examiners must include the EDR page in all examination reports.

Summary of Items Subject To Adverse Classification

Generally, classification information automatically pulls from other report schedules.

Contingent Liabilities

Only Category I contingent liabilities (liabilities that will result in an equivalent increase in bank assets if the contingencies convert to actual liabilities) are subject to adverse classification.

Financial Performance and Condition Ratios

The standard ratios included on this page are derived from examination results, Call Reports, and the UBPR. When Call Report data is used, ratio calculations are consistent with UBPR User's Guide definitions.

Selection of Ratios

Data in the Asset Quality section and the top portion of the Capital section[1] is based on results from current and prior examinations (if applicable). The left column of the bottom three Capital ratios[2] and the Earnings and Liquidity ratios should tie to the Examination as of Date of the current examination. The information in the adjacent three columns is user-defined. When selecting the period and type of information displayed in the adjacent columns (whether institution or peer), examiners should select the data that best supports examination conclusions.

Examiners can add one user-defined ratio to each section to further support examination findings. User-defined ratios for prior periods that are not readily available can be shown as NA and footnoted as Not Available, or manually calculated based on UBPR definitions.

Note: The Capital Category will need to be changed from "W-Well-Capitalized" if the bank is operating under a formal corrective action even if the capital ratios meet the requirements of the Well-Capitalized PCA category. (Change the category designation by overwriting the Capital Category cell in Genesys.)

[1] Tier 1 Leverage Capital/Average Total Assets, Tier 1 Risk-Based Capital/Risk-Weighted Assets, and Total Risk-Based Capital/Risk-Weighted Assets

[2] Retained Earnings/Average Total Equity, Asset Growth Rate, and Cash Dividends/Net Income

COMPARATIVE STATEMENTS OF FINANCIAL CONDITION

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Purpose

This schedule presents a general snapshot of the institution's balance sheet. It is not intended for detailed financial analysis. Examiners should use the institution's Report of Condition, UBPR, and other sources for balance sheet analysis.

General

This schedule should conform to Call Report Instructions. If Call Report Instructions change, examiners may need to add new line items.

Show all asset categories net of specific and general valuation allowances, except Total Loans and Leases, which has a separate line item for general valuation allowances (the Allowance for Loan and Lease Losses).

Dates

Left Column - In the left column, place the financial information for the current Examination as of Date. Generally, this will be the most recent quarter-end available; however, month-end or another date may be more appropriate when circumstances dictate.

Right Column - The right column should usually detail information for the year-end prior to the Examination as of Date shown in the left column. However, when desired, substitute a different date, such as the Examination as of Date from the prior examination. If using a date other than the previous Examination as of Date, ensure the information follows Call Report guidelines.

At the first examination of a new institution, examiners may use the right column to display a projected balance sheet. If this information is not useful, leave the right column blank. In the case of a new institution, footnote the date the institution opened.

Assets, Liabilities, and Equity Capital

Ensure line items tie to Call Reports line items and footnote any unusual items. If an examination as-of date does not correspond to a quarter-end, line items must still conform to Call Report definitions.

Off-balance Sheet Items

Off-Balance Sheet Items should correspond to those listed on Call Report Schedule RC-L, although Schedule RC-L includes further breakdowns. If additional categories are needed, space is available below Other Off-Balance Sheet Items.

Include only Category I contingent liabilities (contingencies that give rise to accompanying increases in assets if the contingencies convert into actual liabilities). Do not include Category II contingent liabilities (those that are not expected to result in an increase in assets if converted to actual liabilities, such as pending litigation). Category II contingent liabilities should be discussed on the ECC page under the financial aspect most significantly affected (for example, capital, management, earnings, or liquidity). If more than one financial aspect is impacted, comments relating to the other areas should briefly reference the contingencies and be cross-referenced as needed.

Footnotes

Use this section strictly for footnotes, not comments.

LOAN AND LEASE FINANCING RECEIVABLES

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Purpose

The purpose of this schedule is to provide an overview of the types of loans in an institution's loan portfolio and the volume of past-due and nonaccrual loans. This schedule is not intended for in-depth loan analysis. Examiners should review an institution's internal records, Call Reports, and UBPR to gain a thorough understanding of the composition and quality of a loan portfolio.

General

Complete this schedule according to Call Report Instructions.

Percentages - Round percentages to the nearest whole percent in the loan portfolio section and to the nearest hundredth percent in the past-due and nonaccrual section.

Dates - Examiners have the flexibility to use the same or different dates for the loan category and past-due/nonaccrual sections. The loan category date will usually be the Examination as of Date. The past-due/nonaccrual date should normally correspond with the Asset Review Date.

Note: Past due and nonaccrual ratios may not tie to Call Report ratios if the Asset Review Date and the Examination as of Date are not the same. When the dates differ, ensure the dates used are clearly footnoted. Examiners may prepare the loan portfolio section as of the Asset Review Date if significant loan portfolio changes occurred after the Examination as of Date.

Loan Portfolio Breakdown

All Other Loans and Leases - This item includes overdrafts.

Note: Gross loans and leases per the Call Report may actually be total loans and leases (gross loans and leases less unearned income). Call Report Instructions encourage but do not require institutions to report loan categories net of unearned income. Using total loans is acceptable when total and gross figures are not substantially different or unearned income is difficult to separate from loan categories.

Past-due And Nonaccrual Loans And Leases

Past-due and nonaccrual information should correspond to information in Call Report Schedule RC-N. Refer to the instructions for Schedule RC-N and the Call Report Glossary under "Nonaccrual Status."

Note: The past-due columns are only for past due loans that are still accruing interest. The nonaccrual column may contain current and past-due loans.

Total Past Due and Accruing - This column is the sum of the previous two columns within each category.

Percent of Category Columns - The Percent of Category column calculates the ratio of past-due and accruing loans to the respective loan category. The Nonaccrual Percent of Category column calculates the ratio of nonaccrual loans to the respective loan category. (The totals in these two columns are not the sum of the ratios above the totals. The column totals are the Total Past Due and Accruing and the Nonaccrual dollar amounts expressed as a percent of gross loans and leases. The total Percent of Category ratio plus the total Nonaccrual Percent of Category ratio equals the Past Due and Nonaccrual Loans and Leases/Gross Loans and Leases ratio shown on the Examination Data and Ratios Page.) *Note:* The percent of categories columns should not add to 100 percent unless the entire loan portfolio is past-due or on nonaccrual.

Restructured Loans and Leases

Memorandum: Restructured Loans and Leases - Include restructured loans here only if they are past due and accruing or on nonaccrual. These restructured loans are included in the above past-due and nonaccrual totals. Footnote restructured loans that are not past due and accruing or on nonaccrual.

Restructured loans, also known as troubled debt restructurings, are described in ASC Subtopic 310-40, Receivables - Troubled Debt Restructurings by Creditors (formerly FASB Statement No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings," as amended by FASB Statement No. 114, "Accounting by Creditors for Impairment of a Loan"). Such loan restructurings may include, but are not limited to, reductions in principal or accrued interest, reductions in interest rates, and extensions of the maturity date because of deterioration in the borrower's financial position.

The following loans are not considered troubled debt restructurings:

- A loan extended or renewed at a stated interest rate equal to the current interest rate for new debt with similar risk,
- A loan that was a troubled debt restructuring, which had, subsequent to its restructuring, been assumed by a financially sound, unrelated third party, and
- A loan to purchasers of ORE which, to facilitate disposal, is granted at contract rates lower than market rates for loans of similar risk.

References: ASC Subtopic 310-40, Receivables – Troubled Debt Restructurings by Creditors
Call Report Instruction Glossary under Troubled Debt Restructurings

Footnote

Use this area to clarify items in the above sections. Do not use it to detail loan categories. A continuation page may be used if it is necessary to break down loan categories (such as, construction, commercial real estate, 1- to 4-family residential).

RECAPITULATION OF SECURITIES

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Purpose

The purpose of this schedule is to analyze the general composition of a bank's investment portfolio, as well as any appreciation or depreciation in securities. Review the institution's internal records, Call Reports, and UBPR to gain a thorough understanding of the composition and quality of the investment portfolio.

General

Examiners should complete this schedule in accordance with Call Report Instructions-Schedule RC-B and the Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities.

Rounding - Round percentages to the nearest hundredth of a percent.

Trading Account Assets - Do not include trading account assets, other than as a footnote.

Sub-investment Quality/Investment Quality

This schedule allows examiners to detail investment and sub-investment quality securities for States and Political Subdivisions, Mortgage-backed Securities, Other Debt Securities, and Equity Securities. When applicable, schedule sub-investment quality securities immediately below the appropriate line item. For instance, if an institution has a sub-investment quality other debt security (other domestic debt), add a line item titled Sub-investment Quality Other Domestic Debt Securities directly below Other Domestic Debt Securities. The manually created Sub-investment line items will not appear unless a sub-investment quality security exists.

Fair Value And Estimated Fair Value

Fair Value is defined as the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants in the principal, or most advantageous, market of the asset or liability at the measurement date. The value is often referred to as an "exit" price.

An orderly transaction is a transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities. It is not a forced liquidation or distressed sale.

If using other than quarter-end statements and it is impractical to obtain the fair value for some securities, include the amortized cost of those securities in the Fair Value column. For each line item, footnote the dollar amount of amortized costs included in the Fair Value column.

Asset-backed Securities

Asset-backed securities are backed by assets other than 1- to 4-family residential properties. For example, securities backed by credit card receivables, home equity lines, automobile loans, other consumer loans or commercial and industrial loans. Footnote, if appropriate, the type of assets securitized if other than those previously listed.

References: Call Report Instructions for Schedule RC-B
Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities

Manual Section 3.3, Securities and Derivatives
Capital Markets Handbook
Call Report Glossary, particularly

- Coupon Stripping, Treasury Receipts, and STRIPS
- Marketable Equity Securities
- Participation in Pools of Securities
- Trading Account

ITEMS SUBJECT TO ADVERSE CLASSIFICATION
←

Purpose

The purpose of this schedule is to detail adversely classified items and when necessary communicate the rationale for adverse classifications via write-ups.

General

The page heading includes the interagency definitions of Substandard, Doubtful, and Loss.

All types of assets are subject to adverse classification.

Asset Classification Write-Ups

Asset classification write-ups are prepared to support the examiner's conclusions and recommendations to the Board of Directors, senior management, and regulatory authorities (including support for enforcement actions). Write-ups may not be necessary when the Asset Quality (AQ) component is rated 1 or 2. However, <u>when AQ is rated 3 or worse, examiners are to prepare a sufficient number of write-ups</u> to explain individual asset classifications, highlight underwriting deficiencies, and support examination recommendations and ratings.

Examiners should structure their write-ups to present information most effectively. For example, full scope write-ups, addressing the elements discussed under the Loan Write-Ups heading below, may be completed for loans over a certain size or to support specific conclusions or recommendations detailed on the ECC or RMA pages. Less comprehensive write-ups, or write-ups that only include a bulleted list of facts, may be completed for less complex credits. Examiners may also include lists of individual loans, or group homogeneous loans together, if appropriate. The examiner-in-charge has discretion as to the level of detail necessary to support conclusions and satisfactorily convey examination findings.

Regardless of the Asset Quality rating, examiners should consider including loan write-ups when any of the following circumstances are present:

- Significant weaknesses or adverse trends in credit underwriting or administration policies or practices,
- Material Loss classifications,
- Management disagrees with one or more classifications,
- Directors or management are not adequately aware of the impact of significant weaknesses in credit policies, practices, or conditions,
- Adversely classified assets involve institution insiders, or
- Internal credit grading systems are deficient.

Report Presentation

General

- In all cases, the dollar amount of adverse classifications must be included in the table at the top of the Examination Data and Ratios (EDR) page.
- If adverse classification write-ups are not prepared, examiners may list individual assets and groups of homogeneous assets on the Items Subject to Adverse Classification page.

- Regardless of ROE presentation, a detailed list of classifications should be left with management before the end of the examination. In this case, a copy of the list, signed by an executive officer (signifying acknowledgement of receipt of the list), should be retained in the workpapers.
- If classified assets are grouped together, include a comment as to the number of assets and basis for classification. For example, "32 Consumer Installment Loans adversely classified based on the Uniform Retail Credit Classification and Account Management Policy."
- The order of adversely classified asset categories should follow the table at the top of the EDR page. Use appropriate subheadings, alphabetize assets within categories, and subtotal each category containing adversely classified items.

Loan Write-ups

Examiners are encouraged to follow Federal Plain Language Guidelines when completing ROE comments, including loan write-ups. Following the guidelines helps improve the effectiveness of Reports by making comments and recommendations easier for directors and managers to understand. Therefore, examiners should consider the needs of their readers and avoid the overuse of jargon and acronyms. When you are considering whether to use an abbreviation, or how many you can use in a comment, remember that they should make comments easier for your readers to understand. The effectiveness of write-ups is significantly diminished if the overuse of jargon and abbreviations make a document harder for readers to understand by forcing them to refer to the list of approved abbreviations too often.

When full-scope loan write-ups are prepared, comments should address pertinent factors affecting a classified asset.

To the extent necessary, write-ups should address the following elements:

Identification - Indicate the name and occupation or type of business of the borrower. In the case of business loans, identify the business structure (corporation, partnership, sole proprietorship, etc.). Identify signers, cosigners, endorsers, and guarantors.

Description - Concisely describe the make-up of the debt as to the loan type, original and current amounts, and terms. Briefly describe the loan's general history, purpose, and source of repayment.

Collateral - Describe and evaluate any collateral, including its condition and/or marketability. When relevant, identify the appraiser. Also, state if the appraisal or estimate of value is independent or in-house.

Financial Data - Present key balance sheet and income information of the borrower and guarantors. The amount of financial information included in the write up should coincide with its relevance to the classification.

Summarization of the Problem - Explicitly point out the reasons for the adverse classification. Where portions of the line are accorded different classifications or are not subject to adverse classification, state the reasons for the split classifications.

Management's Intentions - Describe management's intention with the debt/borrower. Include any corrective actions contemplated by management, and identify the bank manager who committed to the actions.

Responsibility - Immediately following each loan write-up, identify the originating officer, servicing officer, and the examiner who reviewed the loan.

Consider the following when preparing write-ups:

- The format of write-ups within each asset category should be consistent in presentation, style, and appearance.
- Be concise, but do not omit pertinent information. Assess only relevant factors.
- Write informatively and factually. Do not include extraneous information that may overshadow important weaknesses.

- Round to the nearest thousand (with 000 omitted) in both the heading and adverse classification. In narrative comments, round dollar amounts to the nearest dollar (for example, $24,985) or to the nearest thousand (for example, $25M). Note: Round all dollar amounts in narrative ROE comments the same.
- When participation loans are adversely classified, list each participant and the participant's corresponding ownership percentage (whether or not originated by the institution). This requirement does not apply to Shared National Credits.
- When applicable, discuss contingent liabilities with the related credit relationship. However, do not extend adversely classified contingent liabilities with classified credits. Adversely classified contingent liabilities should be listed under the subheading Contingent Liabilities.
- When applicable, include overdraft amounts in outstanding debt recaps and discuss details on material or chronic overdrafts of borrowers with adversely classified loans in the same general comment.
- If an adversely classified asset has been partially charged off prior to the asset review date, note the date and amount of the charge-off.
- If an asset was adversely classified at prior examinations, indicate the number of times the asset was previously classified.
- If a previously classified and written up asset is again listed for classification, an abbreviated narrative, or a simple listing of name and amount, may be sufficient, <u>if all of the following conditions are met:</u>
  - The fundamental deficiencies have not materially changed,
  - Management agrees with the adverse classification,
  - Management and the board are sufficiently familiar with the deficiencies, and
  - Management and the board are taking feasible steps to improve or collect the asset.
- Indicate if the loan is identified on the institution's internal watch list. If internally identified, indicate the internal rating.
- Indicate the past-due (30 days or more) or nonaccrual status of an asset. Occasionally, it may be pertinent to disclose delinquencies of less than 30 days.
- Indicate if a loan had numerous extensions or rewrites.

Note: It may not be necessary to address credit factors that do not have a significant bearing on a classification. For example, it may be unnecessary to identify the interest rate on a loan that is delinquent because a borrower went out of business and is no longer making payments. However, examiners may need to identify the interest rate on a variable rate loan that is chronically delinquent if the rate is about to increase and further strain the borrower's repayment ability. Additionally, it may be unnecessary to include numerous details on several small loans if a majority of a borrower's debt is centered in one or more large loans. For example, if a borrower has six loans totaling $1 million and the current balance of one of the loans is $950,000, the remaining five loans might be grouped together and described as, "Five related loans totaling $50,000 originating in 2005-2010. Debts classified Substandard due to the troubled financial condition of the borrower and weak overall collateral protection." (Do not group small loans together if detailed descriptions of the credits would provide better support for other examination comments or recommendations.)

Miscellaneous

- When adversely classified loans or other assets involve alleged fraud, embezzlement, or other dishonest conduct, state the facts that support the adverse classification. Do not discuss any possible criminal intent or conduct.
- Clearly distinguish the adversely classified assets of consolidated subsidiaries from institution-only classified assets.

ITEMS LISTED FOR SPECIAL MENTION

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Purpose

The purpose of this schedule is to detail assets listed for Special Mention and to communicate the rationale for the criticism.

General

The page heading includes the definition for Special Mention items.

Do not include smaller items unless they are part of a large grouping listed for related reasons.

Write-Ups

Each item listed for Special Mention should be supported by a write-up. However, items that exhibit similar deficient characteristics may be grouped together under a single write-up. The narrative, which generally need not be lengthy, should focus on weaknesses in management's administration, documentation, servicing, and/or collection activities, and on how these deficiencies can reasonably be expected to lead to increased credit risk if not remedied.

ANALYSIS OF LOANS SUBJECT TO ADVERSE CLASSIFICATION

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Purpose

The purpose of this schedule is to provide insight regarding the migration of classified loans from one examination to the next. From the analysis, the examiner will be better able to cite specific areas of change and the causes of these changes. In particular, the schedule may illustrate deterioration in the loan portfolio through the migration of loans previously classified Substandard to more severe classification categories.

When To Complete

- When institutions have marginal or unsatisfactory loan quality.
- When the volume or composition of adversely classified loans changed significantly from the previous examination.

General

Classification totals from the previous FDIC examination should normally be the starting point for the schedule. The FDIC does not usually have access to state or other regulatory examination classification workpapers, which makes it difficult to use non-FDIC examinations as the starting point. However, when possible, analyze changes from a previous non-FDIC examination.

Generally, do not include adversely classified consumer loans and overdrafts. If overdrafts or consumer loans are included, they should be footnoted. Examiners also have discretion to exclude other small dollar loan balances from the schedule. Examiners should footnote amounts that are excluded.

Reminder: Reductions pertain only to loans adversely classified at the previous examination.

Additional Line Items

Examiners may add line items when necessary. For example, other line items under Additions may include Previously Classified ORE where disposition did not originally meet the criteria for consummation of a sale (under ASC Subtopic 360-20, Property, Plant, and Equipment – Real Estate Sales (formerly FASB Statement No. 66, Accounting for Sales of Real Estate)), but now, subsequent to the transfer of the ORE, meet those requirements.

Payments vs. Recoveries

Nominal recoveries on loans charged off since the previous examination may be handled by: (a) including recoveries in Payments and deducting them from the line item Charged-Off, or (b) making no adjustment. However, when recoveries are significant, examiners should add a line item called Recoveries rather than include recoveries in the line item Payments. The amount included in the line item Recoveries would also be deducted from the line item Charged-Off.

Further Advances - Loans Not Adversely Classified Previously

Circumstances when this line item may be used include:

- Advances (since the previous examination) on a loan existing at the previous examination, and
- A new loan is granted to borrowers who were indebted to the institution at the previous examination and whose loans were not adversely classified at that time.

Note: For practical purposes, do not research the payment and advance history on a loan that was on the bank's books at the last examination and not adversely classified previously. The amount listed in Further Advances - Loans Not Adversely Classified Previously should be the difference between the current balance and the previous examination balance (assuming the current balance is greater than the previous examination balance).

Further Advances - Loans Adversely Classified Previously

Circumstances when this line item may be used include:

- Advances (since the previous examination) on an adversely classified loan existing at the previous examination, and
- A new loan granted to borrowers who were adversely classified at the previous examination.

Credits Newly Extended

Include loans to borrowers who were not indebted to the institution at the previous examination.

Note: The aforementioned examples are not all-inclusive.

ANALYSIS OF OTHER REAL ESTATE SUBJECT TO ADVERSE CLASSIFICATION ←

Purpose

The purpose of this schedule is to provide analysis of adverse ORE classifications from one examination to the next. From the analysis, examiners will be better able to cite specific areas of change and the causes of the changes. In particular, the schedule may illustrate deterioration in the ORE portfolio through the migration of ORE classified Substandard to more severe classification categories.

When To Complete

Examiners should consider completing this schedule if the volume of ORE is material or the composition of adversely classified ORE changed significantly since the previous examination.

General

Generally, the previous FDIC examination should be the starting point for preparing the schedule. The FDIC does not always have access to state or other regulatory examination workpapers, which makes it difficult to use non-FDIC examinations as the starting point. However, if it is possible to analyze changes from the previous non-FDIC examination, examiners may do so.

This schedule is designed to illustrate changes in adverse ORE classifications since the previous FDIC examination. Therefore, only include activity for ORE that was on the books at the last examination and ORE assets on the books at the current examination. (Do not schedule assets that both transferred into and transferred out of ORE between examinations.) If significant activity in the ORE account occurred between examinations, examiners should evaluate the reasons why assets transferred in and how they transferred out (with or without internal financing). Narrative comments may suffice to address this activity. For example, assume the following:

Book value at previous examination: $ 5MM
Book value at current examination: $ 3MM
Book value of ORE acquired and sold between examinations: $12MM

In situations such as this, a separate schedule may be completed for the acquisition and sale of the $12MM. (This schedule may aid in analyzing management practices, asset quality, and loss histories.)

Examiners have the flexibility to exclude some ORE parcels. (That is, when numerous smaller parcels represent only a small portion of the total volume of ORE.) Footnote the schedule to indicate what is excluded.

Additional Line Items

Add line items when necessary.

Examples of other possible line items under Reductions:

- To Premises
- Sales for Cash
- Sales to Insiders
- Now Adversely Classified Loan (This line item may be used when internally financed sales of ORE, which did not originally meet ASC Subtopic 360-20 requirements, now meets those requirements.)

Examples of other possible line items under Additions:

- Capitalized Improvements (This line item may be used when capitalized improvements are substantial as a whole or to a particular parcel. Otherwise, one of the Further Advances line items may be used.)
- Formerly Premises
- Loans to Facilitate the Sale of ORE (sales of ORE that do not meet the criteria for the consummation of a sale under ASC Subtopic 360-20). Use this line item when a significant volume of sales has occurred. Otherwise, sales can go under ORE from Credits Newly Extended.

Reminder: Reductions pertain only to ORE adversely classified at the previous examination.

Charged-off

This line item may include losses on the sale of ORE, or write-downs on existing ORE, that resulted from re-evaluations or new appraisals.

Not Adversely Classified Previously

This line item may include amounts representing both loans and ORE at the previous examination.

ORE From Credits Newly Extended

This line item may include loans to facilitate ORE sales that do not meet down-payment requirements (that is, loans reported as ORE for Call Report purposes). Additionally, this item may include loans extended since the previous examination that are now adversely classified ORE.

Note: The aforementioned examples are not all-inclusive.

ASSETS WITH CREDIT DATA OR COLLATERAL DOCUMENTATION EXCEPTIONS

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Purpose

The purpose of this schedule is to support criticisms of excessive documentation exceptions and highlight specific weaknesses, such as numerous exceptions involving outdated financial information.

When To Include

This schedule may be included for support when documentation exceptions are excessive and comments on the ECC page or RMA page are appropriate. Do not include this schedule in the Report when the number of exceptions is not deemed excessive. Instead, leave a detailed list with management.

Note: In certain circumstances, ECC or RMA page comments may be appropriate if excessive deficiencies were outstanding when the examination commenced, but were substantially corrected during the examination and this schedule is not included in the Report.

General

During the examination, examiners should provide management with a list of documentation deficiencies on specific assets. This procedure is intended to expedite early correction of the deficiencies. Generally, deficiencies corrected during the examination are not included in this ROE schedule. However, examiners may include corrected deficiencies (clearly noted as having been corrected during the examination), to demonstrate reactive, rather than proactive, management practices.

Examiners have the flexibility to add line items in the heading to more accurately describe documentation exceptions encountered at the institution. For example:

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

Include the date of a borrower's financial statement in the Date of Most Recent Financial Statement column only when financial statements are stale or otherwise deficient. Enter "None" when credit files contain no financial statements.

When documentation deficiencies are listed on adversely classified assets, cross-reference the appropriate ROE page.

Use this schedule to detail loan documentation deficiencies, as well as deficiencies in other assets/items (for example, ORE, securities, and letters of credit). Use subheadings to segregate categories and list exceptions in alphabetical order by the borrower's name within each subheading.

CONCENTRATIONS

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PURPOSE

The purpose of this schedule is to identify asset and liability concentrations and evaluate the institution's related risk management practices for certain concentrations.

This page should summarize *specific* asset and funding concentrations, their economic vulnerabilities, risk management practices, and management's plans relating to each concentration when such concentrations are particularly large.

Examiners should assess *overall* concentration-management practices and any recommendations relating to asset concentrations under Question 1 on the Risk Management Assessment (RMA) page. Include assessments of *overall* risk management practices and any recommendations relating to funding concentrations under Question 3 on the RMA page. If the RMA page is not included in the Report of Examination (ROE), include assessments on the Examiner Conclusions and Comments (ECC) page. Material recommendations and management responses should always be summarized on the ECC page. Concentrations not meeting thresholds set forth in these instructions may also be included and analyzed in the ROE at the discretion of the Examiner-in-Charge to the extent the analysis supports material examination findings.

WHEN TO INCLUDE

Use this schedule to highlight asset or liability concentrations and to communicate the examiner's analysis of the potential risks for concentrations that exceed certain levels. Asset concentrations relate to groups of assets that share similar risk characteristics. An institution's asset quality, earnings, or capital can be disproportionally affected by a single economic event if the institution holds significant asset concentrations. On the liability side, a funding concentration exists when an institution depends on one, or few, sources for a disproportionate share of its funding. The primary risk of a funding concentration is that an institution may have to replace those sources quickly at unfavorable terms. This risk may become more pronounced if the bank's condition, or the condition of the party providing the funds, has deteriorated.

Reminder: List concentrations in order of importance (concentrations with higher risks should be listed first). When capital is low enough to make a concentration by a percentage of capital meaningless, use percentage of assets as a guideline for the calculation (generally two percent of total assets (TA)).

CONCENTRATION CATEGORIES REQUIRING LISTING

Asset and funding concentrations that meet or exceed the category thresholds below should be listed on the Concentrations page. As a general rule, asset concentrations for loan-related assets should be listed by category according to their aggregate total as a percentage of total capital (TC)[3]. Further, asset concentrations for non loan-related assets should be listed by category according to their aggregate total as a percentage of tier 1 capital[4].

1) Asset concentrations representing 25 percent or more of TC (for loans) or tier 1 capital (for non-loans) by:

- Individual borrower,
- Small, interrelated group of individuals,
- Single repayment source with normal credit risk or greater, or
- Individual project.

[3] "Total Capital" equals total risk-based capital as reported in the Consolidated Reports of Condition and Income (FFIEC 031 and 041), Schedule RC-R-Regulatory Capital, line 21.

[4] "Tier 1 capital" as reported in the Consolidated Reports of Condition and Income (FFIEC 031 and 041), Schedule RC-R-Regulatory Capital, line 11.

Note: Concentrations representing less than 25 percent of TC or tier 1 capital may be listed if elevated risk is evident or inclusion supports material examination findings.

2) Concentrations representing 100 percent or more of TC (for loans) or tier 1 capital (for non-loans) by:

- Industry,
- Product line[5],
- Type of collateral, or
- Short-term obligations of one financial institution or affiliated group[6].

3) Funding concentrations representing 10 percent or more of TA by a single funding source.

Note: Funding concentrations representing less than 10 percent of TA may be listed if elevated risk is evident or inclusion supports material examination findings.

4) Potentially volatile funding sources that, when combined, represent 25 percent or more of TA. These sources may include brokered, large[7], high-rate[8], uninsured, and Internet-listing-service deposits, other potentially volatile deposits, Federal funds purchased, or borrowings. For example, if brokered deposits and uninsured deposits each represent 15 percent of TA, the combined 30 percent concentration should be included on this page. Any unique risks or controls relating to the various funding sources should be discussed separately within the write-up.

U.S. GOVERNMENT SECURITIES

Securities issued by the U.S. Treasury, U.S. Government agencies and corporations, and other obligations either backed by the full faith and credit of or fully guaranteed by the U.S. Government (hereafter referred to as "U.S. Government securities") are considered risk-free from a credit risk standpoint. Therefore, these securities and other assets collateralized by them should generally not be scheduled as concentrations, provided the existence of the collateral has been verified. However, examiners may exercise judgment in scheduling concentrations of U.S. Government securities if the instruments could potentially impact an institution's financial condition, particularly through market risk exposure. For example, an examiner may list a concentration in U.S. Government securities (such as zero coupon bonds) that present outsized market risk and potential depreciation in a changing interest rate environment. Finally, concentrations for other U.S. Government-related securities that are not in the zero percent risk-weighted category for regulatory capital purposes may be scheduled at examiner discretion.

OTHER CONSIDERATIONS

Concentrations are not inherently problematic and should not be automatically criticized. However, concentrations add a dimension of risk that management must consider when formulating strategic plans and risk management policies. Management's ability to diversify the institution's balance sheet may be limited by geographic or economic factors. In other instances, management may choose a specific business model or product line that results in concentrations. When management cannot or does not achieve reasonable diversification, adequate risk management programs often require increased oversight, strong credit and liquidity management practices, appropriate management information systems and reporting, and possibly higher capital levels. Furthermore, management should also apply the sound risk management standards established in various agency issuances,

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[5] Product lines are common programs used by an institution that target specialty lending within a broad loan category, such as leveraged financing, accounts receivable, home equity, row crops, farm equipment, and subprime.

[6] For the purposes of concentration identification, short-term obligations represent Federal funds sold with a maturity of one day or less or Federal funds sold under a continuing contract, and resale agreements that have an original maturity of one business day (or is under a continuing contract) and are in immediately available funds in domestic offices.

[7] Aggregate deposits of a customer representing 2 percent or more of total deposits.

[8] Generally, "high rate" refers to deposits receiving 75 basis points above the national average for similar deposits. Refer to http://www.fdic.gov/regulations/resources/rates/index.html and FIL 69-2009 for additional information.

including the Interagency Guidelines Establishing Standards for Safety and Soundness (Appendix A to Part 364 of the FDIC's Rules and Regulations), the Interagency Guidelines for Real Estate Lending Policies (Appendix A to Subpart A of Part 365 of the FDIC's Rules and Regulations), and the Joint Guidance on Concentration in Commercial Real Estate Lending, Sound Risk Management Practices (Financial Institution Letter 104-2006), in a manner appropriate to the size and complexity of the institution's operations.

In determining whether, and how, to list a concentration, remember that concentrations involve similar risk factors (for example, industry type, source of revenue, management, or collateral support). If a weakness develops in a key risk factor, it can adversely affect the concentrated assets or liabilities and the institution's earnings and capital. Nevertheless, ROE treatment of concentrations is flexible and requires sound examiner judgment. For example, if an institution's loan distribution is concentrated in one general class of borrower (such as consumer loans or agricultural loans), or is limited by the types of borrowers that dominate an institution's trade area, it may be appropriate to simply identify the concentrations for informational purposes and focus assessments on the adequacy of related underwriting, credit administration, monitoring, or other risk management practices.

Out-of-Territory Concentrations - When properly managed and monitored, out-of-territory lending can diversify an institution's total loan portfolio. Historically, these obligations were often regarded as a diversified class of borrower and not listed as concentrations. However, if out-of-territory credits are concentrated in a particular loan type or geographic area, these exposures could pose increased concentration risk. When examiners identify out-of-territory concentrations, they should document concentration levels, (for example, by loan type or geographic location), and evaluate common risk factors, such as exposure to depressed local economies, or elevated credit administration requirements[9]. At a minimum, out-of-territory concentrations should generally be listed as concentrations for informational purposes, and should include brief assessments of common risk factors and risk management practices. Examiners should complete a write-up if the concentrated assets appear vulnerable to one or more risk factors.

Purchased Loans and Participation Loans - Similar to and often associated with, out-of-territory loans, a significant volume of purchased or participated loans may result in concentration risks. If the loans are centered in a particular loan type or geographic location, purchased through the same loan broker, or originated from the same financial institution, examiners should list and evaluate the loans as concentrations. Additionally, regardless of the type or location of the loans, examiners should consider the unique risks associated with managing purchased or participated credits and should assess the adequacy of management's pre-purchase analysis and on-going credit administration practices.

Correspondent Bank Concentrations - A financial institution's relationship with a correspondent may result in credit (asset) or funding (liability) concentrations. A credit concentration exists when an institution advances or commits a significant volume of funds to a correspondent. A funding concentration exists when an institution depends on one or a few correspondents for a disproportionate share of its total funding. While correspondent concentrations often meet legitimate business needs, the concentrations represent diversification risks that management should consider when formulating strategic plans and internal risk limits. Such relationships warrant robust risk management practices, particularly when aggregated with other similarly sized funding concentrations. At a minimum, list significant due-to and due-from accounts. Refer to Federal Reserve Board Regulation F, Part 206-Limitations on Interbank Liabilities and the Correspondent Concentration Risks Interagency Guidance for additional details.

Mutual Funds - Despite their inherent diversification, include an investment in a single mutual fund whose book value represents 25 percent or more of tier 1 capital (including those investing exclusively in U.S. Government securities).

Non-Agency Securitization Exposures in Structured Credit Products **-** Non-agency structured credit products, such as private label mortgage backed securities, asset backed securities, collateralized debt obligations, and collateralized loan obligations, can contain complex structures and characteristics that make their performance more

[9] Evaluate management's ability to effectively administer the loans. In addition to evaluating standard underwriting, documentation, appraisal, monitoring standards and practices, etc., consider the additional requirements for obtaining timely information from geographically dispersed locations.

volatile and susceptible to losses in adverse market or economic environments. Examiners should include these investments as concentrations when the aggregate book or fair value (whichever is greater) of an investment type represents 25 percent or more of tier 1 capital or when the aggregate book or fair value (whichever is greater) of all such investment types exceeds 100 percent of tier 1 capital.

Extensions Of Credit To A Foreign Government - Aggregate as a class of borrower, extensions of credit to a foreign government, its agencies, and majority-owned or controlled entities. If the extensions of credit are equal to or in excess of the 25 percent guideline, schedule them as a concentration. Loans to private sector enterprises may also be included with public sector borrowings if an interrelationship exists in the form of government guarantees, moral commitments, significant subsidies, or other pertinent factors pointing toward reliance on public sector support. Include amounts where sizable extensions of credit to related private entities equal or exceed the 25 percent guidelines. The aforementioned procedures are intended to facilitate reporting of concentrations involving borrowers evidencing commonality of commercial credit risk. Follow outstanding instructions when handling transfer risk or country risk, where all public and private sector credits within a country are aggregated and related to the institution's capital structure. The International Banking section of the Manual and the instructions for the International section of the Bank of Anytown contain additional guidelines regarding concentrations in the area of credit to foreign governments and their entities.

CONCENTRATION WRITTEN ANALYSIS

Industry and product line loan concentrations are listed on the Concentrations page at 100 percent of TC; however, a written analysis is triggered when that concentration is 300 percent or more of TC. Examiners are to provide a written analysis on the Concentrations page summarizing material factors regarding each asset or funding concentration that exceed the following thresholds:

- Individual borrower concentrations (including small interrelated groups of individuals, a single repayment source or an individual project) of 25 percent or more of TC.
- Industry, product line, or collateral type loan concentrations of 300 percent or more of TC. For example, written analysis would be required for a concentration that includes non-owner occupied commercial real estate (CRE) loans; owner occupied CRE loans with similar risk characteristics; agricultural real estate loans; agricultural production loans (crop loans); livestock loans; leveraged loans; or asset-based loans, among others.
- Acquisition, Development and Construction (ADC) loan concentrations of 100 percent or more of TC.
- Obligations of one or a closely related group of municipalities[10] of 100 percent or more of tier 1 capital.
- Non-agency securities (including private label mortgage backed securities, asset backed securities, and structured products) of 100 percent or more of tier 1 capital.
- Single source funding concentrations of 10 percent or more of TA.
- Aggregate levels of potentially volatile funding sources of 25 percent or more of TA.

Examiners have the option to combine concentrations with similar risk characteristics into one written analysis. For example, if the institution has ADC loans exceeding 100 percent of TC that include an exposure to a single developer of more than 25 percent of TC, then both concentrations may be combined into one analysis.

Identify only the funded exposures in the "Detail" and "Amount Extended" columns; unfunded amounts should be commented on in the narrative analysis. Undisbursed loan commitments should not be included when calculating the listing threshold for a concentration. However, examiners should consider, and address in written analysis if warranted, the impact of the unfunded loan commitments (e.g., acquisition, development and construction lending) in the assessment of concentration management.

[10] Examiner judgment is needed to assess when municipalities are related. For example, if a bank invests over 100% of tier 1 capital in municipals located in one county, an examiner could find that there is an economic co-dependence on local employers and other microeconomic factors that could collectively impact the local municipalities' repayment capacity in some counties but not in others. Secondly, an examiner could find that a class of municipal securities, like non-rated bonds, "dirt" bonds, or revenue obligations, might be appropriate for inclusion as a concentration above 100 percent of tier 1 capital.

Written Analysis Instructions

The written analysis should address material factors within the following topical areas.

Identification – Briefly describe the concentration and the percentage of capital or assets it represents. Also, describe the methodology used by the institution to identify and monitor exposure to this specific concentration and provide an assessment of its effectiveness.

Economic and Competitive Factors - Discuss and assess management's consideration of relevant economic and competitive conditions that affect the risk profile of the concentration.

Risk Stratification and Vulnerability Assessment - Discuss the current risk profile and trends, including (when appropriate) product type, collateral type, geographic location, internal risk ratings, source of funding, and other factors deemed relevant.

Also, include management's assessment of the concentration's vulnerability to an economic downturn, sharp interest rate movements, or other stress events. For asset concentrations, detail management's estimate of potential deterioration in credit quality and provide an assessment of the reasonableness of the methodology used. For funding concentrations, include management's estimate of exposure to potential increased volatility or risk of run off.

Comments should also specifically address any interrelationship between concentrated asset and funding exposures, especially if an economic downturn or other stress event could negatively affect both positions at the same time.

Risk Management and Control Processes - Discuss the adequacy of risk management practices and control processes regarding the concentration including current levels, proposed levels, and stress test results (if applicable). Comments should also address the following matters:

- Management's consideration of current and projected economic and competitive factors when establishing guidance and monitoring processes such as limits, underwriting standards and pricing terms. When applicable, such as for certain commercial real estate, subprime, or leveraged loan concentrations, this should also include stress test assumptions.
- Strategic actions to address changing risk profiles of the concentration, including capital adequacy determinations, staffing and managerial needs, pricing actions, etc.
- Adequacy of the incorporation of analytical information (such as stress test results, if conducted) into policy limits, staffing and managerial resources, capital support, funding requirements, etc.
- Sufficiency of reports used by management and the Board regarding concentration exposure levels and risk estimates.

Summary - Summarize management's plans regarding administration and oversight of the concentration and assess the concentration's overall risk profile.

Reference: FIL-9-2001 Subprime Lending
FIL-104-2006 Commercial Real Estate Lending Joint Guidance
FIL-13-2010 Funding and Liquidity Risk Management Interagency Guidance
FIL-18-2010 Correspondent Concentration Risks Interagency Guidance

CAPITAL CALCULATIONS

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Purpose

The purpose of this schedule is to detail regulatory capital calculations, including adjustments resulting from examination findings.

General

Examiners should prepare this schedule according to Part 325 of the FDIC Rules and Regulations. The date of the financial information should be the same as the Examination as of Date.

For Risk-Based Capital purposes, if Tier 1 Capital is zero or negative, Tier 2 Capital elements will not be recognized when calculating Total Risk-Based Capital. If Total Capital is a negligible or a negative amount, but there are capital components that are not being counted due to the Risk-Based Capital rules, additional line items and footnotes should be added to show that these capital components exist and are available to absorb losses.

Computation Of Tier 1 Capital

The definition of Tier 1 Capital is the same for both Leverage and Risk-Based Capital standards.

Individual captions are provided for Tier 1 Capital elements and the amounts included are prior to adjustments to Tier 1 Capital.

Adjust Tier 1 Capital after the line item Total Equity Capital. Refer to Schedule RC-R of the Call Report Instructions for line item explanations. In addition to those items, make adjustments for any of the following items identified during the examination process:

Assets Other Than Loans & Leases Classified Loss - This item may include Category I contingent liabilities classified Loss. Refer below for further explanation.

Additional Amount to be Transferred to Tier 2 for Inadequate ALLL - Refer below for explanation.

Other Adjustments to (from) Tier 1 Capital - This item may include:

- <u>Estimated Losses in Contingent Liabilities</u> - This item only pertains to Category II contingent liabilities, such as those that might arise from a trust department or pending litigation.
- <u>Differences in Accounts Which Represent Shortages</u> - This item may include shortages in assets or overages in liability accounts.
- <u>Losses From Apparent Criminal Violations</u> - Material losses attributed to a criminal violation that cannot be addressed by a specific asset classification should be deducted from Tier 1 Capital under the caption Irregular Transaction - Estimated Loss. When the exact amount of the loss has not been determined, the examiner may recommend that the institution engage an outside accountant or legal counsel to conduct an appropriate audit or investigation.

Include the above items only when significant, and add appropriate footnotes.

Computation Of Tier 2 Capital

Tier 2 Capital is used only for Risk-Based Capital standards. Refer to Schedule RC-R of the Call Report Instructions for line item explanations.

Allowance for Loan and Lease Losses (ALLL)

The line item, *Allowance for Loan & Lease Losses,* is the ALLL (excluding any Allocated Transfer Risk Allowances) reflected on the Comparative Statements of Financial Condition page. If applicable, add any allowances for off-balance sheet credit exposures reflected in RC-G, Other Liabilities. As necessary, deduct the amount of loans and leases classified Loss on the line item *Less: Loans & Leases Classified Loss* and include any adjustments necessary to replenish the ALLL to an adequate level in the line item *Add: Amount Transferred from Tier 1*. The resulting figure is the *Adjusted Allowance for Loan and Lease Losses.*

Eligible ALLL - The eligible amount of the ALLL to be included in Tier 2 Capital is limited to 1.25 percent of gross Risk-Weighted Assets. When the eligible amount is less than the amount shown on the line item *Adjusted Allowance for Loan & Lease Losses,* make the appropriate adjustment on the line item *Ineligible Portion of ALLL.* Do not include Allocated Transfer Risk Allowances.

***Other Tier 2 Capital Components* -** Include mandatory convertible debt (e.g. equity contract notes) and any other items required by Part 325 of the FDIC Rules and Regulations.

Maximum Tier 2 Capital - The amount of Tier 2 Capital that may be recognized for Risk-Based Capital purposes is limited to 100 percent of Tier 1 Capital. Deduct any excess amount greater than the limit of 100 percent of Tier 1 Capital before calculating Tier 2 Capital. Include this deduction in the line item *Other Adjustments to (from) Tier 2 Capital.*

Tier 3 Capital Allocated for Market Risk

Refer to Schedule RC-R of the Call Report Instructions for information regarding financial subsidiaries as defined by the Gramm-Leach-Bliley Act of 1999. The sum of Tier 3 Capital and Tier 2 Capital cannot exceed 100 percent of Tier 1 Capital.

Calculation Of Total Capital

The line item *Less: Deductions for Total Risk-Based Capital* should include Investments in Unconsolidated Banking and Finance Subsidiaries. However, these subsidiaries normally are consolidated for Part 325 Capital purposes. Additionally, deduct reciprocal cross-holdings of capital instruments issued by institutions. Further, include any deductions resulting from limitation on the aggregate amount of Tier 3 and Tier 2 Capital detailed above. Other deductions from capital may be required on a case-by-case basis.

Deductions For Loss Classifications And Inadequate ALLL

Part 325 states that on a case-by-case basis and in conjunction with supervisory examinations, other deductions from capital may also be required. These should include any adjustments deemed appropriate for identified losses, including assets other than loans and leases classified Loss and provisions for an inadequate ALLL.

Use the following method to adjust capital for items classified Loss and to adjust for an inadequate ALLL. This method avoids adjustments that may result in a double deduction when Tier 1 Capital already has been effectively reduced through the provision expense in establishing an adequate ALLL. Additionally, this method addresses those situations where certain institutions have overstated the amount of their Tier 1 Capital by failing to take provision expenses necessary to establish and maintain an adequate ALLL.

Method

- Deduct as a separate line item the amount of Loss for items other than loans and leases in the calculation of Tier 1 Capital.
- Deduct as a separate line item the amount of Loss for loans and leases from the ALLL in the calculation of Tier 2 Capital and, if significant, deduct from Tier 1 Capital the provision expenses necessary to replenish the ALLL to an adequate level.

Evaluation of the adequacy of the ALLL includes consideration of the amount of adversely classified loans and leases. If the ALLL is considered inadequate, make an estimate of the amount of provision needed for an adequate ALLL. Make the estimate after the identified losses in the ROE have been deducted from the ALLL. Do not deduct loans and leases classified Doubtful from capital. These items will be included in the evaluation of the ALLL and, if appropriate, will be accounted for by the adjustment for an inadequate ALLL.

Make an adjustment from Tier 1 Capital to Tier 2 Capital for an inadequate ALLL only when the amount is considered significant. The decision as to what is significant is a matter of judgment. As such, consider how much the adjustment would change the Tier 1 Leverage Capital ratio, how much the reader's perception of the institution's capital level will be influenced, and how much the institution's capital category for Prompt Corrective Action will be changed. Where adjustments for an inadequate ALLL may reduce an institution's capital level to a point where Prompt Corrective Action or other restrictions may apply, particular care and attention, including consultation with the appropriate Field Supervisor and Regional Office, should be considered prior to incorporating such adjustments in the Report.

Capital Treatment Of Other Real Estate (ORE) Reserves

ORE valuation allowances are not recognized as a component of capital for either Risk-Based Capital or Leverage Capital standards. A valuation allowance is established for each parcel of ORE during the holding period when the real estate’s fair value minus the estimated costs to sell the real estate is less than the real estate’s "cost." Call Report Instructions clarify that valuation allowances must be determined on an asset-by-asset basis. As a result, the individual valuation allowance should be subtracted from the related asset's "cost" to determine the property’s carrying value.

Risk-Weighted Assets AND Risk-Weighted Off-Balance Sheet Items

Calculate Risk-Weighted Assets as of the latest Call Report date. Generally make calculations using Call Report and UBPR data. Follow Schedule RC-R of the Call Report Instructions for information to be included or deducted from Risk-Weighted Assets and Off-Balance Sheet Items. Make adjustments for any Risk-Weighted Assets classified Loss and any other Risk-Weighted Asset deductions. Adjust for other items identified during the examination process in the Other Adjustments to (from) Tier 1 Capital line item.

A supplemental workpaper is available to detail the Risk-Weighted Asset structure. Items in this section are derived from the workpaper.

Market Risk Equivalent Assets

Refer to Schedule RC-R of the Call Report Instructions for information regarding financial subsidiaries as defined by the Gramm-Leach-Bliley Act of 1999.

Average Total Assets

Average Total Assets are as of the latest Call Report date. Refer to Schedules RC-K and RC-R of the Call Report Instructions for detailed information on this figure. Use the amounts deducted from Tier 1 Capital above to adjust *Average Total Assets* and to calculate *Adjusted Average Total Assets. Adjusted Average Total Assets* is based on the definition of Total Assets in Part 325. *Note:* Do not deduct estimated losses in contingent liabilities from total assets.

Reminder: Take Average Total Assets from the latest Call Report date, even if using a month-end financial date throughout the ROE.

Memoranda Items

Securities appreciation (depreciation) - The dollar amount of securities appreciation (depreciation), net of Loss classifications, reflected in the HTM and AFS portfolios.

Contingent Liabilities - The first item, Contingent Liabilities, refers to both Category I and Category II contingent liabilities. The second item, Potential Losses, refers only to Category II contingent liabilities. Refer to the *Contingent Liabilities* section of the Manual for a discussion of estimated and potential losses.

References: Part 325 of the FDIC Rules and Regulations
Manual Section 2.1, Capital
Call Report Instructions

ANALYSIS OF EARNINGS

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Purpose

This page provides an overview of a bank's earnings and changes in equity accounts. It also summarizes activity in the ALLL and trends in pertinent ratios.

Selection of Financial Periods

Use dates consistently in the Comparative Statement of Income, Reconcilement of Allowance for Loan and Lease Losses, and Other Component Ratios and Trends sections.

Three financial data columns are available, allowing for two calendar years and one interim period (or three calendar years for examinations commencing shortly after the end of a calendar year). The interim period should correspond with the Examination as of Date.

Comparative Statement of Income

This schedule should reflect data that conforms to Call Report Instructions. Headings correspond to those in the Report of Income, the supplemental Comparative Statements of Income and Changes in Equity Capital Accounts page, and the UBPR (except that the UBPR is completed on a tax-equivalent basis). Genesys automatically populates the data fields; however, examiners should modify the information if necessary (for example, if Call Report changes are required or if information other than quarter end is used). Footnote all changes made.

Total Non-Interest Expense - Total non-interest expense is commonly referred to as overhead expense.

Applicable Income Taxes - Worksheets for calculating Call Report Applicable Income Taxes are included in quarterly Call Report updates. The worksheets can be beneficial in verifying the accuracy of income tax accruals.

Extraordinary Credits (Charges), - Items that qualify for inclusion in this category are rare; refer to Call Report Instructions for details.

Other Increases/Decreases - This title does not correspond to a specific Call Report category but encompasses all categories in the Changes in Equity Capital section (RI-A) that are not included in other line items.

Reconcilement Of Allowance For Loan And Lease Losses (ALLL)

Negative Provisions to the ALLL - Negative provisions may be appropriate if clearly supported and applicable accounting guidelines are followed.

Other Increases (Decreases) - Other Increases (Decreases) in the ALLL are rarely encountered; refer to Call Report Instructions for details.

Other Component Ratios and Trends

Examiners should include additional ratios when they are informative and support ECC page comments.

Note: The Net Income to Average Total Equity Ratio is commonly referred to as the Return on Equity (ROE) ratio.

Noncurrent Loan and Leases to ALLL Ratio - Note the difference in definitions of noncurrent loans and leases and past-due loans and leases. Refer to the User's Guide for the UBPR and Call Report Instructions for these definitions.

COMPARATIVE STATEMENTS OF INCOME AND CHANGES IN EQUITY CAPITAL ACCOUNTS

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Purpose

This page provides details of income and expense items and a summary of changes in equity capital accounts. Include this schedule when needed to support ECC page comments.

General

Complete this schedule according to Call Report Instructions.

Dates used should be consistent with the Analysis of Earnings page.

Footnotes

Only footnotes, not comments, should appear here.

RELATIONSHIPS WITH AFFILIATES AND HOLDING COMPANIES

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Purpose

Examiners use this page for detailing information on bank affiliates, their relationships to the bank, and credits extended to affiliated entities. It can also be used to provide a financial overview of the bank's holding company.

General

Include this schedule, when needed, to support ECC page comments.

Financial Statements - While examiners may obtain financial statements of the holding company (consolidated and parent-only), affiliates, and consolidated and unconsolidated subsidiaries for financial analysis purposes, include the statements in the Report only when necessary to support comments.

Service Corporations and Premises Subsidiaries - Affiliated service corporations and affiliates holding title to premises or ORE for the institution's benefit should be included here.

Holding Company Ratios And Trends

Ratios are included to facilitate holding company financial analysis. All ratios, except This Institution's Assets to Consolidated Holding Company Assets, are available in the Federal Reserve Bank Holding Company Performance Reports (BHCPR). Calculate the referenced ratio from information in Call Reports and the BHCPR. The inclusion of additional BHCPR ratios is encouraged when the ratios contribute to financial analysis or comments.

Note: The type and availability of BHCPRs depend upon the size of a holding company's consolidated assets. No BHCPR is available for companies with assets below $50 million. Only an annual BHCPR with the parent company section is available for companies with assets between $50 and $100 million. Annual BHCPRs are available for companies with assets between $100 and $300 million. Semi-annual BHCPRs are available for companies with assets over $300 million.

Extensions of Credit to Affiliated Organizations Schedule

Extensions of credit to, and securities issued by, affiliated organizations (when the organizations are related interests of insiders), should be included both here and on the Extensions of Credit to Directors/Trustees, Officers, Principal Shareholders, and Their Related Interests page.

Include extensions of credit to insiders that are collateralized by securities issued by affiliated organizations (as well as on the Extensions of Credit to Directors, Officers, Principal Shareholders and Their Related Interests page). Include these items because they are subject to the provisions of Section 18(j) of the Federal Deposit Insurance Act and Section 23A of the Federal Reserve Act with regard to determining possible violations of extensions of credit to affiliated organizations.

Note: Indirect extensions of credit include borrowings guaranteed by an affiliate.

Comments

Holding Company - Describe holding company relationships here. Generally include the following information:

- Name,
- Location,
- Period of existence,
- Number of shares of the institution's stock owned or controlled by the company, by each subsidiary of the company, and by trustees for the benefit of stockholders or members of the company, and
- A description of holding company trends and their potential impact on the institution. Consider the amount and terms of outstanding debt, lender- or Federal Reserve System-imposed restrictions or covenants, and the dividend payout record. Discuss any adverse trends or conditions on the ECC or RMA page, depending upon their significance.

Include comments on the ECC page when payments from an institution to its holding company are large and do not appear justified based on the services received by the institution. Also, consider compliance with Section 23B of the Federal Reserve Act.

Affiliates/Subsidiaries - Fully describe affiliate relationships in the comments section. The following information should be included:

- Name,
- Location,
- Asset size,
- Net income,
- Nature of affiliation,
- Period of existence,
- Circumstances under which the affiliation arose, and
- Primary business activities of the affiliate.

Include officers or directors when relevant. Additionally, include details regarding the amount and terms of any extensions of credit by the institution to affiliates. This information is important because the provisions of Section 18(j) of the Federal Deposit Insurance Act and Section 23A of the Federal Reserve Act apply insofar as determining possible violations of extensions of credit to affiliated organizations. Generally, comments should be brief pertaining to each extension of credit.

Nonbank Banks - Note when the institution under examination is a grandfathered nonbank bank. List violations of the Competitive Equality Banking Act of 1987 on the Violations of Laws and Regulations page and summarize the violations in a memorandum to the Regional Office. In such cases, include appropriate information on the parent company.

References:
- Related Organizations section of the Manual
- User's Guide for the Bank Holding Company Performance Report
- Section 18(j) of the FDI Act
- Section 23A of the Federal Reserve Act
- Section 23B of the Federal Reserve Act
- Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure
- Federal Reserve Board Regulation W
- Part 362 of the FDIC's Rules and Regulations

EXTENSIONS OF CREDIT TO DIRECTORS, OFFICERS, PRINCIPAL SHAREHOLDERS, AND THEIR RELATED INTERESTS

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Purpose

The purpose of this page is to provide details regarding loans extended to bank insiders and their related interests.

When to Include

Use this schedule to highlight loans to directors, executive officers, principal shareholders, and their related interests that are subject to criticism due to overall volume, credit quality, or preferential treatment.

General

Cross-reference here and on the appropriate Report pages extensions of credit subject to adverse classification, violation, or comment. List the current balances of indebtedness in the total column. Footnote charged-off items.

If a director or principal shareholder is also an executive officer, include that person as an executive officer. (Executive officers are subject to the more stringent restrictions of Regulation O.)

Definition of Terms

Prepare the schedule in conformance with Regulation O definitions of extension of credit, unimpaired capital and surplus, director, executive officer, principal shareholder, and related interest.

List of INSIDER Credits

List insiders alphabetically by description: Group A (Executive Officers and their related interests), and Group B (Directors/Trustees and Principal Shareholders and their related interests). Generally, comments regarding extensions of credit to insiders should be brief and not include detailed descriptions of the credits or related collateral. However, include details on material overdrafts or other unusual items.

Per Regulation O, directors, executive officers, and principal shareholders of the holding company are considered to be directors, executive officers, and principal shareholders, respectively, of the institution. As such, the prior approval, terms, creditworthiness, and lending limit provisions of Regulation O are applicable. List these individuals when appropriate.

In unusual circumstances, examiners may wish to obtain information regarding extensions of credit to non-executive officers and other employees. If such information is listed, do not include the indebtedness in the table at the top of the schedule.

Duplications With Extensions of Credit to Affiliates

Extensions of credit to, and securities issued by, affiliated organizations that are related interests of insiders should be reported here and on the Extensions of Credit to Affiliated Organizations schedule of the Relationships with Affiliates and Holding Companies page.

References:

- Federal Reserve Board Regulation O
- Section 337.3 of the FDIC Rules and Regulations
- Manual Section 4.3, Related Organizations

COMPOSITE RATING DEFINITIONS

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Purpose

This page provides definitions of the composite CAMELS (UFIRS) and specialty examination ratings detailed in the ROE. Disclosure of composite and component ratings encourages a more complete discussion of examination findings and assists bank directors and managers in making effective risk management decisions.

General

Examiners should ensure that each composite rating listed on the ECC page is defined on this page. List definitions in the same order as the ratings listed on the ECC page.

References:

- Uniform Interagency Consumer Compliance Rating System - Statement of Policy 11/28/80
- Appendix A to Part 345 of the FDIC's Rules and Regulations
- Uniform Rating System for Information Technology (FIL 12-99 02/05/99)
- Uniform Financial Institutions Rating System (FIL 105-96 12/26/96)
- Uniform Interagency Trust Examination Rating System (FIL 115-98 10/21/98)

All rating definitions are available at www.fdic.gov/regulations/examinations/ratings/.

Note: When using the Genesys application to generate the ROE, the rating definitions should be automatically populated when composite ratings are entered on the ECC page.

SIGNATURES OF DIRECTORS/TRUSTEES

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Purpose

This page, when signed and dated by all of the institution’s directors, serves as the directors’ certification that they each reviewed the Report in its entirety.

This form is the last page in all ROEs forwarded to institutions.

General

Enter the full name of each director in alphabetical order,. This will facilitate the proper signatures of directors after they reviewed the ROE.

The page will be included in the institution's copy of the ROE. The signed form is to remain attached to the Report and retained in the institution's files for examiner review at subsequent examinations.

OFFICER'S QUESTIONNAIRE

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Purpose

The purpose of the Officer's Questionnaire is to obtain information that might not otherwise come to the examiner's attention during the examination.

General

- Examiners may provide management with an electronic copy of the Questionnaire. The questions are locked in tables and cannot be altered without considerable effort.
- The Questionnaire should be retained for a minimum of five years from the examination start date. The Questionnaire should be retained indefinitely when irregularities are discovered or suspected during the five year retention period.
- The Questionnaire may be submitted with the Report of Examination when appropriate. For example, the Questionnaire should be included if the examiner suspects that an officer knowingly provided incorrect information in the document.
- Most questions should request information since the date of the previous FDIC examination. However, examiners have the discretion to request only information since the previous state examination, if a state ROE is acceptable.
- Examiners may interpret questions to help management complete the Questionnaire. If an EIC believes an officer gave an answer in error due to oversight or misunderstanding, the signing officer may be permitted to correct the answer. The signing officer should initial all corrections.
- The Questionnaire is an official document prepared by the institution. Do not alter it.
- The EIC has flexibility in determining the as-of date of the Questionnaire. The Questionnaire may be completed as of the Examination as of Date or the Examination Start Date. However, the Questionnaire should never be completed as of a date subsequent to the date the institution received the questionnaire.
- The Questionnaire should be completed on a consolidated basis.
- Generally, the chief executive officer should sign the Questionnaire. However, any executive officer, as defined by Regulation O, may sign if significant problems are not anticipated.
- Answers can be listed on continuation pages when adequate space is not provided following a question. Copies of institution documents are acceptable, provided they furnish at least the requested information and contain original signatures. If printouts are voluminous, they may be provided separately from the Officer's Questionnaire. The Questionnaire should state when separate information was given to the EIC, and the information should identify the questions to which it pertains.

Question 1

The purpose of the question is to:

- Determine the extent of interest capitalization.
- Identify loans with potentially poor credit quality.
- Identify credit practices that may distort past-due information.
- Identify practices that may adversely affect the quality of the institution's reported earnings.

Forward affirmative answers to examiners reviewing loans. An excessive number of these loans may distort the institution's financial position by overstating earnings and understating the past-due ratios. If there is a lengthy response to this question, it may be appropriate to include comments regarding the accuracy of the past-due ratios on the RMA page. Excessive use of these practices may warrant an ECC page comment.

Question 2

The purpose of the question is to:

- Assist in determining compliance with the reporting requirements of Section 7(j) of the FDI Act.
- Assist in determining or assessing the extent of interbank activity, and assist in understanding relationships between entities and their management teams.
- Review insider relationships, when applicable.
- Assist in determining or assessing direct or indirect control issues, asset quality, and dividend requirements of other entities.
- Generate information necessary for bank correspondence cross-referencing and verifying the accuracy of information at other institutions.

References: Section 7(j) of the FDI Act
Section 23A of the Federal Reserve Act
Bank Holding Company Act
Banking Act of 1933
Manual Section 4.3, Related Organizations

Question 3

The purpose of the question is to:

- Determine compliance with applicable laws and regulations.
- Assist in reviewing legal lending limits.
- Assist in determining asset quality.
- Assist in determining concentrations.
- Assist in reviewing potential conflicts of interest.
- Identify straw borrowers, also known as bogus or pass-through borrowers. If loan proceeds went to the benefit of a person other than the person named on the note, or otherwise disclosed in bank records, it should be applied to the benefiting parties' aggregate debt for legal lending limit purposes.

References: Federal Reserve Board Regulation O
Part 353 of the FDIC Rules and Regulations
Manual Section 4.5, Violations of Laws and Regulations

Question 4

The purpose of the question is to:

- Determine compliance with applicable laws and regulations.
- Assist in reviewing potential conflicts of interest and preferential treatment.
- Assist in determining the extent of such activities, and assist in better understanding the entities' business relationships with each other.
- Assist in reviewing asset quality.
- Assist in determining concentrations in this type of lending.
- Allow for the appropriate cross-referencing of files and verification of data at other institutions.

Note: In larger institutions, examiners may want to request only executive officers' extensions of credit.

References: Federal Reserve Board Regulation O
Section 106(b)(2) of the Bank Holding Company Act
Part 349 of the FDIC Rules and Regulations (may be violations at other entity)
Part 337 of the FDIC Rules and Regulations

Question 5

The purpose of the question is to:

- Determine the extent, and allow for the review, of insider transactions.
- Assist in determining whether insider transactions harmed the institution.

Transactions may involve equipment leases, leasing of bank premises, or insiders providing institution-related services such as appraisals, IT services, legal services, or insurance.

References: Manual Section 9.1, Fraud and Insider Abuse
Manual Section 4.5, Violations of Laws and Regulations
Manual Section 4.1, Management

Question 6

The purpose of the question is to:

- Assist in reviewing potential conflicts of interest.
- Assist in determining if such transactions have an adverse effect on the institution.
- Assist in reviewing potential misapplication of funds.
- Assist in determining tying arrangements prohibited under Section 106 of the Bank Holding Company Act of 1956.

Reference: Manual Section 4.3, Related Organizations

Question 7

The purpose of the question is to:

- Assist in reviewing potential conflicts of interest.

Question 8

The purpose of the question is to:

- Determine compliance with applicable laws and regulations regarding golden parachute payments.
- Identify poorly designed compensation structures that misalign incentives and induce excessive risk-taking.
- Determine potential abuse resulting from excessive compensation.
- Determine potential adverse effects on profitability.
- Assist in checking the accuracy of accounting issues and financial statements (that is, if the institution has booked appropriate liabilities).

This question looks for potential payments that may meet the definition of a golden parachute payment as defined by Section 18(k) of the FDI Act. Such payments might be prohibited if the institution becomes troubled. Examiners can also use the information provided in the response to review for excessive compensation.

References: Section 18(k) of the FDI Act
Part 325 of the FDIC Rules and Regulations (Prompt Corrective Action)
FIL-66-2010 Guidance on Golden Parachute Applications
Part 364 of the FDIC Rules and Regulations
Manual Section 4.1, Management

Question 9

The purpose of the question is to:

- Assist in identifying undesirable lengths of contracts and potential excessive liabilities.
- Assist in determining any impairment of capital.
- Review for adverse termination clauses.
- Determine impact on the institution's future profitability.

Note: Use the Regulation O definition of equity capital when determining ten percent of equity capital.

This question is intended to identify contracts that may adversely affect the safety and soundness of the institution. Appropriate management review and approval should be recorded for large contracts.

Reference: Section 30 of the FDI Act

Question 10

The purpose of the question is to:

- Determine compliance with applicable state laws and regulations.
- Verify the directors' continued eligibility to serve on the bank's board. Many states require a director to own stock in the institution before becoming a director. Additionally, some states prohibit individuals from being directors if they were indicted or convicted of a criminal offense, or have loans that have been adversely classified. State laws govern the meaning of disqualification for the response to this question. Cross check responses here with responses in question No. 12 for possible tie-ins.

Question 11

The purpose of the question is to:

- Determine compliance with applicable laws and regulations.
- Ensure notification was given to proper authorities.
- Assist in reviewing recovery potential from the bonding company.
- Indicate possible internal routine and control deficiencies.

References: Section 8(e) of the FDI Act
Part 353 of the FDIC Rules and Regulations
Manual Section 4.5, Violations of Laws and Regulations

Question 12

The purpose of the question is to:

- Determine compliance with applicable laws and regulations.

Reference: Sections 8(e), 8(g), and 19 of the FDI Act

Question 13

The purpose of the question is to:

- Assist in ensuring proper internal control and accounting over such items.
- Assist in determining the institution's capital position.
- Assist in determining compliance with key-man life insurance guidance.

This question may encompass a variety of answers. Typical answers include charged-off assets of undetermined value and the cash surrender value of a key-man life insurance policy when the institution is named as beneficiary.

Reference: Manual Section 2.1, Capital

Question 14

The purpose of the question is to:

- Determine the impact of contingent liabilities, the likelihood of contingencies becoming direct liabilities, and the potential impact on capital.

Note: In some instances, institutions incur significant costs in obtaining a formal attorney's letter. As such, examiners should not specifically request or require such a letter as a means of answering this question. Nonetheless, many institutions will obtain an attorney's letter. Normally, a summary should be provided here, and the attorney’s letter(s) should be retained in the examination workpapers. If the letter(s) are being included in the Report (with the Officer's Questionnaire), include the letters on a continuation page.

References: Manual Section 2.1, Capital - Contingent Liabilities

Question 15

The purpose of the question is to:

- Identify affiliated organizations.
- Identify loans to affiliates.
- Reveal trust powers and the extent to which trust powers are exercised.
- Ensure all contingent liabilities are reviewed.

References: Section 303.7 of the FDIC Rules and Regulations
Manual Section 12.1, Applications

CONFIDENTIAL – SUPERVISORY SECTION

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Purpose

The purpose of this page is to communicate non-public information to regulatory personnel. Generally, information on this page should not duplicate information in the open section of the Report.

Note: Use descriptive headings to separate topics and improve readability.

Mandatory Comments

Institution Control and Relationships - Concisely identify the individuals or organizations that control the institution, material subsidiaries, and affiliates. Such information is important in tracking chain bank organizations and updating holding company records.

Examiners should interpret the word "controlled" broadly. Control may exist in an individual or group, through stock ownership, or other means. Depending on the situation, ownership of varying percentages of stock may result in control. In a mutual institution, effective control may exist in the form of a board, committee, or dominant individual. A concentration of decision-making power and a lack of oversight or accountability are keys to determining the level of control.

References: Change in Bank Control - Section 7(j) of the FDI Act
Part 362 - Activities of Insured State Banks and Insured Savings Associations
Statement of Policy on Changes in Control in Insured Nonmember Banks

Director Involvement - Prepare a brief statement summarizing the extent of director participation during the examination process.

Examination Scope - Prepare a post-examination comment addressing any significant deviations between projected and actual hours (greater than 15 percent deviation), examination scope, or examination procedures. If significant variances did not occur, provide a sentence such as, "There were no significant variances between projected and actual examination hours, examination scope, or examination procedures."

Loan Penetration - Include the following:

- Asset review date,
- Number of relationships reviewed,
- Dollar volume of credit extensions reviewed/percent of total credit extensions,
- Dollar volume of non-homogenous credit extensions reviewed/percentage of total non-homogenous credit extensions, and
- Credit review cutoff point (if applicable).

The loan penetration comment may also include a breakdown of scoped loans by major loan type, location, officer, or other information.

Note: This information can be effectively presented in chart form.

Bank Secrecy Act Review Scope - Include the BSA examination number and a brief comment detailing the scope of the BSA review and the procedures performed. Include the time period for which FinCEN CTR/SAR filing data was compared to bank records, and identify the individuals with whom BSA review findings were discussed. If the bank's policy allows for numbered accounts, indicate their existence to ensure these high-risk accounts are reviewed at subsequent examinations.

Office of Foreign Asset Control Scope - Include a brief comment stating the scope of the OFAC review and the procedures performed.

Specialty Examinations

Examiners should use this page to communicate information that would be inappropriate or unnecessary to include in the open section of the ROE. Comments should conform to outstanding specialty directives, but in general may include:

- Specialty examination numbers (used for hours tracking),
- A brief scope statement, noting any areas of in-depth review,
- Confidential information supporting examination comments, recommendations, and ratings,
- Confidential information regarding management, strategic plans, offices, products, or services, and
- Recommendations for future examinations.

Situation-Specific Comments

The following topics can be addressed on this page:

- Confidential information supporting the management rating,
- Comments reconciling apparent discrepancies between the assigned rating and recommended supervisory actions (or lack of recommended actions),
- Planned management changes,
- Sensitive or nonpublic information such as merger discussions, and
- Difficulties conducting the examination due to lack of cooperation from management.

Capital Enhancement Sources

When applicable, note potential capital resources, including the perceived capacity and willingness of potential investors to purchase stock. The following items may also be addressed:

- A complete list of present shareholders detailing the amount of stock held and their financial worth (small holdings may be aggregated if a complete listing is impractical),
- Individual director's capacity and willingness to purchase stock,
- A list of prominent customers and depositors who are not shareholders but who may be interested in acquiring stock,
- A list of other individuals or possible sources of support in the community who, because of known wealth or other reasons, might want to subscribe to new stock, and
- Any other information regarding new capital sources, along with the examiner's opinions regarding the most likely prospects for the sale of new equity.

Express Determination Letters

Include a brief comment if management requests, and is provided or denied, an express determination letter for tax purposes. For additional details, refer to Section 3.2 (Loans), of the Manual.

Suggestions and Comments for Future Examinations

Comments may include the following:

- Name of external IT servicer(s), applications serviced, and contact personnel,
- Personnel needed to start an examination,
- Special personnel requirements, (for example, capital markets experts),
- Name and location of branches to be included in the next examination,
- Locations and business hours for branches, operation centers, or credit offices,
- Records maintained at locations other than the main office,
- Number and working hours of state examiners at joint or concurrent examinations,
- Working space limitations, and
- Any other information that may improve examination efficiencies.

Recommendations for Administrative Actions

Note: Do not reference administrative actions on the Confidential Page. Address, in a separate memorandum, actions such as: (1) imposing or not imposing civil money penalties, (2) terminating insurance, (3) issuing a Cease and Desist Order or other formal action, (4) issuing a Memorandum of Understanding or other informal action (Board Resolution), and (5) releasing an institution from outstanding action.

When administrative action is contemplated, remember that Confidential-Supervisory Section comments may be a matter of record at an administrative hearing. All comments must be accurate, well supported, and able to withstand cross-examination.

DIRECTORS/TRUSTEES AND OFFICERS

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Purpose

This confidential page provides information of interest to nonbank users of the ROE. The information assists Case Managers, other field, regional, or Washington Office management, and other regulatory authorities in their case management, applications processing, ROE review, and general bank supervision duties.

List all directors, executive officers, and principal shareholders (as defined in Federal Reserve Regulation O) under those respective subtitles. Other officers or employees (such as officers who head functional areas or the internal auditor) may be included at the discretion of the examiner-in-charge. Generally, detail functional responsibilities, banking experience, and post-secondary education for all officers listed. For directors, include their occupation, banking experience, and any other significant information relating to their contribution to the institution. When relevant, identify the related interests of all directors, executive officers, and principal shareholders.

Include holding company officers or directors who exert significant control over the institution's affairs (for example, when a holding company treasurer manages a subsidiary institution's investment portfolio), even though they are not official officers/directors of the institution.

Note: While inclusion of this page in the ROE is discretionary, the information must be gathered and input into Genesys for transmittal to reviewers. Retain copies of source documents in the workpapers.

Other

Net Worth - Directors’ net worth should be obtained and included when relevant (for example, when an institution's capital position is inadequate and directors may be a source of additional capital). When estimated net worths are obtained, footnote the Date of Statement column to indicate the source of information (for example, net worths estimated by President Smith).

Attendance at Board Meetings - Board meeting attendance figures shown should be since the previous FDIC or state examination, unless otherwise noted.

Parent Company Ownership - If a holding company owns the institution, note ownership in the holding company. If relevant, examiners may include the percentage of shares owned below the number of shares owned. When informative, total the Number of Shares Owned column. Show the percentage of shares controlled by the directorate as a whole.

Salary and Bonus - Footnote the dates of salary and bonus information if it is not the current annual salary or most recent annual bonus.

Home Addresses of Directors - List the directors' complete home addresses here or on a separate continuation page when the following conditions exist:

- Formal or informal administrative action is contemplated,
- The institution is rated a composite 3, 4, or 5, or
- Civil money penalties may be recommended.

Memoranda - Note the following information:

- Number of board meetings since the previous FDIC or state examination
- Memberships in important committees (particularly audit)
- Directors' fees for board and committee meetings

INTERNATIONAL REPORT PAGES AND WORKPAPERS

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INTERNATIONAL REPORT PAGES -- COUNTRY RISK

Three report schedules are used to reflect examiner analysis of the country risk element in an institution's international operations. Complete these report pages as a Report of Examination section and include them after the schedules of domestic Items Subject to Adverse Classification and domestic Items Listed for Special Mention. The three report schedules include the following:

- Transfer Risks Subject to Classification or Comment
- Analysis of the Country Exposure Management System
- Selected Concentrations of Country Exposure

Instructions for completing these three schedules are on the following pages.

DISCLAIMER: These pages are provided for ILLUSTRATIVE PURPOSES ONLY. They are not intended to correspond with or tie to information in the Bank of Anytown Report of Examination.

INTERNATIONAL REPORT PAGE

TRANSFER RISKS SUBJECT TO CLASSIFICATION OR COMMENT

This page lists assets adversely classified Substandard, Value Impaired, or Loss, designated as Other Transfer Risk Problems, or subject to comment (Moderately Strong or Weak) as a result of transfer risk considerations. Examiners should follow the instructions for the Items Subject to Adverse Classification page as a guideline for including or not including the transfer risk write-ups in the Report of Examination. If transfer risk write-ups are omitted from the ROE, examiners should provide the write-ups to bank management.

Credits will be adversely classified where an interruption in payment has occurred or an interruption in payment is imminent. The decision to adversely classify or to designate as Other Transfer Risk Problem, Weak, or Moderately Strong is made by the Interagency Country Exposure Review Committee. The Committee also prepares the write-up supporting the adverse classification or comment.

The page should contain the details of the composition of the institution's claims subject to transfer risk. The amount extended for adverse classification or comment should be as of the asset review date, if possible, particularly if there has been a change in outstanding exposure balance since the date of the last quarterly Country Exposure Report.

Adverse classifications will be either Substandard, Value Impaired, or Loss, while other designations will be either Other Transfer Risk Problem (OTRP), Weak, or Moderately Strong. Do not schedule exposures designated as strong. Provide a paragraph detailing the composition of the institution's claims subject to transfer risk.

Report exposures alphabetically by country, with a total for each category, either Substandard, Value Impaired, or Loss, OTRP, or exposures subject to special comment appearing on the last page.

Summarize the amount adversely classified due to transfer risk by asset category (for example, securities or loans) and add to the amount adversely classified due to commercial risk, with adjustments made to eliminate any duplication with respect to assets adversely classified for commercial credit weaknesses.

It is entirely possible that a segment of the institution's exposure in a particular country will also be adversely classified because of commercial credit deficiencies. In these circumstances, prepare the customary write-up on the Items Subject to Adverse Classification page. Be careful not to duplicate the adverse classification on the Transfer Risks Subject to Classification or Comment page. Elimination of duplications need not be made at each criticism cited. Rather, a single elimination may be made at the end of the listing of adverse classifications for commercial risk or transfer risk, as explained below. However, the most severe criticism must always prevail.

For example, if an asset in Country A is classified Doubtful for commercial credit risk while the transfer risk is Substandard, make the adjustment for the duplication before calculating a total for adverse classifications due to transfer risk. The same procedure applies if both transfer risk and commercial risk bear the same degree of classification. Refer to the following example:

TRANSFER RISK	SUB STANDARD	VALUE IMPAIRED	LOSS
Subtotal assets classified due to transfer risk 5,000,000 due to transfer risk	5,000,000	0	0
Less-amount classified due to commercial credit risk	500,000		
Total adversely classified assets due to transfer risk	4,500,000		

On the other hand, if the transfer risk is more severe, eliminate the duplication at the location where totals for assets adversely classified due to commercial risk are calculated by using the subscript Less-amount classified due to transfer risk.

ALLOCATED TRANSFER RISK RESERVE

Pursuant to the International Lending Supervision Act (ILSA), the Federal banking agencies require institutions to establish and maintain a special reserve when the value of international loans has been impaired by a protracted inability of the borrowers in a country to make payments on external indebtedness or no definite prospects exist for orderly restoration of debt service (for example, loans classified Value Impaired). Determination of the level of the special reserve, Allocated Transfer Risk Reserve (ATRR), is the responsibility of the Interagency Country Exposure Review Committee (ICERC). The ATRR must be established by a charge to current income and be segregated from the institution's general allowance for possible loan losses. Do not include the ATRR as a part of bank capital. The institution has the option to charge off the required amount rather than set up the ATRR. Examiners should ascertain whether the appropriate percentage ATRR or charge-off of outstandings to Value Impaired exposures has been made. The amount of charge-off or ATRR required is that amount which is equal to the appropriate percentage level on outstandings as illustrated:

	EXPOSURE TO COUNTRY X	**EXPOSURE TO COUNTRY Y**
Outstanding Balance	1,000,000	2,000,000
ATRR (ICERC sets requirement For Country X at 15%	150,000 (ATRR or Charge-off)	
ATRR (ICERC sets requirement For Country Y at 10% AND Increases ATRR requirement for Country X to 20%)	50,000 (ATRR or Charge-off)	200,000

If a charge-off or reserve of the requisite amount has not been established, the amount should be deducted in capital analysis and remind the institution in the Examination Conclusions and Comments page and the Violations of Laws and Regulations page of the regulatory requirement (refer to Part 351 of the FDIC Rules and Regulations) to charge off the amount or create the special reserve.

The requisite ATRR or charge-off is based on the original amount of exposure to a country less payments received. Loans extended after the initial amount, as determined for ATRR purposes, are generally not subject to an ATRR or charge-off if the new money was extended pursuant to economic reforms and if the credits are performing.

Exposures adversely classified due to transfer risk (less duplication adjustment) are included in the Summary of Items Subject to Adverse Classification and Special Mention section of the Examination Data and Ratios page, under a separate line item, Transfer Risk.

Combine credits that have been adversely classified due to transfer risk problems with commercial loan classifications when evaluating an institution's asset quality and other measures of financial soundness, including capital adequacy. Also, report exposures designated as Weak or Moderately Strong Transfer Risks on the Transfer Risks Subject to Classification or Comment page, with the accompanying write-ups. The criteria for determining exposures warranting comments are as follows:

Strong Transfer Risks - Do not comment on exposures to countries in this grouping. Extremely large exposures to these countries may be commented on in the discussion of the exposure management system and/or the Examination Conclusions and Comments page.

Moderately Strong Transfer Risks - Comment on exposures exceeding 15 percent of capital. For exposures between 10 and 15 percent of capital, there is a presumption in favor of commenting if outstandings with a maturity in excess of one year exceed 7.5 percent of capital. If maturities in excess of one year are less than that amount, there will be a presumption against commenting. Do not comment on exposures below 10 percent of capital.

Weak Transfer Risks - Comment on exposures exceeding 10 percent of capital. For exposures between 5 and 10 percent of capital, there is a presumption in favor of commenting if amounts due in excess of one year exceed 5 percent of capital. If amounts maturing in excess of one year are less than 5 percent, the presumption is against commenting. Do not comment on exposures below 5 percent.

Where comment is optional, the examiner will be allowed some flexibility and may determine not to follow the presumptions if other pertinent banking factors weigh more heavily either for or against comment. These factors might include management ability, the nature of the Committee's comment about the country, or the results of a more detailed breakdown of the composition of the portfolio. For example, if the institution's claims on a country were primarily short-term with presumption against commenting, the examiner might comment on the exposure if management was not following developments in the country and the Committee's write-up indicated a deteriorating situation. Similarly, comment might be omitted in spite of a presumption in favor of commenting if the Committee's report indicated a country's near-term outlook was good and a substantial part of the term credit was maturing in the second year.

To determine whether threshold levels of capital funds have been met, include firm commitments to lend additional funds.

It is possible that certain portions of an institution's exposure in a country (for example, trade transactions) will be listed for special comment, while other portions of the institution's exposure in a country (for example, term loans) might warrant adverse classification or designation as OTRP. Report split designations under the proper columns. To insure the uniform treatment of all short-term loans, the Committee has defined short-term loans as loans or loan amortizations maturing within one year from the applicable examination. That portion of long-term loans representing principal amortizations due within one year will not be included when extending long-term loans only. Trade transactions include only those credits covering the actual movement of goods (for example, commercial letters of credit and acceptances). Acceptances past due or extended are considered to be loans. Extend for special comment or adverse classification, as applicable, contingent liabilities subject to transfer risk (including commercial and standby letters of credit as well as loan commitments) that will result in a concomitant increase in institution assets if the contingencies convert into an actual liability. Classify contingent liabilities extended for adverse classification according to the type and tenor of the institution asset, which would result from conversion of the contingency into an actual liability. For example, classify commercial import/export letters of credit the same as trade transactions, and classify commitments to fund long-term project loans the same as long-term loans. In cases where type or tenor is not easily discernible and where exposure is accorded a split classification, the more severe classification should prevail.

Commitments should include only those commitments for which there has been charged a commitment fee or other consideration, or is otherwise a legally binding commitment. In the case of commitments for syndicated loans, extend only the institution's proportional share of the commitment. Similarly, contractual underwriting commitments (for example, revolving underwriting facilities) and other bond underwriting agreements may be shown net of firm commitments from other parties to purchase the assets without recourse within a short period of time. Accordingly, commitments should include the institution's obligations to participate in syndicated loans and underwritings managed by other institutions.

With respect to traditional concentrations of credit to related or affiliated borrowers within the institution's exposure in a particular country, schedule these lines on the Concentrations page in the usual manner.

INTERNATIONAL REPORT PAGE

ANALYSIS OF THE COUNTRY EXPOSURE MANAGEMENT SYSTEM

Present, in narrative form, an analysis of the institution's system for monitoring and controlling country exposure. Guidelines for conducting such analysis, as well as detailed examination procedures, are incorporated in the International Banking section of the Manual. Include the examiner's evaluation of the institution's procedures for measuring exposure, the institution's system for establishing country lending limits, and the institution's capability to analyze countries. Also, include an assessment of adherence to the institution's stated policies in this area.

The evaluation of the institution's international loan portfolio and the institution's country exposure management may warrant including commentary on the Examination Conclusions and Comments page to bring deficiencies to the attention of management and/or the board of directors. Examples might include very excessive concentrations of transfer risk in one or more countries, a pattern of concentrations to certain classes of countries, large amounts of classified assets, or a weak or ineffectual country exposure management system.

INTERNATIONAL REPORT PAGE

SELECTED CONCENTRATIONS OF COUNTRY EXPOSURES

Use this schedule to display transfer risk exposures considered large relative to the institution's capital and/or considered significant in relation to the economic, social, and political circumstances within a country.

List exposures to countries judged to be strong transfer risks on this schedule if the institution's exposure exceeds 25 percent of the institution's Tier 1 Capital. List moderately strong transfer risks at 10 percent of Tier 1 Capital, and list exposures to weak transfer risks equal to or exceeding 5 percent of Tier 1 Capital on this schedule. Also list all exposures to adversely classified countries or countries designated OTRP. Display exposures in alphabetical order.

The schedule is patterned after the Country Exposure Report (FFIEC 009). If the institution is required to prepare the report, obtain the information from the report most recently filed by the reporting institution (data from the most recently filed report is downloaded when available). Compiling the required data as of the examination start date is unnecessary unless the institution's exposure has changed materially since the date of the report. Spot-check the accuracy of the report by sampling the data provided on several countries shown on the report.

Several insured state nonmember banks have significant country exposures but are not required to submit the report because the institution does not meet the foreign branch, foreign subsidiary, or Edge Act or Agreement subsidiary criteria. Institutions with overseas lending activity in excess of $15 million are required to file periodic reports with the U.S. Treasury under the Treasury International Capital Reporting System. These reports may be useful in determining the volume of the institution's foreign lending activity. If the institution has aggregate exposures to foreign residents (any individual or entity) exceeding $30 million, prepare the report schedule Selected Concentrations of Country Exposure. For institutions with exposures to foreign residents of $30 million or less, the schedule may be prepared if it is significant to evaluating the condition of the institution. In any event, exposures to countries adversely classified by the Committee should be classified in the Report.

Terminology used in the schedule includes the following:

Cross-Border/Cross-Currency Claims - Includes all assets of the institution and its foreign offices where the obligor or asset is domiciled outside the U.S., and the asset is denominated in a currency different from the currency of the country where the obligor or asset is located. Claims include interest-bearing balances with institutions, securities, Federal funds sold and securities purchased under agreement to resell, loans (including own acceptances purchased, acceptances of other institutions purchased, discounted trade bills, and other instruments defined as loans in the instructions to the Report of Condition), direct lease financing, investments in unconsolidated subsidiaries and associated companies, and customers' liability on acceptances outstanding.

Amounts Maturing In: Less Than 1 Year - More Than 1 Year - Base the maturity distribution on amortization or final maturity dates, as appropriate, and not interest adjustment dates or roll-over dates. Include loans payable on demand in the less-than-one-year column. Place current maturities of long-term debt in the less-than-one-year column.

Commitments/Contingent Claims - Refers to binding contractual obligations of the institution and includes only the following: fee-paid loan commitments (less any amounts actually disbursed), undisbursed portions of loans contracted where the funds are available at the borrower's request, commercial letters of credit either issued or confirmed, standby letters of credit, and formal and legal guarantees issued. Excluded from this item are commitments that are subject to further institution approval before disbursement of funds and credit authorizations (internal guidance lines).

Subtotal by Location of Borrower - This column is intended to arrive at a gross total of cross-border claims and commitment/contingent items by country in which the primary obligor resides. The subtotal is calculated by adding the maturity and commitment/contingent claims columns.

Adjustments for Guarantees - These columns are intended to reallocate cross-border and contingent claims to the country of any guarantor (the party ultimately responsible for payment of the obligation in the event of default by the primary obligor). For the purposes of this report schedule, guaranteed claims are those claims of the reporting institution for which a third party formally and legally obligates itself to repay the reporting institution's claims on the primary obligor if the latter fails to do so. Documents that do not establish firm legal obligation, such as comfort letters or letters of awareness or intent, are not considered guarantees. The term guaranteed covers collateralized claims if the collateral is (a) tangible, liquid, or readily-marketable (for example, cash, gold, certificates of deposit, or readily-marketable shares of stocks or bonds); and (b) both held and realizable outside of the country of residence of the borrower. In cases involving collateral, the residence of the guaranteeing party is the country in which the collateral is held unless the collateral is a security, in which case it is the country of residence of the party issuing the security. With respect to claims on institutions, reallocate obligations due from a branch or agent of an institution to the country where the institution's head office is located. This procedure takes account of the implicit obligation of the head office to honor claims on its branches. This procedure will be used to reallocate any claims on U.S. branches and agencies of foreign banks. Reallocate any other claims to institutions, including institutions chartered in a foreign country, institutions that are subsidiaries of institutions, U.S. commercial institutions that are majority-owned by foreigners, or New York investment companies, only if these claims are formally guaranteed by a third party in another country.

Net Local Currency Assets of Offices in the Country - This column is used to indicate the excess of local country assets over local country liabilities of bank offices operating in a foreign country. For example, if the institution operates an office in France, show the net amount of French franc assets (loans to French residents denominated in French francs) held in the offices over French franc liabilities (French franc deposits of French residents) of the office in this column. If local country liabilities exceed local country assets, place a zero in this column.

Exposure by Country of Risk - This column is derived by adding the subtotal by location of borrower, adjustments for guarantees, and net local currency assets of offices in the country. The total identifies the true exposure of the institution in the country.

Exposure by Country of Risk as a Percent of Capital - This percentage is derived by dividing the exposure by country of risk by the institution's Tier 1 Capital.

Since this page is largely patterned after the Country Exposure Report, reviewing this reporting document and its instructions is recommended. The following cross-reference table is provided to assist in relating the report schedule to the Country Exposure Report:

CAPTION ON REPORT PAGE	COLUMN NUMBER ON COUNTRY EXPOSURE REPORT
Less than one year	Schedule 1, Column 5 + Schedule 2, Column 4
More than one year	Schedule 1, Column 6 + 7
Commitments/contingent claims	Schedule 1, Column 15
Other credits guaranteed by residents of this country	Schedule 1, Column 11 + 12 + 13 + 17
Credit externally guaranteed	Schedule 1, Column 8 + 9 + 10 + 16
Net local currency assets of offices in the country	Schedule 1, Column 18 - 19 + Schedule 2, Column 6 - 7 (if value is negative, place a zero beneath the caption)

Although the schedule is primarily intended to display large exposures, include exposures to countries subject to adverse classification or Other Transfer Risk Problems on the page regardless of the percentage of Tier 1 Capital. Reflect on the Summary Analysis of Examination Reports on line 55, Concentrations, the total of the selected concentrations of country exposure exceeding 5 percent of Tier 1 Capital. A comment on the Examination Conclusions and Comments page may be warranted if such exposures are excessive.

Note: The examiner may override the downloaded data on this page when the examiner is aware of information that is significantly different from the download or in other circumstances deemed appropriate by the examiner.

INTERNATIONAL WORKPAPERS

The following workpapers are optional and may assist an examiner in forming conclusions about the institution's international activities. Do not include these workpapers in the Report of Examination. Instead, concerns should be addressed in the ROE on the ECC page, the RMA page, or other appropriate report section, depending upon their significance.

- International Loans, Acceptances, and Letters of Credit – Distribution
- International Loans, Acceptances, and Letters of Credit – Questionnaire
- Eurocurrency Operations
- Foreign Exchange Activities
- Position Analysis – Major Currency Positions
- Position Analysis – Other Currencies
- Maturity Distribution (GAP) Analysis
- Revaluation and Income/Loss Analysis
- Income Loss Schedule
- Policy and Procedures
- Audit and Internal Controls – Audit
- Audit and Internal Controls – Internal Controls
- Parallel-Owned Banking Organizations (PBO)

DISCLAIMER: These workpapers are provided for illustrative purposes only. Nothing in them is intended to correspond with or tie to information in the Bank of Anytown Report of Examination.

INTERNATIONAL WORKPAPER

INTERNATIONAL LOANS, ACCEPTANCES, AND LETTER OF CREDIT – DISTRIBUTION

This schedule is intended to help the examiner identify the level of lending, letter of credit, and acceptance financing between the institution and obligors and/or guarantors domiciled outside the United States, its territories, and possessions. The inclusion of obligations guaranteed by foreign domiciled individuals or entities in this definition is based on the concept that ultimate liability for repayment rests with the guarantor. Therefore, the basic objective is to designate those transactions where repayment channels will cross international boundaries. This approach is consistent with the methodology used in the Country Exposure Report (FDIC 6502/03) to reallocate claims to the country of the individual or entity ultimately liable for repayment.

For the purposes of this schedule, guaranteed instruments are those for which a third party formally and legally obligates itself to repay the institution's claim on the direct obligor if the latter fails to do so. Documents such as comfort letters or letters of awareness or intent are not considered guarantees for the purposes of this schedule. The term guaranteed covers collateralized instruments if the collateral meets both these requirements:

- The collateral is tangible, liquid, readily marketable (that is, cash, gold, certificates of deposit, or readily marketable shares of stocks or bonds)
- The collateral is both held and realized outside the United States, its territories, and possessions.

Using the foregoing guidelines, include in the schedule obligations of residents or entities domiciled in the United States bearing a guarantee from a resident or entity in a foreign country. Similarly, exclude from the schedule direct obligations of foreign residents or entities with guarantees from domestically domiciled residents or entities.

Base the distribution of loans in this schedule on the nature of the direct obligor on the indebtedness.

Mortgage loans include liens or deeds of trust on real property, aircraft, or ships. Shipping loans included in this category will be secured by first or second preferred-ship mortgages. Exclude loans collateralized solely by bareboat, time, or consecutive charter, which are more properly shown in the loans to commercial, industrial, and agricultural interests caption.

Include in the caption, Other Loans, credits not properly categorized in the five preceding captions made to obligors with similar characteristics and represent a material percentage of total international loans (approximately 10 percent of international loans is a reasonable criteria).

The caption, Syndication and Consortium Financing, includes the institution's investment in syndicated credits. These loans differ from the customary participation loan as a number of institutions participate at the outset and are known to the borrower. As such, the loan must be structured to meet both the requirements of the participating institutions and the needs of the borrowing entity. The function of packaging the credit to satisfy the needs of parties to the transaction is the responsibility of the syndicate leader.

The caption, Other (Describe), is intended to provide a location for the enumeration of special types of international lending or financing activity deemed worthy of separate enumeration. For example, a separate enumeration of the aggregate volume of syndicated loans originated by the institution as syndicate leader or loans within certain geographic areas may be warranted.

Use the footnote, Does not include loans to U.S. subsidiaries of foreign corporations, to show the aggregate of loans to such borrowers which have not been shown in the categories above in the Distribution schedule.

INTERNATIONAL WORKPAPER

INTERNATIONAL LOANS, ACCEPTANCES, AND LETTERS OF CREDIT – QUESTIONNAIRE

These questions are intended to assist the examiner with identifying risk-management weaknesses in the international area of the bank’s operations. Significant concerns should be addressed on the ECC page, the RMA page, or other appropriate Report section (e.g. the Analysis of the Country Exposure Management System page), depending upon their significance.

INTERNATIONAL WORKPAPER

EUROCURRENCY OPERATIONS

These questions are intended to assist the examiner with identifying risk-management weaknesses in the international area of the bank's operations. Significant concerns should be addressed on the ECC page, the RMA page, or other appropriate Report section (e.g. the Analysis of the Country Exposure Management System page), depending upon their significance.

INTERNATIONAL WORKPAPER

FOREIGN EXCHANGE ACTIVITIES

This workpaper should be used in conjunction with other workpapers addressing risks associated with foreign exchange activities. These other workpapers might include Position Analysis – Major Currency Positions, Position Analysis – Other Currencies, Maturity Distribution (GAP) Analysis, Revaluation and Income/Loss Analysis, and the Income/Loss Schedule. Material concerns should be addressed on the RMA or ECC page, as appropriate.

INTERNATIONAL WORKPAPER

POSITION ANALYSIS – MAJOR CURRENCY POSITIONS

This schedule may be useful for determining the extent of the institution's position in various currencies and unrealized profit and/or loss and assessing the policies and risk management practices related to foreign exchange activities. Concerns should be brought forward to the ECC or RMA page, depending upon their significance.

POSITION ANALYSIS

If an institution has assets or liabilities denominated in a foreign currency, or the institution has commitments to purchase or sell foreign exchange with a future delivery date, a net position for each foreign currency must be calculated. This function facilitates an analysis of exposure to fluctuations in exchange rates and aids in determining unrealized profits and/or losses accruing to the institution on the date of examination. Further, the position analysis enables the examiner to ascertain the institution's practice of adjusting U. S. dollar equivalents of foreign currency accounts at periodic intervals.

To prepare the position on each foreign currency, make a trial balance of each asset and liability account denominated in a foreign currency. Asset accounts (long position) include, but are not limited to, foreign currency on hand, due from bank accounts (nostro), demand and time loans, investments, accrued interest receivable, and commitments to purchase exchange on a spot or future basis. Liabilities (short position) include due to accounts (vostro) with other institutions (including nostro overdrafts), demand and time deposits cash collateral, accrued interest payable, accounts payable, and commitments to sell exchange on a spot or future basis. These accounts or subsidiary records will normally contain both the amount of foreign currency and an equivalent amount in U.S. dollars. The examiner's trial balance of foreign currency should prove to the institution's position sheet, and dollar equivalents should correspond to the general ledger. Certain transactions, such as the previous day's spot or future exchange transactions may not have been recorded on the institution's books. Obtain these so called holdover items from the foreign exchange trader, and include them in the calculation of the currency position.

MAJOR CURRENCY POSITION

This schedule is reserved primarily for the currency posing the greatest exposure to the institution's total capital and reserves. If the institution maintains substantial positions in several currencies, the schedule should be completed separately for each currency.

Derive the entries for foreign currency and dollar equivalents for each asset and liability category from the institution's records. DO NOT REVALUE THESE ACCOUNTS AT CURRENT EXCHANGE RATES. Deduct the lesser of long/short position from the larger figure to arrive at the net position in foreign currency and dollar equivalent. The net position - dollar equivalent should be related to capital and reserves.

INTERNATIONAL WORKPAPER

POSITION ANALYSIS – OTHER CURRENCIES

This schedule may be useful for determining the extent of the institution's position in various currencies and unrealized profit and/or loss and assessing the policies and risk management practices related to foreign exchange activities. Concerns should be brought forward to the ECC or RMA page, depending upon their significance.

POSITION ANALYSIS

If an institution has assets or liabilities denominated in a foreign currency, or the institution has commitments to purchase or sell foreign exchange with a future delivery date, a net position for each foreign currency must be calculated. This function facilitates an analysis of exposure to fluctuations in exchange rates and aids in determining unrealized profits and/or losses accruing to the institution on the date of examination. Further, the position analysis enables the examiner to ascertain the institution's practice of adjusting U. S. dollar equivalents of foreign currency accounts at periodic intervals.

To prepare the position on each foreign currency, make a trial balance of each asset and liability account denominated in a foreign currency. Asset accounts (long position) include, but are not limited to, foreign currency on hand, due from bank accounts (nostro), demand and time loans, investments, accrued interest receivable, and commitments to purchase exchange on a spot or future basis. Liabilities (short position) include due to accounts (vostro) with other institutions (including nostro overdrafts), demand and time deposits cash collateral, accrued interest payable, accounts payable, and commitments to sell exchange on a spot or future basis. These accounts or subsidiary records will normally contain both the amount of foreign currency and an equivalent amount in U.S. dollars. The examiner's trial balance of foreign currency should prove to the institution's position sheet, and dollar equivalents should correspond to the general ledger. Certain transactions, such as the previous day's spot or future exchange transactions may not have been recorded on the institution's books. Obtain these so called holdover items from the foreign exchange trader, and include them in the calculation of the currency position.

OTHER CURRENCIES

For each currency, aggregate the assets and purchase commitments (long position) and liabilities and sale commitments (short position), and deduct the smaller figure to arrive at the net position for each currency. The net dollar equivalent should be related to capital and reserves.

Note the net position of the Canadian dollar in the schedule in the Bank of Anytown. If the foreign currency total is net long while the U.S. dollar equivalent is net short, a split position exists. This so-called split position usually results from a heavy volume of activity flowing through the institution's nostro accounts which will subsequently require adjustment to restore balance to the relationship between the foreign currency and U.S. dollar equivalent.

In calculating the aggregate position (U.S.) for all currencies, add all U.S. equivalent figures irrespective of sign (that is, short positions are added to long positions as a positive number).

QUESTIONS 1 (A & B)

These questions help determine whether the institution's net position appears unwarranted, excessive, or speculative. It is difficult to enumerate a benchmark, which would indicate an ill-advised position; however, the following criteria may be used in evaluating the institution's position:

- Competency of the trading and executive officers
- Purpose of the position
- The volatility of the individual currencies
- Volume of business in the county
- Size of the institution

Negative responses to these questions may suggest the need for commentary in the Report.

INTERNATIONAL WORKPAPER

MATURITY DISTRIBUTION (GAP) ANALYSIS

Although an institution has no net open position in a currency (that is, assets and purchases equal liabilities and sales), it may nevertheless be exposed to exchange risk by virtue of unmatched maturing obligations creating periods of uneven foreign currency inflows and outflows. To illustrate, an institution may have a preponderance of maturing foreign currency assets or maturing contracts to purchase foreign currency, vis-à-vis maturing liabilities or obligations, to sell foreign exchange with a particular time interval. As such, the institution will be in a net long position (an excess of foreign currency cash) during the time period, and a decision must be made whether to hold the currency in the due from foreign bank account (nostro account), invest the funds short-term, or to sell the exchange either spot or forward for delivery at the time the gap begins and repurchase either spot or forward for delivery when the gap ends. This situation is referred to as positive gap, which exposes the institution to possible loss of income from holding idle funds where no investment or sale has been arranged or exchange losses if the currency depreciates. Conversely, the institution may be in a negative gap position where maturing liabilities or contracts to sell exchange exceed maturing assets or contracts-to-purchase exchange during a particular time period. This situation has liquidity implications in that the institution must either borrow the currency short term or be in a position to purchase (spot or forward) for delivery at the time the gap begins, and perhaps sell (spot or forward) for delivery at the time the gap ends.

Institutions should have firm policies on the maximum gap exposure permitted in certain currencies. The decision to close a gap when it is created, or to let it remain open for a time, will largely depend on money market interest rates as well as the difference between applicable spot and forward exchange rates (commonly known as the swap rate) or the deviations between two forward exchange rates. Potential movement in the swap rate (for the most part determined by interest rate differentials between the two countries) is the customary measure of profit potential or loss exposure during the period within which the gap exists.

In using this schedule, it is mandatory to complete a maturity distribution only for major currencies outlined in the Major Currency Position segment of this questionnaire. At the discretion of the examiner, currency positions enumerated in the Other Currencies portion of the Position Analysis form may be scheduled, if material. Show each currency on a separate form. Question No. 2 at the bottom of the form applies to all currencies so listed.

In arranging the maturity distribution, it is recommended that at least the first two weeks of activity subsequent to the examination start date be detailed on a daily basis. (In active departments, a daily enumeration for the first month following the examination start date may be appropriate). Thereafter, semi-monthly or monthly intervals may be used depending on the institution's method of pricing forward commitments and the volume of activity. Longer range maturates may be grouped by years.

The preparation of this schedule requires the inclusion of all ledger accounts comprising the currency position. Show ledger accounts not bearing a maturity date in the first day's maturates. Show spot contracts as of the date settlement is expected to occur. The total of assets and purchases (long), liabilities and sales (short), and the net amount of these two columns should correspond to the foreign currency amounts shown in the position sheet. Compare the net gap for each period to limits imposed by institution management. Further, review the cumulative gap position (the addition of gaps for each time interval) for conformance to policy and the incidence of excessive periods of positive or negative gap. Such events may require comment if potential exposure appears ill-advised from the viewpoint of possible losses and/or liquidity concerns.

As to the final three columns at the right hand side of the form, it will normally be unnecessary to complete a profit and loss revaluation on this form. However, if a position results in a material profit or loss, the examiner may wish to complete this portion of the report form. Refer to the example given in the Revaluation and Income/Loss Analysis schedule discussed below. Price future contracts at the given premium or discount rate. Price spot contracts and ledger accounts at the spot. When one or more rates are used to price a position at a point in time, type various in the Spot Rate column. All swap contracts should be removed before valuing the position since the profit/loss is fixed at the time of the transaction and reflected in the return on the asset for which the swap was effected. In any event, the schedule can be used as a workpaper to calculate the future profit/loss adjustment in the revaluation schedule.

INTERNATIONAL WORKPAPER

REVALUATION AND INCOME/LOSS ANALYSIS

The purpose of this schedule is to determine as of the examination as of date the unrealized profit or loss for the institution in connection with positions undertaken in foreign currency. The computation is based on the assumption that the entire position will be liquidated (that is, all long foreign currency positions will be sold and all short positions will be covered).

The primary input to this schedule is the position analysis schedule on this questionnaire. List each currency under the column Monetary Unit. Insert in the Book Value column the institution's net position in the foreign currency amount and U.S. dollar equivalent less any swap contracts included in the position. (Refer to the following paragraph for an explanation of these transactions). Obtain the spot exchange rate from the Wall Street Journal or similar publications containing foreign exchange rates. Express the exchange rates in terms of the U.S. dollar cost per unit of foreign currency (that is, one Deutsche mark sells for $.4938) with the values carried to four decimal places or four-digit level of significance (one Japanese yen equals $.004560). Multiply the net amount of foreign currency by the spot rate to arrive at the current market value of the position. Apply the following rules when determining the spot rate profit or loss on each position:

1. Long foreign currency position combined with long U.S. dollar equivalent. Profit is excess of market value over book value; loss is the excess of book over market.
2. Long foreign currency position combined with short ( ) U.S. dollar equivalent. Profit is the current market value plus the short U.S. dollar book value.
3. Short foreign currency position combined with short ( ) U.S. dollar equivalent. Profit is the excess of book value over current market value; loss is the excess of market value over book value.
4. Short foreign currency position combined with long U.S. dollar equivalent. Loss is the current market value plus the long U.S. dollar book value.

Rules No. 2 and No. 4 refer to split positions previously mentioned in the instructions for calculating the net open position. Note in rule No. 2, the position can only result in profit, while in rule No. 4 the only possibility is a loss.

A financial swap is a combination of a spot purchase or sale of a foreign currency against a forward sale or purchase of the currency. By affecting the arrangement the institution effectively locks in the potential gain or loss from entering into a transaction involving the temporary movement of funds into another currency and back again. For example, the institution has an investment opportunity to lend 1,000,000 pounds sterling for three months. The institution will purchase necessary exchange spot for $1.8660 per pound sterling ($1,866,000) to make the loan. Simultaneously, the institution will enter into a forward exchange contract to sell 1,000,000 pounds sterling at the anticipated maturity date for $1.8690 per pound sterling ($1,869,000). Customarily, the institution will sell forward the expected interest income as well. Accordingly, the institution has realized a $3,000 profit on the transaction at the inception of the loan. Customarily, the profit (or alternatively cost) is applied to the rate of interest on the loan to determine the true yield on the investment. The profit (or loss) is accrued to income and expenses monthly. In these circumstances, it is inappropriate to allocate the profit to the exchange function. A review of the institution's records will facilitate the identification of swap transactions and, as previously stated, these amounts should not be included in the revaluation schedule.

Adjust the spot-rate profit (loss) for discounts or premiums on forward exchange contracts, which are included in the net currency position. A discount is a rate of exchange lower than the spot rate expressed in terms of percentage per annum or points on which a dealer buys or sells foreign exchange for forward delivery. For example, if a dealer quotes $186 and $191 (bid and asked) for spot sterling, and the discounts for six-month forward exchange contracts are .0300 and .0275, the forward quotes would be modified to $183 and $1.8825. In most cases, the discount reflects an interest rate differential in the U.S. vis-à-vis the U.K. although in periods of downward market pressure on a currency a discount may indicate market anticipation of a lower price for the currency. A premium is a rate of exchange higher than the spot rate. Again, interest rate phenomena and possibly upward market pressure will play a role in this situation. The premium situation works exactly opposite discount example. That is, premium quotes are added to the applicable spot rates quoted.

The calculation of future profit (loss) adjustments will require the listing of all contracts by maturity or value dates from near-term to longer-term. Certain contracts are made on an option basis because of uncertainty as to the date when foreign currency will be received or needed. In option contracts involving the purchase of exchange, list contracts with premiums at the earliest date and contracts with discounts as of the latest date. Conversely, show contracts involving the sale of exchange at premiums at the latest date and those at a discount at the earliest date. The format of the maturity distribution will depend on the system used by the institution in providing future rates. A summary of contracts on a monthly basis can be prepared provided the rates supplied by the institution are based on a monthly scale. If rates are on a semi-monthly basis, prepare the summary figures by the first and second halves of the month. To calculate the profit and loss on futures, the following rules apply:

1. A long position at a discount reflects a loss
2. A short position at a discount reflects a profit
3. A long position at a premium reflects a profit
4. A short position at a premium reflects a loss

In the absence of a significant profit or loss from the revaluation of the foreign currencies, it is not necessary to adjust book capital.

QUESTION 3 - SIGNIFICANCE OF PROFIT OR LOSS

In weighing the significance of profit or loss from foreign exchange operations, it is important to consider the amount in relation to the capital account of the institution, the volume of exchange activity, and the institution's history in sustaining profits and/or losses. The criteria enumerated as guidance in responding to questions 1a & b would also warrant consideration.

INTERNATIONAL WORKPAPER

INCOME/LOSS SCHEDULE

This schedule is relatively self-explanatory. Information required to complete the schedule should be readily available from the bank's financial records.

INTERNATIONAL WORKPAPER

POLICIES AND PROCEDURES

These nine questions discuss the institution's policies, reporting mechanisms, and procedures in relation to foreign exchange activities.

INTERNATIONAL WORKPAPER

AUDIT AND INTERNAL CONTROLS – AUDIT

This workpaper and the following one are designed to focus attention on the safeguards implemented by the institution through the audit function and internal controls. The questionnaire is designed for use in an institution with a relatively sophisticated trading operation. Therefore, the examiner must weigh carefully the recommendation of certain control or audit features which are cost ineffective. Nevertheless, the institution should implement protective devices such as separation of duties, test checking of transactions, and firmly established operating procedures to prevent irregularities or departure from accepted norms. In essence, the traditional rules of practice used in preventing undue exposure in domestic departments apply equally to the foreign exchange function. Concerns with the institution's international audit and internal control procedures may be brought forward to the ECC or RMA page, depending upon their significance.

INTERNATIONAL WORKPAPER

AUDIT AND INTERNAL CONTROLS – INTERNAL CONTROLS

This workpaper and the previous one are designed to focus attention on the safeguards implemented by the institution through the audit function and internal controls. The questionnaire is designed for use in an institution with a relatively sophisticated trading operation. Therefore, the examiner must weigh carefully the recommendation of certain control or audit features which are cost ineffective. Nevertheless, the institution should implement protective devices such as separation of duties, test checking of transactions, and firmly established operating procedures to prevent irregularities or departure from accepted norms. In essence, the traditional rules of practice used in preventing undue exposure in domestic departments apply equally to the foreign exchange function. Concerns with the institution's international audit and internal control procedures may be brought forward to the ECC or RMA page, depending upon their significance.

INTERNATIONAL WORKPAPER

PARALLEL-OWNED BANKING ORGANIZATIONS (PBO)

PURPOSE

The purpose of this schedule is to detail all of the information needed to ascertain whether a parallel-owned banking organization (PBO) exists.

WHEN TO COMPLETE

Complete this schedule when an individual, family, or group of persons acting in concert appear to exercise control, as provided in the supervisory definition of control for PBOs as detailed in the International section, of an institution in the United States and have an interest in a bank or bank holding company in a foreign country. Examiners should consider all of the issues detailed in the Parallel-Owned Banking Organizations page to ascertain whether a PBO exists. If the examiner determines that a PBO does not exist, the Parallel-Owned Banking Organizations page should be maintained in the examination workpapers to document the basis of the examiners' conclusion. If the examiner determines that a PBO does exist, the Parallel-Owned Banking Organizations page should be maintained in the examination workpapers unless an adverse trend is noted. The page should be included in the Report of Examination if any adverse trends are noted within the PBO relationship. Upon the examination's completion, the region should forward the Parallel-Owned Banking Organizations page, whether it is included in the Report of Examination or not, with a cover letter to the RMS Associate Director of the International and Large Bank Branch.

GENERAL

The FDIC typically does not request or review information on foreign banks or foreign bank holding companies during the examination process. If a PBO relationship is suspected, the examiner needs to request additional information to understand the ownership/control structure of the foreign entity. The information on the foreign bank and/or foreign bank holding company could include, but is not limited to:

- Shareholder list of the foreign bank and any of the companies that own/control it;
- Minutes of the most recent shareholder meeting;
- Annual Reports;
- Composition of the board of directors and executive management;
- Organizational chart;
- Web site addresses,
- Policies that the bank in the United States has been instructed to follow;
- Products or services that the bank in the United States has been instructed to offer; and
- Cross-border transactions or services.

ADDITIONAL LINE ITEMS

The examiner may add line items when necessary in each section of the page. The examiner should adjust the length of the page by moving the discussion of items 1 through 8 between the pages as needed.

BANK AND/OR BANK HOLDING COMPANY INFORMATION

The first section instructs the examiner to list the bank(s) and/or bank holding company(s) within the PBO. The examiner may need to add a row or rows to this table, copying the information requested for an entity in either the United States or in a foreign country into the new row. If a PBO has multiple banks or bank holding companies in the United States and/or foreign countries, the examiner may decide to limit the list. The examiner should footnote the schedule with the basis of any omissions, such as detailing only those organizations that regularly engage in transactions with the bank in the United States, and provide a list of those entities' names and the city and country in which they are located. The examiner also may want to footnote the schedule for any bank or bank holding companies that are wholly owned subsidiaries.

STOCK OWNERSHIP

Detail the stock ownership of the bank(s) and/or bank holding company(s) in the United States and in the foreign country that provide the primary nexus for the PBO. Since the nexus could contain more than one bank or bank holding company in the United States or in the foreign country, the examiner may need to add a row or rows to this table for additional entities. The examiner should list the name of the entity for which the beneficial owner(s) information is being provided after the space labeled **U.S. Name**: and **Foreign Name:** that is above the Beneficial Owner line. In addition, the examiner can add or delete rows within the table, depending upon the number of beneficial owner(s).

FACTORS CONSIDERED

Provide a response to each of the factors and/or attributes that are listed. If not applicable, so state.

SUMMARIZE THE EXAMINATION'S FINDINGS

Specify whether an affiliate relationship, as defined by the Federal Reserve Act and/or the Federal Reserve Board's Regulation O, exists. Cross-reference any concerns or criticisms here and on the appropriate report page(s), *i.e.*, the ECC; Item 5 (Bank Secrecy Act) and Item 6 on the RMA; Violations of Law and Regulations; and Relationships with Affiliates and Holding Companies. Send a written notification to the RMS Associate Director of the International and Large Bank Section. Refer to the International section of the Manual of Examination Policies for additional information.

FOOTNOTE

The aforementioned examples are for illustrative purposes and are not all-inclusive.

APPENDIX A – ABBREVIATIONS

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The following are the principal abbreviations used in this Report of Examination.

et al	And Others
et ux	And Spouse
a/k/a	Also Known As
AA	Average Assets
AGI	Adjusted Gross Income
AL	Acres of Land
ALLL	Allowance for Loan and Lease Losses
AP	Accounts Payable
APBO	Accounting Principles Board of Opinion
AR	Accounts Receivable
ARM	Adjustable Rate Mortgage
AV	Appraised Value
BHC	Bank Holding Company
BSA	Bank Secrecy Act
BV	Book Value
CA	Current Assets
CD	Certificate of Deposit
CL	Contingent Liabilities
CLOC	Commercial Letter of Credit
CPA	Certified Public Accountant
CSV	Cash Surrender Value
CT	Certificate of Title
d/b/a	Doing Business As
DPC	Debts Previously Contracted
DT	Deed of Trust
EDP	Electronic Data Processing
End	Endorser or Endorsed
EV	Estimated Value
F&F	Furniture and Fixtures
FA	Fixed Assets
FASB	Financial Accounting Standards Board
FHA	Federal Housing Administration
FHLB	Federal Home Loan Bank
FHLMC	Federal Home Loan Mortgage Corporation
FNMA	Federal National Mortgage Association
FS	Financial Statement
GP	General Partner
GNMA	Government National Mortgage Association
Gty	Guarantor or Guaranteed
Inc	Incorporated
ISF	In-Substance Foreclosure
JM	Joint Maker
JV	Joint Venture
LOC	Line of Credit
LP	Limited Partner
LS	Livestock
M	Thousands
M&E	Machinery & Equipment
MBS	Mortgage-Backed Security
Mdse	Merchandise
MM	Millions
MMDA	Money Market Deposit Account
Mtge	Mortgage
MV	Market Value
NI	Net Income
NIM	Net Interest Margin
NOI	Net Operating Income
NOW	Negotiable Order of Withdrawal
NP	Notes Payable
NR	Notes Receivable
NW	Net Worth
OA	Other Assets
OD	Overdraft
OH	Overhead
OL	Other Liabilities
ORE	Other Real Estate
OS	Operating Statement
PL	Prior Lien
PLLL	Provision for Loan and Lease Losses
PORE	Potential Other Real Estate
PPD	Prepaid
PS	Property Statement
PV	Par Value
ROA	Return on Assets
RBC	Risk-Based Capital
REM	Real Estate Mortgage
RSA	Rate-Sensitive Assets
RSL	Rate-Sensitive Liabilities
RE	Real Estate
SA	Security Agreement
SBA	Small Business Administration
SFAS	Statement of Financial Accounting Standards
SFR	Single-Family Residence
SLOC	Standby Letter of Credit
TA	Total Assets
TE	Tax Equivalent Basis
TL	Total Liabilities
UBPR	Uniform Bank Performance Report
UCC	Uniform Commercial Code
VA	Veteran’s Readjustment Act
WC	Working Capital

APPENDIX B – GRAMMAR AND PUNCTUATION GUIDE

←

The general rules and standards contained in this appendix are applicable only to the Report of Examination. The rules and standards cover matters commonly encountered in Report comments and are intended to promote consistency. The general rules are not a substitute for writing and grammar guides. Refer to those resources for formal guidance.

HYPHENATION - ADJECTIVES:

General Rule: Two- and three-word modifiers that express a single thought should be hyphenated when they precede a noun (an out-of-date policy).

Do not use a hyphen if each of the words can modify the noun without the aid of the other modifying word or words (a new digital computer).

Do not hyphenate words that follow the noun they modify (the policy is out of date).

<u>Examples:</u>

A full-scope examination began on June 30.

The loan is secured by a single family residence.

The apartment complex has 50 units.

HYPHENATION - PREFIXES:

General Rule: Words containing prefixes generally do not require hyphens. Include the hyphen after the prefix if not doing so would cause confusion in sound or meaning.

<u>Examples:</u>

nonaccrual nonperforming subtotal

HYPHENATION - COMPOUND VERBS:

General Rule: Compound verbs can be separate, solid, or hyphenated. If you do not find a compound verb in a dictionary, write the components as separate words.

<u>Report standards:</u>

charge off paid off write off/ up/ down

HYPHENATION - COMPOUND NOUNS:

General Rule: Compound nouns may be separate, solid, or hyphenated. If you are not certain whether a compound word should be hyphenated, check a dictionary. If you do not find a compound noun in a dictionary, hyphenate the components.

Report Standards: charge-off pay-off write-off/-up/-down examiner-in-charge

HYPHENATION - SUSPENDING HYPHEN:

General Rule: When a series of hyphenated adjectives has a common basic element, and the element is shown only with the last term, insert a suspending hyphen after each of the incomplete adjectives to indicate a relationship with the last term.

Examples:

long- and short-term securities
private- and public-sector partnerships

CAPITALIZATION:

General Rule: There are numerous exceptions to basic capitalization rules. The most important rule is to be consistent throughout a Report. Examiners may deviate from the following standards as long as they are consistent.

Report Standards: Do not capitalize bank unless it is used with the full name of the institution.

Capitalize Board of Directors, Board, or Directors when referring to a specific board.

Capitalize Call Report, Call Report Instructions, and Consolidated Reports of Condition and Income.

Do not capitalize examiner-in-charge unless it is followed by a specific person's name.

Capitalize account titles (for example, Other Borrowings).

Capitalize only the word Federal in Federal funds sold or purchased (unless referring to an account title).

Capitalize Regional Director and Regional Office.

Capitalize Report of Examination and Report when referring to a specific report.

Do not capitalize the word State unless referring to a specific public agency or the word is being used in the same sentence as Federal (which should always be capitalized).

Capitalize Substandard, Doubtful, Loss, and Special Mention when referring to FDIC asset classification titles.

Capitalize the specific titles of formal institution policies (for example, the Loan Administration Policy vs. the loan policy).

Capitalize the titles of specific institution committees (for example, the Audit Committee).

DATES:

Report Standard: A comma precedes and follows the year when the month and day precede the year. However, when the date consists only of month and year, commas are not necessary.

Examples: The examination that began on December 2, 1998, was completed in two weeks.

The report is due in January 1999.

NUMBERS:

General Rule: Write out numbers below 10. Use figures for numbers 10 and above.
Regardless of the number's size, use figures if they are followed by a unit of measure.
Write out numbers that begin a sentence.
Do not begin a sentence with a large number.

Examples: The bank employs five people.
The examiners cited 14 deficiencies.
Twenty-six examiners attended the field office meeting.

SPELLING:

Report Standards: installment totaling totaled

BANK OF ANYTOWN

ANYTOWN	**ANY COUNTY**	**ANYSTATE**

Region:	Any Region	Certificate Number:	99999
Examiner-In-Charge:	Sandra E. Smart		
Examination Start Date:	August 01, 2012		
Examination As Of Date:	June 30, 2012		

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Uniform Financial Institutions Rating System

	Current Exam	**Prior Exam**	**Prior Exam**
Examination Start Date	08/01/2012	11/13/2011 / S	10/21/2010
Examination As Of Date	06/30/2012	09/30/2011	09/30/2010
Composite Rating	**3**	**3**	**3**
Component Ratings:			
Capital	**3**	**2**	**2**
Asset Quality	**4**	**4**	**3**
Management	**3**	**3**	**3**
Earnings	**4**	**4**	**3**
Liquidity	**2**	**2**	**2**
Sensitivity to Market Risk	**2**	**2**	**2**
Information Technology	**2**	**1**	**2**
Trust	**2**	**2**	**2**
Compliance[1]	**2**		
Community Reinvestment Act[1]	**S**		

1 Examination dated xx/xx/xxxx

SUMMARY

The bank remains in less than satisfactory condition. Asset quality is weak, earnings are poor, and management needs to make additional efforts to comply with the outstanding Memorandum of Understanding (MOU). Capital is less than satisfactory in relation to the present risk profile. Liquidity is satisfactory, and sensitivity to market risk is moderate. Information Technology, Trust, Bank Secrecy Act (BSA), and Anti-Money Laundering programs are satisfactorily managed. Compliance and Community Reinvestment Act programs are also satisfactory.

MATTERS REQUIRING BOARD ATTENTION

Examiners identified numerous deficiencies that require the Board's prompt attention. The Board should take immediate action to:

- Review and document its implementation of corrective actions regarding the three outstanding MOU items,
- Approve appropriate definitions for credit grades, and review management's progress in meeting loan-review frequency standards,
- Review management's progress in correcting credit administration deficiencies,
- Revise the budget,
- Update the strategic plan,
- Develop a plan to ensure currency transaction reports (CTRs) are filed in a timely manner, and
- Strengthen internal controls and the independence of the internal audit function.

The Board is reminded of the importance of addressing these weaknesses and its responsibility to respond appropriately to the matters highlighted above. For additional details, refer to related comments included throughout this Report of Examination.

MEMORANDUM OF UNDERSTANDING

The bank entered into a MOU on January 21, 2011, based on the October 21, 2010, FDIC examination findings. Management and the Board have not fully addressed three MOU provisions, including an inadequate Allowance for Loan and Lease Losses (ALLL), significant errors in recent Reports of Condition and Income, and lack of documentation on credit extensions. Refer to the Compliance with Enforcement Actions page for additional details.

ASSET QUALITY - 4

Asset quality remains weak and is the primary impediment to improving the bank's overall financial condition. As reflected on the Examination Data and Ratios page, the volume of adversely classified items has decreased by 12 percent since the prior examination, with the volume of adversely classified loans dropping by 24 percent. Despite these improvements, adverse classifications still represent 84 percent of Tier 1 Capital and the ALLL. Additionally, the volume of Loss classifications increased from $194M at the 2011 examination to $1,015M at the current examination. (Asset Review Date: 6/30/2012.)

Loans

Examination classifications are concentrated in the commercial real estate (CRE) portfolio. Loans adversely classified Loss (portions of three relationships totaling $890M) are CRE loans that were adversely classified Substandard at the prior examination.

Most troubled credits result from liberal lending practices exacerbated by the depressed regional economy, particularly the local fishing industry. In response to past regulatory criticisms, management has taken affirmative steps to strengthen credit administration by tightening overall underwriting standards, strengthening collection efforts, decreasing CRE advance rates from 90 percent to 75 percent, and avoiding financing for speculative real estate acquisition and development projects. Although these actions have longer-term positive implications, present credit quality remains hindered by numerous workout situations and the deterioration of existing credits not previously subject to adverse classification. Additional details regarding trends in the level of adversely classified loans are included on the Analysis of Loans Subject to Adverse Classification page.

Loan Review and Internal Grading System

The defined scope of the internal loan review and grading system is adequate. However, management has been unable to comply with internal review frequency standards due to elevated personnel demands associated with working out problem assets. Additionally, assigned credit grades for several larger credits were inaccurate, as exemplified by the partial Loss classification of the Irma Deat, Ltd., and Last Chance Motel credits. In both cases, the credits were internally rated substandard. Additionally, several credits adversely classified Substandard by examiners were internally rated watch. To address this issue, management should more tightly define all credit grades and ensure they are accurately applied.

President Allie C. Lincoln stated that management would review all grading definitions by year-end 2012, and meet review frequency standards by mid-2013.

Allowance for Loan and Lease Losses

The ALLL is inadequate by at least $325M, primarily due to liberal internal credit grading. Additionally, the ALLL allocation for non-watch list credits is inadequate based upon recent loan loss experience on non-watch list loans. Specifically, the institution's average loss rate on non-watch list loans since 2010 is approximately 0.75 percent; however, management only allocates 0.1 percent for residential mortgages and only 0.5 percent for all other non-watch list loans.

President Lincoln indicated management intends to file amended June 30, 2012, Reports of Condition and Income to address income reporting issues and will include a $325M loan loss provision in the amended filings. She stated management would file the amendments prior to September 30, 2012. President Lincoln initiated a review of the loan grading system during the examination and stated that all existing loss-rate percentages would be reviewed.

Credit Administration

Credit administration, although improving, requires further attention. As detailed on the Assets with Credit Data or Collateral Documentation Exceptions page, the number of loans possessing documentation exceptions remains high. In particular, the following credit administration weaknesses should be promptly addressed:

- *Credit Analysis on Participations Purchased* - The bank does not perform pre-purchase credit analysis on participations purchased. An institution purchasing all or part of a loan should perform the same degree of independent credit analysis as if it were the originator.

- *Inspections and Lien Waivers* - The bank does not perform inspections or obtain mechanic's lien waivers prior to making construction loan advances. It is essential that management perform timely inspections and obtain lien waivers to protect the bank's collateral and lien positions.

- *Rent Rolls* - Loan officers do not obtain rent rolls and vacancy figures on an ongoing basis for loans secured by commercial real estate. Rent roll and vacancy information are essential to monitor these types of loans properly.

- *Lien Perfection* - The institution periodically allows perfected interests in collateral to lapse by not filing timely Uniform Commercial Code continuation statements. An effective tickler system to assist in keeping filings current is necessary to prevent a loss in collateral protection.

President Lincoln stated loan officers would immediately begin performing pre-purchase analyses on participations purchased. She also stated that the volume of documentation deficiencies is primarily due to understaffing and indicated management is in the process of hiring an additional loan clerk to assist in this area.

Other Real Estate (ORE)

Management maintains appropriate policies and procedures for acquiring, holding, and disposing of ORE. However, due to deterioration in existing credits, the dollar volume of adversely classified ORE increased

$535M, or 78 percent, since the previous examination. The ORE portfolio primarily consists of CRE previously written down to fair value. The $100M ORE Loss classification reflected in this Report is based on the recently obtained (August 3, 2012), appraised value of the Rolly property.

Concentrations

Several asset concentrations, including a fishing industry concentration, are listed on the Concentrations page. The concentrations are not criticized due to current risk levels. However, management does not currently have procedures in place to identify and monitor such concentrations. Given the potential for increased risk posed by asset concentrations, the Board of Directors should establish appropriate policies and procedures to ensure these risks are properly identified and monitored.

President Lincoln indicated she would develop procedures for identifying and monitoring concentrations and present them to the Board for its review and approval by year-end 2012.

Disposition of Assets Classified Loss

President Lincoln stated that assets classified Loss totaling $1,015M will be charged off by September 30, 2012.

EARNINGS - 4

Earnings performance remains poor. As detailed on the Analysis of Earnings page of this Report, the bank experienced significant operating losses in 2010 and 2011. Although the bank shows net operating income of $103M for the first six months of 2012, profits are substantially overstated due to inadequate provisions for loan losses. As reflected on the Examination Data and Ratios page, the bank will show a negative 0.58 percent Return on Average Assets, based on a net operating loss of $222M, after amending the June 30, 2012 Call Report for the additional $325M ALLL provision.

The poor earnings performance is a direct result of persistent poor asset quality and increasing ORE levels. The high level of nonperforming assets has weakened interest income, required high ALLL provisions, and increased overhead expenses. Although the volume of nonaccruals and other nonearning assets remain high, the net interest margin for the first six months of 2012 improved from 4.37 percent at year-end 2011 to 4.74 percent as of June 30, 2012. This improvement is primarily the result of management's ability to maintain average interest rates in the loan portfolio above 5 percent, while reducing the average cost of funds to below 1 percent.

Total Noninterest Expense as a percentage of Average Assets has steadily increased over the last three years and reached 3.82 percent as of June 30, 2012. Overhead expenses are nearly 100 basis points above comparable institutions, primarily due to expenses associated with ORE. Given the composition and level of problem assets, management does not expect ORE-related expenses to diminish in the near future. Overhead expenses will also increase due to the planned hiring of additional lending personnel. However, in an effort to reduce overhead, management plans to close the institution's only branch office on September 30, 2012.

The 2012 budget forecasts net income of $226M. With the exception of inaccurate assumptions related to the level of provision expense, the budgeting process is adequate and the assumptions used are reasonable. Future profitability is primarily dependent on improved asset quality and controlled overhead expenses.

Chairman of the Board Sean Ratzlaff stated that the directorate and senior management would revise the budget to depict provision expense levels more accurately. He directed President Lincoln to have the revised budget ready for Board review and approval at the November 2012 Board meeting.

MANAGEMENT - 3

The overall performance of senior management and the Board of Directors remains less than satisfactory. The bank's current financial condition is primarily the result of liberal lending policies and poor credit administration practices. As documented in prior examination reports, the present management team aggressively pursued loan growth without regard for prudent lending standards and, ultimately, asset quality. Although initial signs of more prudent loan underwriting and improved credit administration are evident, asset quality remains weak and significant aspects of the credit function remain deficient as discussed in detail under Asset Quality.

Board Supervision

Board minutes indicate that Chairman Ratzlaff and President Lincoln dominate policy discussions and decisions. Board members should ensure they adequately fulfill supervisory responsibilities. For example, Director Michael D. Jones attended only 5 of the 12 Board meetings held since the previous examination. Regular attendance at Board and committee meetings is a prerequisite to fulfilling the duties of a director; directors who are unable to meet this obligation should consider resignation. The absence of formal strategic objectives and the inadequacy of written policies have compounded the difficulties of the bank's directors, particularly the outside directors, in fully discharging their oversight responsibilities.

Director Jones stated that he frequently travels out of town on business; however, he committed to attending Board meetings on a more regular basis.

Apparent Violations

Examiners cited apparent violations of the Treasury Department's Bank Secrecy Act regulations for late CTR filings and the Federal Reserve Board's Regulation O for two insider loans that did not receive full Board approval. An apparent violation of the BSA was also cited at the last FDIC examination, and although the number of late filings has declined, repeat infractions reflect unfavorably on the Board and management. The Board of Directors should implement improved controls and procedures to ensure timely CTR filings and appropriate Regulation O loan approvals.

Chairman of the Board Ratzlaff committed to improve BSA and Regulation O controls and promised future compliance.

Strategic Planning

The 2010 strategic plan has not been maintained and is inconsistent with the present condition of the institution, the regional economy, and the local competitive environment. Specifically, the plan's assumptions do not consider the continuing decline of the local fishing industry, the potential impact of a new commercial bank in town, or the recent merger of two local savings and loan associations. Based on these factors, many of the goals and strategies in the plan are outdated and unrealistic. The Board should revise the current plan to address these factors and conditions.

Chairman Ratzlaff stated that the strategic plan would be reviewed and updated before the end of 2012.

Audit and Internal Control

The audit and internal control functions lack independence. While the scope and frequency of the internal audit program are acceptable, Internal Auditor Jasmine Jackson reports directly to President Lincoln. Since President Lincoln is ultimately responsible for most of the day-to-day operations reviewed by the internal auditor, this situation compromises the independence of the internal audit program. The internal auditor should report directly to the Board of Directors or the Audit Committee of the Board to ensure the independence and effectiveness of the audit function. President Lincoln is also a member of the Audit Committee, which oversees the external audit function. Her presence on the committee further limits audit independence. Several outside directors are qualified to serve on the Audit Committee and it is recommended that the Board strengthen the audit function by limiting committee membership to outside directors.

Several internal control deficiencies are detailed under Item 5 of the Risk Management Assessment section of this Report. While these deficiencies are relatively minor, management incorrectly reported that two of these items were corrected in the response to the last external audit. This error underscores the need for more independence in the audit function.

Chairman of the Board Ratzlaff stated that the Board would consider these recommendations at its next meeting. He also stated the internal control deficiencies would be addressed by the end of 2012.

Reports of Condition and Income

Material errors were noted in the last three quarterly Reports of Condition and Income. In numerous cases, examiners were unable to reconcile bank records with the quarterly filings. The most significant errors relate to inaccurately reported interest and fee income on loans, and the inappropriate inclusion of gains on the sale of repossessed assets in interest and fee income.

Executive Vice President/Cashier John M. Gutierrez stated he will file amended June 30, 2012, Reports of Condition and Income, prior to September 30, 2012, to address these issues.

Bank Secrecy Act

The BSA program is generally satisfactory; however, examiners cited apparent violations of Title 31 C.F.R Chapter X Section 1010.306(a)(1) of the Treasury Department's Bank Secrecy Act regulations. The apparent violations relate to Currency Transaction Reports that were not filed within prescribed periods. Refer to the Violations of Laws and Regulations page for additional details.

President Lincoln indicated procedures would be implemented within 90 days to ensure CTRs are submitted in a timely manner.

Office of Foreign Assets Control (OFAC)

Effective policies, procedures, and controls are in place to ensure satisfactory compliance with OFAC regulations.

CAPITAL - 3

Capital is less than satisfactory in relation to the bank's risk profile. The Adversely Classified Items Coverage Ratio remains high at approximately 84 percent. In addition, after making needed provisions to fund the ALLL adequately, the bank has had net operating losses over the past two and a half years. The existing concentration in fishing industry loans, considering the industry's current depressed condition and anticipated continuing decline, adds to capital concerns. The Tier 1 Leverage Capital ratio of 7.44 percent, detailed on the Examination Data and Ratios page, reflects current examination adjustments for assets classified Loss and the provision expense needed to fund the ALLL appropriately.

President Lincoln pointed out that dividends have not been paid for five years. She further stated that no dividends would be paid until the Tier 1 Leverage Capital ratio exceeds eight percent and earnings become positive and stable.

LIQUIDITY - 2

The bank's liquidity position is satisfactory. Asset growth has been minimal since the prior examination and the loan portfolio is shrinking. Management has increased the volume of investments in mortgage-backed securities, with the portfolio maintaining slight appreciation. Non-core funding has increased slightly but management is using these funds appropriately. While liquidity levels and funds management practices are generally satisfactory, management should develop a written funds management policy and a contingency funding plan commensurate with the bank's risk profile. Off-balance sheet commitments are minimal.

President Lincoln stated a written funds management policy and a contingency funding plan would be developed by March 31, 2013.

SENSITIVITY TO MARKET RISK - 2

Sensitivity to market risk is moderate and risk management practices are satisfactory. Funding sources reasonably match the bank's asset repricing structure, and the loan portfolio includes a high volume of adjustable-rate commercial loans. Over the past two years, depositors have moved funds out of maturing time deposits and into money market demand accounts. Management actively manages rates on these deposits, as the local market is very competitive. The bank does not engage in off-balance sheet derivative activity.

Management regularly monitors the bank's rate sensitivity position using income simulations and an economic value of equity model. Management presents detailed quarterly reports to the Board. However, management and the Board should establish, and monitor compliance with, policy limits that reflect the board's interest rate risk tolerance.

Chairman of the Board Ratzlaff stated that management and the Board would establish interest rate risk policy limits by year-end 2012.

TRUST - 2

The Trust Department operates in general conformance with the Statement of Principles of Trust Department Management. The Board and management's performance and risk management practices are satisfactory relative to the size of the department and the complexity of trust activities. Only moderate weaknesses are present and within management's ability to correct.

The Board adopted a general Trust Policy, but should consider adding policy criteria regarding environmental reviews of real estate that may be held in current or future trust accounts.

Trust Officer Nancy Hancock agreed to develop such guidance for the Board's consideration by the end of the year.

Account administration is generally in compliance with originating documents. Potential conflicts of interest exist from the trust department using own-bank deposits, as well as from holding stock of the parent holding company and an affiliate in one trust account. Trust Officer Hancock surveys local deposit rates to ensure competitive rates are being paid on deposits, but does not maintain documentation of her surveys.

Trust Officer Hancock stated she would maintain documentation of comparable rates in the future.

Asset management practices are generally satisfactory. All account transactions, including discretionary disbursements, are included in monthly Board reports, and the Board reviews all accounts annually. Management should annually document its needs assessment for each applicable account and/or beneficiary, and indicate whether the account's investment mix is meeting those needs. In addition, three trust accounts use fixed income and/or equity mutual funds. Qualified staff should annually review each mutual fund's investment mix and performance relative to an appropriate benchmark.

Trust Officer Hancock committed to documenting annual needs assessments for each trust account, as well as annual mutual fund reviews.

INFORMATION TECHNOLOGY - 2

Overall IT performance is satisfactory. The IT Steering Committee regularly reviews the performance and controls of the bank's computer center and service providers; however, documentation of the committee's 2011 review of critical service providers was incomplete. Management should appropriately document vendor reviews to ensure key service providers are financially viable, adequately protecting customer data, and meeting service level agreements.

President Lincoln stated management would appropriately document all vendor reviews in the future. She added that management would obtain and analyze financial statements, audit reports, continuity plans and tests, and contractual performance results for all critical service provider reviews.

The current IT risk assessment identifies information assets, threats to information assets and data, and controls to mitigate identified threats. However, management has not estimated the probability or impact of identified threats. To ensure risk assessments are properly supported, management should assess and rate both the probability of occurrence and potential impact of all identified threats.

President Lincoln indicated management would assess and rate the probability of occurrence and potential impact of threats in all IT risk assessments completed after September 31, 2012.

The bank is in substantial compliance with the Interagency Guidelines Establishing Standards for Safeguarding Customer Information set forth in Part 364, Appendix B, of the FDIC Rules and Regulations. However, better documentation of the Board's annual review of the Information Security Program could be achieved by including a copy of the presentation in the official Board packet.

Chairman Ratzlaff indicated the documentation would be made a part of the Board's official records in the future.

MEETING WITH THE DIRECTORATE

A Board of Directors meeting was held on September 18, 2012. All directors were present with the exception of Director Henry P. Herrington. William E. Smith, partner in the bank's auditing firm, was also present. Deputy Commissioner of Banking Cynthia B. Jones represented the State Department of Banking. Field Supervisor James D. Gilmore, Examiner-in-Charge Sandra E. Smart, and Financial Institutions Examiner Monica D. Powers represented the FDIC. All matters listed above were discussed with the Board. Most of the discussion concerned the increase in severity of adverse classifications, the need to improve the ALLL methodology, and management's efforts to improve loan administration procedures. The Directorate and management's commitments for corrective action are noted above. Chairman of the Board Ratzlaff asserted that because of the improvement in the bank's overall condition, the MOU should be removed.

DIRECTORATE RESPONSIBILITY

Each member of the Board of Directors is responsible for reviewing this Report of Examination. Each Director must sign the Signatures of Directors page, which affirms that he or she reviewed the Report in its entirety.

Examiner (Signature)	Reviewing Official (Signature) and Title
Sandra E. Smart	Dale K. Watson, Assistant Regional Director

A Memorandum of Understanding (MOU) between the FDIC and the bank became effective on January 21, 2011. Provisions of the MOU that require further efforts or are of a continuing nature are detailed below.

2(b). The bank shall maintain an adequate Allowance for Loan and Lease Losses.

Based on this examination's findings, the Allowance for Loan and Lease Losses is underfunded by at least $325M. Refer to the Examination Conclusions and Comments (ECC) page of this Report for details.

3(a). The bank shall maintain a Tier 1 Leverage Capital ratio at or in excess of seven percent.

As of June 30, 2012, the Tier 1 Leverage Capital ratio approximates 7.44 percent based on management's planned amendments to the Call Reports.

3(d). The bank shall comply with the FDIC's Statement of Policy on Risk-Based Capital.

As of June 30, 2012, the Total Risk-Based Capital ratio is 11.75 percent, and the Tier 1 Risk-Based Capital ratio is 10.48 percent.

4. The bank shall file accurate Call Reports.

Examiners noted significant errors in the December 31, 2011, and the March 31 and June 30, 2012, Call Reports which require amendments. Refer to the ECC page for details.

5. The bank shall not extend or renew, directly or indirectly, credit to, or for the benefit of, any borrower who has a loan or other extension of credit with the bank that has been charged off or classified, in whole or in part, Loss, Doubtful, or Substandard, unless rationale for the extension is noted in the official Board minutes and the appropriate credit file.

On January 30, 2012, the bank extended a $50M loan to U. R. Worth. The borrower was adversely classified Loss at the previous examination. The Board did not specifically document the reason(s) for the extension in the official Board minutes or in the appropriate credit file.

6. The bank shall not declare or pay any dividends without the written consent of the FDIC.

No dividends have been declared or paid since the previous examination.

1. Are risk management processes adequate in relation to economic conditions and asset concentration levels?

No. The Board's strategic plan is outdated and unrealistic. In addition, management makes no effort to monitor asset concentrations. A concentration of credit in the fishing industry, which is projected to remain depressed for the foreseeable future, is listed on the Concentrations page of this Report. Recommendations to improve oversight practices are included on the ECC pages.

2. Are risk management policies and practices for the credit function adequate?

No. Internal credit review and grading are weak, and credit administration practices are deficient. Recommendations for improvement are included under Asset Quality on the ECC page. Additionally, although the bank's loan policy is generally adequate, it does not address the following matters:

- *Participation Loans* - The bank regularly purchases loans or portions of loans from other institutions. These specialized lending activities are not covered in the loan policy.

- *Construction Loans* - The bank finances the construction of 1-4-family residences. While practices are generally adequate, the policy lacks specific guidelines pertaining to construction lending. President Lincoln was provided with a detailed list of issues that should be considered.

- *Environmental Risk* - An environmental risk policy is nonexistent. Examiners provided FDIC environmental-risk program guidelines to management.

President Lincoln stated that management would develop guidelines for purchased loans and construction lending and revise the loan policy by December 31, 2012. She further stated management is currently developing an environmental risk policy.

3. Are risk management policies and practices for asset/liability management and the investment function adequate?

Generally, yes. Management's liquidity management practices are generally adequate; but does not have a written funds management policy or a contingency funding plan. These deficiencies are discussed more fully on the ECC page in the Liquidity comment.

Investment policy guidelines are adequate; however, management's adherence to its written investment policy is inconsistent. On at least three occasions since the previous examination, President Lincoln exceeded her purchasing authority when she purchased securities over $250M without prior Board approval.

The Board should ensure management purchases investments in conformance with existing policy standards or determine if it would be prudent to revise the standards to meet purchasing needs.

President Lincoln stated that she was presented with the opportunity to purchase these securities at a good price and could not wait for Board approval. She further stated she would comply with the policy in the future or discuss modifying the policy with the Board at the next Board meeting.

4. Are risk management processes adequate in relation to, and consistent with, the institution's business plan, competitive conditions, and proposed new activities or products?

No. The strategic plan is outdated. Refer to comments under Management on the ECC page.

5. Are internal controls, audit procedures, and compliance with laws and regulations adequate (includes compliance with the Bank Secrecy Act [BSA] and related regulations)?

No. As indicated under Management on the ECC page, apparent violations of Bank Secrecy Act regulations and Regulation O are cited during this examination. Full details of these citations can be found on the Violations of Laws and Regulations page. In addition, the audit and internal control functions lack independence.

<u>Internal Controls</u>

Examiners noted the following weaknesses in the bank's system of internal controls:

- *<u>Joint Custody of Negotiable Collateral</u>* – The bank does not maintain joint custody over negotiable collateral. Several bearer bonds are maintained in a dual-lock drawer in the vault; however, both keys to the drawer are readily accessible to tellers. The bank's external certified public accountant also noted this deficiency in her December 2011 audit. Management should implement an effective system of joint custody.

- *<u>Vacation Policy</u>* – The bank's vacation policy requires employees to be absent from their normal duties for an uninterrupted period of two weeks each calendar year. Executive Vice President Leslie S. Commander did not remain absent during her two-week vacation in 2011 as she returned daily to reconcile the Federal funds sold account. Management is strongly encouraged to enforce its policy, particularly for employees who are responsible for sensitive transactions.

- *<u>Reconcilement of Correspondent Bank Accounts</u>* – Management has not reconciled the correspondent bank accounts for the past three months. While personnel reconciled these accounts during the examination, they should be reconciled at least monthly.

President Lincoln stated she would take action to address these deficiencies before year-end.

6. Is Board supervision adequate, and are controls over insider transactions, conflicts of interest, and parent/affiliate relationships acceptable?

No. Board supervision is less than satisfactory. Numerous underwriting weaknesses and credit administration deficiencies remain uncorrected from prior examinations, and the Board has not established an effective independent internal audit function. Refer to comments under Management on the ECC page for more details. Additionally, examiners cited two loans as apparent violations of Federal Reserve Regulation O because management did not obtain prior approval on loans to the related interests of President Lincoln and Director Larry G. Killingbird. Refer to the Violations of Laws and Regulations page of this Report for details.

BANK SECRECY ACT

Title 31 C.F.R Chapter X Section 1010.306(a)(1) of the Treasury Department's Bank Secrecy Act regulations requires a covered financial institution to file a Currency Transaction Report (FinCEN Form 104) within the prescribed period.

Examiners identified numerous instances where CTRs were not filed within the required 15-day period. This infraction was also cited at the previous FDIC examination. Between October 2011 and July 2012, 289 of 944 CTRs (31 percent) were filed late. In many cases, CTRs were signed by the approving official more than 15 days after the transaction date. The time between the transaction date and receipt by the Treasury Department on these late filings was generally around 20 to 25 days, with a few exceeding 70 days.

BSA Officer Donna Ludlow stated that some of the late CTRs were filed after an internal audit noted that the forms had not been submitted; however, she could offer no explanation as to why the remaining CTRs were filed late. President Lincoln stated that new procedures would be implemented within 90 days to ensure all CTRs are submitted in a timely manner in the future.

PRIOR BOARD APPROVAL OF INSIDER LOANS – REGULATION O

The Federal Reserve Board's Regulation O, which implements Section 22(h) of the Federal Reserve Act and is made applicable to insured nonmember institutions by Section 18(j)(2) of the Federal Deposit Insurance Act covers transactions with bank insiders. Section 215.4(b)(1) of Regulation O requires extensions of credit by an institution to a director or related interest exceeding the greater of $25M or five percent of unimpaired capital and surplus to have prior approval of the institution's board of directors.

The bank is in apparent violation of this section for extending the following loans with the prior approval of the Executive Loan Committee, which is composed of only three Board members, rather than prior approval by the full Board.

Borrower	Date of Note	Original Amount
Lincoln, Allie C.	12/11/2011	$500M
Any Body, Inc. (A related interest of President Lincoln and Director Killingbird.)	12/28/2011	$250M

President Lincoln stated that these exceptions were the result of oversight. She further indicated that bank policy requires that all insider loans receive the prior approval of the full Board. Examiners noted that all other insider loans received prior Board approval. President Lincoln and the Board of Directors promised future compliance.

ASSET QUALITY		ADVERSELY CLASSIFIED			
		Substandard	Doubtful	Loss	Total
Loans and Leases		4,290	140	890	5,320
Securities		45			45
Other Real Estate Owned		1,125		100	1,225
Other Assets				25	25
Other Transfer Risk					
Subtotal		5,460	140	1,015	6,615
Contingent Liabilities		230			230
Totals at Exam Date	06/30/2012	5,690	140	1,015	6,845
Totals at Prior Exam	09/30/2011	7,345	220	194	7,759
Totals at Prior Exam	09/30/2010	6,655	177	67	6,899

	Exam Date 06/30/2012	Prior Exam 09/30/2011	Prior Exam 09/30/2010
Total Special Mention	354	515	
Adversely Classified Items Coverage Ratio	84.41	102.71	94.92
Total Adversely Classified Assets/Total Assets	8.21	9.93	8.20
Past Due and Nonaccrual Loans and Leases/Gross Loans and Leases	6.76	8.42	9.12
Adversely Classified Loans and Leases/Total Loans	9.86	12.68	11.30
ALLL/Total Loans and Leases	3.67	3.18	2.50

CAPITAL	Exam Date 06/30/2012	Prior Exam 09/30/2011	Prior Exam 09/30/2010
Tier 1 Leverage Capital/Average Total Assets (1)	7.44	7.55	7.67
Tier 1 Risk-Based Capital/Risk-Weighted Assets	10.48	9.88	9.90
Total Risk-Based Capital/Risk-Weighted Assets	11.75	11.39	11.40
Capital Category			
The capital category relates only to the Prompt Corrective Action provisions of Part 325 of the FDIC Rules and Regulations. PCA Categories: W – Well-capitalized, A – Adequately capitalized, U – Undercapitalized, S – Significantly undercapitalized, C – Critically undercapitalized	W	W	W

	Period Ended 06/30/2012	Peer 06/30/2012	Period Ended 12/31/2011	Period Ended 12/31/2010
Retained Earnings/Average Total Equity	3.39	9.32	(2.05)	(3.86)
Asset Growth Rate	2.66	6.78	0.42	0.20
Cash Dividends/Net Income		32.65		

EARNINGS	Period Ended 06/30/2012	Peer 06/30/2012	Period Ended 12/31/2011	Period Ended 12/31/2010
Net Income (After Tax)/Average Assets (1)	(0.58)	1.03	(0.15)	(0.30)
Net Interest Income (TE)/Average Earning Assets	4.74	4.64	4.37	4.64
Total Noninterest Expense/Average Assets	3.82	2.90	3.62	3.54

LIQUIDITY	Period Ended 06/30/2012	Peer 06/30/2012	Period Ended 12/31/2011	Period Ended 12/31/2010
Net Non-Core Funding Dependence New $100M	12.23	10.35	14.67	9.63
Net Non-Core Funding Dependence New $250M *	64.45	66.20	68.79	69.24
Net Loans and Leases/Assets	57.69	52.47	51.60	68.21

(1) 6/30/10 Ratio reflects management's planned $325M adjustment to the ALLL.

* Ratio reflects time deposits exceeding the $250M deposit insurance limit as non-core funding; data not collected prior to 3/31/10.

Comparative Statements of Financial Condition | 99999

ASSETS	06/30/2012	12/31/2011
Total Loans and Leases	53,931	55,545
Less: Allowance for Loan & Lease Losses	1,979	1,748
Loans and Leases (net)	51,952	53,797
Interest-Bearing Balances	20	
Federal Funds Sold and Securities Purchased Under Agreements to Resell	4,000	9,100
Trading Account Assets		
Securities: Held-to-Maturity (at Amortized Cost)	2,787	5,993
Available-for-Sale (at Fair Value)	10,888	
Total Earning Assets	**69,647**	**68,890**
Cash and Noninterest-Bearing Balances	5,895	4,743
Premises and Fixed Assets	2,530	2,709
Other Real Estate Owned	1,225	690
Intangible Assets		
Other Assets	1,307	1,175
TOTAL ASSETS	**80,604**	**78,207**
LIABILITIES		
Deposits	67,815	66,221
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	441	516
Other Borrowed Money	5,857	5,136
Other Liabilities	301	307
Subordinated Notes and Debentures		
Total Liabilities	**74,414**	**72,180**
Minority Interest in Consolidated Subsidiaries		
EQUITY CAPITAL		
Perpetual Preferred Stock		
Common Equity Capital	6,190	6,027
Includes net unrealized holding gains (losses) on available-for-sale securities.		
Other Equity Capital		
Total Equity Capital	**6,190**	**6,027**
TOTAL LIABILITIES, MINORITY INTERESTS, AND EQUITY CAPITAL	**80,604**	**78,207**
OFF-BALANCE SHEET ITEMS		
Unused Commitments	4,333	5,893
Letters of Credit	209	824
Other Off-Balance Sheet Items		
Other Derivative Contracts		
Appreciation (Depreciation) in Held-to-Maturity Securities	56	

Footnotes:

Loans and Lease Financing Receivables | 99999

Date: 06/30/2012

Category:	Amount	Percent
Real Estate Loans	21,938	40.53
Installment Loans	7,058	13.04
Credit Card and Related Plans	90	0.17
Commercial Loans	22,292	41.18
All Other Loans and Leases	2,753	5.09
Gross Loans and Leases	54,131	100.00

PAST DUE AND NONACCRUAL LOANS AND LEASES

Date: 06/30/2012

Category	Past Due 30 through 89 Days and Accruing	Past Due 90 Days or More and Accruing	Total Past Due and Accruing	Percent of Category	Nonaccrual	Nonaccrual Percent of Category
Real Estate Loans	800	44	844	3.85	1,402	6.39
Installment Loans	125		125	1.77	107	1.52
Credit Card and Related Plans	3		3	3.33		
Commercial and All Other Loans and Leases	626		626	2.50	554	2.21
Totals	1,554	44	1,598	2.95	2,063	3.81
Memorandum Restructured Loans and Leases Included in the Above Totals						

Footnotes:

Description	HELD-TO-MATURITY		AVAILABLE-FOR-SALE	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
U.S. Treasury Securities	1,537	1,593		
U.S. Government Agency Obligations				
Issued by U.S. Gov't Agencies			2,550	2,554
Issued by U.S. Gov't-sponsored Agencies				
Issued by States & Political Subdivisions	250	250		
Mortgage-backed Securities (MBS)				
Pass-through Securities:				
Guaranteed by GNMA			7,322	7,415
Issued by FNMA and FHLMC				
Other pass-through securities				
Other MBS (include CMOs & REMICs):				
Issued or Gtd. by FNMA, FHLMC, or GNMA				
Collateralized by MBS Issued or Gtd. by FNMA, FHLMC, or GNMA				
All Other Mortgage-Backed Securities				
Asset-backed Securities (ABS)				
Credit Card Receivables				
Home Equity Lines				
Automobile Loans				
Other Consumer Loans				
Commercial and Industrial Loans				
Other				
Other Debt Securities				
Other Domestic Debt Securities				
Foreign Debt Securities	1,000	1,000		
Equity Securities				
Investments in Mutual Funds and Other Equity Securities with Readily Determinable Fair Values			919	919
Totals:	2,787	2,843	10,791	10,888

SECURITIES APPRECIATION (DEPRECIATION)

Description	Held-to-Maturity	Available-for-Sale	Total
Securities Appreciation (Depreciation)	56	97	153
As a Percent of Amortized Cost	2.01	0.90	1.13

Footnotes:

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

		CATEGORY	
AMOUNT, DESCRIPTION AND COMMENTS	Substandard	Doubtful	Loss
500 (1) Nonaccrual 96 Days Past Due			
250 (2) Nonaccrual 96 Days Past Due			
750	750		

Note: Ensure write-ups are consistent with the RMS Manual of Examination Policies and ROE Instructions.

LOANS

AMHILL TOOL & DIE, INC.
By: Robert E. Hill, President
Gty: Roger S. Barrett

Amhill Tool & Die, Inc. manufactures custom plastic-forming dies and provides injection-molding services.

(1) Note originated 1/7/08 at $500M to refinance a $450M mortgage on the obligor's manufacturing plant and provide $50M working capital. The note matures 1/7/15 and requires interest-only payments, with principal due on demand. (2) Term note originated 6/10/09 at $280M, matures 6/11/16, and was extended to refinance a working capital note at another financial institution. The primary source of repayment for both notes is operating cash flow.

The loans are cross collateralized by a first mortgage on the manufacturing plant, located in Anytown, Anystate, and a first security interest in all business assets. A 12/7/07 appraisal reflects a property value of $625M; however, the valuation appears stale given downward trends in local real estate values. As of 12/31/11, management estimated the value of account receivables and inventory at $100M and assigned an estimated liquidation value of $125M to machinery and equipment. Reliance on the machinery and equipment as a secondary repayment source is restricted by their highly specialized nature and limited marketability.

Amhill Tool & Die, Inc. has been negatively impacted by cancelled contracts and high employee turnover. Weak cash flows have caused on-going delinquency problems and management placed the notes on nonaccrual on 3/31/12. The obligor's 12/31/11 income statement reported gross income of $800M and a net operating loss of $100M. Gross sale revenues declined steadily since year-end 2008, and operating losses of $123M and $234M were reported as of 12/31/09 and 12/31/10, respectively. Net worth declined to $125M at year-end 2011, and debt service coverage was calculated at 0.91 times as of 12/31/11. The guarantor's 12/31/10 personal financial statement reflects liquid assets of $30M, a net worth of $375M, and total assets of $890M centered in his ownership interest in Amhill Tool & Die, Inc.

EVP/SLO Commander indicated managerial conflicts contributed to the loss of several lucrative contracts and numerous highly trained employees; however, he stated production output is increasing due to the addition of two knowledgeable managers and improved employee training. He also stated management intends to obtain a new property appraisal, restructure the notes to better match the corporation's cash flows, and to require principal and interest payments on the modified mortgage note.

AMOUNT, DESCRIPTION AND COMMENTS	CATEGORY Substandard	Doubtful	Loss

Debts classified Substandard based on inadequate cash flows, continuing delinquencies, and marginal collateral protection.

Internal Rating: 6 (Watch)
Originating/Servicing Officer: Commander
Examiner: T. Hinojosa

AMOUNT, DESCRIPTION AND COMMENTS	Substandard	Doubtful	Loss
340 BOND, JAMES	200	140	
1,250 IRMA DEAT, LTD.	750		500
290 KRING, CHRISTOPHER Gty: Sam Kring, Inc.	290		
865 LAST CHANCE MOTEL, INC.	500		365
275 RABBIT, PETER	250		25
1,550 EIGHT LOANS LESS THAN $250,000 List left with management.	1,550		
TOTAL ADVERSELY CLASSIFIED LOANS	4,290	140	890
SECURITIES			
45 ANYCOUNTY MUNICIPAL GENERAL OBLIGATION	45		
TOTAL ADVERSELY CLASSIFIED SECURITIES	45		

Items Subject to Adverse Classification (Continued)			99999
		CATEGORY	
AMOUNT, DESCRIPTION AND COMMENTS	Substandard	Doubtful	Loss
OTHER REAL ESTATE OWNED			
550 ONE WAY HOME, INC. PROPERTY	550		
675 ROLLY PROPERTY	575		100
TOTAL ADVERSELY CLASSIFIED ORE	1,125		100
OTHER ASSETS			
25 SUN, RAYMOND Repossessed Heavy Equipment			25
TOTAL ADVERSELY CLASSIFIED OTHER ASSETS			25
CONTINGENT LIABILITIES			
230 KRING, CHRISTOPHER	230		
Amount represents unfunded portion of loan commitment for construction of a single-family residence.			
TOTAL ADVERSELY CLASSIFIED CONTINGENT LIABILITIES	230		
TOTAL ADVERSELY CLASSIFIED ITEMS	5,690	140	1,015

Items Listed for Special Mention	**99999**

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

DESCRIPTION	AMOUNT

Note: Ensure write-ups are consistent with the RMS Manual of Examination Policies and ROE Instructions.

LOANS

354 RAIN, ROBERT	354
TOTAL LOANS LISTED FOR SPECIAL MENTION	354

Analysis of Loans Subject to Adverse Classification

99999

DESCRIPTION	SUBSTANDARD	DOUBTFUL	LOSS	TOTAL
Book Value at Last Examination: 09/30/2011	6,641	220	176	7,037
Reductions:				
Payments	1,030	58		1,088
Not Now Adversely Classified	955	162		1,117
Now Classified Substandard				
Now Classified Doubtful	140			140
Now Classified Loss	890			890
To Other Real Estate or Other Assets				
Charged-Off	209		176	385
TOTAL REDUCTIONS	3,224	220	176	3,620
Additions:				
Not Adversely Classified Previously	873			873
Further Advances - Loans				
Not Adversely Classified Previously				
Further Advances - Loans				
Adversely Classified Previously				
Credits Newly Extended				
Previously Classified Substandard		140	890	1,030
Previously Classified Doubtful				
Previously Classified Loss				
TOTAL ADDITIONS	873	140	890	1,903
Book Value at This Examination: 06/30/2012	4,290	140	890	5,320

Analysis of Other Real Estate Owned Subject to Adverse Classification | 99999

DESCRIPTION	SUBSTANDARD	DOUBTFUL	LOSS	TOTAL
Book Value at Last Examination: 09/30/2011	672		18	690
Reductions:				
Not Now Adversely Classified				
Sales With Outside Financing				
Sales With Financing Provided By Subject Institution				
Now Classified Substandard				
Now Classified Doubtful				
Now Classified Loss	100			100
Charged-Off			18	18
TOTAL REDUCTIONS	100		18	118
Additions:				
Not Adversely Classified Previously	550			550
Further Advances - ORE or Loans Not Adversely Classified Previously				
Transferred from Previously Adversely Classified Loans				
Further Advances - ORE or Loans Adversely Classified Previously	3			3
ORE From Credits Newly Extended				
Previously Classified Substandard ORE			100	100
Previously Classified Doubtful ORE				
Previously Classified Loss ORE				
TOTAL ADDITIONS	553		100	653
Book Value at This Examination: 06/30/2012	1,125		100	1,225

Assets with Credit Data or Collateral Documentation Exceptions	99999

This Page includes assets with technical defects not corrected during the examination. The appropriate number or description is noted in the "Deficiency Description" column.

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

Name or Description	Amount	Date of Most Recent Financial Statement	Deficiency Description
LOANS			
AMHERST, MARY	400	None	7
BODY, CHARLES	1,932	12/31/10	7
C&C MARINA	1,973	06/30/10	7
GOETZ, MICHAEL	1,538	None	1
IRMA DEAT, LTD.	750		4, 6
JENNINGS, JENNIFER	1906		5, 6
KRING, CHRISTOPHER	290		4, 5, 6
Gty: Sam Kring		None	7
LAST CHANCE MOTEL, INC.	500		3, 4, 6
TOTAL	9,289		

Total represents 33 percent of the dollar volume of loans reviewed.

Name or Description	Amount	Date of Most Recent Financial Statement	Deficiency Description
OTHER REAL ESTATE OWNED			
ONE WAY HOME, INC. PROPERTY	550		5
TOTAL	550		

Total represents 45 percent of the dollar volume of ORE reviewed.

Concentrations	99999

Listed below are concentrations of obligations, direct and indirect, according to the following guidelines: 1) Asset concentrations of 25% or more of Tier 1 Capital by individual borrower, small interrelated group of individuals, single repayment source or individual project; 2) Concentrations of 100% or more of Tier 1 Capital by industry, product line, type of collateral, or short term obligations of one financial institution or affiliated group. Any other concentrations may be listed in the 25% category if desired. An appropriate percentage of total assets is used when a bank's capital is so low as to make its use meaningless. U.S. Treasury securities, obligations of U.S. Government agencies and corporations, and any assets collateralized by same are not scheduled.

DESCRIPTION	DETAIL	AMOUNT EXTENDED
CORRESPONDENT BANK CONCENTRATIONS		
FIRST NATIONAL BANK Anothercity, Anotherstate		
Due From Account	3,025	
Federal Funds Sold	4,000	
		7,025
This concentration represents 124 percent of Tier 1 Capital.		
CREDIT CONCENTRATION		
John and Mary Smith Relationship		
John Smith		
Consumer installment	75	
John and Mary Smith		
RE mortgage	275	
JMS Corporation		
JM: John and Mary Smith		
Secured commercial loans (3)	685	
Commercial letters of credit (2)	215	
J&M Realty Trust		
Gty: John and Mary Smith		
Commercial RE mortgage	700	
		1,950
This concentration represents 34 percent of Tier 1 Capital.		
INDUSTRY CONCENTRATION		
Shellfish Fishing Industry (NAICS Code 114112)		8,694
This amount is composed of 49 loans to fishing industry-related borrowers. Repayment of these loans is dependent upon the same sources of income and upon extension of fishing rights granted in the Georges Bank by the Canadian Department of Fisheries, which expire in 2013. The industry concentration represents 153 percent of Tier 1 Capital.		

Capital Calculations	99999

Tier 1 Capital		
Perpetual Preferred Stock and Related Surplus		
Common Stock	2,955	
Surplus	3,072	
Retained Earnings	103	
Accumulated Other Comprehensive Income and Other Equity Capital Components	60	
Total Equity Capital	6,190	
Net Unrealized Gains (Losses) on Available-For-Sale Securities (if a gain, deduct from Total Equity Capital in the calculation of Tier 1 Capital, if a loss, add it to Total Equity Capital)	60	
Less: Net Unrealized Losses on Available-For-Sale Equity Securities		
Accumulated Net Gains (Losses) on Cash Flow Hedges (if a gain, deduct from Total Equity Capital in the calculation of Tier 1 Capital, if a loss, add it to Total Equity Capital)		
Less: Nonqualifying Perpetual Preferred Stock		
Qualifying Minority Interest in Consolidated Subsidiaries		
Less: Disallowed Goodwill and Other Disallowed Intangible Assets		
Less: Disallowed Servicing Assets and Purchased Credit Card Relationships		
Less: Disallowed Deferred Tax Assets		
Other Additions to (Deductions from) Tier 1 Capital		
Subtotal: Tier 1 Capital Elements	6,130	
Less: Assets Other Than Loans & Leases Classified Loss	125	
Less: Additional Amount to be Transferred to Tier 2 for Inadequate Allowance for Loan and Lease Losses	325	
Other Adjustments to (from) Tier 1 Capital (1)		
Tier 1 Capital		5,680
Tier 2 Capital		
Qualifying Subordinated Debt and Redeemable Preferred Stock		
Cumulative Perpetual Preferred Stock Includible in Tier 2 Capital		
Allowance for Loan & Lease Losses	1,979	
Less: Loans & Leases Classified Loss	890	
Add: Amount Transferred from Tier 1 Capital	325	
Adjusted Allowance for Loan & Lease Losses	1,414	
Less: Ineligible Portion of Allowance (If Applicable)	728	
Allowance for Loan and Lease Losses Includible in Tier 2 Capital	686	
Unrealized Gains on Available-For-Sale Equity Securities Includible in Tier 2 Capital		
Other Tier 2 Capital Components		
Other Adjustments to (from) Tier 2 Capital		
Tier 2 Capital (Not to Exceed 100% of Tier 1 Capital)		686
Tier 3 Capital Allocated for Market Risk (Tier 3 Plus Tier 2 Not to Exceed 100% of Tier 1 Capital)		
Less: Deductions for Total Risk-Based Capital (1)		
Total Capital		6,366
Risk-Weighted Assets and Average Total Assets Calculations		
Risk-Weighted Balance Sheet Items	55,761	
Risk-Weighted Off-balance Sheet Items	159	
Market Risk Equivalent Assets		
Less: Risk-Weighted Amounts Deducted from Capital	1,015	
Gross Risk-Weighted Assets		54,905
Less: Ineligible Portion of ALLL & ATRR (1)	728	
Total Risk-Weighted Assets		54,177
Average Total Assets (From 06/30/04 Call Report Schedule RC-K)	76,803	
Less: Amounts Deducted from Tier 1 Capital (1)	450	
Adjusted Average Total Assets		76,353
MEMORANDA		
Securities Appreciation (Depreciation)		153
Contingent Liabilities/Potential Loss	4,542/	

Footnotes:

(1) Includes adjustment for financial subsidiaries as defined by the Gramm-Leach-Bliley Act of 1999, if applicable.

Comparative Statement of Income

	Period Ended 06/30/2012	Period Ended 12/31/2011	Period Ended 12/31/2010
Interest Income	2,519	5,582	7,329
Interest Expense	894	2,452	3,850
Net Interest Income	1,625	3,130	3,479
Noninterest Income	304	589	643
Total Noninterest Expense	1,467	2,902	2,904
Provision for Loan and Lease Losses	300	1,025	1,580
Securities Gains (Losses)	15	48	
Net Operating Income (Pre-Tax)	177	(160)	(362)
Applicable Income Taxes	74	(36)	(117)
Net Operating Income (After-Tax)	103	(124)	(245)
Extraordinary Credits (Charges), Net			
Net Income	103	(124)	(245)
Other Increases/Decreases *Includes changes in the net unrealized holding gains (losses) on Available-For-Sale Securities*	60		
Cash Dividends			
Net Change in Equity Accounts	163	(124)	(245)

Reconcilement of Allowance for Loan and Lease Losses

	Period Ended 06/30/2012	Period Ended 12/31/2011	Period Ended 12/31/2010
Beginning Balance	1,748	1,407	950
Gross Loan and Lease Losses	181	884	1,274
Recoveries	112	200	151
Provision for Loan and Lease Losses	300	1,025	1,580
Other Increases (Decreases)			
Ending Balance	1,979	1,748	1,407

Other Component Ratios and Trends

<u>Ratio</u>	Period Ended 06/30/2012	Period Ended 12/31/2011	Period Ended 12/31/2010
Net Interest Income (TE)/Average Earning Assets	4.74	4.37	4.64
Total Noninterest Expense/Average Assets	3.82	3.62	3.54
Net Income/Average Total Equity	3.39	(2.05)	(3.87)
Net Losses/Average Total Loans and Leases	.025	1.24	1.88
Earnings Coverage of Net Losses (X)	6.70	(1.19)	(1.08)
ALLL/Total Loans and Leases	3.67	3.15	2.50
Noncurrent Loans and Leases/ALLL	106.47	143.88	100.64

Footnotes:

Comparative Statements of Income and Changes in Equity Capital Accounts | 99999

ITEMS	06/30/2012	12/31/2011	12/31/2010
INTEREST INCOME:			
Interest and fee income on loans	2,185	4,826	6,305
Income from lease financing			
Interest on balances with depository institutions			
Income on Federal funds sold and repos	66	350	512
Interest from assets held in trading accounts			
Interest and dividends on securities	268	406	512
Other Interest Income			
TOTAL INTEREST INCOME	2,519	5,582	7,329
INTEREST EXPENSE:			
Interest on deposits	858	2,434	3,832
Expense on Federal funds purchased and repos	5	18	18
Interest on demand notes, other borrowed money, mortgages, and capitalized leases.	31		
Interest on subordinated notes and debentures			
TOTAL INTEREST EXPENSE	894	2,452	3,850
NET INTEREST INCOME	1,625	3,130	3,479
NONINTEREST INCOME:			
Services charges on deposit accounts	234	461	415
All other noninterest income	70	128	228
TOTAL NONINTEREST INCOME	304	589	643
NONINTEREST EXPENSE:			
Salaries and employee benefits	750	1,422	1,342
Premises and fixed assets expense (net of rental income)	271	549	584
Amortization expense of intangible assets (including goodwill)			
Other noninterest expense	446	931	978
TOTAL NONINTEREST EXPENSE	1,467	2,902	2,904
Provision for loan and lease losses	300	1,025	1,580
Securities gains (losses)	15	48	
NET OPERATING INCOME (PRETAX)	177	(160)	(362)
Applicable income taxes	74	(36)	(117)
NET OPERATING INCOME (AFTERTAX)	103	(124)	(245)
Extraordinary credits (charges) net of income tax			
NET INCOME	103	(124)	(245)
Other increases in equity capital accounts	60		
Other decreases in equity capital accounts			
Cash dividends declared on common stock			
Net change in equity capital accounts for the period	163	(124)	(245)
Equity capital accounts at beginning of the period	6,027	6,151	6,396
Equity capital accounts at end of the period	6,190	6,027	6,151

Footnotes:

HOLDING COMPANY RATIOS AND TRENDS

	HOLDING COMPANY		
CONSOLIDATED HOLDING COMPANY	(Date)	(Date)	(Date)
Net Operating Income to Average Assets			
Total Risk-Based Capital Ratio			
Leverage Capital Ratio			
This Institution's Assets to Consolidated Holding Company Assets			
PARENT ONLY			
Pre-Tax Operating Income and Interest Expense to Interest Expense (X) (Fixed Charge Coverage)			
Operating Income - Tax + Non-Cash Items to Total Operating Expense and Dividends Paid (Cash Flow Match)			
Total Liabilities to Equity			
Equity Investments in Subsidiaries to Equity (Double Leverage)			
Equity Investment in Subsidiaries - Equity Capital/Net Income - Dividends (Double Leverage Payback in Years)			

EXTENSIONS OF CREDIT TO AFFILIATED ORGANIZATIONS

DESCRIPTION	DIRECT	INDIRECT	TOTAL
A. Affiliated organizations including securities issued by affiliated organizations.	250		250
B. Indebtedness of others, or portions of such indebtedness, collateralized by securities issued by affiliated organizations.			0
Total	250	0	250
Less duplications within and between groups			0
Net Total	250	0	250

Comments:

HOLDING COMPANY

Any Company, Inc.
Anytown, Anystate

SUBSIDIARY

Any Time, Inc.
Anytown, Anystate

OTHER AFFILIATES

Any Body, Inc.
Anytown, Anystate

This page as shown above does not include all information that could be included to support examination findings, but is for illustrative purposes only. Refer to the instructions for this page for specifics.

Extensions of Credit to Directors/Trustees, Officers, Principal Shareholders, and Their Related Interests	99999

Description	Total
A. Executive Officers and their related interests	1,200
B. Directors/Trustees and Principal Shareholders and their related interests	250
TOTAL	1,450
Less duplications within and between groups	250
NET TOTAL	1,200
Capital and unimpaired surplus as of last Call Report date (Per Regulation "O")	7,094
Net total insider borrowing as a percentage of unimpaired capital and surplus	16.92%

NAME AND COMMENTS (Designate all duplications with a "D")	Detail	% of Unimpaired Capital & Surplus
GROUP A		
LINCOLN, ALLIE C. Director and President	500	7.05%
GUTIERREZ, JOHN M. Executive Vice President and Cashier	450	6.34%
ANY BODY, INC. Duplication debt guaranteed by President Lincoln and Director Killingbird.	250 D	3.52%
TOTAL	1,200	
GROUP B		
ANY BODY, INC. A related interest of President Lincoln and Director Killingbird. Both individuals guarantee the debt.	250 D	3.52%

Safety and Soundness

Composite 3. Financial institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

Information Technology

Composite 2. Financial institutions and service providers rated composite "2" exhibit safe and sound performance but may demonstrate modest weaknesses in operating performance, monitoring, management processes, or system development. Generally, senior management corrects weaknesses in the normal course of business. Risk management processes adequately identify and monitor risk relative to the size, complexity, and risk profile of the entity. Strategic plans are defined but may require clarification, better coordination, or improved communication throughout the organization. As a result, management anticipates, but responds less quickly to changes in market, business, and technological needs of the entity. Management normally identifies weaknesses and takes appropriate corrective action. However, greater reliance is placed on audit and regulatory intervention to identify and resolve concerns. The financial condition of the service provider is acceptable and while internal control weaknesses may exist, there are no significant supervisory concerns. As a result, supervisory action is informal and limited.

Trust

Composite 2. Administration of fiduciary activities is fundamentally sound. Generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within management's capabilities and willingness to correct. Fiduciary activities are conducted in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Compliance

Composite 2. An institution in this category is in a generally strong compliance position. Management is capable of administering an effective compliance program. Although a system of internal operating procedures and controls has been established to ensure compliance, violations have nonetheless occurred. These violations, however, involve technical aspects of the law or result from oversight on the part of operating personnel. Modification in the bank's compliance program and/or the establishment of additional review/audit procedures may eliminate many of the violations. Compliance training is satisfactory. There is no evidence of discriminatory acts or practices, reimbursable violations, or practices resulting in repeat violations.

Community Reinvestment Act (CRA)

A CRA rating of "**Satisfactory**" is assigned. An institution in this group has a satisfactory record of helping to meet the credit needs of its assessment area, including low- and moderate income neighborhoods, in a manner consistent with its resources and capabilities.

Refer to *http://www.fdic.gov/regulations/examinations/ratings/index.html* for definitions of all composite ratings.

Signatures of Directors/Trustees	99999

We the undersigned directors/trustees of Bank of Anytown, Anytown, Anystate, have personally reviewed the contents of the Report of Examination dated June 30, 2012.

Signatures of Directors/Trustees	**Date**
HENRY P. HERRINGTON	
MICHAEL D. JONES	
LARRY G. KILLINGBIRD	
KELLY A. KING	
ALLIE C. LINCOLN	
JOHN S. MARVEL	
JOHN D. PICKINGER	
SEAN RATZLAFF	

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

CONTROL AND RELATIONSHIPS

Any Company, Inc., a one-bank holding company, continues to own 100 percent of the bank's common stock. Bank directors own or control a combined 908,584 shares or 56 percent of holding company stock. President Lincoln is the largest individual stockholder, controlling 500,326 shares or 31 percent of the outstanding stock. Any Time, Inc. is a subsidiary of the bank and holds title to ORE. Any Body, Inc., is an on-premise insurance agency owned by President Lincoln and Director Killingbird. President Lincoln stated that no ownership or management changes are planned.

DIRECTOR INVOLVEMENT

Invitations for the bank's directors to participate in examination discussions were extended during the pre-exam and on-site portions of the examination. Outside director involvement was limited to the Board meeting.

EXAMINATION SCOPE

Examination Number 12345

The examination scope was expanded from the pre-exam planning (PEP) memo in the following areas:

- *Construction Lending* – Expanded due to administrative problems identified in the original loan sample. Ten additional construction loans serviced by the two construction lenders and originated in 2012 were reviewed.
- *Bank Secrecy Act Review* – Expanded to include a review of all Currency Transaction Reports filed in 2012 due to indications that they were being filed late.
- *Call Reports Review* – Expanded to include year-end 2011 in response to the volume of errors noted with our original review.

As a result, examination hours, totaling 760, are 150 over budget (25 percent). Other examination procedures were not modified from those identified in the PEP memo.

LOAN PENETRATION

Asset review date:	6/30/2012
Number of relationships reviewed:	55
Total $ of credit extensions reviewed / % of Total	$28,148M / 52%
Total $ of non-homogenous credit extensions reviewed / % of Total	$27,635M / 60%
Credit extension cutoff review point:	$450M

REMINDERS – The loan penetration comment can include a breakdown of credit extensions by major loan types, location, officer, etc., as appropriate.

INFORMATION TECHNOLOGY (IT) SCOPE

Examination Number 12348

The IT examination included a review of logical and physical security, electronic payments, IT-related audits, vendor management, and disaster recovery planning. The review also included an assessment of management's efforts to comply with Interagency Guidelines Establishing Standards for Safeguarding Customer Information (Guidelines) set forth in Part 364, Appendix B, of the FDIC Rules and Regulations. Findings of the IT review were discussed in detail on August 27, 2012, with Information Technology Manager William Robbins and President Lincoln.

TRUST EXAMINATION SCOPE
Examination Number 12346

The scope of the trust review included a review of policies, practices, and procedures, trust-related comments in Board minutes, the last external audit, selected accounts, compliance with applicable laws, and matters criticized at previous examinations. The account review included seven accounts.

Fiduciary activities pose limited risk to the institution. Total Trust Department assets are $3,318M held in 8 personal trust accounts, 44 burial trust accounts, and 1 farm management agency account. Department records are currently maintained manually, but Trust Officer Hancock is gradually migrating the accounts to a computerized system using Delta Data software running on a stand-alone computer.

A meeting was held on August 27, 2012, with President Lincoln and Trust Officer Hancock to discuss Trust examination findings in detail.

BANK SECRECY ACT (BSA) REVIEW SCOPE
Examination Number 12347

Examiners reviewed the bank's compliance with the BSA and financial recordkeeping regulations. Core analysis procedures of the Examination Documentation module were completed, as well as expanded procedures related to timely CTR filings, to summarize the findings of this review. Examiners compared bank records with information on the FinCEN CTR filing data report for October through December 2011, and year-to-date 2012. FinCEN 314(a) requests are being received and checked by management. BSA examination findings were discussed on August 27, 2012, with President Lincoln and BSA Officer Donna Ludlow.

OFFICE OF FOREIGN ASSETS CONTROL (OFAC) SCOPE

Examiners reviewed the bank's OFAC risk assessment, policies and procedures, independent testing of the bank's OFAC compliance program, blocked accounts, and correspondence received from OFAC. Examiners also conducted sample testing of the bank's OFAC compliance program.

SUGGESTIONS FOR FUTURE EXAMINATIONS

- There is sufficient working space for seven examiners.
- Management accommodated working hours of 7:30am to 5:30pm.
- The examination crew should contain at least one examiner with experience in construction loan analysis.
- ALERT data can only be provided in fixed-width format.

List alphabetically all directors/trustees, senior officers, and principal stockholders. Also indicate their titles. Number of shares owned is not rounded. (J – indicates stock jointly owned; P – indicates preferred stock owned; H – indicates holding company stock owned; C – indicates stock controlled but not owned)

Names and Comments	Net Worth		Year Joined Bank	Year of Birth	Atten-dance	Number of Shares Owned	Salary and Bonus (B)
	Amount	Date of Statement					
Biographical and background information on directors, officers, and other key management officials listed on this page should be prepared in accordance with the Report of Examination Instructions.							
<u>DIRECTORS/TRUSTEES</u>							
HERRINGTON, HENRY P. Attorney *Address*	501	3/1/2011	1980	1961	12	50,992 (H)	
JONES, MICHAEL D. Commercial RE Consultant (1) *Address*	7,890	6/1/2011	1983	1959	5	5,005 (H)	
KILLINGBIRD, LARRY G. Automobile Dealership Owner (1) *Address*	10,000	(3)	1981	1955	12	200,150 (H)	
KING, KELLY A. Retired Doctor *Address*	2,500	6/1/2011	1979	1933	12	1,010 (H)	
LINCOLN, ALLIE C. President (1)(2) *Address*	1,357	2/1/2011	1982	1951	12	500,326 (H)	100 25(B)
MARVEL, JOHN S. Economist *Address*	3,565	3/1/2011	1981	1950	11	150,500 (H)	
PICKINGER, JOHN D. Certified Public Accountant (2) *Address*	7,234	8/7/2011	1982	1954	11	101 (H)	
RATZLAFF, SEAN Chairman of the Board (1)(2) *Address*	5,000	(4)	1980	1960	12	500 (H)	24(B)

Names and Comments	Net Worth		Year Joined Bank	Year of Birth	Atten-dance	Number of Shares Owned	Salary and Bonus (B)
	Amount	Date of Statement					
<u>OFFICERS, NOT DIRECTORS/TRUSTEES</u>							
COMMANDER, LESLIE S. Executive Vice President - Commercial Lending (1)			1983	1960			85
GUTIERREZ, JOHN M. Executive Vice President / Cashier (2)			1983	1958			70
<u>PRINCIPAL SHAREHOLDERS, NOT DIRECTORS/TRUSTEES OR OFFICERS</u>							
ANY COMPANY, INC. Anytown, Anystate						162,247	

(1) Loan Committee
(2) Investment Committee
(3) Estimated by President Lincoln
(4) Estimated by *Money Magazine*

Total Holding Company shares owned by the Directorate: 908,584
Percentage Holding Company ownership by the Directorate: 56 percent

There have been 12 regular Board meetings since the last regulatory examination.
Director fees are $250 per Board meeting attended.
Committee fees are $100 per committee attended.

INTERNATIONAL

REPORT PAGES

AND WORKPAPERS

Transfer Risks Subject to Classification or Comment	99999

		CATEGORY			
AMOUNT, DESCRIPTION, AND COMMENTS	Exposures Warranting Special Comment	Other Transfer Risk Problems	Substandard	Value Impaired	Loss
Argentina October 21, 2010					
All Other Exposures (including Bank Credits)				181	
Less: Credit Risk Adverse Classification				(181)	
Net Exposure				0	

In December 2009, the Argentine government defaulted on $50 billion of bonds held by foreign creditors and subsequently imposed strict capital controls that have severely limited the ability of private borrowers to service their external liabilities. Private Argentine borrowers have accumulated significant interest and principal arrears to external creditors. Prior to the present interruption of external debt service, the country had been current on payments since completing a Brady-plan restructuring of bank debt in the early 1990s. A Paris Club rescheduling in 1992 accompanied that exercise.

U.S. banks cut their exposures to Argentina sharply in 2010, reflecting both large reductions in business activity and credit lines, and significant write-offs. In June 2010, U.S. banks' cross-border exposure totaled $6.2 billion, down roughly 44 percent from a year earlier. Locally funded business fell by over two-thirds, to $3.3 billion.

A severe and extended …

Performing short-term trade credits …

Amount scheduled represents restructured trade exposure with Banco CMF, scheduled as Value Impaired (net of reserve). Amount is not extended for transfer risk as it is subject to a credit risk Doubtful classification.

Note that this write-up is incomplete. Refer to specific guidance for this page in the Report of Examination Instructions Section of the Manual.

DISCLAIMER: This page is provided for illustrative purposes only. It is not intended to correspond with or tie to information in the Bank of Anytown Report of Examination.

Management of the country risk process is regarded as generally satisfactory. Senior management and the Asset/Liability Management Committee continue to closely monitor the economic and political stability of countries where the bank maintains international transaction activity. Due to deteriorated economic and political situations in certain of the countries where the bank conducts business, there has been a reorientation of business strategy. The Board has strategically decided to focus future business development on its domestic banking market and to basically reduce its overall risk emanating from transfer risk exposure. As a result, the bank has substantially reduced the level of approved country limits, and it has "frozen" most assigned limits, and the resulting level of net transfer risk exposure. Also, the Board has reduced …

The current examination revealed five concentrations of transfer risk …

The International Policy is adequate; however, the following deficiencies …

Note that this write-up is incomplete. Refer to specific guidance for this page in the Report of Examination Instructions Section of the Manual.

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CROSS BORDER/CROSS CURRENCY CLAIMS AND CONTINGENT CLAIMS				**ADJUSTMENT FOR GUARANTEES**				
Amount Maturing in								
Less than 1 year	More than 1 year	Commitments / Contingent Claims	Subtotal by location of borrowers	Plus other credits guara- -nteed by residents in this country	Less credits externally guaranteed	Net local current assets of offices in this country	Exposure by Country of risk	Exposure by Country of risk as a % of Tier 1 capital
ARGENTINA								
981					800		181	1.00%
BRAZIL								
2,000							2,000	11.00%
DOMINICAN REPUBLIC								
1,000							1,000	6.00%
ECUADOR								
1,233					1,209		24	0.14%
GUATEMALA								
5,358					1,698		3,660	21.00%

Note: Adjustments for external guarantee represent available cash and/or ATRR. All dollar amounts are reported in thousands.

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International Loans, Acceptances, and Letters of Credit - Distribution	99999

An international loan, acceptance, or letter of credit is defined as any such instrument between this bank and a resident or entity domiciled outside the United States, District of Columbia, Puerto Rico or other United States Territory or Possession.

DISTRIBUTION

Description	**Amount**
Mortgage loans (Including Ship loans of $_2,327______)	8,732
Loans insured or guaranteed by the U.S. government or its agencies	14,065
Loans to foreign governments, agencies thereof and central banks	15.971
Loans to financial institutions other than central banks	500
Loans to commercial, industrial and agricultural interests	41,689
Other Loans (Describe) Loans to religious institutions	8,572
All other loans	1,171
Total International Loans*	90,700
*Does NOT include loans to U.S. subsidiaries of foreign corporations	12,444

Description	**Amount**
Participation loans and paper purchased	41,505
Placed paper, direct loans and participation loans sold	5,365
Syndication and consortium financing	5,000
International acceptances outstanding	1,489
International letters of credit outstanding	7,836
Other (Describe)	

1. Are duties and responsibilities for the conduct of international operations clearly defined? Comment briefly.

Yes. The bank's Board of Directors has a written policy statement setting forth the various duties and responsibilities of the operating entities within the international division.

2. Does the bank have a definite international lending policy? If "yes", summarize such, state whether it has been approved by the board of directors/trustees, and indicate extent of compliance.

Yes. The subject bank's Board of Directors, in line with the directives of the parent bank, has delineated specific guidelines on clientele to be served, limits on country exposure both in the aggregate and by maturity within those limits and risks to be undertaken. Officers submit recommendations to the international loan committee which has authority to approve loans up to $5 million. Larger loans require senior loan committee approval. In all cases, these policies have been followed.

3. (a) Comment upon policy guidelines in effect regarding country risk assets and volume limitations imposed thereon. (b) How often are guidelines reviewed? (c) Does the bank have any country risk concentrations of credit? If "yes", list the country and percentage of such extensions of credit to the bank's total capital and reserves.

(a) Policy calls for all extensions of credit including bank placements, formal loan commitments, and foreign exchange lines to be included within country limits. Claims are reallocated to the country of guarantor or the country where collateral is realizable. Sub-limits are provided by maturity of the obligation. Separate limits are provided for in each of the 15 countries where lending is permitted.

(b) Reviewed quarterly.

(c) Yes, Japan 84%, France 40%, Federal Republic of Germany 59%, United Kingdom 39%.

4. Are guarantees of other banking institutions and/or parent or affiliated organizations of borrowers required on certain loan obligations? If "yes", under what circumstances and in what form are such guarantees extended?

Yes. Letters of Guarantee from two European banks have been furnished as support to financially weak borrowers. The parent bank has extended guarantees in the form of letters of credit essentially to provide additional protection to the subject bank's position. The parent's guarantee was not relied upon as a primary source for repayment of the loan.

5. (a) Describe the general nature and character of collateral pledged, and (b) comment upon the adequacy of supporting documentation.

(a) Collateral includes first preferred ship mortgages, notes and bond obligations of various foreign governments, time deposits, commodities, stocks, and UCC filings.

(b) Supporting documentation appeared in order.

6. Is credit information timely in content and available in sufficient readable detail?

Credit information on loans originated at the Nassau Branch continues to be inadequate. Deficiencies include a lack of current and complete financial information on the obligor and guarantor, an absence of thorough credit analysis, and a lack of complete information on country conditions.

7. (a) Describe the general nature and types of acceptance financing extended, and (b) the general lines of business involved.

(a) Bank is primarily involved in acceptance financing in connection with international trade activity; several million dollars in dollar exchange acceptances were booked between examinations.

(b) Manufactured goods, commodities, and exchange activities of central banks.

8. (a) Describe the general nature and types of letter of credit accommodations offered, and (b) the general lines of business involved.

(a) The bank issues documentary letters of credit to importers, confirms other banks' letters of credit for export customers and, to a limited extent, engages in deferred payment letter of credit financing. Standby letters of credit are undertaken only for prime customers.

(b) Manufacturers, machinery exporters and importers, commodity importers, and foreign governments and agencies.

9. Describe the provision for repayment of (a) acceptances, and (b) drafts drawn under letters of credit. Include comment regarding extent of refinancing.

(a&b) Provisions for repayment are arranged prior to issuance and vary as individual conditions warrant. Repayment is generally accomplished by charge to customer's account or by loan accommodation under approved credit lines in the case of acceptances and by charge to the customer's account or acceptance with respect to letters of credit. In certain situations, refinancing is permitted, generally for short periods.

1. Comment on the general nature and volume of present eurocurrency operations.

Eurocurrency operations are conducted through the Nassau Branch. Investments are primarily loans to South American corporations and central governments, securities of foreign governments and bank placements. Sources of funding are IPC, bank and affiliate time deposits. At examination date, Eurocurrency loans, securities, and bank placements totaled $325 million with $285 million funded by Eurocurrency time deposits and the remainder through main office funds.

2. Describe the procedures followed and guidelines utilized in establishing lines of credit and making and approving due to (takings) and due from (placements). Comment on the adequacy of procedures enabling senior management to ascertain compliance with guidelines and directives.

The parent bank has issued general guidelines to be considered before establishing lines of credit and bank relationships. With respect to banks, these criteria center on the obligor's capital resources, country risk, and type of institution. Bank and nonbank clientele analysis includes consideration of volume and maturity factors, as well as a review of financial responsibility and reputation. Senior management receives weekly reports.

3. (a) Comment on the maturity composition of present eurocurrency takings and placements and the effect of such on the bank's liquidity position. (b) Are asset and liability maturities reasonably matched?

(a) At examination date, Eurocurrency takings totaled $285 million, while placements aggregate $195 million. All placements and 74% of takings ($210 million) mature within 90 days with no adverse effects on the bank's liquidity position.

(b) Both near-term and longer-term maturities are reasonably matched.

4. Are all interbank placements confirmed at inception and, thereafter, subject to periodic direct verification audits?

Yes.

NOTE: A negative answer below (questions 2 through 8(e)) may be indicative of a condition in need of correction. Such answers may call for comment, or expanded treatment, below or elsewhere in the examination report.

	DESCRIPTION	YES	NO
1.	Is the bank engaged, in any manner, in foreign exchange activities? If "Yes", answer the following questions:	X	
2.	Is the net open position of each foreign currency reasonable in relation to the bank's total capital and reserves?	X	
3.	Is the aggregate net open position of all foreign currencies reasonable in relation to the bank's total capital and reserves?	X	
4.	Are the future maturities of foreign currency assets, liabilities, and contracts reasonably matched with respect to long and short positions in all time periods?	X	
5.	Does a current revaluation of the bank's foreign currencies reflect an insignificant profit or loss?	X	
6.	Has the directorate and/or head office imposed reasonable guidelines and limits with respect to foreign exchange operations?	X	
7.	Are guidelines and limits being adhered to by active management?	X	
8.	With respect to foreign exchange operations, are the following adequate:		
	(a) recording procedures?	X	
	(b) bookkeeping procedures other than 8(a)?		X
	(c) contract confirmation procedures?	X	
	(d) internal routines and controls other than 8(c)?	X	
	(e) audit procedures?	X	

8(b) Refer to comments under Audit and Internal Controls.

Position Analysis - Major Currency Positions — 99999

Country United Kingdom	**Monetary Unit Pound Sterling**			
Description	**Assets and Purchases (Long Position)**		**Liabilities and Sales (Short Position)**	
	Foreign Currency	U.S. Dollar Book Value	Foreign Currency	U.S. Dollar Book Value
Cash	1,000	2,600		
Demand Balances Due (Nostro)	50,000	19,800		
Loans	1,000,000	2,500,000		
Securities	100,000	275,800		
Deposits of Banks (Vostro)			100,000	242,000
Other Deposits			400,000	1,040,000
Spot Contracts	1,300,000	3,120,000	1,400,000	3,346,000
Forward Contracts				
Holdovers				
Other: (Specify) Accrued Interest Receivable	10,500	25,200		
Accrued Interest Payable			3,000	7,200
Gross Position	2,461,500	5,943,400	1,903,000	4,635,200
Less: Long/Short	1,903,000	4,635,200		
Net Position	558,500	1,308,200		
Net position as a % of the bank’s total capital and reserves:	2.90%			

Position Analysis - Other Currencies | 99999

		OTHER CURRENCIES						
		Long		**Short**		**Net Position**		**(%)***
Country	**Monetary Unit**	Foreign Currency	U.S. Dollar Book Value	Foreign Currency	U.S. Dollar Book Value	Foreign Currency	U.S. Dollar Book Value	**Net Position**
Australia	Dollar	24,600	27,900			24,600	27,900	0.06%
Canada	Dollar	66,000			90,000	66,000	(90,000)	0.20%
France	Franc	1,000,000	210,000			1,000,000	210,000	0.47%
Germany	Mark	693,000	215,000	203,000	61,000	490,000	154,000	0.34%
Italy	Lire	27,873,600	30,500	54,344,500	59,500	(26,470,900)	(29,000)	0.06%
Switzerland	France					0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
						0	0	0.00%
Subtotal (U.S.)						0	536,200	0.00%
Plus: Major Currency (U.S.)							1,308,200	
Aggregate Position (U.S.)						0	0	
* as a percentage of the bank's Total							1,844,400	3.88%
Capital and Reserves.								

DESCRIPTION	YES	NO
1a. Is the net open position of each foreign currency reasonable in relation to the bank's total capital and reserves?	X	
1b. Is the aggregate net open position of all foreign currencies reasonable in relation to the bank's total capital and reserves?	X	

MATURITY DISTRIBUTION SCHEDULE

Monetary Unit	Maturity Dates	Assets and Purchases Long	Liabilities and Sales Short	Net Gap for Period Long/Short	Spot Rate P = Prem. D = Disc.	Profit	Loss
		F.C.	F.C.	F.C.		U.S.	U.S.
Pound (UK)	5/15	51,000	100,000	(49,000)			
	5/16	25,000		25,000			
	5/17	25,000		25,000			
	5/18	35,000		35,000			
	5/19	50,000	40,000	10,000			
	5/22		50,000	(50,000)			
	5/23	50,000	75,000	(25,000)			
	5/24	100,000	50,000	50,000			
	5/25	50,000		50,000			
	5/30	50,000	75,000	(25,000)			
	5/31		100,000	(100,000)			
	June	110,500	100,000	10,500			
	July	125,000	203,000	(78,000)			
	August	175,000	110,000	65,000			
	September		75,000	(75,000)			
	October	245,000	225,000	20,000			
	November	175,000	100,000	75,000			
	December	325,000	200,000	125,000			
	20X6	370,000	300,000	70,000			
	20X7	150,000	50,000	100,000			
	20X8	250,000	50,000	200,000			
	After	100,000		100,000			
	TOTALS	2,461,500	1,903,000	558,500		0	0
				Less:	Profit/Loss		
				Future	**Adjustment**	0	0
						YES	**NO**
2. Are future maturities of foreign assets, liabilities, and contracts reasonably matched with respect to long and short positions in all time periods?						X	

Revaluation and Income/Loss Analysis | 99999

Monetary Unit	Book Value of Net Position F.C.	U.S.	Exam Date Spot Rate	Current U.S. Market Value (F.C. x Spot)	U.S. Spot Rate Profit (Loss)	U.S. Future Profit (Loss) Adjustment	U.S. Net Profit or (Loss)
Australia $	24,600	27,900	1.149500	28,300	400		400
				0	0		0
Canada $	66,000	(90,000)	0.868300	57,300	147,300	(500)	146,800
				0	0		0
France Franc	1,000,000	210,000	0.219100	219,100	9,100		9,100
				0	0		0
German Mark	490,000	154,000	0.493800	242,000	87,700		87,700
				0	0		0
Italian Lira	(26,470,900)	(29,000)	0.001176	(31,100)	(2,100)		(2,100)
				0	0		0
Swiss Franc	(60,700)	(25,300)	0.532800	(32,300)	(7,000)		(7,000)
				0	0		0
UK Pound	558,500	1,308,200	2.222000	1,241,000	(67,200)	1,000	(66,200)
				0	0		0
				0	0		0
				0	0		0
				Total	168,200	500	168,700

Does not include $ profit (loss) attributable to outstanding SWAP transactions

$ has already been taken into income/expense through accrual accounting

	YES	NO
3. Does a current revaluation of the bank's foreign currencies reflect an insignificant profit or loss?	X	

Income/Loss Schedule	**99999**

Previous Calendar Year	Amount or Percent
Quarterly Average of Gross Assets	562,500,000
Total Foreign Exchange Income	1,000,000
Net Foreign Exchange Income (Loss)	550,000
% of Total Foreign Exchange Income to Average Gross Assets	0.18%
% of Net Foreign Exchange Income (Loss) to Average Gross Assets	0.10%
Year to Date	**Amount or Percent**
Total Operating Income (Bank)	25,156,300
Net Operating Income (Loss)	4,192,700
Total Foreign Exchange Income	735,200
Net Foreign Exchange Income (Loss)	404,400

1. (a) Describe the net and aggregate position limits, maturity exposure limits, and any other limits placed on foreign exchange operations by the board of directors/trustees. (b) Do such limits appear reasonable?

(a) The bank's Board of Directors has authorized trading only in these currencies listed in the position schedules. Overnight limits for each currency with the exception of the pound sterling are fixed at $250M; pound sterling limit is $1,500M. The aggregate position limit for all currencies is $2,000M. Maturity gaps are authorized only on major active currencies up to $100M not to exceed 3 months. Major active currencies have been described as having an active forward market. No general ledger account limits have been formulated.

(b) Limits appear to be reasonable.

2. Describe the limits and guidelines established by the board of directors/trustees for dealing in foreign exchange with other banks and customers.

Individual customer limits are approved by the bank's International Committee based on the customer's creditworthiness and the volume of its foreign currency needs. The bank's written internal credit policy pertaining to bank and nonbank customer foreign exchange lines is:

(a) 100% of foreign exchange line may mature within 180 days;
(b) 50% of the foreign exchange line may mature within 360 days;
(c) 20% of the foreign exchange line is available for contracts with maturities up to 18 months;
(d) no maturities may exceed 18 months.

Excesses must be approved in writing by the account officer who approved the customer line. Maximum daily delivery risk limits per customer are set at 20% of the aggregate limits approved.

3. Fully describe any recent significant deviations by the bank from established limits and guidelines. Include in this description any significant deviations noted after completion of the Position Analysis, and the Maturity Distribution (GAP) Analysis.

No deviations from bank policy were noted in preparing the position analysis. Two exceptions to bank policy on GAP exposure were in evidence due to an inability to obtain forward cover. These exceptions were approved by the International Committee. No other recent deviations from policy were uncovered.

4. (a) Describe the reports (i.e., position maturity, gap, revaluation, etc.) required by the directorate and senior management to ascertain compliance with directives. (b) Is the directorate or senior management notified when actions are taken which constitute deviation from policy? If "Yes", describe the approval procedures for such deviations from policy.

(a) Net position reports enumerating all foreign currency balance sheet items, future contracts, and after-hour and holdover transactions are transmitted to the designee of the International Committee on a daily basis. Reports are prepared by the foreign exchange bookkeeping department and reconciled to the trader's blotter. Maturity gap reports are produced daily with the next month's transaction reflected on a daily basis and subsequent transactions grouped in two-week intervals. Revaluation reports detailing ledger accounts, spot contracts, and forward contracts are developed on a weekly basis.

(b) Bank's written policy provides for the immediate generation of exception reports where applicable limits are exceeded. Prior written approval of account officer is required for deviation from customer limits. Deviation from other limits is not permitted under any circumstances without prior approval of International Committee.

5. If the bank is a subsidiary of a foreign bank, (a) what controls and guidelines has the parent imposed on the bank's foreign exchange activities? (b) Describe the foreign exchange reports prepared by the bank for the parent.

(a&b) The aforementioned guidelines and limits have been implemented at the direction of the parent bank. All reports of the bank's audit department and the reporting mechanisms described in 4(a) are furnished to the parent bank for review.

6. How frequently and by whom is the foreign exchange position revalued? Briefly describe the procedures used in the revaluation. If forward contracts are not revalued at future rates, so indicate.

Revaluation is performed on a bi-weekly basis by the International Operations section. Actual realized profit or loss is calculated by applying current spot rates to balance sheet accounts, as well as contracts of very near maturities. Unrealized profit or loss on future transactions is determined by utilizing the appropriate forward rates to the net position for each future period in the bank's gap report.

7. Describe the general ledger accounts affected by the periodic revaluation and the journal entries used to effect changes in these accounts. If any accounts are being used to capitalize losses or defer immediate recognition of profit, so indicate.

Actual realized profit or loss is charged to the profit and loss account with offsetting entries to the applicable local currency ledger accounts. With respect to future transactions, the bank charges "estimated profit(loss) on foreign exchange futures" account for the amount of the adjustment with an offset to the profit and loss account. Profits and losses are recognized at the date of revaluation.

8. (a) Approximately what volume of the bank's foreign exchange dealings are with related companies or banks? (b) In what manner, if any, do the terms and conditions of such dealings vary from similar transactions with non-related companies and banks?

(a) During 2011, the bank entered into approximately $40,000M of forward contracts to purchase and sell foreign exchange with a related bank, First European Bank, London, England.

(b) Terms and conditions of contracts are substantially the same as transactions with non-related parties.

9. Regarding holdover and/or after hour transactions, (a) describe the bank's system for controlling and recording such transactions and (b) indicate how management is informed of such transactions before recordation. (c) Does the system appear to be correctly designed and adequately controlled?

(a-b-c) The foreign exchange control group prepares a list of holdover items. Holdover items are incorporated into the daily position sheet, which together with the holdover list, is furnished to management on a daily basis. Holdover items are posted as of the dates contracted. The system is considered adequately controlled.

NOTE: A negative answer below indicates a condition which may be in need of correction. Such answers may call for comment below and elsewhere in the regular examination report.

AUDIT			
		YES	NO
1.	Have the directors/trustees made provision for an audit of the foreign exchange area?	X	
	If "Yes," indicate method utilized: X Employment of full time auditor. X Periodic employment of independent auditor. ___ Designation of an audit supervisor and an established program of internal audit by bank personnel. Name of Audit Supervisor:		
2.	If the answer to question 1 is "yes", does the audit program include the following:		
(a)	Periodic proof of forward and spot contracts?	X	
(b)	Periodic proof and/or reconcilement of foreign exchange general ledger accounts?	X	
(c)	Periodic direct verification of forward and spot contracts? Frequency: Annually Amount: $25,200,000	X	
(d)	Review of management reports and adherence to guidelines?	X	
(e)	Comparison of rate quotations in management reports and revaluations with outside sources?	X	
(f)	Perusal of authorized signatures?	X	
(g)	Briefly describe any other audit procedures conducted:		
3.	If applicable, has the bank corrected major criticisms noted in the last independent audit report? Date of audit: 12/31/2011		X
	Briefly describe major criticisms and/or recommendations in such report: The bank was criticized for not maintaining a complete and current set of instructional memoranda describing the information generated from the accounting system and the general and subsidiary ledger accounts affected by trading activity. This defect has been corrected. Deficiencies still exist with respect to confirmation procedures.		
4.	Is the foreign exchange audit program adequate as to scope and frequency?	X	
5.	Does the foreign exchange auditor or audit supervisor report regularly and directly to the bank's board of directors/trustees or a committee thereof?	X	
6.	Is a written audit report of the foreign exchange area maintained by the bank?	X	

2(c) All outstanding spot and forward contracts as of the audit date are directly verified.

NOTE: A negative answer below indicates a condition which may be in need of correction. Such answers may call for comment below and elsewhere in the regular examination report.

INTERNAL CONTROLS		YES	NO
7.	Are all contracts recorded on the date contracted?	X	
8.	Is it a firm rule that all forward and spot contracts be confirmed at inception?	X	
9.	Has the bank instituted an effective and current (within seven days) follow-up system regarding unconfirmed and/or incorrectly confirmed forward and spot contracts?		X
10.	Are foreign exchange contracts and dealing slips prenumbered and used in such order?	X	
11.	Does the bank have an effective system of controls over the trader and the trading environment?	X	
	A “Yes” answer to this question will necessarily require a “Yes” answer to each of the following (as a minimum). Is it a firm rule that:		
	(a) The trader not be allowed to receive confirmations on forward and spot contracts?	X	
	(b) The trader not be allowed to sign contracts?	X	
	(c) The trader be prohibited from initiating and receiving interbank funds transfers, opening current accounts, or receiving credits to current accounts?	X	
	(d) The trader not be involved in the revaluation procedure?	X	
	(e) Trading activities be segregated from other bank activities, in particular the accounting, confirmation, and report functions?	X	

8-9 Although the bank has a firm rule regarding the confirmation of spot and future contracts, it was observed that outgoing confirmations are frequently incomplete, with dates of trade and value dates frequently omitted. Further, the confirmation exception log is haphazardly prepared and is not reviewed by an operations officer. These deficiencies were noted by both the bank’s internal and external auditors; however, correction is yet to be effected. It is recommended that these areas of potential exposure be remedied at an early date.

Parallel-Owned Banking Organization (PBO)	99999

DISCLAIMER: This information is provided for illustrative purposes of a complex PBO. It does not correspond to the ownership/control information provided in the Bank of Anytown.

List the following information for the bank(s) and/or bank holding company(s) in the PBO.

U.S. Name: Demo International Bank[1]
City, Country: Miami, FL
Number of Outstanding Shares: 1,000,000

Foreign Name: Demo International, C.A.
City, Country: Caracas, Venezuela
Number of Outstanding Shares: 50,000

Foreign Name: Demo Bank Venezuela[2]
City, Country: Caracas, Venezuela

Foreign Name: Demo Bank Brazil[3]
City, Country: Rio de Janeiro, Brazil

Foreign Name: Demo Bank Mexico
City, Country: Mexico City, Mexico
Number of Outstanding Shares: 100,000

[1] Of the ten entities that comprise the PBO, only the three foreign banks and the foreign bank holding company that actively engage in transactions with Demo International Bank, Miami, Florida are detailed above. The remaining five entities within the PBO structure include: JMM Holdings, Caracas, Venezuela which wholly-owns Demo Bank International, Panama City, Panama; Mendosa Finance Company, Caracas, Venezuela which wholly-owns Demo Bank International, Cartegena, Colombia and Demo Bank International, Bogota, Colombia.

[2] Wholly-Owned subsidiary of Demo International, C.A., Caracus, Venezuela.

[3] Wholly-Owned subsidiary of Demo Bank Venezuela, Caracas, Venezuela.

Detail the stock owned by the beneficial owner(s) whose direct/indirect control forms the nexus of the PBO.

U.S. Name: Demo International Bank	**Number of Shares**	**Percent Owned**	**Type of Control**
Beneficial Owner: Mendosa Family Trust (Jose Mendosa controls 100%)	750,000	75.00%	Direct
Beneficial Owner: Rivera Family Trust (Juan Rivera controls 100%)	250,000	25.00%	Direct

Foreign Name: Demo International, C.A.	**Number of Shares**	**Percent Owned**	**Type of Control[1]**
Beneficial Owner: Jose M. Mendosa	5,000	10.00%	Direct
Beneficial Owner: Carlita S. Mendosa	12,500	25.00%	Direct
Beneficial Owner: Paco M. Mendosa	7,500	15.00%	Direct
Beneficial Owner: Juan H. Rivera	12,500	25.00%	Direct
Beneficial Owner: Mendosa Family Members	12,500	25.00%	Direct

[1] Mr. Jose M. Mendosa has indirect control of the shares owned by his wife, Ms. Carlita S. Mendosa.

Foreign Name: Demo Bank Mexico	**Number of Shares**	**Percent Owned**	**Type of Control[1]**
Beneficial Owner: Jose M. Mendosa	50,000	50.00%	Direct
Beneficial Owner: Carlita S. Mendosa	25,000	25.00%	Direct

[1] Mr. Jose M. Mendosa has indirect control of the shares owned by his wife, Ms. Carlita S. Mendosa.

Discuss the factor(s) or combination of the attributes (besides or in addition to common stock ownership) that was considered in determining that sufficient control is exercised to conclude that a PBO relationship exists, including whether the individual, family or group of persons acting in concert:

1) Constitutes a quorum or a significant presence on the Board of Directors of both the U.S. depository institution and the foreign bank or the foreign bank holding company.

The members of the Mendosa family listed above serve as the chairman, vice chairman or director for the five foreign entities except that none of them are on the Board of Demo Bank Guatemala. Their membership does not constitute a quorum on any of the three foreign or the U.S. banks' Board, but does constitute a quorum on the Board of the foreign bank holding company, Demo International, C.A.

2) Controls, in any manner, the election of a majority of the directors of the U.S. depository institution and the foreign bank or the foreign bank holding company.

The minutes of the shareholder meeting for the election of the directorate for Demo Bank Venezuela were not available for review. However, it is believed that Mr. Jose Mendosa and his family members controlled the election through their ability to vote a majority of the holding company's stock. Mr. Jose Mendosa's ability to vote the majority of Demo International Bank's stock indicates that he controlled the election of its directorate.

3) Constitutes a quorum or a significant portion of the executive management of both the U.S. depository institution and the foreign bank or the foreign bank holding company.

The members of the Mendosa family listed above serve as the president, vice president or cashier of Demo International Bank, Demo International, C.A. and at the four foreign banks except Demo Bank Guatemala. Their positions constitute a quorum of the executive management at Demo International, C.A., but not at the three foreign banks or at the U.S. bank. However, they occupy critical positions on those teams.

4) Exercises a controlling influence over the management and/or policies of both organizations.

Mr. Jose Mendosa's position as chairman of Demo International Bank and as president of Demo Bank Venezuela enables him to exert a controlling influence over the management and policies of both organizations.

5) Engages in an unusually high level of reciprocal correspondent banking and/or other transactions or facilities between the U.S. depository institution and the foreign bank.

The institutions primarily engage in correspondent bank services, dollar clearings, letters of credit, and trade related transactions. Fee income from transactions with the three foreign banks accounts for slightly over 40 percent of the total fee income generated by Demo International Bank, Miami, Florida in 2011. The U.S. bank also extended a $5 million line of credit secured by a $5 million certificate of deposit to Demo Bank Venezuela, Caracus, Venezuela.

6) Obtains financing to purchase the stock of either the U.S. depository institution or the foreign bank or the foreign bank holding company from, or arranged by, the foreign bank, especially if the shares of the U.S. depository institution are collateral for the stock-purchase loan.

None noted.

7) Requires the U.S. depository institution to adopt particular/unique policies or strategies similar to those of the foreign bank, such as common or joint marketing strategies, cross-selling of products, sharing of customer information, or linked web sites.

The Demo International Bank's web site is linked to Demo Bank Venezuela's web site. Both offer similar loan and deposit products and banking services.

8) Names the U.S. depository institution in a similar fashion to that of the foreign bank.

The titles of the banking organizations use similar naming conventions.

9) Presents any other factor(s) or attribute(s) that impacted the conclusion.

None known.

Summarize the Examination's Findings, including any concerns and criticisms relative to the PBO.

The review determined that a PBO relationship exists between Demo International Bank and three foreign banks and a foreign bank holding company through the common control of the Mendosa family, primarily through Mr. Jose Mendosa's ownership/control of the Demo International Bank in Miami, Florida, Demo International, C.A. (foreign bank holding company), and Demo Bank Mexico in Mexico City, Mexico.

Bank management acknowledges that the institutions are under common control. Management actively monitors all transactions with affiliated entities. No adverse trends were noted except that management was encouraged to devote additional time to review the banks' heightened wire activity. Refer to the Related Organizations page and the Risk Management Assessment page for additional information.

If a PBO relationship exists, then the field supervisor or case manager should forward this document under a cover letter to the Associate Director of the International and Large Bank Branch.

GENERAL INSTRUCTIONS

These instructions provide general guidance for conducting field investigations and preparing the Report of Investigation (ROI). Since each application has unique characteristics and often involves special circumstances, examiners should consult the references below and discuss issues or questions with the appropriate Case Manager. The examiner should look beyond the surface of the proposal and address the likelihood of success or failure. The final report should be comprehensive, well supported, and address any atypical attributes.

REFERENCES

Use the following reference material in preparing the ROI:

- The instructions contained herein
- Statement of Policy on Applications for Deposit Insurance (SOP)
- FDIC Rules and Regulations Part 303, Subpart B, Deposit Insurance, and Federal Deposit Insurance Act sections 5 and 6
- Section 19 of the FDI Act and the Statement of Policy for Section 19 of the FDI Act
- Statement of Policy Regarding use of Offering Circulars in Connection with Public Distribution of Bank Securities
- Statement of Policy on the National Historic Preservation Act of 1966
- Applicable State Statutes and Regulations
- Case Managers Procedures Manual
- DSC Manual of Examination Policies
- Examination Documentation (ED) Modules
- Electronic Data Processing Examination Handbook
- Outstanding Applications memoranda and directives
- Questions and Answers on Stock Benefit Plans
- Division of Insurance and Research (DIR) – Statistics on Depository Institutions
- Uniform Bank Performance Report (UBPR)
- DSC and Risk Management & Applications Section Websites

APPLICATION PROCESSING

The FDIC is responsible for approving or denying all applications for deposit insurance, regardless of the type of institution or fund affiliation. In addition to proposed state nonmember banks, mutual savings banks, and industrial banks, the FDIC acts on any application for deposit insurance from a proposed national bank, member bank, district bank, trust company, Federal or State savings association, or savings and loan. Applications for de novo institutions are filed with the chartering authority and the FDIC using the *Interagency Charter and Federal Deposit Insurance Application*. To ensure interagency applications go smoothly, examiners should contact the chartering agency as soon as possible to coordinate a joint field investigation and reduce regulatory burden.

Generally, examiners should attend any pre-filing or other meetings held by the chartering agency with the applicant. Application processing timelines vary among the banking agencies, therefore close coordination with the chartering agency is necessary. Duplication of work should be avoided such as conducting background checks on proposed officers and directors. Normally, in an application for a thrift or national bank charter, the OTS or OCC conduct the background checks.

REPORT OF INVESTIGATION PROCEDURES

Reports of Investigation often vary in content and structure and emphasis should be placed on producing a well-conceived final product rather than following any strict format. The Statement of Policy on Applications for Deposit Insurance (SOP) is the primary source document for the factors that should be considered during the investigation. These guidelines are designed to assure uniform and fair treatment to all applicants.

Examiners should review the entire application and business plan to identify potential problems, incomplete or inconsistent information, areas of non-compliance with the SOP and/or Federal and State banking statutes, and any other factors which will require additional attention. It is important to identify, early on in the process, any concerns that will require significant attention to ensure that they do not delay the timely processing of the report. Subject Matter Experts in areas such as Consumer Compliance, Information Systems, Trust, Capital Markets, and Specialized Lending should be involved in the investigation when deemed necessary to adequately assess a proposal.

Examiners should be aware that proposals not conforming to the SOP are not delegated to the Regional Office and will be forward to the Washington Office for final action. Further, applications involving foreign ownership of 25% or more (foreign ownership includes ownership by a foreign non-banking entity, a foreign bank, or person who is not a citizen of the United States) are also forward to the Washington Office for final action.

After a thorough review and Regional Office concurrence, examiners should contact the organizers to discuss the specific issues and request any additional information. The examiner should hold a board meeting with proposed directors and senior officers. At a minimum, the meeting should include a discussion of the FDIC’s expectations regarding director supervision, conduct and ethics. A sample agenda with suggested topics is found in Appendix A. The organizers and proposed directors should be individually interviewed to determine the extent of their understanding of the responsibilities they are taking on as directors, their abilities to execute the business plan and their commitment to the proposed bank. A sample Management/Director Interview form is found in Appendix A.

Examiners should not discuss the probable outcome of the investigation with the applicants.

STATUTORY FACTORS

Sections 5 and 6 of the FDI Act specifically deal with the granting of deposit insurance. Section 6 identifies seven statutory factors that must be considered by the FDIC in determining the merits of an application. Those factors include:

1. Financial history and condition;
2. Adequacy of capital;
3. Future earnings prospects;
4. General character of management;
5. Risk presented to the insurance fund;
6. Convenience and needs of the community;
7. Consistency of corporate powers.

The Report of Investigation should detail the relevant facts pertinent to each of the statutory factors and state the examiner's opinion as to whether the criteria under each area has been met. Findings of Favorable Subject to the Imposition of Conditions are permissible if the reasons for such a finding are clearly supported. Narrative comments should fully support any negative finding and when possible, identify any corrective action that, if taken, would favorably resolve the concerns. Examples could be issues such as finalizing blanket bond coverage, obtaining an appraisal on the premises, finalizing stock sale, etc.

While all factors are important and must receive a favorable finding, the FDIC considers Management and Capital as being the two most important factors. The Investigation Report Conclusions and Recommendations page should include a description of the proposal, a summary of each factor, and an overall recommendation relative to the granting of insurance.

MISCELLANEOUS REPORT ISSUES

Generally, the public may inspect the non-confidential portions of an application. While the burden is on the applicant to request confidential treatment of certain application material, the following areas are generally considered confidential:

1. Personal information, the release of which would constitute a clearly unwarranted invasion of privacy;
2. Commercial or financial information, the disclosure of which would result in substantial competitive harm to the submitter; and
3. Information the disclosure of which could seriously affect the financial condition of any depository institution.

The public may obtain photocopies of non-confidential material through a Freedom of Information Act request and by an oral or written request to the Regional Office.

Financial numbers are rounded to the nearest thousand.

COVER – REPORT OF INVESTIGATION

Insert complete name of proposed bank, city, county, and state.

Insert Region, EIC, and type of charter.

- Date investigation commenced would be the date review began in the field office.
- Investigation closed date is date the report was mailed to Regional Office.
- Date of application is obtained from the application.
- Date application accepted is found on ViSION's Application Tracking (AT).

TABLE OF CONTENTS

The table of contents identifies the three major report sections: Conclusions and Recommendations; Assessment; and Other Information. Completion of all pages is mandatory. Examiners may create and add pages under each factor if it supports their conclusions and recommendations.

INVESTIGATION REPORT CONCLUSIONS AND RECOMMENDATIONS

This page should summarize the proposal with enough details to give the reader a complete understanding of the transaction. The investigating examiner should provide a brief summary of the proposed business plan under the "Description of the Transaction" heading. Each statutory factor and finding of Favorable, Unfavorable, or Favorable Subject to Conditions should also be summarized. The investigating examiner should conclude with an overall recommendation.

FINANCIAL HISTORY AND CONDITION

Generally, proposed financial institutions have no financial history to serve as a basis for determining qualification for deposit insurance. Therefore, the primary areas of consideration under this factor are the reasonableness of asset and liability projections and composition in relation to the proposed market, the level of investment in fixed assets, the ability of insiders to provide financial support to the institution, terms upon which transactions with insiders are granted, and whether adequate disclosure of insider transactions has been made.

- Assess the applicant's projected asset and deposit mix for reasonableness and as compared to the proposed business plan and an appropriate peer group.

- Using the financial statements contained in the business plan, construct the projected balance sheet for the first three years of operation. Discuss with the applicant, significant differences between the proposal's projections and yours. If necessary, the applicant should revise the projections. Projections that are not reasonable or unsupportable should lead to an unfavorable finding.

- Total direct and indirect fixed asset investment (including leases) should be reasonable in relation to projected earnings capacity and capital levels. A brief review should determine if the figures provided by the proponents are reasonable with regard to anticipated need and cost. Fixed asset schedules from other newly formed institutions can be used as a point of reference. Compliance with State law should be considered since most states impose a statutory limit on fixed asset investment relative to either capital or total assets.

- When real estate is to be purchased and a building constructed, the investigating examiner should review the cost of the land, estimated construction costs, the identity of the seller and general contractor, completeness of the title policy, and terms of any financing obtained. Part 323 of the FDIC Rules and Regulations is applicable to the purchase of real property, including leaseholds, and a qualifying appraisal is usually required. For leased premises, the terms and reasonableness of the lease should be discussed. Applicants are generally cautioned against purchasing any fixed assets or entering into any non-cancelable construction contracts, lease or other binding arrangements related to the proposal unless and until the FDIC approves the application.

- Any time assets are purchased or leased from insiders or when insiders are involved in providing contracted services, the transactions should be supported by an independent appraisal or competitive bid process. The organizers must substantiate that any transaction with an insider is made on substantially the same terms as those prevailing for comparable transactions with non-insiders and do not involve more than a normal degree of risk. Such transactions must be intended for the benefit of the institution and not entered into as an accommodation to the insider. All such transactions must also be approved in advance by a majority of the incorporators and fully disclosed to all proposed directors and shareholders.

- Organizers, including an affiliated holding company, must demonstrate the ability to provide on-going financial support. Analyzing the ability of the proponents to raise additional capital is important since new banks (operating at a loss) will often experience difficulty in attracting capital from outside sources. Analysis of this will be primarily dependent upon the financial statements submitted by the proponents or Uniform Bank Holding Company Reports when a holding company is involved. If reasonable, consideration should be given to the ability of the proponents to raise additional funds through the capital markets or the local community.

- Assess compliance with the security requirements of Part 326 of the FDIC Rules and Regulations.

- Assess compliance with the National Environmental Policy Act of 1969. The FDIC is responsible for making a determination whether certain decisions made by it constitute "major Federal actions significantly affecting the quality of the human environment" under this Act. Granting of approval for deposit insurance seldom constitutes a significant action requiring an environmental impact statement, but a threshold determination as to the probable effect upon the human environment must be made under the statute. The environmental factors to be considered include: (a) compliance with local zoning laws; (b) location; (c) traffic patterns including the adequacy of roads, parking places and traffic congestion; and (d) any favorable impact such as possible decrease in pollution or fuel consumption.

Compliance with zoning laws is generally the key determining factor for the FDIC since courts have ruled that compliance is an assurance that such environmental effects will be no greater than demanded by the residents acting through their elected representatives.

- Section 106 of the National Historic Preservation Act (NHPA) requires that a Federal agency having authority to license any undertaking shall, prior to issuing any license, take into account the effect of the undertaking on any district, site, building, structure, or object that is included in, or eligible for inclusion in, the National Register of Historic Places (National Register).

  At the time of filing an application for Federal deposit insurance, the proponents should have already been in contact with the appropriate State Historic Preservation Officer (SHPO) regarding whether the proposed main office (as well as any branch office) site is an historic property - that is, listed in, or eligible for listing in, the National Register. The FDIC generally relies on the SHPO's opinion regarding whether the proposed office site is historic and, if it is, what effect the Federal deposit insurance proposal will have on the property. If it is determined that the proposal will have an adverse effect on an historic property, then the FDIC (usually the RO staff) must work with the proponents, the SHPO, other consulting parties, and, in some cases, the Advisory Council, to develop and evaluate alternatives or modifications to the undertaking that could avoid, minimize, or mitigate the adverse effect.

  It is very important that the examiner advise the proponents that absolutely no site preparation work should be initiated until SHPO has been consulted and a determination has been made regarding whether the proposed office site is historic and, if it is, what effect the proposal will have on the historic property.

  For Federal deposit insurance applications that involve establishment of a new national bank or thrift, for which a charter application has been filed with the OCC or OTS, the FDIC may not have to determine whether the proposed office site is historic and how the proposal will affect an historic property, if the primary Federal regulator has assumed this responsibility. The examiner or the Case Manager should contact their counterparts at the Federal chartering authority in order to ascertain which agency will be responsible for complying with the requirements of the NHPA.

Conclude with a "Favorable", Unfavorable" or "Favorable Subjected to Conditions" statement.

ADEQUACY OF THE CAPITAL STRUCTURE

Normally, initial capital of a proposed institution should be sufficient to provide a Tier 1 capital to assets leverage ratio of at least 8% throughout the first three years of operation. In addition, the institution must maintain an adequate allowance for loan and lease losses. This means that the proposed institution **can not** inject the capital as it grows. Opening day capital must be sufficient to maintain at least an 8% Tier 1 Leverage ratio based on the three-year projections. Exceptions apply to new institutions formed by an eligible holding company (See section 303.22).

The adequacy of capital is closely related to the new bank's risk appetite, its deposit volume, fixed assets, and anticipated growth. Deposit projections made by the applicant must be fully supported and documented. Projections should be based on identifiable patterns in the target market. Special purpose institutions (such as credit card banks) should provide initial capital commensurate with the type of business to be conducted and the potential for growth of that business. Additional discussion of unique capital proposals such as contribution of in-kind capital as part of initial capitalization, and capital adequacy of new institutions organized to facilitate and carry on an existing business line is presented below. Examiners are reminded that these types of proposals and others presenting a higher risk profile may warrant a leverage capital ratio greater than 8%.

- Using capital data contained in the application, construct the Proposed Capital Structure table.

    - "Minimum Statutory Requirements" line should include any minimum capital required by the chartering agency.
    - "Amount indicated on Application" should reflect capital allocations shown in the application excluding any adjustments made by the examiner. All components of this line should be based on applicant's projections.
    - "Revised Proposal" line is used only when the organizers present a revised capital proposal.
    - "Recommendation of Examiner" line may or may not be the same as applicant's proposal; however, it must agree with final projections used throughout the report.
    - "Retained Earnings" column is the cumulative 3-year net income.
    - "Third Year Average Assets" column comes from the business plan projections and examiner's estimates.

- The examiner should assess the deposit forecasts and make any necessary adjustments. The proponents should have a good feel for the deposit potential of their market. However, if growth projections are inconsistent with the size of the market, with current economic conditions, or with the overall business plan, adjustments should be made along with the examiner's rationale. Examiners could consult any number of sources including the Uniform Bank Performance Report and DIR's Statistics on Depository Institutions, for supporting data.

- If available, review the stock offering circular, stock solicitation material and related documents. The Washington Office's Registration, Disclosure and Securities Operations Unit normally reviews both private and public offering materials and is available for assistance. All stock of the same class should be offered at the same price, and have the same voting rights. Arrangements that give insiders greater rights or more favorable pricing are not acceptable. A price disparity may allow organizers to gain control disproportionate to their investment and may promote excessive risk taking. In addition, such arrangements are analogous to compensating or paying a fee to organizers solely for their efforts in establishing the institution. Stock price disparities may also be used to hide excessive reimbursement to organizers. Another example of price disparity is offering stock warrants to investors who purchase a large volume of shares in the stock offering. Closely assess the appropriateness of stock offerings that award incorporators warrants to acquire additional shares. Stock warrants to insiders or investors that are beyond the guidance contained under the management factor of the SOP are not acceptable.

- If the institution is being established as a wholly owned subsidiary of an eligible holding company (as defined in part 303, subpart B) consider the financial resources of the parent organization in assessing the adequacy of the initial capital. In some cases, DSC may find favorably with respect to the capital factor when initial capital is sufficient to provide a Tier 1 leverage capital ratio of at least 8% at the end of the first year of operation, based on a realistic business plan, or initial capital meets the $2 million minimum standard set in the SOP, or any minimum standards established by the chartering authority, whichever is greater. The holding company must also provide a written commitment to maintain the Tier 1 leverage ratio at no less than 8% throughout the first three years of operation.

- Stock financing arrangements by proposed officers, directors, and 10% shareholders should be carefully reviewed. Financing arrangements are only acceptable if the investor can clearly demonstrate the ability to service the debt without undue reliance on dividends or other forms of compensation from the new institution. Normally the direct or indirect financing of 75% or more of the purchase price by an individual or the financing of 50% of the purchase price by all insiders in the aggregate will require supporting justification. Ensure that the applicant bank did not agree to maintain compensating balances with the lender in order to procure financing. Also, the proponents should be made aware that such loans can not be refinanced by the applicant bank.

- Watch for voting trust arrangements. Generally, these agreements are discouraged in new banks because of control issues (insiders gaining control disproportionate to their investment), but are not prohibited per se. Review the agreements for any unfavorable features, such as control issues, or hampering sale of additional stock. Examiners should consult with the case manager and/or a regional attorney to obtain additional guidance.

- The stock subscription list should be reviewed to ensure that control issues have been identified and resolved, and to determine the likelihood of a successful offering.

- Cash dividends during the first three years of operation should only be paid from cumulative net operating income and only after an appropriate allowance for loan and lease loss has been established and overall capital is adequate.

Unique capital proposals and capital for institutions organized to facilitate and carry on existing business lines.

The SOP is silent on the issue of organizing an institution with in-kind capital. Likewise, it does not address how the FDIC will assess proposals that entail a new institution organized to facilitate and carry on an existing business line. Nonetheless, the FDIC has been presented with applications containing both proposals. In-kind capital contributions have been in several forms including, but not limited to, real estate, fixed assets, loans, leases, and mortgage banking operations. Existing business lines proposed in prior applications included equipment lease financing, credit card operations, and mortgage banking operations. These proposals present unique risks deserving close scrutiny. Examiners should also evaluate possible 23A and 23B implications and limitation from Part 325 capital calculation. The following points address prior instances where in-kind capital and existing business lines were part of applications.

- In applications where the FDIC will not be the primary regulator, the examiner should participate in the primary regulator's investigation.

- When loans or leases are proposed to be contributed as initial capital, the examiner should conduct a review of the loans and leases comparable to that completed during a traditional safety and soundness examination in order to assess asset quality. The sample should be large enough to assess loan or lease mix, underwriting standards, valuation and residual values, and proper documentation. Valuations should be supported by proper market value analysis such as discounted cash flow analysis. The examiner should strive to obtain an independent physical inspection of the assets in the sample. In lieu of a physical inspection, the examiner may rely on an independent audit confirmation of the assets in question.

- Tangible assets such as real estate and fixed assets contributed as part of initial capital present two main questions: valuation and insider involvement.

  - In the case of real estate, organizers must have an independent appraisal performed by certified or licensed appraisers (see Part 323 of the FDIC Rules and Regulations). The appraisal should conform to generally accepted appraisal standards and arrive at a fair market value. Fixed asset values should be supported by independent market valuations performed by experienced appraisers. Review the appropriateness of scheduled depreciation. A longer than normal depreciation period could overstate book value and earnings. Total fixed asset investment must also conform to State limitations.

  - Transactions involving organizers, directors, officers, or principal shareholders (insiders) should be closely reviewed to determine fairness and proper disclosure. For example, a contribution of bank premises under construction by an insider or related interest should not contain unfavorable features. Proper disclosure to other shareholders, written construction contracts based on a competitive bid process, and independent appraisals should be required.

  - In-kind capital contributions may be proposed in the form of the market value of an existing business such as a mortgage company. Proposals such as this should be fully supported by at least two appraisals of the company's fair market value. Examiners should ensure that the appraisals are independent, current (within 6 months) and based on recognized valuation methods.

Proposals for new institutions organized to facilitate and carry on an existing business line also provide special capital considerations. Contribution of the business as initial capital may or may not be a part of the proposal; however, recent cases have contained both. These include:

- An institution organized with a leasing company to provide equipment lease financing.
- An institution partly capitalized with seasoned auto loans, specializing in direct purchase of dealer-originated auto loans and from an affiliate credit finance company.
- An institution formed by an energy company, capitalized with in-kind contribution of consumer loans and will specialize in providing loans for energy-related home improvements.
- An institution formed by a farm equipment retailer to acquire its credit card receivables and continue origination and servicing company branded credit cards.
- An institution formed by a company that provides capital lease financing for small to medium sized businesses over the Internet. New bank to provide retail funding and lease financing.

Examiners should look to the prior performance of the business and the character of the management continuing on with the institution. The management group should be sufficient to satisfy the management factor. The business line should be financial in nature, and not expose the institution to undue risk. The business plan should be reasonable and the projections should be well supported by historical performance and sound analysis. Examiners should use all available information such as Dun & Bradstreet reports, SEC filings, independent audit reports, public recordings, and credit rating agency reports to verify data. If deemed necessary, an on-site visit to review the existing business' operations should be conducted.

When assets are proposed to be contributed as capital or purchased from organizing group or affiliate, values should be supported by independent appraisals. Asset quality should be assessed the same way credit reviews are conducted, i.e. sample by risk, volume, delinquency, underwriting, etc (refer to ED risk focus modules). If the business has not had a recent audit, or credit or collateral documentation is not complete, an independent verification or inspection of assets should be obtained.

Conclude with a “Favorable”, Unfavorable” or “Favorable Subjected to Conditions” statement.

EARNINGS PROSPECTS

Construct the “Estimated Income and Expense”, and the “Estimated Average Deposits and Average Earning Assets” schedules using the financial statements contained in the Business Plan.

The examiner should determine whether the proposed bank is likely to be profitable within a reasonable period of time, usually three years. The main concern is whether the applicant’s projections are realistic and supportable. The earnings should be sufficient to provide an adequate profit. When projections are not reasonable or deficiencies are material, revisions should be requested from the proponents. Examiner-derived estimates can be incorporated into the report; however, comments should clearly address the differences between the examiner's estimates and those of the organizers. Common shortcomings in projections include, but are not limited to:

- Unreasonable earning asset yields
- Unreasonable interest expense factors
- Overstated earnings factors (NIM, ROAA)
- Underestimating data processing costs
- Understated overhead costs
- Inadequate loan loss provisions
- Failure to write-off organizational expenses during the first year of operations

Items to be considered include projected loan growth relative to other new banks and that of competing institutions, likely structure of the deposit base, investment objectives, estimated asset and liability mix, reasonable noninterest income, and probable provision expense. Consideration should also be given to ensure consistency with other projections such as deposit growth and personnel expense. Projections and assumptions should be consistent with the overall business plan.

The UBPR generally provides sufficient data to assess the line items contained in the projections. Financial data from recently formed institutions should prove to be the most beneficial. Peer data is also available for all new banks established within three years and under $50 million in assets. Peer data for established community banks also warrants review especially when serving the same general area or market niche. Examiners should be aware that using peer ratios of established banks might result in some differences since new banks generally have a larger percentage of assets funded by capital. This results in higher margins during the early years. Examiner's selection and use of Peer data should be fully discussed and supported.

Loan loss provisions should be closely reviewed. Niche or special purpose banks that engage in higher risk lending, such as subprime loans and high loan to value lending, should fully support their loan loss reserve methodology, estimated losses and provisions. The methodology should account for replenishing the reserve to an adequate level after charge-offs.

Conclude with a "Favorable", Unfavorable" or "Favorable Subjected to Conditions" statement.

GENERAL CHARACTER OF MANAGEMENT

Management is often the most important factor. Although the SOP indicates that evidence should support a management rating tantamount to a "2" rating or better under the Uniform Bank Rating System, this is somewhat difficult to determine without an operating record as a management team. As a result, the assessment of management should center on an evaluation of the individual's background in relation to their proposed duties and responsibilities. Consideration should be given to the following:

- Financial institution experience
- Other business experience
- Personal and professional financial responsibility
- Reputation for honesty and integrity; and
- Familiarity with the economy, banking needs, and general character of the community in which the bank will operate.

Examiners should provide an overall assessment of the management team and board of directors on the General Character of Management page. Address each proposed officers and directors' qualification on the biographical section of the report. Comments should also include any prior experience that may reflect positively or negatively on the individual, any serious business failures or compromising of debts and length of residence in the community or trade area. All entities in which the proposed officer or director has a financial or other significant interest should also be identified.

The examiner should normally conduct personal interviews with all of the organizers, senior management, and directors. Any pertinent information derived should be included with the individual's biographical information. Current and former employers may also be contacted unless a prospective officer raises a valid objection (current employers may not know officer is seeking other employment and contacting them may cause the officer harm). Prior employer's concerns over privacy laws, however, may prevent them from divulging much information. At a minimum, a former employer should be able to tell you the individual's title, and whether the individual is eligible for rehire.

The biographical and financial information (FDIC 3064-0006, Interagency Biographical Financial Report) submitted as part of the application serves as the primary tool in assessing financial standing and responsibility. All questions should be answered and fully supported. These forms should disclose any prior bankruptcies or the compromise of any debt. The forms should also include information on contingent liabilities, civil litigation, prior criminal convictions, administrative proceedings, and other matters involving a breach of trust.

A section 19 application will be necessary if an employee, officer, director, controlling shareholder or Institution Affiliated Party has been convicted of a criminal offense involving dishonesty or breach of trust, money laundering or has entered into a pretrial diversion in connection with a prosecution of such an offense. The Applicant must obtain the FDIC's written consent under section 19 of the FDI Act before any such person may serve in one or more of those capacities.

Significant assets in the form of closely held corporations, partnerships, or sole proprietorships should be supported by detailed financial statements on these entities. Net equity positions should be reviewed to determine the reasonableness of the carrying value and the potential impact of related debt. In addition, if an individual's financial standing is largely dependent upon appreciated value of real estate or closely held companies, the basis for valuation of the assets should be sought.

For state nonmember charters, background checks are normally requested by the Regional Office and if necessary and available, forwarded to field personnel for review during preparation of the investigation report. Such information provides an independent, third party check that can be used to verify the applicant's stated financial position, credit history, and confirm the absence of public filings and judgements. Liens, lawsuits, wage assignments, defaults, and public filings such as bankruptcies and judgements will be shown. The major credit reporting agencies also provide an additional service that automatically alerts the requester to possible false social security numbers and high risk addresses such as post office boxes, and multiple business addresses.

If necessary, additional information can be requested through the Regional Office, including Nexis/Lexis. These systems feature searches that can be conducted by key words or names. Nexis provides access to numerous news service publications and Lexis allows for a search of legal databases containing final case law from Federal and State courts. Finalized civil and criminal proceedings as well as bankruptcy cases are listed. Also, a background check can include a search of State Corporation Commission records, Dun & Bradstreet, and county and other State records. The Federal Reserve also maintains information on international and foreign companies.

Be cautious of bank ownership that is restricted to a single individual or entity, or a small group of individuals who lack broad-based financial strength. Also identify any proposed directors that have little or no prior financial institution experience, minimal financial interest in the proposal, or are poorly equipped to contribute to policy formation or adequate supervision. Determine whether senior officers lack necessary experience, or have not served in senior management positions, which provide adequate insight into proposed roles. The SOP requires at least a five-member board of directors. At a minimum, an even mix of directors with and without banking experience is preferred. The proposed board should provide for officer/director continuing education, and a management succession plan.

The SOP requires that the proposed full-time chief executive officer be made known to the FDIC. If the proposed CEO has not served in a similar capacity, it is important to determine whether the individual has the technical competence to fulfill the responsibilities of the position. Further, the proposed CEO's expertise and experience should correlate with the proposed business plan. Knowledge of such areas as lending and investments, interest rate risk management, internal controls, and bank regulations should be considered.

The proposed operating policies and strategic plan should be reviewed in assessing management. Inadequate policies may be an indication of a weak management team. Written investment, loan, funds management, and liquidity policies should be reviewed and comments should be made regarding their soundness and acceptability. The CEO is also expected to be a qualified and experienced lending officer. If not, an explanation should be provided and the name of the proposed chief lending officer should be furnished.

While conditional approval can be granted prior to the selection of a chief executive officer or primary lender, this is allowable in only very limited circumstances. An example is where the new bank will be owned by an "eligible holding company" as defined in section 303.22 of the FDIC's regulations. Ultimately, prior to opening, these individuals should be identified and their abilities assessed. Any changes in the directorate, active management, or 10% shareholders prior to the bank's opening must also be disclosed to the FDIC in writing.

When it appears that an unfavorable ruling will be made regarding an individual's qualifications or fitness to serve, the examiner should consult with the responsible Case Manager. The examiner should thoroughly support any negative assessment by:

- Conducting an adequate investigation into the individual's qualifications;
- With the concurrence of the Case Manager, give the individual the chance in an interview or letter to respond to any objections raised;
- Checking any files to which the FDIC has access before making an adverse determination regarding the individual;
- To the extent possible, attempting to locate documentary evidence rather than relying on oral opinions.

All information relied upon should be maintained. When information is obtained from an outside source, every effort should be made to obtain such information in writing and verify through a secondary source.

Organizational expenses should be reviewed for reasonableness. Prudent management would not commit a bank to excessive expenses, the existence of which may be indicative of a management deficiency, even if the fees or costs were approved by formal action of the incorporating shareholders. This applies to all costs, organizational expenses, and legal fees. Identify and assess the source of funding; start-up cash, personal or bank loans.

Review expenses for professional or other services rendered by insiders for any indication of self-dealing to the detriment of the institution or its shareholders. The FDIC expects full disclosure to all directors and shareholders of any arrangement with an insider.

Employment agreements should be reviewed to ensure that the contracts limit severance pay to a duration of one year. Under Part 359 - Golden Parachutes, severance payments are limited to one year in the case of troubled institutions. While not applicable to non-troubled institutions, the one-year guideline should be used as a benchmark. Section 359.1(f)(2)(v) states payments pursuant to a nondiscriminatory severance plan should not exceed the base compensation during the twelve months immediately preceding termination. Employment contracts that contain severance payments exceeding one year of compensation should be assessed for appropriateness and supported by extraordinary factors.

Stock Options and Warrants

Organizers/incorporators (incorporators) may propose establishing stock benefit plans, including stock options, stock warrants, and similar stock based compensation plans. Participants may include officers as well as directors, although the FDIC anticipates that such plans will focus primarily on active officers. Stock benefit plans may also be established to compensate incorporators who place funds at risk to finance the organization or who provide professional or other services during the organizational phase. Stock option/warrant plans are also found in both private and public stock offering material.

Management stability is generally an essential element for the ultimate success of a de novo institution. Therefore, the structure of the stock benefit plans, whether available to active management or incorporators, should encourage the continued involvement of the participants and serve as an incentive for the successful operation of the institution. Satisfactory management should not commit the bank, directly or indirectly, to plans that result in excessive compensation to insiders, place undue incentives on short-term performance (at the potential expense of long-term safety and soundness), or present other unfavorable features.

The SOP describes features that are required in order for stock benefit plans to be deemed acceptable, and sets forth certain unacceptable features. In considering whether stock benefit plans are acceptable, each case should be reviewed independently. Stock benefit plans involving only a nominal percentage of ownership in the proposed institution need not be subjected to in-depth scrutiny.

Guidance provided in the SOP distinguishes between two types of award plans:

1. Options/warrants granted to directors and active management to reward future performance. (Type 1)
2. Options/warrants granted to incorporators as compensation for financial risk borne during the organizational phases or as compensation for professional or other services rendered in conjunction with the organization. (Type 2)

Type 1 plans for active directors and officers must include the following provisions and should be reviewed as part of the total compensation package:

- disclosure,
- duration limits (maximum 10 years),
- vesting requirements (generally, a minimum of three years, in equal amounts),
- transferability restrictions (not transferable),
- exercise price requirements (not less than fair market value at time of grant),
- rights upon termination (expire within a reasonable time), and
- an "exercise or forfeiture" clause (in the event capital falls below regulatory minimums).

Examiners should refer to FASB Statement No. 123, “Accounting for Stock-based Compensation”, which provides guidance on calculating fair market value of stock options.

Type 2 plans do not require vesting, transferability restrictions, or continued association with the institution, but would require equal restrictions regarding disclosure, duration limits, strike price requirements, and an "exercise or forfeiture" clause.

Type 2 plans for incorporators not continuing as directors or officers should serve as compensation for services rendered or "seed" money placed at risk. Typically, it is the latter since professional services (accounting, legal, etc.) are normally paid for in cash. Incorporators often receive a proportional amount of stock after the bank is established as "repayment" of their initial financial contribution. In addition to stock acquired in this manner, incorporators may also receive some proportional volume of stock options/warrants as compensation for financial risk borne during the organizational phase of the bank.

The following summarizes the plan types:

Type 1 Plans

- **Directors and officers who are not incorporators** may participate in prospective management incentive plans. Such plans should be reviewed as part of the total compensation package offered to the individuals involved.

- **Incorporators who are also directors and officers** are allowed to receive a maximum of one option/warrant for each share of stock for which they subscribed in the initial offering. An incorporator who will also be a senior executive officer may receive additional options as part of a prospective management incentive plan. The volume of additional options/warrants proposed beyond that based on stock subscribed should be reviewed for reasonableness on a case-by-case basis, giving consideration to the individual's financial commitment, time, expertise, and continuing involvement in the management of the proposed institution.

Type 2 Plans

- **Incorporators who are not continuing as directors or officers** are allowed to receive a maximum of one option/warrant per share received for "repayment" of seed money and do not qualify for options/warrants based on additional stock subscribed beyond that which is a return of seed money.

- **Incorporators who are not continuing as directors or officers** who agree to accept shares of bank stock as payment for professional services (which otherwise would have been purchased from non-insiders) are also allowed to receive a maximum of one option/warrant for each share received as payment for professional services. The value of such professional services should be supported by proper documentation.

RED FLAGS. Stock appreciation rights, phantom stock, and other similar plans that include a cash payment to the recipient based directly on the market value of the depository institution's stock are unacceptable. These plans have the potential of removing an undetermined amount of cash from the bank's capital accounts, in contrast to option plans that provide an infusion. Under a cash-less exercise of options plan, a broker lends funds to exercise the options and immediately sells the shares to repay the loan. This discourages insiders from retaining the stock and having an on-going stake in the bank. Further, the bank should not be assuming responsibility for paying any of the taxes associated with exercise of the options. These types of options are objectionable in the formative years of a new bank when there is often a need to preserve capital during a period of rapid growth and operating losses.

If the proposal involves the formation of a de novo holding company and a stock benefit plan is being proposed at the holding company level, that plan will be reviewed by the FDIC in the same manner as a plan involving stock issued by the proposed institution. Many de novo banks are organized as subsidiaries of a bank holding company whose only substantive function is to own the stock of the proposed bank. If the FDIC did not assert its right to set standards on stock benefit plans sponsored by de novo shell holding companies organized to sponsor new banks, the FDIC would in essence be giving up its ability to review stock benefit plans in new banks since the agency's requirements could easily be avoided by organizing a bank holding company.

The FDIC does not assert the right to regulate stock benefit plans for *operating* holding companies or holding companies with other material businesses. Additionally, the above criteria relating to stock benefit plans should not be applied to operating institutions but rather only to de novo institutions.

Finally, the following documents provide good guidance and resource on the subject of stock options; Fairmark Press Tax Guide for Investors http://www.fairmark.com/execcomp the Foundation for Enterprise Development http://www.fed.org and the National Center for Employee Ownership http://www.nceo.org .

Fidelity bond coverage and excess employee dishonesty bond coverage should equal or exceed $1 million if the primary blanket bond is less. It is helpful if a binder or commitment letter is obtained; however, approval may be conditioned upon acquisition of adequate coverage prior to opening.

Applicants are expected to commit to obtain an opinion audit by an independent public accountant annually for at least the first three years. The requirement for an external audit is a standard condition of the FDI Order granting deposit insurance. When the applicant is owned by a holding company, a consolidated audit of the holding company will generally suffice.

The proposed management structure should be reviewed to ensure that no management interlocks exist as defined in Part 348 of the FDIC Rules and Regulations.

Conclude with a “Favorable”, Unfavorable” or “Favorable Subjected to Conditions” statement.

RISK TO THE FUNDS

Assess the proposed institution’s business plan, particularly addressing any unsound activities, practices or other issues. Any high-risk activity to establish market share, attain growth, or provide for profitable operations should be discussed. Business plans that are not commensurate with management's capabilities, should be addressed here as well. Operating plans that rely on high risk lending, niche marketing or significant funding from sources other than core deposits or that diverge from conventional banking will require substantial documentation as to the suitability of the proposed activities. Extensive documentation will also be necessary when economic conditions are marginal. The business plan should demonstrate a reasonable ability to achieve sustainable market share, generate earnings, and attract and maintain adequate capital.

Industrial Loan Companies (ILC) and Special Purpose Banks (SPB)

Industrial loan companies and special purpose banks are unique in that neither are considered “banks” under the Bank Holding Company Act. As such, parent and affiliated entities are not regulated by Federal or State supervisory agencies.

Currently, states offering the ILC charter include California, Colorado, and Utah. The charters typically allow institutions to be organized and owned by commercial enterprises, including retailers and manufacturers. Special purpose banks can include credit card issuers organized under the Competitive Equality in Banking Act (CEBA) and trust companies. Because these charters allow institutions to export rates and terms, the formats can provide for a single platform from which to operate in all 50 states. The charters also provide access to the payment system and additional sources of funding.

However, the ILC charter also presents a potentially significant limiting factor that emanates from the stated intention of serving the working class within an institution’s defined market area. To encourage ILC’s to maintain this focus, institutions are prohibited from accepting demand deposits if total assets exceed $100 million, generally. Although not restricted by regulation, in practice, special purpose institutions might limit their deposit activities.

In general, ILC’s and special purpose banks limit their deposit activities to money center operations or brokered deposits; retail accounts might be limited to time deposits and accounts securing outstanding credit lines. In certain operations, including credit card and trust operations, deposit activities might be limited to a single account from the parent organization – a $500,000 deposit that, under the FDIC’s General Counsel’s Opinion, qualifies as “being in the business of accepting deposits.”

Regardless of the form of charter, ILC’s and special purpose charters present unique characteristics that must be fully considered during the investigation. As noted, these include the absence of a regulatory regime outside the insured entity and unique limitations or practical restraints on deposit activities. When coupled with the broad powers conferred, examiners must be particularly cautious in reviewing management competencies, corporate structures and relationships, and the underlying business plans.

Conclude with a “Favorable”, Unfavorable” or “Favorable Subjected to Conditions” statement.

CONVENIENCE AND NEEDS OF THE COMMUNITY TO BE SERVED

Discussion of this factor should begin with a description of the primary trade area, including its location and population. A drive through the neighborhood surrounding the proposed location may be beneficial in determining the visibility, proximity to potential customers, accessibility, and immediate competition. A general discussion of land development in the immediate trade area may also be pertinent. Any differences between the examiner's perception of the trade area and that of the proponents should be discussed.

Also provide a general discussion of the relevant economic conditions, primary industries, and employers. Economic data should be limited to relevant information and relate a general understanding of the vitality and composition of the local economy. Population figures are particularly relevant (especially growth rates) and data establishing trends and projections should be provided if available. Several sources of economic data that provide insight into the economic conditions of the State, county or MSA are available. These include the Federal Reserve Quarterly Economic Review, the FDIC's statistical publications and databases, and other economic periodicals published by creditable sources.

Detail competition, both bank and non-bank, if applicable. Usually this is provided by the organizers, but driving through the surrounding area or consulting data that provides a summary of branches can be beneficial.

Finally, consider the services to be offered by the applicant and how they differ from those presently available including physical convenience. Consult with the responsible Case Manager to determine CRA requirements.

Conclude with a “Favorable”, Unfavorable” or “Favorable Subjected to Conditions” statement.

CONSISTENCY OF CORPORATE POWERS

This factor was originally intended to eliminate institutions with broad-based charters that permitted the applicant to engage in unusual or risky forms of business. However, most states have issued statutes that preclude granting any powers inconsistent with the FDI Act. If any doubts exist, the Legal Division should be contacted. Pursuant to Section 24 of the FDI Act, no insured bank may engage in any activity that is not permissible for a national bank unless the FDIC has determined that the activity would not pose a significant risk to the fund and the institution is in compliance with applicable capital regulations. Applicants are also prohibited from exercising trust powers without the written approval of the FDIC; most States also require written approval.

Conclude with a “Favorable”, Unfavorable” or “Favorable Subjected to Conditions” statement.

OTHER MATTERS

Currently, it is the responsibility of the examiner to evaluate the applicant's Articles of Incorporation and Corporate Bylaws. Of particular importance is a review of the director indemnification, to ensure that the agreements are not overly liberal. Liberal clauses, which include protection against gross negligence and fraud, should be closely scrutinized. The FDIC has taken the position that such broad agreements are not acceptable. With case manager concurrence, consult with a Regional Office attorney.

Review the offering circular when securities are to be offered to the public. The goal is to ensure that de novo financial institutions comply with the anti-fraud provisions of the Federal securities laws that require full and adequate disclosure. Flawed disclosures may expose the institution to litigation and serious capital loss. Refer to the FDIC Statement of Policy Regarding Use of Offering Circulars in Connection with Public Distribution of Bank Securities. The Washington Office’s Registration, Disclosure and Securities Operations Unit normally reviews both private and public offering materials and is available for assistance.

The review should insure that the circular provides sufficient disclosure of all material facts. SEC Rule I Ob-5 makes it unlawful to employ any device, scheme, or artifice to defraud, to make any untrue statement of a material fact or to omit a material fact in connection with an offering of any security.

In most cases, when securities are offered to the public an attorney specializing in securities law is employed. This usually ensures that the basic disclosures are made.

Offering circulars may also disclose proposed stock option plans, employment agreements, and issuance of stock warrants that should be closely reviewed.

Officials of area depository institutions should be contacted during the investigation and given an opportunity to express their opinions regarding the application. Opinions of other business and community leaders may also prove beneficial. Any formal objections should be investigated and appropriate comments set forth in the report. Sole reliance upon the opinions of competitors should be avoided and impartial conclusions should be reached. A sample Community/Competition Interview form is found in Appendix A.

For applicant’s proposing to deliver services over electronic channels, such as the Internet or wireless devices, the examiner should assess the information systems infrastructure, policies and security. An information systems subject matter expert should be required to participate in the investigation, depending on the complexity of the proposed delivery channel.

INVESTIGATION REPORT SUMMARY

Detail the applicant's designated contact person, including title, mailing address, email address, fax and phone number.

APPENDIX A

PROPONENTS/ORGANIZERS MEETING AGENDA SAMPLE

AND

MANAGEMENT/DIRECTOR INTERVIEW FORM

AND

COMMUNITY/COMPETITION INTERVIEW FORM

ANYWHERE BANK (PROPOSED)
MEETING WITH PROPONENTS
MAY 15, 2002

AGENDA

I. Opening Remarks

- A. Acquaint Directors With Their Responsibilities and Liabilities
- B. Apprise Organizers of Regulatory Involvement and Concerns

II. Directors Responsibilities

- A. Sound, Independent Business Judgment
  - a. Candid, Open Discussion of Bank Business
  - b. Documentation of Decisions and Expression of Dissent Within the Board Minutes
  - c. Confidentiality and Integrity
- B. Informed of All Facets of Bank, Operations, Regulatory Environment, Competitive Environment
  - a. Management, Reports, UBPRs
  - b. Report of Examination and Visitation
  - **c.** Internal and External Audit Reports
  - d. Trade Publications, Seminars, Meetings
- C. Direct the Bank in a Prudent Manner
  - a. Establish goals, policies and strategies
  - b. Hire Suitable Management to Implement Goals
  - c. Monitor Management's Compliance with Board Directives
  - d. Discipline or Dismiss Management as Necessary
- D. Build Business for the Bank
- E. Ethical Conduct and Policy
  - a. Regulation O
  - b. Represent the Bank in Your Community

III. Director Liability

- A. Can be Personally Liable for Losses Arising From
  - a. Legal lending Limit Violations
  - b. Insider Transactions
  - c. Bank Failures
- B. Civil Money Penalties

- C. Civil Suites (Shareholders) for Breaches of

a. Duty of Care
b. Duty of Knowledge
aa. Willful Ignorance is not a Defense Against Liability for Negligence

D. Board Minutes are Legal Record and Vehicle for Expressing Dissent

IV. Ongoing Regulatory Involvement

A. Pre-opening Visitation
B. New bank Visitation
C. Examinations
a. Safety and Soundness
b. IS/Other Specialty
c. Compliance

V. Why Banks Fail

A. Bad Loans – Poor underwriting, selection of risk, etc..
B. Poor Funds Management
C. Pursuit of Earnings with High-Risk Lending and Investment
D. Bad Management; Lack of Board Supervision

MANAGEMENT/DIRECTOR INTERVIEW FORM

Proposed Bank: ____

Location: ____

Director/Officer's Name: ________________________________ Born:__________________

Resident Of: ______________________________________ Years: ______________

Principal Business: ____

# of Shares Subscribed:________________________ % of Subscription financed:__________

Stock Payment Method:____

Reasons for becoming a Director/Officer?: ____________________________________
____
____
____

How associated with proposal?: ____
____
____
____

Previous experience as financial institution Director/Officer (If yes, when and where): ____________
____
____
____
____

Why does community need this Bank?:____
____
____
____

What strengths/contributions will you bring to Board/Bank?:___________________________
____
____
____

How long have you known other Director/Officers?:_______________________________
____
____
____

Management/Director Interview Form
Page 2

Impressions of other proponents as individuals and as a working team?: ______________________________

Is any one proponent Dominant? Passive? :______________________________

How much loan/deposit business will you bring to the bank in the first year?:______________________________

Ever been denied credit for reasons of credit problems?:______________________________

Ever been indicted/convicted of a felony?:______________________________

Questions/Comments:______________________________

COMMUNITY/COMPETITION INTERVIEW QUESTIONNAIRE

Date:____________________ Interviewee Name:________________________
Location: _______________________________

Need for an additional bank?:____

Economy and outlook of the market/trade area?:____

Deposit growth in the market/trade area and at your institution?: ____________________________

Impressions and reputation of organizers/CEO?:____

Percentage of the market the new bank can expect to achieve?: ____________________________

Loan rates at your institution? (Ask for a loan rate schedule in order to compare):_________________

Deposit rates? (Ask for a deposit rate schedule): ____

Any official protest or objection to the proposal?:_____________________________________

FDIC

Report of Investigation

THIS REPORT OF INVESTIGATION IS STRICTLY CONFIDENTIAL

BANK OF ANYTOWN

ANYTOWN **ANYCOUNTY** **ANYSTATE**

Regio n: Any Region

harter:

Investigation Commenced:	11/30/2001	Date of Application:	09/25/2001
Investigation Closed:	02/06/2002	Date Application Accepted:	10/22/2001

FEDERAL DEPOSIT INSURANCE CORPORATION

FDIC 6510/10 (02-2002)

TABLE OF CONTENTS

This Report of Investigation consists of three major sections: Conclusions and Recommendations; Assessment; and Other Information. Investigating examiners should refer to the FDIC Statement of Policy on Applications for Deposit Insurance and Part 303 Subpart B – Deposit Insurance, of the Rules and Regulations for guidance. In considering applications for deposit insurance for a proposed depository institution, the FDIC must evaluate each application in relation to the factors prescribed in section 6 of the FDI Act. In general, the application will receive deposit insurance if all the statutory factors plus the considerations required by the National Historic Preservation Act and the National Environmental Policy Act of 1969 are resolved favorably.

CONCLUSIONS AND RECOMMENDATIONS

ASSESSMENT

OTHER

INVESTIGATION REPORT CONCLUSIONS AND RECOMMENDATIONS

Description of the Transaction

Applicant is a Federally chartered National Association in organization and as such, has no financial history. Proponent *originally* applied to the Office of the Comptroller of the Currency (OCC), its primary regulator, for permission to organize as a National Association on August 23, 2000.

However, due to the volume of substantive deficiencies in the Application, the OCC and Federal Deposit Insurance Corporation, requested additional supporting information during the Fall of 2000. In summation, these deficiencies emanated from the lack of supporting documentation regarding critical business model assumptions including but not limited to, customer acquisition rates as well as, deposit/loan growth composition and volumes. Other material weaknesses included the absence of profitability within the formative stages and independent market research supporting the feasibility of the nontraditional delivery channels proposed {non-branch kiosk}. Weaknesses emanating from the original proposal were never satisfactorily resolved and the Applicant withdrew the proposal on April 16, 2001.

Applicant, after substantive modifications to the business model and management team, resubmitted the proposal on October 9, 2001. The proposal calls for the Applicant to be part of a two-tier holding company structure. The United States (US) based holding company and initial-tier will be Holding Company-2, Incorporated, Anytown, Anystate. It will be a wholly owned subsidiary of Holding Company-1 plc, London, England, the top-tier holding company. Both holding companies are active and fully operational as of the date of application. The Applicant intends to file an application with the Federal Reserve Bank for the formation of a bank holding company.

The Applicant's business model espouses the use of multiple delivery channels (integrated model) to service its customer base including: a traditional retail bank site and supermarket branch network, as well as, a fully transactional web site and customer call center.

Financial History and Condition

The Applicant has provided reasonable support for asset and liability projections. Moreover, the proposed investment in fixed assets is within regulatory guidelines. Organizational expenses, while seemingly excessive, are fully covered by the initial level of capital. While the finding on this statutory factor is ***favorabl**e*, one open supervisory item remains. This pertains to the submission of acceptable agreements covering the two proposed related party transactions. Said related party transactions should ensure that the resulting expenses to the insured institution are on terms prevailing in the market for similar services performed and/or due not result in any economic disadvantage or consequence. Related party transactions are summarized on page 8 of this Report.

Adequacy of the Capital Structure

The Applicant has provided for a strong initial capitalization base. Such capital is commensurate with the inherent risks of the business plan and sufficient for the projected growth of the institution. Year three proforma leverage ratio amounts to 8.82%. While the finding on this factor is ***favorable,*** it is contingent on the execution of the licensing (lease) agreements for the in store branches with Albertsons, Inc.

Future Earnings Prospects

The Applicant's business model suggests that it can attain adequate profitability. This profitability is based viable assumptions, which are comparable to various banking peer groups. The finding on this factor is ***favorable.***

INVESTIGATION REPORT CONCLUSIONS AND RECOMMENDATIONS (Continued)

General Character of Management

The general character of the proposed management team appears fundamentally sound and consistent with a rating of "2" under the Uniform Financial Institutions Rating System. Proposed management's aversion for risk is suggested by the concentration of less risky residential real estate during the formative years. While the finding on this factor is ***favorable***, one open supervisory item remains pending. To date, the Applicant has not submitted any stock benefit plans/agreements on its executive officers or directors. In light of exceptions taken during the prior proposal on the extent of option grants to certain executive officers, appropriate due diligence should be accorded prior to chartering.

Risk to the Fund

The proposal does not appear to present any undue risk to the insurance fund. This determination is based on the business model's strong initial capitalization base, seemingly conservative management team and investment philosophy, as well as, the viable and multi-faceted branch network strategy. The finding on this factor is ***favorable***.

Convenience and Needs of the Community

Given the extent of competition and available market share, the Applicant would not adversely impact competition or the delivery of financial services within the market area. The finding on this factor is ***favorable.***

Consistency of Corporate Powers

The finding on this factor is ***favorable***.

Recommendation

The Examiner has concluded that all seven statutory factors have been favorably resolved. However, three open supervisory items remain and should be satisfactorily addressed prior to chartering.

Examiner

FINANCIAL HISTORY AND CONDITION

Assess the reasonableness of asset and liability projections, and composition in relation to the proposed market. Assess the financial condition of parent company and its significant subsidiaries, if applicable. Asses the investment in fix assets. The applicant's aggregate direct and indirect fixed asset investment, including lease obligations, must be reasonable in relation to its projected earning capacity, capital, and other pertinent matters of consideration. Proposed fixed asset investments should conform to applicable State law limitations. Assess compliance with security requirements of Part 326 and with the National Historic Preservation Act. Evaluate any financial arrangement or transaction involving the applicant and an insider(s). The transaction should demonstrate that: (1) the proposed transaction is made on substantially the same terms as those prevailing at the time for comparable transactions with non-insiders, and does not involve more than normal risk or present other unfavorable features; and (2) the proposed transaction must be approved in advance by a majority of the incorporators. In addition, full disclosure of any arrangements with an insider must be made to all proposed directors and prospective shareholders. An insider is a person who is proposed to be a director, officer, or incorporator, a shareholder who directly or indirectly controls 10 percent or more of a class of the applicant's outstanding voting stock; or the associates or interest of any such person.

Summary and Findings

Proposed Retail Bank Site and Supermarket Branch Network

<u>Retail Bank Site</u>

Holding Company-2 (USA), the initial-tier holding company, has leased approximately 6,100 square feet of ground floor space in a five story commercial office building located at 2001 Palm Blvd., Anytown, Anystate. This site serves as the headquarters to Holding Company-2 and retail banking location of the proposed institution. It formerly served as a site for another financial institution and thus contains a vault and drop box area. The current building contains a certain amount of unoccupied space to accommodate the Applicant's future growth needs. An option on this additional space has been structured and provided for within the lease. The site is located within Metropolitan, AnyCounty, and on a heavily traveled boulevard adjacent to a major intrastate highway (I-95). The service area within the immediate vicinity, contains numerous commercial office buildings, service establishments, a shopping mall, financial institutions, as well as, nearby residential developments and condominiums.

<u>Lease Agreement - Retail Bank Site</u>

An office building lease was executed between 2001 Partners, L.C. and Holding Company-1 plc, London, England, the top-tier holding company. It contains an initial three-year lease provision, as well as, certain options. The tenant may extend subject lease for two (2) five (5) year periods under the same terms and conditions. In addition, tenant may also exercise an option for an additional 4,800 square feet within the building under similar terms and conditions. Rent is payable monthly and subject to annual increases based on the lesser of 5% or the percentage rise in the Consumer Price Index. The current rent within the lease includes real property taxes based on 1999 estimates. Any subsequent increases in said taxes are based on the tenant's pro rata share. No bankruptcy or dissolution clause was noted. A security deposit of $19,000 was collected.

<u>Supermarket Branch Network</u>

The organizers intend to operate a total of twelve supermarket branches during the first year of operation with Albertsons, Inc. as its host retailer. Eleven of the twelve branches were fully operational units that were closed July 2001 by Wachovia, NA, following its acquisition of Republic Security Bank, Anytown, Anystate. Albertsons will open the last supermarket branch (twelve) in November 2002. The proposed supermarket branch network will have seven locations in two counties, and will be located within heavily populated cities and townships.

<u>Lease Agreement – Supermarket Branches</u>

Albertsons and the Applicant have yet to complete and execute a contract on the twelve store locations proposed. Currently, Albertsons has submitted a proposal to the Applicant for all twelve stores. While no contract exists yet, proposed CEO Hamm has made assurances that Albertsons management has reserved said branches for the Bank and removed them from their branch availability list. All eleven existing banking facilities (one in process of construction) have been vacant since July 2001. Albertsons' legal counsel is presently preparing a License Agreement for execution, which may reportedly include the following terms and conditions.

Each License (lease) term will be for a minimum of five years, and include two five-year options. Initial license fees will be $30,500 annually ($2,541/mo.+ ATM fees of $250/mo) with modest increases for each successive option term. While the branches are essentially complete, any additional remodeling and/or modification related expenses will be borne by Applicant. All personal and real property taxes are the responsibility of the host, Albertsons.

Branch Network Host – Albertson's Inc. (NYSE: ABS)

Albertson's Inc, a national supermarket operator, is one of the world's largest food and drug retailers, with annual revenue of approximately $37 billion. The company is based in Boise, Idaho and operates more than 2,500 retail stores in 36 states. The company has a market capitalization of nearly $13 billion and holds a credit rating[1] for its outstanding senior notes and debentures of BBB+ (investment grade rating).

Recently Albertsons issued a press release (November 29, 2001) reaffirming the company's intent of preserving Anystate as a strategic market. This release was in response to securities analyst reports that the company had weak market share in many Anystate, cities and was potentially planning an exit out of the entire state. Such a decision would have serious repercussions for the Applicant's deposit assumptions considering the supermarket channel's relative importance to customer and deposit acquisition. The press release stated that the company was attempting to increase operating efficiencies by closing under-performing stores but will invest $125 million throughout the state for new store construction and remodeling. The capital expenditure represents a 25% increase over the prior year. Proposed CEO Hamm stated that company officials have not identified any of the eleven supermarket branch locations in subject proposal for closure.

Asset and Deposit Funding Projections

Deposit Growth Considerations – Prevailing Market Share, Competitive Factors & Recent Denovo Activity

Statistics delineating all FDIC insured institutions with offices located in Anycounty-1 and Anycounty-2, Anystate, suggests that there is intense competition for existing market share. Competition comes from three distinct sources; (1) retail branches within the both county's market, (2) Internet divisions of retail banks, and (3) banks/thrifts operating exclusively on the Internet.

As of June 30, 2001, there were a total of 450 banking offices located within Anycounty-1 with aggregate deposits of $22.4 billion, representing a nearly 5% year over year (YOY) deposit increase. For the same period, Anycounty-2 reflected 405 banking offices with aggregate deposits of $23.9 billion, or a 5.5%YOY increase.

The bulk of the market share within both counties is held by the branch offices of larger out of state regional and super-regional holding companies. Despite the extent of competition, the organizers believe that they can differentiate their proposed institution by delivering high quality service via multiple delivery channels. The Applicant will employ marketing strategies professing same and will stimulate growth through the strategic pricing of deposits and efficiency of service.

Denovo Institutions – Traditional

A review of denovo institutions, which have opened in Southeastern Anystate suggests that nearly all have experienced a certain degree of success in attracting funding. This has occurred despite intense competition by local and out of area institutions within those respective markets. Contributing factors to their success include all and/or a combination of the following: (1) favorable state/local economy and area demographics (2) an existing and vast deposit base (3) overall negative consumer perceptions about larger institutions and their inability to provide adequate service and (4) ability of local directors and executive officers to leverage their existing community contacts in order to attract new business.

[1] Standard and Poors Corporation; Bond Guide, December 2001.

The following table depicts the recent experience of certain Denovo institutions within select Anystate markets.

Institution Total Assets – Latest Qtr. Available 9/01- $000	Insured Date Charter Type Business Model	Volume of Total Deposits After Year 1 - $000 **v**. Projections	Volume of Total Deposits After Year 2 - $000 **v**. Projections
Grand Bank Anytown, Anystate $95,313	Feb. 1999 State Traditional Retail	$51,422 * $18,500	$65,663 $32,752
Landmark Bank, NA Anytown, Anystate $145,450	Aug. 1998 National Traditional Retail	$20,701 * $13,800	$39,930 $26,900
Marine Bank & Trust Anytown, Anystate $65,011	Jul. 1997 State Traditional Retail	$24,149 * $15,000	$36,799 $28,000
Independent Community Bank Anytown, Anystate $33,815	Oct. 1998 State Traditional Retail	$13,625 * $25,000	$27,153 $35,000
First Peoples Bank Anytown, Anystate $35,352	Apr 1999 State Traditional Retail	$18,110 * $20,000	$24,115 $27,500
Gulfstream Business Bank Anytown, Anystate $99,701	May 1999 State Traditional Retail	$33,542 * $20,152	$43,747 30,736
Flagler Bank Anytown, Anystate $33,501	Apr. 2000 State Traditional Retail	$10,795 * $10,330	$28,503 $18,210
Transcapital Bank Anytown, Anystate $93,097	Jul 1999 State Traditional Retail	$41,228 * $27,280	$77,199 $48,430

Projections obtained from respective Reports of Investigation, Summary of Investigation Report, and/or supporting Regional office data when available. * Represents less than twelve months from insured date unless a later opening date is specified.

<u>Deposit Projections & Assumptions</u>

As depicted on page 12 of this Report, the Applicant projects total deposit volumes of $95.1 million, $164.5 million, and $202.8 million, within the first three years, respectively. Additional key assumptions include the following:

- Customer funding will come from the following sources: Branch network 81.5%, 13% Internet, Other (executive officer call program, customer call center, promotional/event kiosks, referrals) 5.5%.

- The distribution channels above project to achieve customer volumes of 9,124, 15,004, and 17,932 during the first three years, respectively. Within this assumption, Applicant further assumes that each customer will have two accounts. This translates to yearly total account volumes of 18,248; 30,004; and 35,864, respectively.

FINANCIAL HISTORY AND CONDITION (Continued)

- In arriving at total deposit volumes, the Applicant estimated that each account would retain an average balance of between $5.2M to $5.6M. The table on the subsequent page summarizes these calculations.

	Year 1	Year 2	Year 3
Deposit Customer Volumes – Cumulative	9,124	15,004	17,932
Account Volumes – Cumulative	18,248	30,008	35,864
@ average Balance of $5,216 Y1, $5,481 Y2, and $5,657 Y3 = Year-end Deposit Volumes	$95.1 MM	$164.4MM	$202.8 MM

With regard to the *Retail Branch* delivery channel, the Applicant assumes that its twelve supermarket branch network and traditional retail office will generate a sustainable deposit base during the formative years. The Applicant argues that eleven of the twelve proposed supermarket branch locations were profitable and viable branches when they were closed just six months ago by Wachovia Bank, following its acquisition of Republic Bank. According to proposed CEO Hamm, Wachovia's decision to close the branches, was driven primarily by philosophical differences and Wachovia's general unfamiliarity over that particular retail distribution channel.

Mr. Hamm stated that the branches are supported by Albertsons' extensive market research. As a matter of necessity and prudent retail practices, Albertsons will assess and enter new store markets only when certain favorable economic and demographic factors prevail. These factors include densely populated areas, traffic patterns, competition, and household income profiles. The favorable outcome of these studies will determine ultimate capital investment and store locations. Mr. Hamm argues that this research is critical to the proposal and a reason why the former branches were successful when owned by Republic Bank. The table below depicts the branch network's one-year history in attracting core funding. Results for December 2000 reflect nearly a 50% rise in funding from the previous period. Applicant projects that it can regenerate at least 65% {$78MM} of the balances existing at year-end 2000 during its formative first year.

Anycounty-2 Stores (7)		Dec-99	Jun-00	Sep-00	Dec-00
Total $ Mil.		**54.5**	**58.4**	**62.1**	**67.1**
Average		7.8	8.3	8.9	9.6

Anycounty-1 Stores (4)		Dec-99	Jun-00	Sep-00	Dec-00
Total $ Mil.		**25.7**	**41.8**	**47**	**53.1**
Average		6.4	10.5	11.8	13.3

Totals All 11 Branches	80.2	100.2	109.1	120.2
Average/Branch	7.3	9.1	9.9	10.9

In addition to the actual experience of the former branches, in-store branch projections have also been based on studies from two credible market sources, specializing in supermarket branches and alternative delivery systems; National Commerce Bank Services (NCBS), Memphis, TN., and International Banking Technologies (IBT) Norcross, GA. A 2000 NCBS study of 61 financial institutions covering 148 in-store branches resulted in the following average branch (NCBS owned branches) statistics below.

- Total accounts: 1,523
- Total Deposits: $11,906M
- Checking: $1,896M {16% of total – Average Balance (AB) $2,243}
- Savings/MMDA $4,532M {38% of total – AB of $10,739}
- CDs: $5,478M {46% of total – AB $21,317}

IBT, one of the largest retail consulting companies in the industry, has market data on clients ranging in size from, $21 million to $600 billion. It categorizes the performance of supermarket branches into high, median, and low. The Proposal's assumptions on the next page are compared with IBT's *median* supermarket branch performance measures (per branch). Applicant projections are also included for its one main office and traditional retail branch.

Period	IBT Median SM Branch Statistics	Applicant Projections – 12 Supermarket	Applicant Projections – 1 Main Office
Year 1	1,800 new accounts – Total Deposits $6.3MM	1,115 new accounts – TDs $5.8MM	3,346 new accounts – TDs $17.5MM
Year 2	1,440 new accounts – Total Deposits $12.7MM	672 new accounts – TDs $9.5MM	2,016 new accounts – TDs $28.3MM
Year 3	1,200 new accounts – Total Deposits $19.0MM	355 new accounts – TDs $11.8MM	1,066 new accounts – TDs $35.3MM

Actual branch history and empirical data, as well as, market research from both NCBS and IBT lend credence to the subject proposal's supermarket branch assumptions. Remaining branch assumptions for the main office appear reasonable and attainable based on recent denovo experience, relatively modest volume expectations in relation to total deposits, and intangibles such as the proposed CEO's following within the community.

With regard to the *Internet* channel, the Applicant projects an account acquisition rate of 7 per day and 12 accounts per day for years 2 and 3. As support for these assumptions, the Applicant stated that since inception, its corporate web site has averaged 184 visitors per day (well over the 31,389 reported during the previous investigation) with over 879 registered parties. It is uncertain as to whether these "hits" are attributable to the interest regarding the Applicant's pending application for Federal deposit insurance or merely concerned investors (which number in the thousands) seeking additional financial information. Notwithstanding, the projections appear plausible considering information provided by Anybank, a pure play denovo internet bank in Anytown, Anystate. According to the bank's chairman, Anybank was recently experiencing traffic of over 2,500 visitors per day and adding an average of 20 deposit accounts per day. During its first year, Anybank was adding an average of 50 accounts daily. Anybank reported recent average account balances of $5M for DDA, $40M for MMDA, and $60M for CDs. It is important to note however, that Anybank has been highly aggressive with respect to deposit pricing during its formative months. Applicant deposit projections for this channel appear reasonable based on existing site traffic and recent competitor experience.

Asset Projections and Assumptions

Applicant's loan projections are largely supported by qualitative factors including the proposed CEO's following in the community given his executive position (Chief Credit Officer) with the former Anybank, Anytown, Anystate. In addition, he reportedly knows a network of real estate and commercial lenders, many of whom were reportedly direct reports while at Anybank. Mr. Hamm stated that he has kept in close contact with several lenders who reportedly hold considerable portfolios of high-quality performing loans and are seeking other employment opportunities.

During the formative stages, the projections call for a conservatively weighted real estate portfolio. Year 1 projections assume a 77% real estate weighting with 58% comprising single family mortgage and home equity loans to prime borrowers. A meaningful portion of the residential portfolio will be purchased via established brokers known to both the proposed CEO and senior lending officer. Mr. Hamm reportedly has vast experience in purchasing mortgage pools with favorable yield and prepayment characteristics. This strategy will be important to the Applicant during the first year given its needs to deploy excess liquidity into higher yielding instruments. Commercial loans will focus on small business and SBA loans. Mr. Hamm stated that these products were successfully delivered and managed by he and the proposed senior lending officer while at Anybank. In light of the proposed CEO's experience and reputation in the market, no exceptions were taken to the loan projections scheduled.

Fixed Assets and Organizational Expenses

Capital Investments

The Applicant's investment in fixed assets is within existing OCC statutory limitations, which permit total fixed asset investment of up to 100% of total capital. The total proposed investment in fixed assets to initial capital is 15%. Two insider or related company transactions were disclosed and noted below.

Total investment in fixed assets at inception is proposed as $4,099M versus actual expenses (as of 11/30/2001) of $1,700M. Approximately 77% {$2,984M} of the net investment pertains to the Applicant's technology platform. This includes computer hardware, software, and associated networks. The remaining 27%{$1,115M} investment pertains to the Applicant's customer call center as well as associated expenses and holdings of furniture and fixtures. Capitalized assets are being depreciated utilizing the straight-line basis over a five-year schedule. The only material capital investment subsequent to opening will be the costs incurred to re-establish the in-store branches estimated at $60M per branch.

Related Party Transactions

Front-End Web Application Design and Deployment

Holding Company-1 plc, London, England (the top-tier holding company; refer to page 14 for organizational structure) will provide the insured bank with the initial front-end web application. This technology service will result in a one-time charge to the proposal of $90M and an additional investment of $20M in year one. A license agreement was not available for review during the Application process. Applicant stated that the service will be commensurate with the prevailing market, observe existing arms-length guidelines for related party transactions, and will be independent of the services provided by the Chief Technology Officer (CTO) Frank Gray.

Dual Employees

Proposed CFO Nigel Newbury and CTO Frank Gray will perform their duties in a dual capacity for both the top-tier holding company in London and the proposed national bank. During the formative years, the CFO and CTO will spend approximately 50% and 90% of their time respectively at the proposed West Palm Beach main office. A service agreement will be executed between the bank and holding company at a salary level commensurate with their roles and the exact time they allocate to the proposal. Currently, salaries allocated to the respective executives to be borne by the proposed institution are $55M per annum. A formal agreement was not yet formalized and/or submitted for review.

Organizational Expenses

The Applicant's organizational expenses are *substantial.* Problems with the original business plan, lack of initial fiscal prudence and length of time are all contributing factors. Since the original application of August 2000, which began during Q4 1999, organizers have withdrawn the Application for Deposit Insurance (April 2001), refilled a new proposal (October 2001) with a notably different business model and delivery modes, replaced various board members and certain key executives and hired new replacements. In the process, the Applicant restructured and incurred costs by reducing staff that was prematurely added by the previous CEO. During the previous application, extensive expenses were incurred for salaries (volume of staff) as well as, legal, professional and advisory fees. These fees have continued to accrue, although at a lesser extent since the arrival of proposed CEO Hamm.

The following table outlines the proposed pre-opening expenses versus actual expense items incurred in connection with the chartering process. The actual expenses from the previous submission are shown for illustrative purposes and to identify any large variances subsequent to that time. The Applicant has included expenses from the original submission inasmuch as previous costs/expenses are directly or indirectly related to the current proposal. The Applicant asserts that errors made previously have resulted in a benefit gained during the current Application.

Expense Category	**Application Projection**	**Actual Expense** 11/30/2001	**Actual Expenses @ Last Proposal – 12/31/2000**
Pre-opening Salaries & Benefits	$1,522M	$1,280M	$677M
Living/Relocation Expenses	$6M	$6M	$6M
Recruitment	$82M	$82M	$82M
Travel/Staff Related Expenses	$65M	$69M	$37M
Occupancy and Office Related	$563M	$473M	$156M
Attorneys & Professional Fees	$982M	$968M	$417M
Tax, Audit, Application, Dep, Other	$680M	$523M	$91M
Total Organizational Expenses	$3,900M	$3,401M	$1,466M

Pre-opening salaries are substantial and equal nearly 38% of total organizational expenses (year-to-date). The high volumes are attributable to the number of staff retained by the organizing group during the organizational phase, including that of certain highly compensated proposed officers. As of year-end 2000, the Applicant had hired and retained twenty employees. While this figure has since been reduced to eleven at year-end 2001, a high-level of expenses was still accruing throughout the first half of 2001 from the original higher staffing table. Since the arrival of proposed CEO Hamm, he has taken a proactive role in reducing these related expenses by releasing unwarranted and/or prematurely hired staff.

Attorneys, professional, and consulting fees are substantial and were highly criticized at the previous Corporation investigation. The criticism involved their excessive levels for the chartering of a denovo bank. It was argued that most of the expenses were discretionary and could have been controlled and managed in a more prudent and cost effective manner.

Included within the expenses are those associated with the Applicant's counsel/advisor. The Applicant retained the firm of Hodson & Hodson (HH), Washington, D.C., for legal and advisory services in connection with the chartering and application process. The engagement letter executed January 6, 2000 provides for an hourly billable rate ranging between $250 - $400. Overall fees for the chartering process were originally estimated by counsel to be between $250,000 and $300,000. In addition to this firm, the Applicant retained and incurred expenses with two other consultants that have since been discontinued under the current proposal. The high rate of legal and professional expenses billed from HH declined considerably after January 2001. Since proposed CEO Hamm's arrival, he has discontinued the previous practice of utilizing HH as regulatory liason during the current Application filing. Mr. Hamm stated that this has saved considerable monies and lowered the expense rate during Q3 and Q4 2001.

In addition to the legal and professional fees billed by HH, the pre-opening expense category includes consultancy fees billed by Holding Company-1 plc, in the amount of $428M. The fees pertain to the time commitment expended by several dual employees (employees of the holding company and proposed bank), which included the current officers (CFO Newbury, CTO Gray), certain software developers, and the former CEO and founder Casey Grant. The consulting fees constituted their salary calculated on a pro-rata basis for the amount of time expended during the organizing process, including application of an overhead component. The calculations were reportedly discussed with Holding Company-1's external auditor who assessed their reasonableness and accompanying tests for transactions with non-affitiliated parties. Documentation regarding this due diligence was not available for review during the Investigation process.

The last pre-opening expense item exhibiting a high variance was the "other" line item. Nearly the entire variance is represented by depreciation expenses associated with the Applicant's technology platform and very conservative prior depreciation schedule of three-years.

A key mitigating factor to the seemingly excessive pre-opening and organizational expenses pertains to the fact that the proposal has successfully raised capital during two separately underwritten offerings (see capital adequacy section on offerings and company structure). The holding company's equity position was recently reported at £19,137,532 or approximately $27.36 million. The proposal calls for an initial capital infusion of $26.9 million. The volume of capital from inception can absorb the high organizational expenses and support the proposed growth of the Applicant. Any actions by Regulatory Authorities to disallow certain organizational expenses above (from the previous submission) will simply result in the holding company having to absorb those costs. Considering the finite resources of the holding company and unlikely prospects of successfully executing a third capital offering, any organizational costs borne by the holding company will likely result in a <u>lower</u> initial capital infusion to the bank. Lower capital at inception would be offset by reduced organizational expenses, thus likely amounting to a wash or little financial impact.

Security Requirements & National Historic Matters

With regards to the proposal's security program, including compliance with Part 326 of the FDIC Rules and Regulations, organizers have committed to fully adhering to all applicable requirements. With regard to the National Historic Preservation Act, the State's Division of Historical Resources, corresponded with the Applicant on June 14, 2000. The department stated that the primary site (main office) would not interfere with any applicable historic sites and/or accompanying statutes. In regards to the retail supermarket branch network, all locations proposed are former branches of a federally insured institution. As such, no historic preservation or environmental impact concerns are anticipated.

Pending the submission of acceptable agreements covering two proposed related party transactions, the overall findings with regard to this factor is <u>FAVORABLE.</u>

FINANCIAL HISTORY AND CONDITION (Continued)

PROJECTED BALANCE SHEET			
	YEAR END BALANCE		
ASSETS	FIRST YEAR	SECOND YEAR	THIRD YEAR
CASH AND NONINTEREST BEARING BALANCES	3,816	5,940	6,893
INTEREST BEARING BALANCES			
SECURITIES – Held-to-maturity			
Available-for-sale	38,280	51,480	34,887
FED FUNDS SOLD AND REPURCHASE AGREEMENTS			
LOANS			
Construction and land development secured by real estate			
Loans secured by farmland			
Loans secured by 1-4 family residential properties	3,893	7,749	8,309
Junior lien loans secured by 1-4 family residential	34,915	44,848	56,463
Loans secured by multifamily (5 or more) residential properties			
Loans secured by non-farm non-residential properties	12,548	35,544	58,226
Credit card and related plans to individuals			
Agricultural loans and other loans to farmers			
Commercial and industrial loans	13,444	25,882	41,457
Loans to individuals for household and personal expenditures			
Other loans	2,075	5,738	11,332
LESS: Unearned income			
Allowance for loan and lease losses	836	1,497	2,197
NET LOANS	66,039	118,264	173,590
PREMISES AND FIXED ASSETS	4,015	3,054	2,202
ALL OTHER ASSETS	2,138	3,329	3,862
TOTAL ASSETS	114,288	182,067	221,434
LIABILITIES			
DEPOSITS			
Demand deposits and noninterest bearing deposits	7,007	12,652	15,463
Interest bearing deposits	49,461	85,363	106,529
Time deposits of less than $100,000	27,098	46,514	56,622
Time deposits of $100,000 or more	11,613	19,935	24,266
TOTAL DEPOSITS	95,179	164,464	202,880
FED FUNDS PURCHASED AND REPURCHASE AGREEMENTS			
BORROWINGS			
OTHER LIABILITIES	638	704	763
TOTAL LIABILITIES	95,817	165,168	203,643
EQUITY CAPITAL			
COMMON STOCK	1	1	1
SURPLUS	26,899	26,899	26,899
UNDIVIDED PROFITS	(8,429)	(10,001)	(9,109)
OTHER EQUITY CAPITAL			
TOTAL EQUITY CAPITAL	18,471	16,899	17,791
TOTAL LIABILTIES AND EQUITY CAPITAL	114,288	182,067	221,434
Tier 1 Leverage Capital Ratio	16.16%	9.28%	8.03%

ADEQUACY OF THE CAPITAL STRUCTURE

Generally, initial capital should be sufficient to provide for the maintenance of an 8 percent Tier 1 capital to assets leverage ratio (as defined in the appropriate capital regulation of the institution's primary Federal regulator) throughout the first three years of operation. The institution must also maintain an adequate allowance for loan and lease losses. Determine if the institution is being established as a wholly owned subsidiary of an eligible holding company (as defined in Part 303, subpart B). Assess the adequacy of proposed capital in light of projected deposits and growth, business plan risk tolerance, and the ability of proponents or parent company to provide additional capital. Special focus depository institutions (such as Internet or credit card banks) should provide projections based on the type of business to be conducted and the potential for growth of that business. All stock of a particular class in the initial offering should be sold at the same price, and have the same voting rights. Proposals which allow insiders to acquire a separate class of stock with greater voting rights or at a price more favorable than the price for other subscribers are not acceptable. Discuss financing arrangements for directors, officers, and 10 percent or more shareholders. Financing arrangements by insiders of more than 75% of the purchase price of the stock subscribed to by one individual or more than 50% of the purchase price of the aggregate stock subscribed by the insiders as a group should be supported to be considered acceptable. Insiders should demonstrate the ability to service the debt without reliance on dividends or other forms of compensation from the applicant.

PROPOSED CAPITAL STRUCTURE

ITEM	COMMON STOCK SHARES	PV	AMOUNT	SURPLUS	RETAINED EARNINGS	TOTAL	THIRDYEAR AVERAGE ASSETS	CAPITAL ASSET RATIO
Minimum Statutory Requirements			0			0		%
Amount Indicated on Application	1,000	1.00	1,000	26,899,000	(9,109,000)	17,791,000	201,602,000	8.82%
Revised Proposal			0			0		%
Recommendation of Examiner	1,000	1.00	1,000	26,899,000	(9,109,000)	17,791,000	201,602,000	8.82%

SALE PRICE PER SHARE OF CAPITAL *(original proposal)*	*(revised proposal)*	FEES OR COMMISSIONS IN CONNECTION WITH SALE OF STOCK
IPO: 2p (£ .02 or 3¢) Secondary IPO: 20p or 30¢ Assumes exchange rate @ £1.00 : $1.50		0.00

Summary and Findings

Initial Capitalization

The top-tier holding company (see ownership structure) has successfully executed two capital offerings totaling £22 million or approximately $35.2 million. The proposal calls for a direct infusion from said holding company.

The organizer's general consensus is that the level of proposed capital will suffice. In the event that additional capital is required, the Applicant has stated that the feasibility of a third public offering (see ownership structure) will be largely contingent upon favorable conditions within the European equity markets. Proposed CEO Hamm suggested a possible listing application to a US stock exchange may be pursued to enhance the likelihood of additional capital sources and share liquidity.

Founding directors are listed as follows: Lance Price (HC Director), Casey Grant (former director/officer), Nigel Newbury (proposed CFO), Stephen Helm (former director/officer), John Wise, Hamilton Trustees Limited.

ADEQUACY OF THE CAPITAL STRUCTURE (Continued)

Top-tier Holding Company – Additional Information on Capital

Shares Authorized: 750,000,000
Shares Outstanding: 350,000,000
Par Value: @ 50p or .75¢; assumes original exchange rate @ £1.00:$1.50
Principal Shareholders:

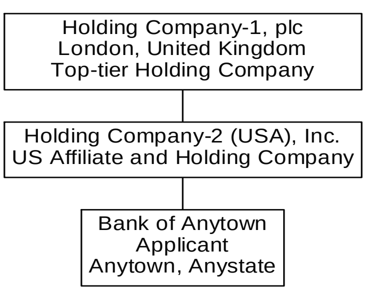
Shareholder	Category	Shares Held	Percent of Outstanding Shares
Casey Grant	Former Director	54,750,000	15.64%
Hamilton Trustees Limited	Institution	36,875,000	10.54%

Casey Grant, *former* proposed CEO of the bank and its holding company, is no longer affiliated with the proposal, other than as its single largest shareholder. Mr. Grant has requested two special board meetings to seek the voluntary dissolution of the holding company. Such proposal was soundly defeated by shareholders with over a 2:1 margin

Hamilton Trustees, Ltd. (10.5% shareholder) is reportedly a passive shareholder (no board or management representation) and trustee to certain trust funds. Hence, the beneficial owner of the shares is a trust, reportedly established to benefit certain charitable organizations. Per Mr. Newbury, no discussions have taken place with the Federal Reserve (as of January 7, 2002) to establish any element of control with respect to such party.

Ownership Structure

As depicted in the chart below, the top-tier holding company, Holding Company-1 plc, is headquartered in London and owns the Applicant via a United States (US) based holding company, Holding Company-2. The top-tier holding company, incorporated November 30, 1999, was established as a Public Limited Corporation (PLC). A PLC retains the status and functionality of a US based corporation and is the proper vehicle should the company wish to tap the country's capital markets. It is a registered entity within the UK, governed by prevailing regulations (Companies Act) including minimum capital requirements. In addition, the liability of its members is *limited* to the amount of shares held. According to proposed CFO Newbury, the top-tier holding company has no other operating subsidiaries besides the US holding company. It was reportedly evaluating other financial opportunities in the United Kingdom (UK) and elsewhere in an effort to establish alternative revenue sources. In this regard, Holding Company-1 plc, had reportedly met with officials of the UK's Financial Services Authority (FSA) with the intent on formally applying to become a UK Depository Institution. No formal applications have been made as of the Application date.



Holding Company-1 plc, is a publicly traded company, which was admitted and listed on the Alternative Investment Market (AIM – tantamount to the NASDAQ small capitalization equity market in the US) of the London Stock Exchange on December 16, 1999. It successfully completed an initial public offering during late 1999, raising £2 million (before associated expenses of £61,928) as well as, a fully underwritten secondary offering in February 2000, which raised an additional £20 million (also before associated expenses of £505,563). Total capital raised in US dollars approximated $35.2 million (before expenses).

Holding Company-1 plc – Financial Position

As of the most recent interim financial report (June 30, 2001), the entity held total assets of £19,581,817 or approximately $27.4 million. Total equity was £19,137,532 with cash representing the bulk at £18,231,943 or $25.5 million. Cash balances are invested within various European correspondents in short term, money market instruments and placements. For the same period above, operating losses after taxes totaled £1,250,942 or $1.7 million; a sharp rise (247%) over prior year losses. Reportedly, then eprime bank (in formation) incurred significant operating costs anticipating the issuance of a National Bank charter, which later failed to materialize. These higher operating costs, which included a high volume of staff were exacerbated by one-time restructuring charges related to personnel and other expense reductions programs. According to Mr. Newbury, the monthly cash "burn rate" or actual costs net of interest income was approximately $112M per month. Given the absence of dividends during the foreseeable period, the holding company will need to continue managing expenses and/or develop other revenue producing avenues to stem operating losses and its accompanying effect on capital.

According to proposed CFO Newbury, the company's stock retains five market makers and is held by over nine institutional investors (mainly mutual funds companies). In December 2001, the company possessed a market capitalization of approximately £8.75 million or approximately $12.3 million, thus representing a steep discount to June 2001's book value.

With a recent share price of 2.5p (£.03 or ¢3.57), the 52 week range consisted of 11.25p (£.11 or ¢16.09) to 2.25p (£.23 or ¢3.21). At this price, the stock was trading nearly 78% off its yearly high. The holding company's low, which it reached in October 2001, was attributable to a combination of the failed charter attempt, as well as, adverse market conditions.

Capital Adequacy Assessment

Proposed Business Model

The proposal calls for launching an integrated model leveraging technology and a traditional physical branch network. These multiple channels include one traditional retail banking office, a network of twelve convenience-driven supermarket branches, a fully transactional website and customer call center. The model attempts to focus on the efficient delivery of banking products with superior customer service. The in-store supermarket branch network will be employed within a large regional supermarket host located in heavily populated and demographically favorable service areas, cities/townships. The proposal also seeks to target the growing Hispanic community within Anycounty-1 and Anycounty-2 and will deliver products and services (Web/phone) in a bilingual format.

Projected Growth and Business Model Risks

Capital levels in light of projected growth and prevailing business model risks appears satisfactory. The business plan's overall risk assessment appears Low to Moderate.

On the asset side of the balance sheet, the proposal seeks considerable loan growth. This loan growth however, appears to be conservatively weighted towards the real estate sector in general and within products secured by primary residences (conventional/prime SFRs and HELs). Refer to the previous comments (page 8) regarding Asset Projections and Assumptions. The proposed loan mix represents a notable reduction in risk versus the previous proposal which was focusing extensively on higher yielding commercial loans. The ability to generate loans during the formative years will be partly facilitated by residential portfolio loan purchases. This is reportedly an area of expertise of the proposed CEO and SLO. Risks in these products will seemingly be limited to the premium paid given the current interest rate environment and accompanying earnings risk (write-down of premium on the asset side) should these underlying assets pre-pay (interest rate risk). The extent of loan volume appears to be coming at the expense of liquidity, which is a little lower than would otherwise characterize a denovo bank (proforma Loan to Deposit Ratios 69%, 72% and 86%, for first three years, respectively). However, given the current interest rate environment and low yields on short term Federal Funds, many institutions are attempting to minimize said holdings in order to achieve a more optimal net interest margin.

With regard to the deposit side of the growth projections, risks have been reduced considerably versus the previous proposal given the adoption of an established and more traditional funding channel. The supermarket branch network proposed in the model has a prior history and reportedly held actual deposit volumes of $120 million as of the year-end 2000[2]. This proven channel along with the main office, transactional website, and business referral prospects of the proposed CEO and select board members should provide reasonable assurances to the proposal's deposit projections.

[2] Raw data from the former Republic supermarket branches were not available for Examiner review. Proposed CEO Hamm stated that internal RSB reports (now property of Wachovia) were proprietary and thus restricted.

Business model risks emanate primarily from the denovo's operating environment. The operating environment is currently faced with a yield curve, which while steep and historically beneficial for financial institutions, contains a very low short-term rate base. The risk, from an asset/liability management and earnings perspective, is that short-term rates remain at historical lows. As such, any additional rate declines (Federal Funds Target Rate and resulting Prime lending rate reductions) may result in a further compression of net interest margins. Short-term rate reductions were recently implied by the 30-Day Federal Funds Futures contracts, which settle in April 2002[3]. Ensuing rate reductions could make net interest income and profitability goals for the denovo more challenging thus increasing the operating losses. Other risks with regard to the operating environment pertain to the current state of the local, state, and national economies. Any prolonged national recession could begin to more negatively impact the State and the bank's proposed service areas. This risk would occur at a time when the bank could be ramping its loan portfolio. Mitigating factors to the economic environment include the apparent strength of the new management team (CEO Hamm, SLO Well and Directors Wart and Marcotte) and the higher concentration on less risky residential mortgage lending.

In the interim, the business model risks also include the current status of the lease or licensing agreements with the retail host, Albertsons. While the organizers contend that the twelve proposed branch locations have been reserved for the denovo bank, firm agreements have yet to be executed. The failure of procuring any or all of these proposed branch locations by the organizers could have a negative impact on the applicant achieving deposit and/or loan projections. While lower growth would result in generally higher capital ratios, it might impact earnings given the sizeable fixed charges and overhead that the Applicant would need to overcome to become profitable.

While the finding on this factor is <u>FAVORABLE</u>, it is contingent on the execution of the licensing (lease) agreements for the in-store branches with Albertsons Inc.

[3] Chicago Board of Trade; January 11, 2002 April Contract settlement price of 98.405.

FUTURE EARNINGS PROSPECTS

Assess the reasonableness of earnings projections and supporting assumptions of the business plan in relation to the economic environment and competition. Projected interest income, expense, non-interest income and expense, and provisions for loan and lease losses should be analyzed and compared to experiences of other new banks in the trade area or in a similar market. When necessary, the examiner should make adjustments to the applicant's projections and discuss the basis for the differences. Incorporators should demonstrate through realistic and supportable estimates that, within a reasonable period (normally three years), the earnings of the proposed institution will be sufficient to provide an adequate profit.

Summary and Findings

The Applicant projected a net operating profit (loss) of ($8,429M), ($1,573M), and $893M for the initial three years of operation, respectively or a cumulative operating loss of ($9,109M). These underlying projections were based on reasonable average earning assets to average assets assumptions (what-if scenario 5) of 89%, 92%, and 94% over the respective periods. Applicant asserts that the average earning asset assumptions are on the conservative range given the proposal's technology platform and lower emphasis on costly traditional retail branches and fixed assets. The Applicant argues that the assigned average earning asset assumptions represent the most conservative scenario possible and that higher earning asset utilization during the formative years are plausible based on peer group data. Any higher utilization may result in improved net interest margins and a higher operating profit in year three.

Margin Analysis

In light of the substantial interest rate volatility during calendar years 2000 (Central Bank tightening of the money supply) and 2001 (aggressive loosening and adding of system liquidity), any meaningful comparative analysis is better served by assessing the net interest income line as opposed to individual yield and cost factors. This facilitates analysis of the proposal's assumptions over varying interest rate environments.

The table below depicts the proposal's estimates for net interest income and non-interest income to average assets during the formative years. Comparisons for reasonableness include an Examiner calculated average of denovo institutions (Banks listed on page 6 of this report) as well as, various peer group and State averages for the period ending September 30, 2001.

Institution	Net Interest Income	Non-Int. Income	AEA/AA
Examiner Denovo Sample -Mean	3.71%	0.79%	93.91%
UBPR Peer Group 9	3.91%	0.74%	94.05
UBPR Peer Group 13	3.99%	0.70%	93.47
UBPR Peer Group 25	3.72%	0.57%	91.72
Mean – All Insured Banks – Anystate.	3.91%	0.83%	92.19%

National Bank Year 1	3.94%	0.38%	89.37%
National Bank Year 2	4.41%	0.54%	92.46%
National Bank Year 3	4.70%	0.55%	93.70%

Notes: Source: Uniform Bank Performance Reports; Peer Group 9=Banks with TA of $100-$300 million within Metropolitan Area; Peer Group 13=Banks with TA of $50-$100 million within Metropolitan Area; Peer Group 25= Banks established within last 3 years<=$50 million. AEA/AA represents Average Earning Assets to Average Assets.

Comparative analysis suggests that the Applicant's Net Interest and Non-Interest Income estimates appear reasonable during the first year of operation. During years 2 and 3, the Applicant's loan mix begins to shift from lower yielding residential and home equity loans (58% year 1 versus 43% and 38% years 2/3) to higher yielding commercial real estate products. While the changes in loan mix are ramped over a two-year period, the rising emphasis on the commercial real estate (19% year 1 mix, 30% and 33% years 2-3) category is accompanied by higher asset yields ranging from 100-125 basis points. This attempts to explain part of the expansion in the subject margins. Proposed CEO Hamm argues that the proposal's ability to underwrite fundamentally sound and higher- yielding commercial real estate loans is heightened by his previous relationships with many of the former lending officers of Anybank, Anytown. Said officers reportedly have established portfolios within the proposed service areas and are seeking other employment opportunities following Anybank's consolidation into Regionalbank.

FUTURE EARNINGS PROSPECTS (Continued)

On the funding side of the balance sheet, two factors emerge which seemingly justify lower cost of funds and consequently wider margins. First, the Applicant proposes to open with $26.9 million in capital or over 2 to 2.5 times the capital typically employed by denovo banks in Southern Anystate. The higher paid-in capital effectively lowers funding costs associated with initial balance sheet activity (loan/bond purchases and origination). Secondly, the proposal would be procuring funding liabilities in a very favorable interest rate environment. This environment characterized by historically low short-term interest rates enables the Applicant to attain a lower *average* cost of funds. This lower cost, coupled with the present steep yield curve, could justify the higher margins.

Of the eight denovos listed on page 6, Grand Bank in its third year of operation achieved a 4.44% net interest income (NII) to average assets ratio. This ratio, which is in the 75th percentile, occurred during an arguably more difficult interest rate environment (negative yield curve during 2H 2000) than the Applicant would likely experience. Nonetheless, the Examiner adjusted year 3 NII to average assets ratio to 4.44% to determine the impact on year three profitability and ensuing capital ratio. Despite the decline in margin, the Applicant would still exhibit profitability and a year 3 capital ratio of 8.56%.

Sensitivity Analysis

The Applicant submitted an analysis of the impact that certain scenarios would have on proforma earnings (Year 3 stress testing). These scenarios, which were part of the base plan, appear to be well formulated and realistic based on current market conditions and inherent risks within the Applicant's operating plan. The scenarios examined include the following:

- *Loan Growth would only amount to 75% of year 3 base forecasts.* Under this scenario, projected net loans would ramp at a slower rate of growth and culminate in 75% of the base plan. In this scenario, net loans and percentage of plan figures would equate to $58 million (88%), $94 million (80%), and $131 million (75%), during the three respective years.

- *Deposit Growth would only equate to 75% of original forecasts.* In this scenario, the Applicant would stress test the outcome of a less than favorable deposit gathering event. With regard to scenario 2, total deposits would amount to $71 million, $124 million, and $152 million, during the respective three years.

- *Failure to attain a lower-cost deposit mix.* Under this event, the Applicant examines the impact of achieving a less than optimal deposit mix or a high concentration of costlier time deposits. Specifically, time deposits would increase to 53% or more throughout the first three years versus original forecasts of 40-41%. This scenario assumes that marketing/pricing strategies would fail to generate the optimal level of generally less costly MMDAs.

- *Interest rate shocks of 100 basis points*. Applicant assumes parallel shifts in rates (upward/downward) and that the bank would be able to adjust rates paid on deposits to reasonably match the change in yield bearing instruments.

Net Income / Sensitivity Analysis $000	Year 3
Scenario One – *Slower Loan Growth*	$751M
Scenario Two – *Lower Deposit Growth*	<$100M
Scenario Three – *Higher Cost Deposit Mix*	$806M
Scenario Four – *Rate Rise 100 bps*	$1,449M
Scenario Four – *Rate Drop 100 bps*	$1,090M

The Applicant projects year 3 profitability in all scenarios tested. The highest risk to the business model is presented by scenario 2, slower deposit growth. Aside from actively managing its cost structure to minimize the probability of losses in year 3, proposed management is reasonably confident that it can attain 75% or more of the deposit forecasts reflected in the plan. Supporting arguments for its claim are (1) General success of denovos in the Southern Anystate market in attracting funding at a reasonable cost, (2) The level of reported public interest in the proposal to establish depository relationships prior to conditional approval. This includes various verbal commitments reportedly made from various organizations in Anytown to the Applicant. Additional deposit referral business (in excess of $10MM for DDA/NOW) has also been alluded by the Applicant's influential Anytown board members (Wart and Marcotte). (3) The success of the supermarket branch network as it existed twelve months ago. Applicant stresses the last factor adds considerable credibility to the deposit forecasts. Despite having been in the Anytown market for less than three years, the investigating Examiner believes that proposed CEO Hamm enjoys a relatively strong reputation in the banking community. This reputation and extent of contacts should greatly assist the Applicant in garnering deposits from both the supermarket network and the retail banking office.

The finding on this factor is <u>FAVORABLE.</u>

FUTURE EARNINGS PROSPECTS (Continued)

ESTIMATED INCOME AND EXPENSES			
	ESTIMATED AMOUNT		
DESCRIPTION	FIRST YEAR	SECOND YEAR	THIRD YEAR
Interest Income			
Real Estate loans	2,542	5,287	8,178
Installment loans	98	332	728
Credit Card loans			
Commercial and all other loans	614	1,611	2,758
Lease financing receivables			
Balances due from depository institutions			
Taxable securities issued by states and political subdivisions			
Tax-exempt securities issued by states and political subdivisions			
U.S. Government and other debt securities	954	2,683	2,556
Other securities			
Federal Funds sold and securities purchased under agreements to resell			
Total Interest Income	4,208	9,913	14,220
Interest Expense			
Transaction accounts (NOW, etc.)	60	175	242
Time Deposits of less than $100,000	448	1,307	1,831
Time Deposits of $100,000 or more	192	560	784
Money Market deposit accounts	432	1,245	1,752
Other savings deposits	33	95	133
Federal Funds purchased and other borrowings			
Total Interest Expense	1,165	3,382	4,742
Net Interest Income (NII)	3,043	6,531	9,478
NII % of Average Earning Assets	3.94%	4.41%	4.70%
Provision for Loan and Lease Losses	836	797	918
Non-interest Income	291	796	1,112
Non-interest Expense			
Salaries and Benefits	7,027	8,103	8,779
Net Occupancy Expenses			
Other Operating expenses:			
Advertising and Marketing			
Professional Services (legal, accounting, etc)			
Computer Services/Data Processing			
Miscellaneous			
Net organization expenses *(1st year only)*	3,900		
Total Non-interest Expense (NIE)	10,927	8,103	8,779
NIE % of Average Assets	14.14%	5.47%	4.35%
Income (Loss) before Income Taxes	(8,429)	(1,573)	893
Income Tax Expense			
Net Income (NI)	(8,429)	(1,573)	893
NI % of Average Assets	(10.91)%	(1.06)%	0.44%
Average Assets	77,277	148,135	201,602

Explain examiner adjustments made to applicant's projections.

FUTURE EARNINGS PROSPECTS (Continued)

ESTIMATED AVERAGE DEPOSITS AND AVERAGE ASSETS						
DESCRIPTION	AVERAGE DURING					
	FIRST YEAR	Yield or Cost	SECOND YEAR	Yield or Cost	THIRD YEAR	Yield or Cost
AVERAGE DEPOSIT AND BORROWINGS						
Transaction Accounts (NOW, etc.)	5,440	1.10%	12,505	1.40%	17,277	1.40%
Time Deposits of less than $100,000	16,133	2.78%	36,806	3.55%	51,565	3.55%
Time Deposits of $100,000 or more	6,914	2.77%	15,774	3.55%	22,100	3.55%
Money Market deposit Accounts	19,040	2.27%	42,930	2.90%	60,396	2.90%
Other Savings deposits	2,274	1.19%	6,353	1.50%	8,898	1.49%
Transaction Accounts (DDA Noninterest)	6,484	%	15,453	%	23,438	%
		%		%		%
Federal Funds Purchase		%		%		%
Total estimated average deposit/ borrowings	**56,285**		**129,821**		**183,674**	

AVERAGE ASSETS						
Real Estate loans	36,401	6.98%	69,626	7.59%	105,254	7.77%
Installment loans	1,372	7.14%	3,894	8.52%	8,508	8.54%
Credit card loans		%		%		%
Commercial and all other loans	8,892	6.92%	19,620	8.21%	33,598	8.20%
Lease financing receivables		%		%		%
Interest-bearing balances due from banks	2,552	%	4,882	%	6,417	%
Taxable securities issued by states and political subdivisions		%		%		%
Tax-exempt securities issued by states and political subdivisions		%		%		%
U.S. Government and other debt securities	22,988	4.15%	44,851	5.98%	43,393	5.89%
Other securities		%		%		%
Federal funds sold and securities purchased under agreements to resell		%		%		%
		%		%		%
		%		%		%
		%		%		%
		%		%		%
Total estimated average earning assets	69,070		136,827		188,911	

Explain examiner adjustments made to applicant's projections.

Note: Cost factors above are as a percentage of Average Interest Bearing Liabilities only.

GENERAL CHARACTER OF THE MANAGEMENT

Proposed management, including the board of directors or trustees, is evaluated against all factors necessary to operate the institution in a safe and sound manner, including the ability to identify, measure, monitor and control the internal and external risks presented by the proposed business plan. Proposed directors and officers should be evaluated on the basis of their financial institution and other business experience, duties and responsibilities in the proposed institution, personal and professional financial responsibility, reputation for honesty and integrity, and familiarity with the economy, financial needs and character of the trade area. Examiners should consider, at a minimum, proposed board oversight and support; management expertise and depth; proposed credit, funds management, interest rate risk and investment guidelines and internal and external audit programs. Comments should provide a forward-looking assessment of an institution's management team, including its operating philosophy and tolerance for risk-taking.

Summary and Findings

Meeting with Organizers

An organizer's meeting was held December 12, 2001 to discuss the application process, as well as, various other safety and soundness matters. Supervisory Examiner Ivie Smart attended on behalf of the Corporation.

Proposed Members of Active Management

Joe Hamm – Chairman/Chief Executive Officer (CEO)

Mr. Hamm's duties will include responsibilities for planning and establishing policy and ensuring all board objectives are executed. In addition, he will supervise senior officers, as well as establish parameters for profitability, business and strategic planning. While Mr. Hamm has not previously served in this capacity of an insured institution, he does possess extensive executive level leadership and credit experience. Previous roles have also included active participation on various board committees notably, strategic planning, executive, loan, and asset/liability management. His commercial credit experience in particular is viewed as a key strength within the organizing group. This experience, along with information obtained from available regulatory sources suggest that he will employ a conservative operating philosophy with regard to risk selection. Actions taken by Mr. Hamm during his brief association with the group appear to confirm this philosophy. During interviews with the undersigned examiner, Mr. Hamm stated he recognized the salient risks with the previous proposal and recommended that the operating plan be materially changed. In addition, he also recognized that HH's role in the regulatory application process should be reallocated to him as CEO. The latter has seemingly made the process more efficient from both a cost and regulatory perspective. Finally, Mr. Hamm eliminated the reliance on outside consultants (other than HH as Counsel) that were frequently employed by the previous CEO and President. He stated that it is his role to formulate a credible strategy, plan, and accompanying assumptions.

Nigel Newbury – Chief Financial Officer (CFO)

Mr. Newbury's proposed duties include supervising all internal management and financial reports, treasury function including asset allocation strategies, producing risk management and profitability reports and budgets, and participating in strategic planning. The position description defines that he will directly supervise the financial controller/treasurer. While Mr. Newbury has not served in this capacity within a commercial or community bank, he does possess a background in accounting and financial management at both a recognized public accounting firm and other large multinational corporations.

Frank Gray – Chief Technology Officer (CTO)

Mr. Gray will have direct oversight over the senior technology officer and development manager. The position's function includes overall responsibility for the design, implementation, and maintenance of all the Applicant's software, computer hardware, and technology infrastructure. Mr. Gray will also identify and recommend solutions to the Applicant's technology needs and problems. In summary, his responsibility is to manage the systems to ensure that efficient customer service is maintained. Mr. Gray appears to possess extensive experience for the proposed position. In the interview, Mr. Gray stated that the senior technology officer (his direct report) would be the US based technology officer, while Mr. Gray executes his other roles at the top-tier holding company in London.

John Well - Chief Lending Officer

Mr. Well's duties will encompass responsibility for loan growth and the preservation of asset quality. Inherent in this role will be the employment of conservative underwriting and risk management systems. His background contains considerable lending, credit administration and operations experience within both commercial and consumer portfolios, which appear compatible with the proposed Application and business model.

Proposed Board Members

The proposed board includes eight members, five of which are designated as non-executive (outside directors). The outside directors have a vast array of experience in banking and finance, law, communications, technology, and criminal investigations. A key improvement in the current management team over the prior proposal includes the addition of directors (either inside in the case of Mr. Hamm, outside with regard to Mr. Lamar) with previous commercial bank executive/board experience.

A second strength includes the addition of directors Wart and Marcotte. Both individuals appear to hold prominent roles in the community and may serve to provide meaningful business referrals for the proposal during the formative stages. Other strengths include Mr. Mason' background and appearances that he will ask the necessary questions from executive management. Based on the organizational minutes and discussion with other proponents, Mr. Mason is among the most vocal individuals on the board. In the interview, Mr. Mason stated that his residence in the Northeast would not preclude him from fulfilling his supervisory duties or attending board/committee meetings.

Proposed Operating Programs

According to information contained in the Application and Mr. Hamm, the Applicant will adopt comprehensive operating guidelines with regard to lending, funds management and interest rate risk, investments, and audit. A pre-opening visitation by the primary regulator should confirm and validate the appropriateness of these policies.

GENERAL CHARACTER OF THE MANAGEMENT (Continued)

List alphabetically, by group, all *Directors, Non-Director Officers, and Others owning 10% or more of total capital.* Indicate the status of each individual listed by checking the appropriate box *(D-Director; O-Officer; S-Shareholder).* Under "Summary and Findings" indicate *(a)* years and reputation in the community; *(b)* director or officer positions held in other banks and the names of such banks; *c)* dominant individuals and the extent, character, and effect of such domination; and *(d)* capabilities of each individual with reference to his duties and responsibilities, and the amount of time devoted to the institution.

NAME AND ADDRESS	AGE	RELATIONSHIP WITH BANK		
	38	☐ **Director** ☒ **Officer** ☐ **10% Shareholder**		
Well, John 13821 Folkstone Circle Anytown, Anystate	LIABILITIES 139,084	NET WORTH 116,338	SHARES OF STOCK 140,500	ANNUAL SALARY 90,000
	TITLE Proposed Chief Lending Officer			
OTHER BUSINESS AFFILIATIONS OR PROFESSIONS Career Credit and Lending Officer				

Summary and Findings

Mr. Well was born in Middletown, Connecticut and has resided in the area since 1999. He holds an undergraduate degree in economics from Dartmouth, College, Hanover, New Hampshire. Mr. Well has over fourteen years banking experience including senior level positions in lending and credit administration. He reportedly has considerable experience within consumer and commercial loan portfolios, policy formulation, credit scoring and loan pricing strategies, as well as, auditing, operations and retail branch oversight. He has spent nearly his entire banking career working under the tutelage and supervision of proposed CEO Hamm.

Banking Experience

From 1999 until his recent appointment, Mr. Well served as SVP and Senior Credit Officer of Anybank, Anytown, Anystate. In this position, he was responsible for credit quality of the bank's consumer, mortgage, and small business portfolios. Leading a staff of seventeen, Mr. Well established a Small Business Operation which generated monthly loan volume of $5 million. In addition, he managed the credit scoring process for small business and consumer lending including, validation and oversight of system parameters. Prior to that, he served ten years at Anybank, Anytown, Anystate, in several lending and managerial roles including VP and Consumer Credit Manager, Branch Manager, and Regional Consumer Loan Officer. Notable accomplishments included managing the bank's credit scoring system, managing a large loan staff, and successfully generating nearly $100 million in new loans during a three year period.

Interview Comments

Mr. Well became associated with the proposal at the request of Mr. Hamm, whom he reported to while employed at Anybank. He stated that he brings considerable experience with regard to commercial and consumer credit underwriting, portfolio and risk management. He added that these areas have been the cornerstone to his entire banking career. Additionally, Mr. Well stated he also has a perspective in audit and controls given his experience as a staff auditor. He added that he experienced the real estate recession in the Northeast and has an understanding and aversion for speculative transactions. While Mr. Well could not estimate the volume of loan business he would attract during the formative stages, he does know many seasoned lenders who retain established and profitable relationships. He anticipates, as does Mr. Hamm, employing former lenders who are actively seeking other opportunities. Mr. Well stated he was very involved in preparing the loan projections in the proposed business plan. He stated the projections were reasonable based on the proposed development officers and their respective portfolios, as well as, the generating ability of the former supermarket branches. He added that this two pronged approach is also enhanced by his experience in selectively purchasing high-quality consumer mortgage portfolios. Such activity, he said, could be employed to fill budget shortfalls and otherwise more efficiently employ earning assets during the first year. With regard to the former supermarket branches, Mr. Well stated that the eleven branches produced monthly consumer loan volumes ranging from $100M-$500M.

Financial Information and Stock Ownership

As of November 2001, Mr. Well's primary assets consisted of $38M in cash and a personal residence valued at $175M. Liabilities consisted primarily of a $126M mortgage payable. His $5000 investment in the proposal was reportedly purchased with cash.

NAME AND ADDRESS	AGE	RELATIONSHIP WITH BANK		
Mason, Perry 130 Old Army Road Anytwon, Anystate	62	☒ **Director** ☐ **Officer** ☐ **10% Shareholder**		
	LIABILITIES	NET WORTH	SHARES OF STOCK	ANNUAL SALARY
	0	3,213,000	25,000	0
	TITLE Proposed Director (nonexecutive)			
OTHER BUSINESS AFFILIATIONS OR PROFESSIONS Consultant. Retired executive credit officer for counterparty risk and former English trial lawyer.				

Summary and Findings

Mr. Mason was born in Limassol, Cyprus and became a U.S. Citizen in 1989. He also holds citizenship in the United Kingdom. Mr. Mason received a Masters and Bachelor of Arts degrees in Law from Cambridge University, Cambridge, England and subsequently realized his Barrister-at-Law license in 1960. For nearly eight years prior to retiring in 1999, Mr. Mason served as Executive Vice President, Global Trading Credit Group at Anybank, Anytown, Anystate. Responsibilities included management of all counterparty credit exposure for the Derivatives Products Group. Additionally, he supervised and developed risk management systems for the trading group, and served on various committees including, Asset Liability Management, Credit Policy, and Payment Systems Risk. He held similar responsibilities for nearly five years as Managing Director while at Regionalbank, Anystate. Other notable responsibilities include various Vice President level assignments at Anybank, Anystate and London. These duties entailed the development of marketing and credit strategies, lending, and asset management, including trading assets within Europe, Pacific Rim and U.S.

Interview Comments

Mr. Mason became involved with the Applicant as a result of some consulting work he performed for Risk Management, plc, London, England, and its Chairman John Wise. Mr. Wise is also a 1.8% shareholder of Holding Company-1 and serves as a nonexecutive director. Mr. Mason stated that he has experience dealing with complex financial problems and understands how to manage risks. He stated that he would not be able to introduce many deposit or lending relationships given his lack of contacts within the market area. Mr. Mason acknowledged that he has little or no financial stake in the proposal, but views his reputation as a key contribution. In this regard, he would feel inclined to notify the Regulatory Authorities should any material supervisory issues become apparent. Mr. Mason is more enthusiastic and confident about the current proposal versus the previous model. He feels that the deposit base is better quantified given that many of the proposed branches were active and successful less than a year ago. In addition, he feels the proposal now has a more experienced board and executive management team given the addition of Messrs. Hamm (Proposed CEO) and Lamar (Outside Director).

Financial Information and Stock Ownership

As of August 2001, Mr. Mason reports no liabilities and liquid assets (bonds, equity securities and cash) of nearly $2,217M. Other material assets include his residence valued at $550M. According to Mr. Mason, his limited investment ($2,400) in the proposal was purchased with cash.

IV. GENERAL CHARACTER OF THE MANAGEMENT (Continued)

<table>
<tr><td rowspan="3">NAME AND ADDRESS

Marcotte, Janet
2 McCairn Court
Anytown, Anystate</td><td>AGE
49</td><td colspan="3">RELATIONSHIP WITH BANK
☒ Director ☐ Officer ☐ 10% Shareholder</td></tr>
<tr><td>LIABILITIES
175,740</td><td>NET WORTH
821,946</td><td>SHARES OF STOCK
26,000</td><td>ANNUAL SALARY
0</td></tr>
<tr><td colspan="4">TITLE
Proposed Director (nonexecutive)</td></tr>
<tr><td colspan="5">OTHER BUSINESS AFFILIATIONS OR PROFESSIONS
Vice President and General Sales Manager, BellSouth.</td></tr>
</table>

Summary and Findings

Ms. Marcotte was born in Columbus, Ohio and has resided in Anytown for over 40 years. She holds undergraduate and graduate degrees in Business Administration from University of Anystate, Anytown and SouthEastern University, Anytown, Anystate, respectively. She currently holds a senior management level position with BellSouth, a company for which she has been employed with for nearly 30 years in various marketing capacities. In her current capacity, Ms. Marcotte is responsible for BellSouth's sales and technology operations, a regional business unit accounting for nearly $700 million in total revenues. She does not have any prior commercial/community banking experience.

Interview Comments

Ms. Marcotte became associated with the proposal through her civic relationships with proposed director Wart. She appears active in local community circles and serves on the board of the Anytown Economic Development Council. She stated that her community contacts and professional longevity within the county could assist in providing meaningful business opportunities for the proposal. Given her position with a technology-based company, Ms. Marcotte stated she could provide valuable insight into the needs of the bank's target market and potential internet users. She has reportedly gained extensive experience in marketing to a comparable demographic segment within her company and knows how to serve customer's technology needs. Ms. Marcotte stated that proposed President Hamm has crafted a credible business model; integrating a traditional retail site and supermarket branch banking with an internet component, within two high growth Markets.

Financial Information and Stock Ownership

As of December 2000, Ms. Marcotte reports liquid assets (cash and listed securities) of $238M and stock options with a estimated value of $460M. A personal residence valued at $300M represents her other primary asset. Liabilities consist primarily of a $165M mortgage payable. According to Ms. Marcotte, her limited investment ($1,000) in the proposal was purchased with cash.

IV. GENERAL CHARACTER OF THE MANAGEMENT (Continued)

<table>
<tr><td rowspan="4">NAME AND ADDRESS

Hamm, Joe
112 Olympic Circle
Anytown, Anystate</td><td>AGE
47</td><td colspan="3">RELATIONSHIP WITH BANK
☒ Director ☒ Officer ☐ 10% Shareholder</td></tr>
<tr><td>LIABILITIES</td><td>NET WORTH</td><td>SHARES OF STOCK</td><td>ANNUAL SALARY</td></tr>
<tr><td>415,400</td><td>1,096,600</td><td>665,000</td><td>150,000</td></tr>
<tr><td colspan="4">TITLE
Proposed Chairman, President, and Chief Executive Officer</td></tr>
<tr><td colspan="5">OTHER BUSINESS AFFILIATIONS OR PROFESSIONS
Career Banker and Senior Lending Officer.</td></tr>
</table>

Summary and Findings

Mr. Hamm was born in Troy, New York and has resided in Anytown for over two years. He attended the Stonier Graduate School of Banking at the University of Delaware and State College, Antyown, Anystate. Mr. Hamm has over twenty-seven years of experience in the banking and financial services industry.

Bank Experience

Prior to joining subject proposal, Mr. Hamm served as Senior Executive Vice President and Chief Credit Officer at Anybank, Anytown, Anystate, a $3.4 billion state member bank, which was recently acquired by Regionalbank. In addition, he served as a member of the bank's Executive Committee, which was designed to establish near term strategic guidance and policy. While employed at Anybank (2-year tenure until acquisition by Regionalbank), he also served as Chairman of the Board of two of Anybank's wholly owned subsidiaries; First Financial, Inc., a national yacht finance company with annual loan volumes of $300MM. Reportedly, the company was the largest originator of yacht loans in the Nation, prior to Mr. Hamm's departure. His second Chairperson role was with Spectrum, a factoring entity generating annual receivable/inventory facilities of $120MM.

Prior to his role at Anybank, he served for eleven years as a Senior Vice President and Chief Corporate Lender and then as Executive Vice President and Chief Credit Officer at Financial Services Corp, Anytown, Anystate, the holding company for AnyNational Bank. While there, Mr. Hamm was responsible for a department of fifty credit and administrative personnel and a $1.4 billion commercial, mortgage, and consumer portfolio. Notable assignments and accomplishments during his eight year tenure was the operation and oversight of special assets and the reduction of non-performing assets from a high of 6.5% to 0.6%. Mr. Hamm also served on various board committees including, Executive, Strategic, Loan, Asset/Liability, and Human Resources. Prior to his EVP/SVP roles he served for five years as a VP and Regional Commercial Loan Officer within the same institution.

Additionally, he has approximately eight years of lending and related experience while employed by MoneyCenterBank, Anytown, Anystate. Mr. Hamm was active in the Anystate Banker's Association for nearly seventeen years and served as a member of the Association's Board of Directors. According to the association's CEO, Mr. Hamm was highly respected by colleagues and active as a Loan Quality instructor at the Anystate School of Banking.

Regulatory History and References

Available information from the Corporation's database suggests that Anybank and AnyNational Bank were fundamentally sound entity's during Mr. Hamm's tenure. Additionally, regulatory information from the Federal Reserve yielded no comments of any supervisory concern regarding his credit background or professional abilities. The undersigned examiner also contacted the State Comptroller's Office. The State's regulatory experience with Mr. Hamm was very favorable.

The undersigned examiner also interviewed the former Chairman and CEO of Anybank during Mr. Hamm's tenure. The former Chairman was very complimentary of Mr. Hamm's leadership skills and credit experience. According to him, Mr. Hamm was hired to ensure that asset quality and risk management systems were preserved during Anybank's growth phase. In this defined role, the former Chairman stated that he did an excellent job at executing and formulating policy.

Interview Comments

Mr. Hamm stated he was disenchanted with Regionalbank's methods of operation after its acquisition of Anybank and sought to pursue other opportunities. The denovo's legal counsel, Hodson & Hodson (HH), contacted Mr. Hamm about becoming an organizer shortly after the former president resigned from the group in April 2000.

Mr. Hamm stated he was skeptical about the prior proposal's business model as well as, the viability of the kiosk as a key delivery channel. His main issue with the kiosk strategy was that it had not been successfully executed within the market place. As a result, Mr. Hamm stated he recommended that the model be changed to incorporate more proven and traditional retail delivery channels. Another key change he recommended was the addition of other board members with strong community ties and/or previous banking experience (proposed director Wart, Marcotte, and Lamar). Mr. Hamm also sought to replace the previous proposed senior lending officer with one he viewed as possessing a stronger skill set and educational background.

Mr. Hamm indicated he has market intelligence over the success of the proposed supermarket branch network, inasmuch as eleven of the twelve branch sites were previous Anybank branch locations. He believes this aspect to be a key strength over the previous proposal. Mr. Hamm stated that despite his less than three years in Anytown, he has a sound foundation within the market area and has developed many contacts, which could lead to lucrative future business for the proposal. Regarding future lending, Mr. Hamm has retained a chief lender (Well) with whom he directly supervised while at AnyNational Bank and Anybank. In addition, other senior lenders have expressed a desire to join the group. Said lenders, according to Mr. Hamm, all would bring seasoned commercial and consumer portfolios generated from the former Anybank.

Financial Information and Stock Ownership

As of August 2001, Mr. Hamm reports a considerable liquid net worth, with $542M in cash and marketable securities. He reflects a personal residence with an assigned valued of $550M and deferred savings plan (401k/IRAs) assets of $420M. Liabilities consist primarily of a mortgage payable of $390M. Mr. Hamm's initial investment of $30M was reportedly purchased with his cash holdings.

IV. GENERAL CHARACTER OF THE MANAGEMENT (Continued)

<table>
<tr><td rowspan="3">NAME AND ADDRESS
Newbury, Nigel
12 Circus St.
Anytown, Anystate</td><td>AGE
42</td><td colspan="3">RELATIONSHIP WITH BANK
☒ Director ☒ Officer ☐ 10% Shareholder</td></tr>
<tr><td>LIABILITIES
177,000</td><td>NET WORTH
2,218,000</td><td>SHARES OF STOCK
7,366,665</td><td>ANNUAL SALARY
55,000</td></tr>
<tr><td colspan="4">TITLE
Proposed Chief Financial Officer</td></tr>
<tr><td colspan="5">OTHER BUSINESS AFFILIATIONS OR PROFESSIONS
Accountant. Also serves as Financial Director and Director of Holding Company-1, London, England.</td></tr>
</table>

Mr. Newbury was born in Hazelgrove Cheshire, England. He holds citizenship in the United Kingdom and also maintains temporary residency in Anystate. He attended Reading University in England and subsequently became a Chartered Accountant with the firm, Touche Ross, London.

From 1996 until his involvement with Applicant in 2000, Mr. Newbury served as Finance Director with Risk Management Systems, London, England. This firm, whose Chairman and founder John Wise is also an invester and noneceutive director of the Applicant's holding company in London, provides financial trading and risk management systems for financial institutions in Europe. They also provide training and advisory services related to risk management. For nine years prior to 1996, he served as Director and Chief Financial Officer for Knight Financial, Inc., in both London and New York, as well as, associated companies throughout Europe and Asia. In this capacity, he led the company's financial planning and accounting group. Mr. Newbury does not have any prior commercial/community banking experience in the UK or US.

<u>Interview Comments</u>

Mr. Newbury stated he collaborated with proposed CEO Hamm in revising the proposed business plan and accompanying financial projections. Mr. Newbury added that while he lacked direct banking experience, he attained a comprehensive finance and accounting background including financial institution auditing, while employed at Touch Ross. He indicated that he had a strong background in risk management practices and financial controls. As Mr. Newbury was one of the authors of the previous business plan and forecasts, which incorporated dubious assumptions and resulted in the Applicant's ultimate withdrawal, he was asked to compare and contrast the current proposal. Mr. Newbury stated that the revised business model emphasizes more traditional and proven delivery channels. He is especially pleased that eleven of the twelve proposed supermarket branches were viable deposit and loan production offices of the former Anybank. As such, he is more comfortable with the model's assumptions and accompanying financial forecasts.

<u>Financial Information and Stock Ownership</u>

As of August 2001, Mr. Newbury reported $22M in cash and $399M related to his equity holdings and warrants in the proposal. Other material assets include his residence in London valued at $1,033M as well as, pension plans and life insurance valued at $940M. Liabilities primarily consist of a mortgage payable with a balance of $163M. Mr. Newbury's investment in the proposal was reportedly purchased with cash and personal savings.

<table>
<tr><td rowspan="3">NAME AND ADDRESS
Gray, Frank
Morlich Lodge
Anytown, Anystate</td><td>AGE
38</td><td colspan="3">RELATIONSHIP WITH BANK
☒ Director ☒ Officer ☐ 10% Shareholder</td></tr>
<tr><td>LIABILITIES
325,000</td><td>NET WORTH
314,000</td><td>SHARES OF STOCK
225,000</td><td>ANNUAL SALARY
55,000</td></tr>
<tr><td colspan="4">TITLE
Proposed Director and Chief Technology Officer</td></tr>
<tr><td colspan="5">OTHER BUSINESS AFFILIATIONS OR PROFESSIONS
Information Technology Professional & Software Designer. Also serves as an Officer of Holding Company-1, London, England.</td></tr>
</table>

Mr. Gray was born in Shropshire, England and holds British citizenship and residency. He is a graduate of Loughborough University, United Kingdom (UK) and received a degree in Mathematics and Engineering.

From 1995 up to his involvement in the proporsal (March 2000), Mr. Gray served as the Head of Front Office Technology/Europe for InternationalBank in London. In this role, he coordinated and led the Year 2000 project as well as, the Euro currency conversion. His primary responsibility, while at the institution was the development and implementation of front office trading systems for financial derivatives and fixed income securitites. Prior to this, Mr. Gray worked for nine years on numerous IT and software design projects including remote sensing technology (satalite systems) for end users such as the European Space Agency and Defense Research Agency in the UK.

<u>Interview Comments</u>

Mr. Gray stated his primary emphasis thus far has been on writing the Applicant's technology plan and designing and implementing the technology infrastucture. Mr. Gray stated he has extensive software design and project management experience and successfully recruited other highly talented designers from his previous employer, InternationalBank. He feels the current proposal offers a more viable business model, given its previous success with RSB. He also added that the Board has been strentghened considerably by the additions of former commercial bankers, Messrs. Hamm and Lamar.

<u>Financial Information and Stock Ownership</u>

As of June 2001, Mr. Gray’ reported net worth, was primarily centered in his personal residence, with an assigned value of $547M. Liabilities of $325M consist of a mortgage payable on his residence in the UK. Mr. Gray’ investment in the proposal of $9,900 was purchased with personal savings.

<table>
<tr><td rowspan="3">NAME AND ADDRESS
Lamar, Austin
12770 Jernigan Avenue
Anytown, Anystate</td><td>AGE
59</td><td colspan="3">RELATIONSHIP WITH BANK
☒ Director ☐ Officer ☐ 10% Shareholder</td></tr>
<tr><td>LIABILITIES
290,000</td><td>NET WORTH
7,511,000</td><td>SHARES OF STOCK
110,000</td><td>ANNUAL SALARY
0</td></tr>
<tr><td colspan="4">TITLE
Proposed Director (nonexecutive)</td></tr>
<tr><td colspan="5">OTHER BUSINESS AFFILIATIONS OR PROFESSIONS
Retired Banker.</td></tr>
</table>

Summary and Findings

Mr. Lamar was born in LaGrange, Georgia and has resided in Anytown, Anystate for approximately one year. He is a graduate of Auburn University, Auburn, Alabama. Mr. Lamar recently retired from RegionalBank, an NYSE listed entity in Anystate, following its acquisition by ForeignBank. During his twenty-six year tenure at the state member bank, he served in a variety of executive and operational capacities.

Bank Experience

From 1990 to 2000, Mr. Lamar served in various executive roles including, RegionalBank's Vice-Chairman of the Board and Chief Financial Officer. At the time of its acquisition by ForeignBank, RegionalBank was an $11 billion commercial bank, operating in Anystate. Prior to that, Mr. Lamar served (1975-1990) at MidsizeBank, Anytown, Anystate, which was merged into RegionalBank in 1990. While at MidsizeBank, he served as a Director as well as its President and Chief Executive Officer (1988-1990). In addition to his executive officer roles during his tenure at MidsizeBank, Mr. Lamar served as CFO, Controller and Audit Manager.

Regulatory History and References

Available regulatory information (from FRB, State, and OCC) suggests that the institutions were fundamentally sound and operated. Contacts at the Federal Reserve Bank confirmed his executive level experience and had no supervisory concerns to report.

Interview Comments

Mr. Lamar became associated with the proposal through the Applicant's legal counsel, HH, an entity with whom he collaborated with on many issues while at RegionalBank. Mr. Lamar stated that he has considerable experience within finance, asset securitization, as well as, mergers and acquisitions. Regarding the latter, he stated he was involved in the acquisition of some forty or more institutions. He also stated that his institutions had experience with the supermarket branch delivery channel. While employed at RegionalBank, they operated over 20 rural supermarket branches with a moderate degree of success. He conveyed that the branches were profitable but did not enjoy the degree of returns as other parts of the institution. According to Mr. Lamar, the supermarket branches generally achieved $4-5 million in deposits and a loan to deposit ratio of 60% within 2 years of opening. He added that he is compelled by the more favorable demographics within the Anystate market, particularly the existing deposit base and retail branch networks employed by the myriad of institutions. This was an aspect that was far less prevalent in the rural areas of Anystate. Mr. Lamar stated that his residence's distance from the main office would not preclude him from being an active director.

Financial Information and Stock Ownership

Mr. Lamar's personal statement dated August 2001, reflected $80M in cash and $4,266M in marketable securities. Other material assets include residential properties valued at $650M and pension plans valued at $2,806M. Liabilities consist primarily of a mortgage payable of $240M. Mr. Lamar's $5,000 investment in proposal was reportedly made with cash.

NAME AND ADDRESS	AGE	RELATIONSHIP WITH BANK		
Miller, Dennis 5678 Muirfield Village Circle Anytown, Anystate	55	☒ **Director** ☐ **Officer** ☐ **10% Shareholder**		
	LIABILITIES	NET WORTH	SHARES OF STOCK	ANNUAL SALARY
	149,012	293,000	57,850	0
	TITLE Proposed Director (nonexecutive)			
OTHER BUSINESS AFFILIATIONS OR PROFESSIONS Retired Special Agent, Federal Bureau of Investigation (FBI).				

Summary and Findings

Mr. Miller was born in Dearborn, Michigan and has resided in Anystate since 1980. He received his Bachelors degree in Biological Sciences from Michigan Technological University, Houghton, Michigan.

Mr. Miller recently retired from the FBI in Anytown, Anystate. He has extensive experience with investigations involving white-collar crimes including, crimes against financial institutions. Particularly noteworthy is his experience regarding bank fraud, embezzlement, and Internet related financial crimes.

Interview Comments

Mr. Miller became associated with the proposal through Casey Grant's (Joe Hamm's predecessor who resigned during 1H2001) father, who resides in the same residential development. Mr. Miller stated that he has many years of experience investigating and prosecuting white-collar crimes in Anystate, particularly, money laundering, as well as, bank, mail and wire fraud. He is reportedly very knowledgeable of Internet related crimes. With regard to strengths he could bring to the Applicant, Mr. Miller stated he would add depth and experience to the audit committee. As a proposed director of the previous Application, Mr. Miller stated he is more comfortable with the supermarket branch network given it has had a proven record at Anybank.

Financial Information and Stock Ownership

As of September 2001, Mr. Miller's net worth was primarily centered in a deferred savings plan. As of the reporting period, the balance of this other asset (Federal Thrift Savings Plan) was $218M. Other material assets included his residence, with a value of $200M. Liabilities primarily consisted of a mortgage payable on his residence of $130M. Mr. Miller's investment in the proposal of about $5,500 was made with his personal savings.

NAME AND ADDRESS	AGE	RELATIONSHIP WITH BANK		
Wart, Philip 118 Olympus Circle Anytown, Anystate	46	☒ **Director** ☐ **Officer** ☐ **10% Shareholder**		
	LIABILITIES	NET WORTH	SHARES OF STOCK	ANNUAL SALARY
	921,896	1,661,484	250,000	0
	TITLE Proposed Director (nonexecutive)			
OTHER BUSINESS AFFILIATIONS OR PROFESSIONS Attorney. President and Managing Partner of the law firm, Wart, West, and West, P.A. (WWW).				

Summary and Findings

Mr. Wart was born in Robana, Illinois and has resided in the Anytown area since 1984. He received an undergraduate degree in economics from Dartmouth College, Hanover, New Hampshire, and Juris Doctorate in law from University of Miami, Miami, Florida. Mr. Wart is a practicing attorney, specializing in corporate, real estate, banking, and securities law. Additionally, he is Chairman of the Anytown Development Board, a not for profit organization committed to advancing the county's business, technology, and educational endeavors.

Interview Comments

Mr. Wart became associated with the proposal through Joe Hamm, whom he advised on several lending transactions, while at Anybank. He stated he is an active member in the community and knows many influential business professionals who can serve as potentially lucrative deposit clients during the formative stages. In that regard, he specifically spoke of the New Technical School in Anytown. He anticipates being able to refer the School's operating account, which reportedly retains balances of $10 million.

Mr. Wart stated he has performed legal work for many financial institutions in Anystate. He was active in processing various regulatory applications for Anybank, in Anytown when he served as general counsel. Additionally, he represented Anybank on many real estate transactions. In addition to proposed CEO Hamm, Mr. Wart knows proposed director Marcotte, a fellow member of the Anytown Development Board.

With regard to the business model, Mr. Wart stated it was conceived on sound research and partly on the success of the eleven- branch supermarket network, while employed by Anybank. He cited the favorable deposit market share in AnyCounty-1 and AnyCounty-2, the depth of the Hispanic market, and relatively low cost structure of the supermarket branch vis a vis the traditional bricks and mortar retail branch site.

Financial Information and Stock Ownership

As of August 2001, Mr. Wart reported $163M in cash and marketable securities, as well as, $1,577M in residential and commercial real estate holdings. Other assets include his 43% interest in the law firm, WWW, with an assigned value of $600M. The firm WWW reported revenues of $3 million for the year ending 2000, representing a 54% increase over the previous year. Mr. Wart's liabilities consist primarily of three mortgage payables with an aggregate balance of $914M. He reports no contingent liabilities. According to Mr. Wart, his $10,000 investment in the proposal was made with cash.

GENERAL CHARACTER OF THE MANAGEMENT (Continued)

Discuss proposed board and management committees and their associated responsibilities. Assess the reasonableness of fees and other expenses associated with the application and organization, including insider involvement. Evaluate the reasonableness of stock benefit plans, including stock options, stock warrants, and other similar stock based compensation plans. The structure of stock benefit plans should encourage the continued involvement of the participants and serve as an incentive for the successful operation of the institution. Assess reasonableness of fidelity coverage. An insured depository institution should maintain sufficient coverage on its active officers and employees to conform with generally accepted industry practices.

Summary and Findings

Board Committee Structure and Fidelity Coverage

The organizers have provided for a usual and customary committee structure to assist in overseeing and managing the bank's operations. No exceptions were noted to these proposals and structures. Organizers stated that sufficient fidelity coverage would be procured and maintained.

Reasonableness of Organizational Expenses

Organizational and pre-opening expenses appear excessive for the formation of a denovo national association and do not reflect favorably on the Applicant.

Most of the responsibility for these high expenses can arguably be attributed to the previous leadership during the prior Application submission (August 2000). Casey Grant, the lead organizer and proposed Chairman/CEO displayed a lack of fiscal discipline during his tenure and was responsible for formulating the previous nontraditional and seemingly higher risk business model. This model was poorly supported and thus required extensive time to procure supporting documentaion and fesibilitiy studies. During this lengthy process, Mr. Grant relied extensively on legal cousel and consultants which added to the expense burden. Finally, Mr. Grant prematurely added a staff of twenty, including highly compensated officers, which impacted pre-chartering costs.

Since the previous management's departure and filing of the new Application, organizational expenses while high, appear to have moderated. Despite the high organizational expenses, management has been successsful, during two separaterly underwritten capital offerings, in forming a substantial amount of capital. It is believed this capital is sufficient to absorb the high costs and provide for the growth of the proposal.

Employment Agreements & Compensation

The Applicant anticipates negotiating employment agreements with several officers. The officers (to date) with corresponding annual salaries are as follows: Chairman/CEO Joe Hamm, $150M; CFO Nigel Newbury[*] $55M; CTO Frank Gray, $55M; CLO John Well, $90M. In addition, Controller Sue Herrera $65M; and Senior Technology Officer Brian Bain $110M will reportedly be under contract. The agreements generally include the following standard terms:

- Employment Term: Generally one year. Continues thereafter unless terminated by either party;
- Other Benefits: Medical, and participation in any existing stock benefit plan.
- Bonus: Sole discretion of Board of Directors
- Termination without Cause: Lump sum payment equal to the present value of the unexpired portion of the employee's term (effectively less than or equal to 1 year). Discount derived using the prevailing Federal funds rate.

<u>Stock Benefit Plan</u>

The Applicant intends to formulate a plan for certain executive officers, directors, and other employees. To date, this plan has not been formalized or submitted for Regulatory review. Organizers have committed to enacting a plan that is consistent with existing regulatory guidelines. Said plan should be scrutinized for reasonableness in light of exceptions taken by the Examiner during the prior

Messrs. Newbury and Gray' respective salaries represent the proposed bank's pro-rata expense only. Additional compensation of $55M for each will be paid by Holding Company-1, London, England. This represents compensation for services performed at the top-tier holding company level. Refer to biographical information for their respective roles.

Application. Exceptions involved excessive option grants to the proposed president, that were nearly 3x the volume of initial shares purchased.

Warrant Holders and Intrinsic Value

Based on the most recent bid of 2.5p (£0.03) per share (or ¢3.75), and existing strike price above of 2p, the intrinsic value of the Mr. Newbury's warrants is less than $50,000. Given the current pricing, this additional form of compensation does not appear unreasonable.

The overall finding on this factor is FAVORABLE, pending receipt of acceptable stock benefit plans.

RISK TO THE FUNDS

As a general matter, the FDIC interprets this factor very broadly, relying on any information available including, but not limited to the applicant's business plan. Assess the proposed institution's business plan. The business plan's goals should be commensurate with the capabilities of its management and the financial commitment of the incorporators. The business plan should demonstrate an ability to achieve a reasonable market share, reasonable earnings prospects, the ability to attract and maintain adequate capital, and demonstrate a responsiveness to community needs. The plan should also demonstrate adequate risk management policies. Business plans that rely on high risk lending, a special purpose market, or significant funding from sources other than core deposits, or that otherwise diverge from conventional bank related financial services require detailed analysis as to the suitability of the proposed activities for an insured institution.

Summary and Findings

The Applicant is proposing to execute a traditional integrated business model with respect to deposit acquisition and funding. Funding will primarily draw on two key delivery channels, a supermarket branch network and traditional retail banking office and to a lesser extent, a fully transactional web-site.

Business Model Strengths

The business model enjoys a strong initial capitalization base, a seemingly conservative management team and investment philosophy, a viable and multi-faceted branch network strategy, and a vast deposit market within its operating environment. These factors comprise the proposal's prevailing strengths.

The most integral change in the proposal versus the prior previous bank model consists primarily of the upgrade in the executive management team and secondly, the adoption of a more fundamentally sound and traditional business model. The new team is led by an executive (CEO Hamm) possessing an extensive commercial banking and lending background. Equally important has been the addition of seemingly strong outside directors, one of whom (Director Lamar) possesses previous executive and director level experience. The remaining new outside directors (Wart and Marcotte) appear to be very influential within various County economic development endeavors. By all accounts, the outside directors may be in a position to influence and stimulate the proposal's funding and business development initiatives. The proposed management's aversion for risk is best manifested in the proforma asset-mix, which is heavily weighted towards residential real estate during the first year of operation. With regard to funding, the business model is seeking to replicate the deposit generating success of the supermarket branch network once operated by Anybank. Its previous success within demographically favorable and densely populated towns and cities adds credence to the model's funding projections.

Business Model Risks

As depicted in the Applicant's sensitivity analysis and stress testing, the model is most vulnerable to a slower rate of deposit growth {Scenario 2} during the formative years. What-if scenarios depict an earnings risk should funding fall below 75% of original projections. A deposit shortfall without any commensurate and effective cost containment plans may adversely impact profitability and the model's ultimate success. In light of funding's importance during the formative stages, any shortfalls may induce management to compete more aggressively on price thereby jeopardizing margins, profitability or risk selection. Executive management's ability to attract funding at a reasonable cost will be critical to the model's success.

The finding on this factor is <u>FAVORABLE.</u>

CONVENIENCE AND NEEDS OF THE COMMUNITY TO BE SERVED

Discuss the proposed institution's primary trade area(s) including location and population. Address economic conditions, primary industries, and major employers. Assess trade area(s) population demographics and the proposed institution's willingness and ability to meet the deposit and credit needs of the community to be served. Assess the competitive dynamics of the market and how the proposed institution will compete for market share.

Summary and Findings

Proposed Service Areas

Per the Applicant, the primary trade areas are contained within AnyCounty-1 and AnyCounty-2, Anystate. A retail branch network encompassing one traditional branch (main office) as well, a supermarket branch network will form the bank's surrounding service areas. During the first year, a total of six branches (five supermarket and one main office) are planned for AnyCounty-1, while seven are envisioned for AnyCounty-2. Given the internet component of this business model, other market areas outside of the proposal could conceivably be pursued.

Community Growth and Demographic Indicators[4] – AnyCounty, Anystate - MSA

Item	2005 *Forecast*	2000	1999	1998
Population (000)	1,247.1	1,131.2	1,106.7	1,084.0
Residential Building Permits	7,637	6,769	6,428	6,387
Mortgage Origination ($Mil)	$6,207	$6,740	$6,946	$8,476
Unemployment Rate	5.1%	4.4%	5.0%	5.6%
Total Employment (000)	560.0	491.4	469.4	457.3
Gross Metro Product $Billion	$45.2	$37.7	$35.2	$33.3
Top Employers & Industries in Trade Area				
Name	**Business Type**	**Employees**		
Columbia Beach Health Care	Medical/Health	4,000		
Intracoastal Health Systems	Management Svc	3,200		
Motorola, Inc	Technology	2,300		
Power and Light	Utility	2,300		
Pratt & Whitney	Mfg./Technology	1,300		

Demographic and Economic Trends – Anytown - MSA

The overall Anytown market remains moderately strong due to the County's higher per capita income and strong job growth, particularly in the services and retail trade sectors. Real Estate markets and favorable adsorption measures (residential housing demand) have been driven by population growth, in-migration from the Southern State Counties, as well as, tourism.

Key short-term risks remain the weak national economy, which has been exacerbated post September 11, 2001. These factors have negatively impacted tourism and its accompanying service industries. In addition, segments of the County, including the Anytown area, have experienced very active new commercial real estate construction activity that has reportedly impacted rental rates for new space. While current vacancy rates of around 14%, are below the 30% prevailing nearly a decade ago, any prolonged recession could make it a more difficult environment for underwriting and funding quality commercial real estate credits. Manufacturing has endured considerable layoffs and remains a weak area for the County. Motorola, State's largest Technology employer, has experienced declining revenue, weakening margins, as well as market share erosion. As a result, substantial layoffs have occurred company wide in addition to its facilities in Anytown.

[4] Source: FDIC Division of Insurance

Community Growth and Demographic Indicators [5] – Anytown, Anystate - MSA

Item	2005 *Forecast*	2000	1999	1998
Population (000)	1,786.9	1,623.0	1,588.7	1,555.2
Residential Building Permits	8,865	9,160	8,574	8,753
Mortgage Origination ($Mil)	$8,227	$9,159	$8,911	$10,453
Unemployment Rate	4.3%	3.7%	4.1%	4.5%
Total Employment (000)	755.4	676.0	652.7	639.5
Gross Metro Product $Billion	$54.8	$46.2	$43.4	$41.3

Top Employers & Industries in Trade Area

Name	Business Type	Employees
North Hospital District	Medical/Health	6,652
Winn-Dixie, Inc.	Retail/Grocery	6,110
American Express	Financial Svc.	4,700
Publix Supermarkets, Inc	Retail/Grocery	4,200
Motorola, Inc.	Technology	4,000

Demographic and Economic Trends – Anytown, Anystate - MSA

Economic trends convey strong growth despite a weaker national economy. Growth has been led by the services, wholesale trade, and finance industries.

The residential housing market is particularly active. Tourism and leisure (hotel/cruise ship lines) remains one of the MSA's key economic drivers, However, its outlook has been impacted by the general state of the economy and September 11, 2001 attack on the US. In addition, international trade with Latin American trading partners may decline somewhat considering the adverse market conditions within Argentina, South America's second largest economy. Manufacturing risks are similar to the Anytown MSA in light of Motorola's size and scale within the area. With regard to commercial real estate, vacancy rates within the Broward office market rose significantly during Q2 2001 to 16.3% versus 9.3% for the same period a year ago[6]. Robust new construction activity, an increase in sublease space, weaker demand, and a softer economy appear to be contributing factors. These trends, should they continue, will pose the same lending risks and challenges previously cited.

Competition – Financial Services

The Applicant will encounter intense competition for funding within both market areas. The FDIC's Summary of Deposits Report for June 2001, indicates that the AnyCounty MSAs hold 450 and 405 banking and thrift offices with aggregate deposit shares of $22.3 and $23.9 billion, respectively. A compelling level of the market share (over 70% for both MSAs) is held by the offices of out of state regional and super-regional bank and thrift holding companies.

The Applicant professes that its multiple delivery channels coupled with attractive rates and efficient service will enable it to compete within the proposed PSA/MSA. The organizers also contend that the recent performance of the eleven supermarket branches as well as, contacts from several directors within the community will enhance the proposal's probability for successfully acquiring deposits within these markets.

The finding on this factor is <u>FAVORABLE.</u>

[5] Source: See Supra

[6] Grubb & Ellis Research , Second Quarter 2001; <u>Vacancy Rates Increase as Construction Continues., Page 1.</u>

CONSISTENCY OF CORPORATE POWERS

Discuss trust powers or any other corporate activities contemplated by the applicant, including those covered by Section 24 of the FDI Act. Address any problems with the Articles of Incorporation or the Bylaws.

Summary and Findings

There is nothing to indicate that the proposal's activities would be inconsistent with the purposes of the Federal Deposit Insurance Act.

The finding on this factor is FAVORABLE.

OTHER PERTINENT INFORMATION

If applicable, provide a summary of comments made by bankers and other interested parties. Address problems with stock offering circular. For applicants delivering services over electronic channels (such as the Internet or wireless devices) assess the information systems infrastructure, policies and security.

Summary and Findings

Summary of Banker Comments

Loren Greene, President & CEO – Anybank & Trust, Anytown, Anystate

Mr. Greene stated he knew proposed CEO Hamm by reputation primarily and suggested he was a very conservative banker. He knows about the proposed bank and opined that the discontinuance of the former delivery channels appeared to be a positive development. With regard to the operating environment, Mr. Greene stated that loan demand has picked up considerably in the county since late 2000, particularly in the SBA, commercial and residential real estate sectors. Funding has been relationship driven and continues to exceed expectations. According to Mr. Greene, the failure of Anybank, which retained a branch directly across from his bank and subject proposal, will assist in reducing the cost of funding for area banks. This is the case given Anybank's aggressiveness with regards to deposit pricing.

Rick Savage, Executive Vice President, Lending – Anybank & Trust, Anytown, Anystate

Mr. Savage served as proposed CEO Hamm's colleague while at Anybank in Anytown. As a Senior Lending Officer, he worked closely with Mr. Hamm who retained the title of Chief Credit Officer. Mr. Savage stated that Mr. Hamm had a strong credit and special assets background. In addition, he stated that Mr. Well (proposed Senior Lending Officer) was also a very competent lender and proficient in operational matters. Mr. Savage suggested that Mr. Hamm would need strong officer support in the operational areas of the bank.

James Brown, Chairman & CEO – Anybank, Anytown, Anystate

Anybank is a federally chartered thrift and a second year denovo. It operates a pure internet business model.
Mr. Brown stated that market acceptance over the bank's model had been positive since the bank's inception. However, according to him, the growth rate has been purely a function of pricing. He added that premium pricing across all deposit categories is what attracts the higher net worth Anytown clientele. The institution is currently experiencing a transaction/CD account mix of approximately 34%/66%. His experience has been that technology for this type of business model was costlier than perceived to be in the planning stages.

Doug Jones, SVP/Retail and Alternative Delivery – Anybank, Anytown, Anystate

Prior to its acquisition by RegionalBank, Anybank was an established National bank which operated 32 in-store retail branches throughout Anystate. The in-store branches are hosted within Albertsons Supermarkets.

Mr. Jones stated that Anybank started this program over four years ago. It is expected to be a profit center for the bank but requires loan production to achieve that goal. Not all locations have been successful thus far. He stated that clientele is very sensitive to deposit pricing and primarily drawn to the time deposit products. He estimates time deposit/MMDA mixes of up to 60%/20%. Given the configuration of their in-store facilities, their loan production mainly caters to consumer type products such as auto and HELs. Mr. Jones stated that customer acquisition becomes a delicate balance of pricing, customer traffic, and marketing abilities of the staff. He concluded that customer traffic was very important for the success of the in store branch. Their institution currently performs studies to locate retail stores which achieve average weekly store traffic of 28,000 shoppers.

Technology Platform and Ensuing Security Risks

Overview

The Applicant plans to offer banking services via multiple electronic delivery channels including the Internet, automated telephone, Customer Call Center (telephone, facsimile, secure web message, e-mail, and regular mail), WAP (handheld wireless), and traditional retail branches.

Services that will be offered are customer identification for account opening, bill pay, check printing, fulfillments, electronic funds transfer (EFT), item processing, AS/400 mainframe hosting, ATM and Visa checkcards. Internet banking will allow account review, bill pay, transactions entry, check order, statements, printing statements, on-line applications, and wire transfers. {A schematic rendering of the operational support service is provided on a subsequent page.}

Vendors/Service Providers

Aurum Technologies (MISER III), Orlando, Florida, will provide the CBS (Comprehensive Banking System) software for processing core banking applications, EFT, Visa checkcards, item processing, network services, Internet connection, VRU as well as, interface to De Luxe check printing, and Equifax credit scoring. Aurum Technologies will host and manage the bank's AS/400 server.

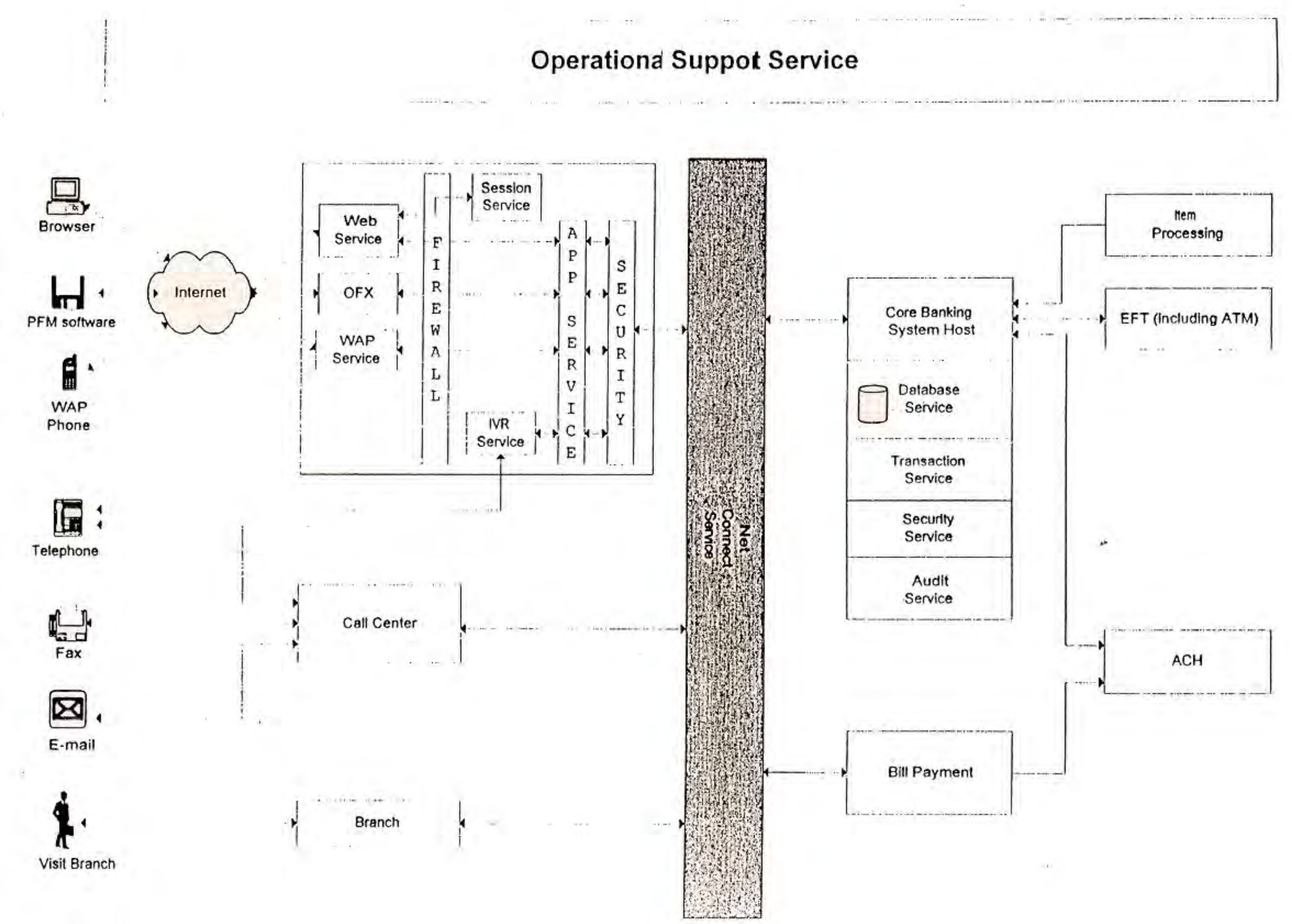
Equifax Credit Services, Inc., Atlanta, Georgia, will provide credit scoring and authentication using Decision Power and eID-Verifier, respectively. Shoreline Business Forms, Inc., Wallingford, Connecticut will provide ATM and Visa check cards. Checkpoint will provide network firewall maintenance. Princeton ecom Corporation, Princeton, New Jersey, will provide bill payments and collections.

Internet access is provided by UUNET through a 1.5 MB T1 line. Fuzion will provide a future second wireless service. There are two local area networks (LANs), located in the London office and in the Anytown office, which are to be joined by a virtual private network (VPN) connection, secured by Checkpoint network firewalls. The web site will be hosted (load balanced) jointly by Applicant and an external provider (Aurum).

According to proposed Senior Technology Officer Brian Bain, the proposed infrastructure retains the sufficient degree of scale and capacity to accommodate forecasted customer account volumes throughout the formative stages.

Facilities

The Applicant has dedicated T1 point-to-point links to Aurum Technologies, Charlotte, NC (hosting center) using redundancy circuits to ensure continuous service at all times. Disaster Recovery is with Sunguard, Philadelphia, Pennsylvania. Telecommunications connectivity was tested and the full system was restored successfully in September 2000. Additionally, the AS400 center in Charlotte is equipped with an emergency system consisting of an uninterrupted power supply (UPS), fire suppression, air conditioning and security access system.



Source: Application for Federal Deposit Insurance

Audit

In addition to monitoring logs; as further delineated within the Security section below, the Applicant will establish a Help Desk to catalogue and report incidents, as well as, follow-up escalation procedures when needed. A third party will be engaged to review all internal products, software and documentation, for compliance with internal standards and ensure that company procedures are implemented.

Security

The ability of the Applicant to provide secure data transmission over its proposed delivery channels will be of paramount importance. Its successful application and accompanying internal controls are believed critical to the success of the Internet as a proposed delivery channel and ultimately, overall customer acceptance.

OTHER PERTINENT INFORMATION (Continued)

In addition to the security measures delineated below, the Applicant is contracting with Aurum, an entity that has attained the requisite SAS 70 certification. This certification, rendered by an independent accounting firm, affirms that a provider's computer systems are being managed and operated in a manner consistent with accepted industry practices.

Security measures proposed for the fully transactional web channel include the following:

Encrypted Transactions

All banking and Internet communications will be encrypted. This will preclude sensitive financial data from being easily read and/or deciphered. Encryption will be accomplished via the use of Secure Sockets Layer Technology. This technology, considered the standard for encryption, is currently utilized by large nationally recognized web browsers. Data transmission from the Applicant's server and Aurum will be encrypted using Data Encryption Standard (DES) encryption, as further described below.

Secure Logon

To preclude the possibility of a third party downloading the Applicant's or a customer's password file, user identification and passwords will be encrypted and stored on a separate database server, not on the Internet or the web server. In addition, password parameters will be structured in a format, which makes the probability of randomly acquiring or guessing said password, extremely low.

Isolated Bank Server

The computer used to provide the Applicant's services would not be directly accessed via the Internet. It will be on a private connection, or intranet, that provides two-way communication between the isolated bank server and Internet server. Consequently, an Internet user will be prevented from accessing the computer that provides the Applicant's services. All banking services will be routed from the Internet server through a firewall. The firewall is a combination of software and hardware devices that specifically defines, controls, and limits access to internal computers from outside computers across a network. The firewall framework means that only authenticated bank customers or administrators may send or receive transactions through it. The firewall will also be immune to penetration from within the network. All messages transmitted or received between the Internet server and the operating server will be encrypted using DES encryption.

This consists of a symmetric key algorithm. Such technology is highly secure as it is not vulnerable to standard ciphertext attacks. Therefore, even if an individual was to route a message to the Applicant's server and through the firewall, the message could not be encrypted in a manner, which would be considered valid by the server. Consequently, the Applicant's server would reject the message.

Authenticated Session Integrity

An authenticated user pertains to any user who signs onto the Applicant's web site with a valid user ID and password. The Applicant's server will be configured to limit exposure to authenticated users who attempt to defraud it. If an authenticated user alters a command (URL), which is sent from the web browser to the server, in any way in an attempt to gain access to another user's account, the Applicant's server immediately detects that the session integrity variables have been violated. Once detected, the Applicant's server will terminate the session and record the unsuccessful attempt in a log so that staff can investigate.

Physical Security & Secure Modem Access

All servers and network computers will reside in secure facilities. Computer operations supporting the Applicant's internet access will also reside in secure back-up facilities. Only employees with a valid access card may enter the physical premises. Access to server systems will require further password authentication. A private line, which is not accessible by or from the public, will connect the Applicant's server with Aurum. A dial-up maintenance port will also permit access to the server. The modem that provides the only access to this port will be specially protected and will only be enabled when necessary.

Service Continuity & Monitoring

The Applicant's server will be "mirrored" so that any existing software and/or hardware bugs should cause no more than a few minutes of service outage. "Mirroring" means that the Applicant's server is backed up continuously so that all data is stored in two distinct physical locations. This level of redundancy is necessary to ensure that access to the Applicant's systems will be reliable. All customer transactions utilizing the Applicant's server will produce one or more entries within a transactional log. The Applicant will regularly review these logs, along with Aurum, to ascertain whether any unusual transactions have occurred.

INVESTIGATION REPORT SUMMARY

DESIGNATED CORRESPONDENT	
NAME Joe Hamm	TITLE President and CEO
COMPLETE ADDRESS *(Include ZIP code)* 2001 Palm Blvd, Anytown, Anystate	

WORKING HOURS					
HOURS EXPENDED				TRAVEL TIME	
EXAMINERS	INVESTIGATION	REPORT WRITING	TOTAL HOURS	DURING NORMAL WORK HOURS	OUTSIDE NORMAL WORK HOURS
Ivie Smart	45	106	151	3	6
			0		
			0		
			0		
			0		

Examiner Comments

None.