Bank Holding Company Supervision Manual

Division of Banking Supervision and Regulation

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Prepared by:
Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System

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Bank Holding Company Supervision Manual
Supplement 25—December 2003

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new and revised supervisory guidance and instructions issued by the Division of Banking Supervision and Regulation since the publication of the June 2003 supplement.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
2060.5	2060.05	This section has been revised to incorporate the May 5, 2003, Statement on Application of Recent Corporate Governance Initiatives to Nonpublic Banking Organizations issued by the Federal Reserve, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. The statement announced that the agencies do not expect to take actions to apply corporate-governance and other requirements of the Sarbanes-Oxley Act to nonpublic banking organizations that are not otherwise subject to them. The agencies, however, encouraged nonpublic banking organizations to periodically review their policies and procedures relating to corporate governance, auditing, and other requirements of the Sarbanes-Oxley Act. Although the act does not require small, nonpublic banking organizations to strictly adhere to its provisions, the agencies expect these banking organizations to ensure that their policies and procedures are consistent with applicable law, regulations, and supervisory guidance and that they remain appropriate for the organizations' size, operations, and resources. (See SR-03-08.)
2110.0	2110.0	This revised section on formal corrective actions discusses the existing restrictions on, and requirements for, severance payments made to institution-affiliated parties (so-called golden parachute payments). The restrictions originated from the Crime Control Act of 1990, which added section 18(k) to the Federal Deposit Insurance Act (12 U.S.C. 1828(k)). The FDIC's regulations on golden parachute payments (or any agreement to make any payment), found in 12 C.F.R. 359, are discussed in this section. The 30-day prior-notice requirement for appointing any new directors or senior executive officers of state member banks and bank holding companies is also discussed. (See section 32 of the FDI Act (12 U.S.C. 1831i) and subpart H of Regulation Y (12 C.F.R. 225.71).) This notice requirement also applies to any change in the responsibilities of any current senior executive officer that proposes to assume a different position. (See SR-03-06.)
3120.0	3120.0	The trust services section is revised to discuss the oversight responsibilities of the board of directors and senior management for operating the fiduciary activities of their financial holding company (FHC) or bank holding company (BHC) in a safe and sound manner. This oversight at the consolidated level is impor-

New Section Number	*Previous Section Number*	*Description of the Change*
		tant because the risks associated with financial activities as well as fiduciary activities can cut across legal entities and business lines. Relying on the examination findings of the appropriate trust activities regulator, the examiner is to review and assess the internal policies, reports, and procedures and the effectiveness of the BHC's or FHC's consolidated risk-management process for trust activities. The revision includes a discussion of the available reported supervisory information and analytical support tools that an examiner can use to evaluate the trust services of the holding company and its subsidiaries. (See SR-00-13.)
3000.0.2 3260.0	3000.0.2 3260.0	Appendix 1 of subsection 3000.0.2 (the detailed list of Board-approved nonbanking activities in section 225.28(b) of Regulation Y) and section 3260.0 have been revised to include the Board's June 27, 2003, approval of a Regulation Y amendment (effective August 4, 2003) to permit BHCs to (1) take and make delivery of title to commodities underlying commodity derivative contracts on an instantaneous, pass-through basis and (2) enter into certain commodity derivative contracts that do not require cash settlement or specifically provide for assignment, termination, or offset before delivery.
3600.30	3600.30	The nonbanking activities section on real estate title abstracting has been revised to include an October 7, 2002, staff opinion on BHC-conducted title abstracting activities for U.S.-registered aircraft. The title abstracting services are limited to (1) performing a title search of aircraft records and (2) reporting factual information on the ownership history of the relevant aircraft and the existence of liens and encumbrances affecting title to the aircraft. Staff opined that the described title abstracting activities for U.S.-registered aircraft would be within the scope of title abstracting activities for real estate previously determined to be permissible under section 4(c)(8) of the BHC Act on June 30, 1995. (See 1995 FRB 806.)
3920.0		This new section discusses the Board's October 2, 2003, approval of an FHC's notice under section 4(k) of the BHC Act to engage in physical commodity trading activities on a limited basis as an activity that is complementary to the financial activity of engaging regularly as principal in commodity derivative activities. (The effective date of the Board's order is also October 2, 2003.)
3950.0		This new section provides inspection guidance on insurance sales activities and consumer protection in sales of insurance as the guidance pertains to FHCs, BHCs, or state member banks. Examiner guidance is provided on (1) conducting risk assessments of BHC or state member bank insurance and annuity sales activities in accordance with the Federal Reserve's risk-focused supervisory approach and (2) examining a state member bank's compliance with the new Consumer Protection in Sales of Insurance (CPSI) regulation contained in subpart H of the Board's Regulation H (12 C.F.R. 208.81–86). The CPSI regulation (effective October 1,

New Section Number	*Previous Section Number*	*Description of the Change*
		2001) *applies only* to insured depository institutions. It implements section 305 of the Gramm-Leach-Bliley Act (the GLB Act) (12 U.S.C. 1831x). The guidance provides a comprehensive review of these insurance and annuity sales activities as they pertain to a BHC or bank and discusses the Federal Reserve's responsibility for enforcing a depository institution's compliance with the CPSI regulation. Consistent with the GLB Act, the guidance incorporates applicable restrictions on examining a functionally regulated subsidiary. The CPSI regulation's supervisory guidance is provided for the BHC examiner's, the board of directors', and senior management's information. The information is made available in this manual to BHC directors and management so they can fulfill their respective responsibilities in overseeing the operations of the BHC and its insured depository institution subsidiaries. The CPSI regulation requires certain disclosures in connection with the retail sale or solicitation of insurance products and annuities by a bank, any other person at bank offices where retail deposits are accepted from the public, or any person ''acting on behalf of the bank.'' Appendix A summarizes the banking agencies' joint statement in which they responded to a request to clarify whether the disclosure requirements apply to renewals of pre-existing insurance policies sold before October 1, 2001. Appendix B is a glossary of terms associated with insurance and annuity sales activities. Inspection objectives, inspection procedures, and an internal control questionnaire are also provided.
4020.4	4020.4	This revised section on bank liquidity incorporates the July 25, 2003, Interagency Advisory on the Use of the Federal Reserve's Primary Credit Program in Effective Liquidity Management. The interagency advisory provides guidance on the appropriate use of primary credit in effective liquidity management. The board of directors and senior management of BHCs and state member banks are advised to consider the Federal Reserve's primary credit program as part of their contingency funding plans and to provide for adequate diversified potential sources of funds to satisfy liquidity needs, which includes planning for certain significant liquidity events. (See SR-03-15.)

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Bank Holding Company Supervision Manual
Supplement 24—June 2003

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new and revised supervisory guidance and instructions issued by the Division of Banking Supervision and Regulation since the publication of the December 2002 supplement.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
2050.0	2050.0	This section on extensions of credit to BHC officials was revised to incorporate certain insider lending restrictions on public companies imposed by the Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act prohibits a publicly owned BHC (public BHC) and its subsidiaries from extending credit, or arranging for another entity to extend credit, in the form of a personal loan to any director or executive officer of the public BHC. The available exemptions to these insider limitations are (1) loans from a federally insured depository institution subsidiary of a public BHC (these loans are subject to the provisions of Regulation O) and (2) home improvement loans, manufactured home loans, consumer loans, and loans made under open-end credit plans or charge cards from a public BHC or its subsidiaries, subject to certain specific conditions.
2060.05	2060.05	The section incorporates the March 17, 2003, Interagency Policy Statement on the Internal Audit Function and Its Outsourcing, issued by the federal banking and thrift regulatory agencies. The 2003 policy statement supersedes a 1997 statement on the subject. The new policy statement incorporates recent developments in internal auditing and addresses supervisory concerns, policies, practices, and procedures pertaining to the internal audit function and its outsourcing. Supervisory guidance is also provided on the independence of accountants who provide institutions with both internal and external audit services. Provisions of the 2002 Sarbanes-Oxley Act and associated Securities and Exchange Commission (SEC) rules are also addressed, as discussed in the 2003 policy statement. Banking institutions that are subject to section 36 of the Federal Deposit Insurance Act—essentially those with $500 million or more in assets—should comply with the Sarbanes-Oxley Act prohibition on internal audit outsourcing to their external auditor. In addition to FDIC-insured depository institutions, the policy statement applies to U.S. financial holding companies (FHCs), bank holding companies (BHCs), and the U.S. operations of foreign banking organizations. When discussing the prohibitions on nonaudit services, the Sarbanes-Oxley Act describes three broad principles that define potential conflicts of interest for an external auditor. An external auditor should not (1) audit his or her own work, (2) perform management functions, or (3) act in an advocacy role for the client. Institutions should use these principles as a framework for analyzing existing

New Section Number	*Previous Section Number*	*Description of the Change*
		or proposed nonaudit services in order to avoid potential conflicts of interest for the external auditor. The inspection objectives and inspection procedures are updated to reflect the revised policy statement. (See SR-03-5 and SR-02-20.)
2065.3	2065.3	The section on the maintenance of an adequate allowance for loan and lease losses (ALLL) was revised to include a description of the definition and computation of the allocated transfer-risk reserve (ATTR), including its provisions and detailed components, as stated in the Board's January 6, 2003, revision to subpart D of Regulation K, sections 211.41–43 (effective February 10, 2003). The ATRR is a special reserve established and maintained for specified international assets pursuant to the International Lending Supervision Act of 1983.
2128.02	2128.02	The asset-securitization section was revised to provide additional risk management–oriented inspection procedures that further prompt the examiner's review of a banking organization's compliance with the current section's asset-securitization guidance and the November 2001 risk-based capital rule changes for BHCs, effective January 1, 2002. Those risk-based capital changes provide for a multilevel ratings-based approach to assessing the capital requirements for agreements involving recourse obligations, direct-credit substitutes, residual interests, and senior subordinated securities in asset securitization.
3000.0	3000.0	The introduction to BHC nonbanking and FHC activities section was revised to state that the Gramm-Leach-Bliley Act (the GLB Act) amended the Bank Holding Company Act (the BHC Act). The GLB Act limits BHCs that are not FHCs to engaging only in activities that had been determined by the Board, by regulation or order, before November 12, 1999, to be so closely related to banking as to be a proper incident thereto, under section 4(c)(8) of the BHC Act and section 225.28(b) of Regulation Y.
3000.0.2	3000.0.2	Appendix 1 was revised to include a reference to the July 9, 2002, staff opinion that certain flood zone–determination services are usual in connection with making mortgage loans and that these services are within the scope of extending credit under section 225.28(b)(2) of Regulation Y. The appendix lists nonbanking activities approved by the Board, under section 4(c)(8) of the BHC Act and section 225.28(b) of Regulation Y, that have been determined to be "closely related to banking."
3070.0.8	3070.0.8	The mortgage banking section was revised to include a July 9, 2002, request for a Board staff legal opinion on the planned provision of flood zone–determination services by a BHC's proposed majority-owned joint venture company. The company would provide mortgage lenders with ongoing flood zone–tracking services in connection with making mortgage loans. The flood determination services would be offered as a separate service in

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		connection with providing real estate appraisals. Board staff confirmed that providing such flood zone–determination services is an essential part of mortgage lending and within the scope of permissible activities related to extending credit under section 225.28(b)(2) of Regulation Y and that the services are usual in connection with making mortgage loans.
3500.0.2.2	3500.0.2.2	The section on tying provisions of the BHC Act was revised to include a November 26, 2002, Board staff legal opinon for effecting combined-balance discounts. A question was asked as to whether members of a household or family, taken together, may be considered a ‘‘customer’’ for the purposes of the combined-balance discount safe harbor, as it is found in section 225.7(b) of Regulation Y. Board staff opined that the term ‘‘customer,’’ as used in that section, may include separate individuals (1) who are all members of the same ‘‘immediate family’’ (as defined in section 225.41(b)(3) or Regulation Y) and (2) who reside at the same address. A combined-balance discount program cannot be operated in an anti-competitive manner.
3510.0.2.3	3510.0.2.3	This revised section on the nonbanking activities of foreign banking organizations discusses a February 7, 2003, Board interpretation that clarifies that a foreign bank’s underwriting of securities to be distributed in the United States is considered an activity conducted in the United States, regardless of the location at which the underwriting risk is assumed and the underwriting fees are booked. Based on this interpretation, any company that wishes to engage in such an activity must either be an FHC under the GLB Act or have authority, by Board order, to engage in underwriting activities under section 4(c)(8) of the BHC Act (so-called section 20 authority). Revenue generated by underwriting bank-ineligible securities in such transactions must be attributable to the section 20 company for those foreign banks that operate under the section 20 company authority.
3905.0	3905.0	The revised section on permissible activities for FHCs includes two separate Board staff legal opinions on whether an insurance agency, owned by an FHC, may engage in certain insurance activities under section 4(k)(4)(B) of the BHC Act (12 U.S.C. 1843(k)(4)(B)). In the first July 10, 2002, opinion, an FHC’s legal counsel asked if an insurance agency, which is owned by an FHC, may engage in certain cited insurance claims administration activities and insurance risk-management services in connection with its insurance sales activities. Board staff opined that the cited activities could be conducted by an FHC, if the insurance services were provided by an insurance agent or broker in connection with its other insurance sales activities. The same FHC’s legal counsel also asked whether an insurance agency or broker owned by an FHC could engage in certain specific insurance risk-management activities. Board staff opined that the specifically listed insurance risk-management services are

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		encompassed within section 4(k)(4)(B) of the BHC Act and that the FHC may conduct the services, subject to the conditions stated within the opinion. In a second July 10, 2002, legal opinion, other legal counsel representing another BHC that had elected to become an FHC requested a Board staff legal opinion on whether acting as a third-party administrator (TPA), on behalf of an insurance company, is an activity that is permissible for an FHC under the BHC Act. A TPA provides one or more insurance companies with the cited administrative and related services that support and assist in the sale of insurance products by the insurance company. The BHC proposed to invest in a company that acts as a TPA for licensed insurance companies that underwrite and sell credit life insurance. Board legal staff opined that the specifically cited services were encompassed within the insurance activities authorized by section 4(k)(4)(B) of the BHC Act when provided to, or on behalf of, an insurance company in connection with the sale or underwriting of insurance. The opinion concluded that an FHC may, under section 4(k)(4)(B) of the BHC Act, provide the listed services to a third-party insurance company in connection with the sale and underwriting of insurance products by a third-party insurance company.
5010.10.3	5010.10.3	The security classifications table, in the section on inspection report preparation for consolidated classified and special-mention assets and other transfer-risk problems, was revised to acknowledge the use of “fair values” (market values). “Fair value” is the current terminology that would be used in the application of generally accepted accounting principles when classifying securities.

FILING INSTRUCTIONS

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Bank Holding Company Supervision Manual
Supplement 23—December 2002

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new and revised supervisory guidance and instructions issued by the Division of Banking Supervision and Regulation since the publication of the June 2002 supplement.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
2065.4		This new section discusses the July 2, 2001, policy statement issued by the Federal Financial Institutions Examination Council (FFIEC) on the design and implementation of the methodologies and documentation practices that are tailored to the size and complexity of a banking organization and its loan portfolio. While this policy statement, by its terms, applies only to federally insured depository institutions, the Federal Reserve believes the guidance it contains is broadly applicable to bank holding companies. The policy statement emphasizes that a banking organization's board of directors is responsible for ensuring that controls are in place to determine the appropriate level of the allowance for loan and lease losses (ALLL). The banking organization should maintain and support the ALLL with documentation that is consistent with its stated policies and procedures, generally accepted accounting principles (GAAP), and applicable supervisory guidance. The ALLL methodology must be a thorough, disciplined, and consistently applied process that incorporates management's current judgment about the credit quality of the loan portfolio. At a minimum, written supporting documentation must be maintained for the following decisions, strategies, and processes: (1) policies and procedures (over the systems and controls that maintain an appropriate ALLL and over the ALLL methodology), (2) the loan-grading system or process, (3) validation of the ALLL methodology, and (4) periodic adjustments to the ALLL process. The questions and answers found in appendix A of the policy statement have been incorporated into this section as numbered examples. Inspection objectives and procedures are provided. (See SR-01-17.)
2110.0	2110.0	This section on formal corrective actions is updated to discuss the statutory provisions that may be used, when warranted, for formal supervisory actions. The types of corrective action are discussed, as well as the actions that the Federal Reserve must take in this regard. Briefly discussed are the use of prompt-corrective-action directives (for federally insured banks only) and the potential assessment of civil money penalties against a bank or company or any of its institution-affiliated parties for noncompliance. Also discussed are the Federal Reserve's supervisory concerns and guidance that focus on the FDIC's regulations pertaining to indemnification agreements and payments. (See SR-02-17.)

New Section Number	*Previous Section Number*	*Description of the Change*
2128.02	2128.02	The asset-securitization section was revised to include an expanded discussion of the asset-securitization process and a new subsection on credit enhancement. A general discussion of the November 2001 changes to the risk-based capital rule for bank holding companies (Regulation Y (12 C.F.R. 225, appendix A)), effective January 1, 2002, is also provided. This revised rule incorporated a multilevel, ratings-based approach to assess capital requirements for agreements involving recourse obligations, direct-credit substitutes, residual interests (except for credit-enhancing interest-only (I/O) strips), and senior subordinated securities in asset securitizations based on their relative credit risk. The approach uses credit ratings from the rating agencies to measure the relative exposure to credit risk and to determine the associated risk-based capital requirement. The changes were approved by the Board on November 8, 2001, and issued in a joint agency press release dated November 29, 2001.
2128.04		Implicit recourse provided to asset securitizations is discussed in this new section, which is based on interagency guidance on this topic, issued May 23, 2002, in a question-and-answer format. (See SR-02-15.) This guidance has been reformatted as illustrative examples. Implicit recourse occurs when a banking organization (including a bank holding company) has provided credit support beyond its contractual obligation to one or more of its securitizations. Implicit recourse demonstrates that the securitizing banking organization is reassuming risk associated with the securitized assets—risk that it initially transferred to the marketplace. Therefore, implicit recourse is of supervisory concern to the Federal Reserve. The May 2002 guidance assists bankers and supervisors in assessing the types of actions that may, or may not, constitute implicit recourse. Possible supervisory actions that the Federal Reserve may take upon a determination that the bank has provided implicit recourse in an asset securitization include (1) an increase in the banking organization's regulatory capital requirements for the selling banking organization, (2) requiring regulatory capital to be held against the entire amount of assets sold, and (3) the possible required deduction of the residual interests from regulatory capital.
2128.05		This new section discusses the inclusion, in asset-securitization documents, of covenants that trigger an early amortization or transfer of servicing and that are linked to adverse supervisory actions. The guidance is based on an interagency advisory issued May 23, 2002. (See SR-02-14.) The banking organization's board of directors and senior management are alerted that the Federal Reserve considers the inclusion of such covenants in securitization documents to be an unsafe and unsound banking practice that undermines the objective of supervisory actions. Further, the board and senior management are encouraged to amend, modify, or remove the covenants in existing transactions. An early amortization or transfer of servicing that is triggered by such events could

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		create or exacerbate any liquidity and earnings problems for a banking organization, possibly leading to a further deterioration in its financial condition.
2128.08	2128.08	The subprime-lending section was revised to incorporate the supplemental January 2001 interagency guidance that is directed primarily to banking organizations (for example, federally insured depository institution subsidiaries of bank holding companies) that have subprime-lending programs that equal or exceed 25 percent of tier 1 regulatory capital. Subprime lending can expand credit access for consumers and offer attractive returns. Banking organizations are expected, however, to recognize that the elevated levels of credit and other risks arising from these activities require more intensive risk management and, often, additional capital. This expanded guidance discusses (1) the characteristics of a subprime-lending program, (2) a set of specific borrower characteristics that may indicate that a banking organization is involved in the subprime-lending market, (3) analysis and documentation standards for the ALLL, (4) factors to be considered when determining the appropriate level of capital needed to support subprime lending, (5) examination procedures for assessing the quality of subprime-loan portfolios, and (6) a list of potentially predatory or abusive lending practices that safety-and-soundness examiners would criticize. An appendix, consisting of questions and answers pertaining to the January 2001 supplemental guidance, is provided. The subprime-lending inspection objectives and procedures have been revised to accommodate this change. (See SR-01-4.)
4060.3	4060.3	This risk-based capital guidelines section has been revised to reflect multiple rule changes, as well as clarifying interpretations, an advisory, and other supervisory guidance. The first revision is the rule change approved by the Board on November 8, 2001 (effective January 1, 2002), that was published on November 29, 2001. This rule change addressed the treatment of recourse obligations, residual interests (except credit-enhancing I/O strips), direct-credit substitutes, and senior subordinated securities in asset securitizations that expose banking organizations (including bank holding companies) primarily to credit risk. New standards have been added for the treatment of residual interests, including a concentration limit for credit-enhancing I/O strips. Credit ratings from rating agencies and certain limited alternative-credit-rating approaches are used to match more closely the risk-based capital requirement for these banking organizations to their relative risk of loss for certain positions in asset securitizations. This section also includes joint interagency interpretive guidance issued on September 5, 2002, discussing the appropriate applications of the November 2001 joint final rule. The guidance addresses the risk-based capital treatment for (1) split or partially rated instruments (instruments that are derived from a securitization and assigned separate ratings for principal and interest), (2) a ratings-based qualification for corporate bonds or other securities

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that are not related in any way to a securitization or structured-finance program (they do not qualify for the ratings-based approach), (3) spread accounts that function as credit-enhancing I/O strips, (4) audits of internal credit-risk rating systems (if audits must be performed by a banking organization's internal-audit department rather than another independent internal entity), and (5) clean-up calls (related to the repurchase of assets pursuant to a clean-up call and whether certain clean-up calls are treated as a recourse obligation or a direct-credit substitute). (See SR-02-16.)

The section addresses the risk-based capital treatment of accrued interest receivables (AIRs) related to credit card securitizations, as discussed in a May 17, 2002, interagency advisory. The AIR asset typically represents a subordinated retained interest in the transferred assets. The asset therefore meets the definition of a ''residual interest'' that requires dollar-for-dollar capital, even if the amount exceeds the fully equivalent risk-based capital charge on the transferred assets under the November 2001 rule change. The accounting treatment for AIRs is also discussed. When accounting under FAS 140, ''Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,'' for the securitization and sale of credit card receivables, and in computing the gain or loss on sale, the banking organization (seller) should report the AIR asset, on the date of transfer, at adjusted cost, based on its relative fair (market) value. (See SR-02-12 and SR-02-22.)

The revised section discusses the January 8, 2002, Regulation Y change to the risk-based capital adequacy requirements (risk-based measure), effective April 1, 2002, that established special minimum capital requirements for equity investments in nonfinancial companies. The capital requirements apply symmetrically to equity investments and impose a series of marginal capital charges on such authorized covered equity investments that increase with the level of a bank holding company's overall exposure to equity investments relative to its tier 1 capital. The highest marginal capital charge requires a 25 percent deduction from tier 1 capital for covered investments that aggregate more than 25 percent of a bank holding company's tier 1 capital. Equity investments through small business investment companies are exempt to the extent that such investments, in the aggregate, do not exceed 15 percent of the bank's tier 1 capital. The Federal Reserve will apply heightened supervision to the banking organizations it supervises as their level of concentration in equity investments increases. (See SR-02-4.)

The revised section also discusses the Federal Reserve's March 23, 2002, supervisory guidance on derivative contracts hedging trust preferred stock with respect to the inclusion of such trust preferred stock in tier 1 capital. To be included in tier 1 capital, an issuing bank holding company must have the ability to defer payments for at least 20 consecutive quarters without giving rise to an event of default. Such a deferral feature, which typically is cumulative in trust preferred stock, is essential in a tier 1 instru-

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		ment because it allows the issuer to conserve its cash resources at a time when its financial condition is deteriorating. When a banking organization hedges trust preferred stock through an interest-rate swap with a deferral feature, the deferral terms on the swap must be symmetrical for both the organization and its counterparty and must not have the effect of draining the organization's resources in a time of stress. Issues of trust preferred stock may not be included in tier 1 capital if they are covered by an interest-rate derivative contract with asymmetrical deferral terms. (See SR-02-10.) A limited rule change (issued jointly by the federal banking agencies) is also discussed, which the Board approved on March 27, 2002 (effective July 1, 2002). The change lowered from 100 percent to 20 percent the risk weight that is applied to certain securities claims on, or guaranteed by, a qualifying securities firm in the United States and in other countries that are members of the Organization for Economic Cooperation and Development. (See the Federal Reserve Board's joint press release of April 9, 2002, and its attachment.)
4060.4	4060.4	This section on the leverage measure of the capital adequacy guidelines was revised to include rule changes in the tier 1 leverage measure for bank holding companies. The changes are based on the capital changes to Regulation Y (12 C.F.R. 225, appendix D). The first change was approved by the Board on November 8, 2001 (effective January 1, 2002), and issued in a joint agency press release dated November 29, 2001. The change pertained to agreements involving recourse, direct-credit substitutes, and residual interests. The second change is applicable to nonfinancial equity investments and was approved by the Board on January 7, 2002 (effective April 1, 2002). (See the January 8, 2002, joint interagency press release and SR-02-4).
4080.0	4080.0	In this section on the Federal Reserve System BHC surveillance program, the description of the surveillance program has been amended so that it applies only to bank holding companies that have $1 billion or more in consolidated assets. The section recognizes the separate surveillance program for BHCs with consolidated assets of less than $1 billion, as discussed in section 4080.1. (See SR-02-1.)
4090.0	4090.0	The country-risk section was substantially revised to include the February 22, 2002, interagency supervisory and examiner guidance on an effective country-risk management process for banking organizations (including bank holding companies). (The interagency guidance was issued by the Federal Reserve, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency.) Country risk is the risk that economic, social, or political conditions in a foreign country might adversely affect an organization's financial condition, primarily through impaired credit quality or transfer risk (a subset of country risk). The section discusses the examiner's responsibilities with regard to ensuring

New Section Number	*Previous Section Number*	*Description of the Change*
		that a banking organization's management of country risks is appropriately addressed during the examination or inspection process. Country risk can occur in many different forms, and the nature of specific risks can change over time. A U.S. banking organization with significant direct or indirect international exposure must have in place an effective country-risk management process that is commensurate with the volume and complexity of its international activities. Examiners should continue to evaluate the adequacy of the country-risk management process at internationally active banking organizations, augmenting their assessments using this guidance. The bank holding company's country-risk management process should include, at a minimum, (1) effective oversight by the board of directors, (2) adequate risk-management policies and procedures, (3) an accurate country-exposure reporting system, (4) an effective country-risk analysis process, (5) a country-risk rating system, (6) country-exposure limits, (7) ongoing monitoring of country conditions, (8) periodic stress testing of foreign exposures, and (9) adequate internal controls and an audit function. A banking organization's country risk-management process should give particular attention to any concentrations of country risk. Inspection objectives and procedures are included. (See SR-02-5.)

FILING INSTRUCTIONS

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Bank Holding Company Supervision Manual
Supplement 22—June 2002

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new and revised supervisory guidance and instructions issued by the Division of Banking Supervision and Regulation since the publication of the December 2001 supplement.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
2129.05	2129.05	This section addresses risk and capital adequacy management of the exposures that arise from secondary-market credit activities. It has been revised to reflect the Board's November 8, 2001, amendment of Regulation H for the risk-based capital adequacy measure (effective January 1, 2002), which addresses the treatment of recourse obligations, residual interests, and direct-credit substitutes.
3500.0.2.2	3500.0.2.2	This section addresses the tie-in considerations of the BHC Act. It is revised to discuss a May 16, 2001, staff interpretation involving a proposal that considers the anti-tying provisions of section 106(b) of the BHC Act Amendments of 1970 (12 U.S.C. 1972) and the Board's safe harbor for combined-balance discounts (12 C.F.R. 225.7(b)(2)). The interpretation confirms that financial products offered by a bank or its affiliates, including insurance products, may properly be included among eligible products in a bank's combined-balance discount program. The interpretation also confirms that the principal amount of an annuity may be counted in determining the size of a customer's balance in eligible products, as may the premiums paid on non-annuity insurance products.
3510.0	3510.0	This section on the nonbanking activities of foreign banking organizations was revised to address changes resulting from the Board's October 16, 2001, revision of Regulation K (effective November 26, 2001). The section explains Regulation K's implementation of two statutory exemptions (found in sections 2(h) and 4(c)(9) of the BHC Act) from the nonbanking restrictions of the BHC Act. The exemptions are available to ''qualifying foreign banking organizations'' (QFBOs). Section 2(h) allows a foreign company principally engaged in banking outside the United States to own a foreign affiliate that engages in impermissible nonfinancial activities in the United States, provided that the affiliate engages in the United States in only the same lines of business it conducts outside the United States and derives most of its business from outside the United States. Section 4(c)(9) allows the Board to grant foreign companies an exemption from the nonbank-activity restrictions of the BHC Act if the exemption would not be substantially at variance with the act and would be in the public interest. Under this authority, the Board has exempted, among other things, all foreign activities of a QFBO from the nonbanking restrictions of the BHC Act.

New Section Number	*Previous Section Number*	*Description of the Change*
		The revised section also discusses Regulation K's multipart QFBO test and an alternate means of satisfying that test. The QFBO test and its modified form are used to determine when an FBO engages primarily in banking activities worldwide. To qualify as a QFBO, an FBO must demonstrate that more than half of its business is banking and that more than half of its banking business is outside the United States.
3550.0	3550.0	The section on international activities of bank holding companies, member banks, and Edge and agreement corporations has been revised to incorporate changes resulting from the Board's 2001 revisions to subpart A of Regulation K. The section discusses the investment provisions of Regulation K (primarily, sections 211.8, 211.9, and 211.10) that implement section 4(c)(13) of the BHC Act. In general, an ''investor'' under Regulation K may make investments, directly or indirectly, in a subsidiary or joint venture or may make portfolio investments subject to certain limits. Such limits are higher where the investor, any parent insured bank, and any parent holding company are well capitalized and well managed. (See SR-02-03 and SR-02-02.) Activities abroad, whether conducted directly or indirectly, must be confined to activities of a banking or financial nature and to those activities that are necessary to carry on such activities. Section 211.10 of Regulation K lists those activities the Board considers to be usual in connection with the transaction of banking or other financial operations abroad. At all times, investors must act in accordance with the high standards of banking or financial prudence, having due regard for diversification of risks, suitable liquidity, and capital adequacy.
3907.0.3.2.1		The merchant banking section was revised to include a December 21, 2001, staff opinion regarding the provision in the Gramm-Leach-Bliley Act that generally prohibits a financial holding company (FHC) from routinely managing and operating a portfolio company, the shares of which are owned by the FHC under the act's merchant banking authority (12 U.S.C. 1843(k)(4)(H)). This new subsection provides examples of permissible covenants between an FHC and a portfolio company that would not involve an FHC in the routine management or operation of a company, consistent with the act and the Board's Regulation Y (12 C.F.R. 225.171(d)).
4080.1		The surveillance program for small bank holding companies having total consolidated assets of less than $1 billion is summarized in this new section. (See SR-02-1.)
4090.0	4090.0	The country-risk section incorporates changes to the reporting requirements or instructions involving country risk, specifically for the FFIEC 009, 009a, and 019 report forms.
5000.0	5000.0	The section on the Federal Reserve's BHC inspection program has been revised to include the changed supervision procedures for BHCs with total consolidated assets of less than $5 billion. Princi-

New Section Number	*Previous Section Number*	*Description of the Change*
		pally affecting the supervision of holding companies having total consolidated assets of less than $1 billion, the procedures revise the requirements for the frequency and type of inspections (or reviews), as well as the requirements for the scope of inspections, meetings with the directors and senior management, rating assignments, and documentation. The procedures promote more effective use of targeted on-site reviews to fulfill inspection requirements. Reserve Banks are directed to use surveillance and other information to focus their attention and resources on holding companies that warrant increased supervision. (See SR-02-1.)

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Bank Holding Company Supervision Manual
Supplement 21—December 2001

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new and revised supervisory guidance and instructions issued by the Division of Banking Supervision and Regulation since the publication of the June 2001 supplement.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
2010.2	2010.2	This section on loan administration and lending standards has been revised to incorporate the April 9, 2001, interagency guidance about risk-management practices for risk-rating leveraged-financed loans. The section discusses how the imputed value of a business (enterprise value) should be evaluated in the risk-rating process. Many leveraged transactions are underwritten with reliance on the imputed value, which is often highly volatile. Sound valuation methodologies must be used, in addition to ongoing stress testing and monitoring of those values. Depository institutions that are substantively engaged in leveraged financing are expected to adequately risk-rate, track, and monitor these transactions and to maintain policies specifying conditions that would require a change in risk rating, accrual status, loss recognition, or reserves. The guidance is to be followed when the board of directors and senior management of financial holding companies (FHCs) and bank holding companies (BHCs) supervise the lending activities of their depository institution subsidiaries. The institutions should have a comprehensive credit-analysis process, frequent monitoring, and detailed portfolio reports to better understand and manage the inherent risk in their leveraged-finance portfolios. The guidance also should be considered as FHCs and BHCs supervise the leveraged-financed lending activities of their nonbank subsidiaries. See SR-01-9.
2010.7	2010.7	This section on the allowance for loan and lease losses (ALLL) has been revised to include a brief summary of a supplemental interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions. The policy was issued by the Federal Financial Institutions Examination Council (FFIEC) on July 2, 2001. It clarifies what the agencies expect for the documentation that supports the ALLL methodology. The statement further emphasizes the need for appropriate ALLL policies and procedures, including an effective loan-review system. The statement provides examples of appropriate supporting documentation, as well as illustrations on how to implement this guidance. See SR-01-17 and its attachment.
2020.1	2020.1	This section on intercompany transactions (transactions with affiliates) has been reorganized and revised to discuss several new interim and final rules, exemptions, and interpretations for certain transactions that pertain to the limitations imposed by sections

New Section Number	*Previous Section Number*	*Description of the Change*
		23A and 23B of the Federal Reserve Act (FRA). The interpretations and exemptions involve derivatives; intraday extensions of credit; and transactions involving depository institution loans made to a customer (1) to purchase a security or other asset through a depository institution broker-dealer affiliate that acts as a riskless principal, or (2) that uses the proceeds to purchase a security from a depository institution broker-dealer affiliate, when the loan was made pursuant to a preexisting line of credit not entered into in contemplation of the purchase of securities from the depository institution affiliate. Another final rule expands the types of securities that are eligible for a bank to purchase from its registered broker-dealer affiliates under section 23A(d)(6), while ensuring that the transactions are conducted according to safe and sound banking practices.
2124.4		This new section includes the federal banking agency interagency guidelines establishing standards for safeguarding customer information (the guidelines). The guidelines, effective July 1, 2001, implement section 501 of the Gramm-Leach-Bliley Act (GLB Act). The guidelines include standards for developing and implementing administrative, technical, and physical safeguards to protect the security, confidentiality, and integrity of customer information. Each bank holding company falling within the scope of the guidelines is required to establish a comprehensive written information security program. Appropriate measures must be adopted to assess, manage, and control the identified risks, commensurate with the sensitivity of the information as well as the complexity and scope of the bank holding company's activities. Specific information security measures are outlined that institutions must consider when implementing an information security program. Bank holding companies are also required to oversee their service-provider arrangements in order to protect the security of customer information maintained or processed by service providers. The bank holding company's board of directors must oversee and approve the development, implementation, and maintenance of the information security program. Examiners should assess compliance with the guidelines during each safety-and-soundness inspection. See SR-01-15.
3901.0	3901.0	This section on U.S. bank holding companies that effectively elect to operate as FHCs has been amended for the December 2000 revision of Regulation Y pertaining to the consequences when an FHC controls a depository institution subsidiary that fails to continue meeting the requirements for being well capitalized and well managed. The section also includes the consequences for when a depository institution subsidiary that an FHC controls fails to maintain a satisfactory or better Community Reinvestment Act rating. See sections 225.83 and 225.84 of Regulation Y, respectively.

New Section Number	*Previous Section Number*	*Description of the Change*
3903.0	3903.0	This section pertains to foreign banks operating as FHCs. Several technical clarifications were made based on the December 2000 final FHC requirements, as found in Regulation Y.
3000.0 3905.0	3000.0 3905.0	The sections for the introduction to nonbanking activities and permissible activities for FHCs have been revised to include changed section references in the revised Regulation K, for international banking operations, approved by the Board on October 16, 2001.
4060.3.2.1.1.5		This subsection discusses the risk-based capital treatment for bank holding companies' (and state member banks') forward equity transactions relating to the repurchase of their common stock. Some banking organizations have continued to treat shares under such arrangements as tier 1 capital. Such transactions can impair the permanence of shares, typically have certain features that are undesirable from a supervisory perspective, and are inconsistent with tier 1 capital status. The Federal Reserve has determined that any banking organization's common stock that is covered by forward equity transactions entered into after the issuance of SR-01-27 (November 9, 2001) will be excluded from tier 1 capital (of a bank holding company or state member bank), other than those transactions specified for deferred compensation or other employee benefit plans.

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Bank Holding Company Supervision Manual
Supplement 20—June 2001

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new and revised supervisory guidance and instructions issued by the Division of Banking Supervision and Regulation since the publication of the December 2000 supplement.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
1000.0	1000.0	The foreword has been revised to provide a broad overview of the Federal Reserve's risk-focused inspection program for bank holding companies (BHCs) and financial holding companies (FHCs). The overview discusses the information-gathering, preliminary risk-assessment, and preplanning phases that culminate in the formal and structured supervisory strategy to be followed during an inspection. The highest risks (such as credit, market, liquidity, operational, legal, and reputational risks) undergo the most rigorous scrutiny, analysis, and transaction testing. The risk-management processes (systems to identify, measure, monitor, and control changing risk exposures) are evaluated for reliability. A determination also is made as to whether the organization's management and directors are actively involved in risk-management oversight. The inspection focuses on the financial indices of the consolidated entity and its component parts to measure the organization's financial strength.
3000.0	3000.0	The introduction to nonbanking activities has been revised to discuss FHCs (authorized by the Gramm-Leach-Bliley Act (GLB Act)). The GLB Act's repeal of certain provisions of the Glass-Steagall Act is discussed, as well as a general overview of permissible financial and nonfinancial activities that are available to BHCs that qualify as FHCs.
3901.0	3901.0	This revised section discusses the requirements for U.S. BHCs desiring to declare and operate as FHCs. The section is amended to include the December 2000 final rule changes to Regulation Y for FHCs. The discussion includes (1) the well-managed criteria that apply to all depository institutions that are controlled by a company that desires to qualify as an FHC; (2) the timing of FHC declarations that are informationally complete; (3) the simultaneous filing of an application to become a BHC and to become an FHC on consummation of the transaction; (4) Federal Reserve responses to complete FHC declarations; and (5) the criteria denoting when an FHC is substantially engaged in permissible activities that are financial in nature, incidental to a financial activity, or otherwise permissible for an FHC under section 4(c) of the Bank Holding Company Act (BHC Act). The section discusses the requirements for an FHC to acquire more than 5 percent of the voting shares or control of a company that is not *engaged exclusively* in activities that are financial in

New Section Number	*Previous Section Number*	*Description of the Change*
		nature, incidental to financial activities, or otherwise permissible under section 4(c) of the BHC Act. If an FHC makes such an acquisition, the acquired company must be substantially engaged (as defined) in activities that are financial in nature, incidental to a financial activity, or otherwise permissible under section 4(c) of the BHC Act. The two-year period to divest or terminate acquisitions of companies that do not comply with this requirement is discussed.
3903.0	3903.0	This revised section on foreign banks operating as FHCs includes the December 2000 revisions to Regulation Y. The section (1) references the factors used to determine the comparability of capital and management of a foreign bank; (2) discusses the requirements for assigning a ''combined ROCA rating'' (see SR-00-14) derived from the examination of a foreign banking organization's (FBO) U.S. branch, agency, and commercial lending operations (this rating is factored into the FBO's overall combined U.S. operations (banking and nonbanking) composite rating); and (3) requires the assurances of the home-country supervisor that the foreign bank's capital and management are considered satisfactory (using a comprehensive consolidated supervision framework and preclearance process) before the Board will consent to an expansion of the foreign bank's U.S. operations as an FHC. The Board does not impose a specific leverage ratio (tier 1 capital to total assets) standard on foreign banks that desire to become FHCs. The leverage ratio may be considered, however, among the factors used to assess comparability. Except in rare instances, a foreign bank will not be considered well capitalized or well managed if it is not subject to comprehensive consolidated supervision.
3905.0	3905.0	The section on permissible activities for qualifying FHCs has been revised to include the activities found to be financial in nature, as listed in section 4(k)(4) of the BHC Act. The revised section also includes a discussion of the January 2001 interim revision of Regulation Y that implements section 4(k)(5) of the BHC Act . A mechanism is provided for FHCs to request the Board or the Secretary of the Treasury to determine whether a particular activity falls into one of three specific categories of permissible activities under section 4(k)(5). The section details the information requirements for this request and discusses the procedures under this interim rule to request a determination as to whether an activity is financial in nature or incidental to a financial activity. The amended section also gives guidance on how to obtain approval to engage in an activity that is complementary to an identified financial activity. The revised section also discusses a March 2000 interim rule that established two operating standards that apply under sections 23A and 23B of the Federal Reserve Act (FRA) for FHCs engaged in underwriting, dealing, or market making. These operating standards apply to certain transactions between specified foreign banking and thrift institutions and their securities affiliates.

New Section Number	*Previous Section Number*	*Description of the Change*
3907.0		This new section discusses the joint adoption by the Board and the Secretary of the Treasury of a final rule, effective February 15, 2001, governing merchant banking investments made by FHCs. Under section 4(k) of the BHC Act, FHCs may make investments as part of a bona fide securities underwriting or merchant or investment banking activity. These investments may be made in any type of ownership interest in any type of nonfinancial entity (portfolio company), and they may represent any amount of the equity of a portfolio company. The section discusses (1) permissible investments; (2) prohibitions on routinely managing or operating a portfolio company; (3) portfolio company holding periods; (4) private equity funds, including restrictions on their management and operation; (5) automatic sunset provisions for aggregate investment thresholds in portfolio companies; (6) risk-management, reporting, and recordkeeping policies; (7) cross-marketing restrictions; and (8) presumptions of control under sections 23A and 23B of the FRA and the safe harbors to the rebuttable presumptions.
3909.0		This new section sets forth supervisory guidance for equity investment and merchant banking activities. Basic safety-and-soundness issues are discussed regarding the management of such investments. This section provides useful management infrastructure and control benchmarks for organizations engaged in such activities. The guidance also identifies sound investment and risk-management practices that merit the attention of both management and supervisors. Banking organizations are encouraged to make appropriate public disclosures of their equity investment activities (recommendations for the scope of such disclosures are provided). Sound practices in providing traditional lending-based banking services to portfolio companies, to portfolio company management, and to general partners of equity investment ventures and funds are also discussed. The potential risks and returns of equity investment and merchant banking activities exceed those of more traditional banking activities. Banking organizations and FHCs engaged in such activities are required to have strong capital positions that are well above current minimum regulatory requirements, along with robust internal methods for allocating capital that are commensurate with the inherent risks of those activities. (See SR-00-9.)
3910.0		This new section discusses the Board's decision, in consultation with the Secretary of the Treasury, to approve a December 2000 final rule authorizing FHCs to engage in acting as a finder, a limited activity that is considered incidental to a financial activity. A finder brings together buyers and sellers of products and services for transactions that buyers and sellers themselves negotiate and consummate. Examples of specific services that a finder may and may not perform are provided. An FHC offering finder services is to provide appropriate disclosures to distinguish its products and services from those that are offered by a third party using the FHC's finder service.

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Bank Holding Company Supervision Manual
Supplement 19—December 2000

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new or revised supervisory guidance and instructions issued by the Division of Banking Supervision and Regulation since the publication of the June 2000 supplement.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
1040.0		This new section sets forth the statutory authority, focus, and scope of BHC inspections as found in the Gramm-Leach-Bliley Act (GLB Act) (section 5 of the Bank Holding Company Act (BHC Act)). The GLB Act provides the Board with specific supervisory guidance pertaining to the breadth of BHC inspections, as well as to inspections of their subsidiaries. The focus of inspections will be on preserving the safety and soundness of the holding company's affiliated depository institutions.
2020.1	2020.1	This section has been revised for changes to section 23A of the Federal Reserve Act (transactions between affiliates) made by the GLB Act. The GLB Act expanded the coverage of section 23A by including transactions between banks and their financial subsidiaries and by providing a definition of financial subsidiary. With respect to transactions between a bank and an individual financial subsidiary of a bank, the GLB Act provides that the 10 percent limit on covered transactions does not apply. The GLB Act also created a rebuttable presumption that a company or shareholder controls another company if the company or shareholder directly or indirectly owns or controls 15 percent or more of the equity capital of the other company as a portfolio company. (See section 4(k)(4)(H) or (I) of the BHC Act.)
	2185.0	The GLB Act repealed section 20 of the Glass-Steagall Act, created financial holding companies (FHCs), and directed the Federal Reserve to rely on functional regulators. Therefore, the entire section pertaining to BHC inspection of nonbank subsidiaries engaged in underwriting and dealing in bank-ineligible securities (so-called ''section 20 companies'') is deleted.
2241.0	2241.0	This revised section includes the June 2000 FFIEC Uniform Retail-Credit Classification and Account-Management Policy that supersedes the February 1999 policy. The revised policy— • stresses the need for institutions to adopt and adhere to prudential internal standards on the number and frequency of extensions, deferrals, rewrites, and renewals of closed-end loans that they grant; • limits re-aging of open-end accounts that participate in a debt-counseling or workout program, following receipt of at least three consecutive minimum monthly payments, or an equivalent cumulative amount;

New Section Number	*Previous Section Number*	*Description of the Change*
		• provides for a current assessment of value to be made no later than 180 days past the contractual due date for loans secured by real estate (any loan balance exceeding the property's value, less selling costs, is to be classified loss and charged off); • clarifies that collateralized loans due to be charged off under the policy can be written down to the collateral's value, less cost to sell, instead of being entirely charged off; and • clarifies that payments received after the applicable charge-off threshold, but before the end of the month in which the charge-off threshold is triggered, may be considered when determining if a charge-off remains appropriate. While the terms of the revised policy apply only to federally insured depository institutions, the Federal Reserve believes that the revised policy is broadly applicable to BHCs (for example, consumer finance nonbank subsidiaries and other similar credit-extending financial affiliates). Examiners are thus advised to consider the methodology used for aging retail loans. The contractual method of loan aging is emphasized as the more accurate and preferred method, although BHCs have the range of options available under generally accepted accounting principles (GAAP). (See SR-00-8.)
3900.0	3900.0	This section was revised to provide information on the focus and scope of the Federal Reserve System's supervisory framework for FHCs. Under the GLB Act, the Federal Reserve has supervisory oversight authority and responsibility for BHCs, including BHCs that operate as FHCs. The GLB Act streamlined the Federal Reserve's supervision of BHCs and provided parameters for working with primary depository institution regulators and other functional regulators (such as those responsible for supervising activities involving insurance, securities, and commodities). The GLB Act designates the Federal Reserve as the umbrella supervisor of FHCs. In carrying out its supervisory oversight role, the Federal Reserve will maintain a supervisory focus concentrated on a consolidated or group-wide analysis of the organization. The Federal Reserve will thus identify and evaluate the significant risks in the diversified holding company, assessing how these risks could affect the safety and soundness and viability of its affiliated depository institutions. The Federal Reserve's supervisory framework for FHCs focuses on addressing supervisory practice for, and relationships with, FHCs, particularly those involved in securities and insurance activities. The Federal Reserve will emphasize analysis of the consolidated financial condition of FHCs and the risks associated with engaging in a broad range of financial activities, since those risks can cut across the organization's legal entities and business lines. The Federal Reserve will thus focus on an FHC's financial strength, stability, consolidated risk-management processes, and overall capital adequacy. The supervisory activities of the Federal Reserve will consist of information gathering, assessments and

New Section Number	*Previous Section Number*	*Description of the Change*
		supervisory cooperation, ongoing supervision, and the promotion of sound practices and improved disclosure. (See SR-00-13 for more details.)
5000.0.4.4.2 5000.0.4.5.1 5000.0.4.5.2	5000.0.4.4.2 5000.0.4.5.1 5000.0.4.5.2	These subsections were revised for a change in the policy regarding the risk assessments for small shell bank holding companies (SSBHCs). According to SR-97-27 and S-letter 2587 (November 3, 1997), a risk assessment should be completed for each SSBHC at least once during each supervisory cycle and within 45 calendar days (extended to 60 calendar days in SR-00-15) of receipt of the lead bank's full-scope examination report. SR-97-27 emphasizes that when significant risk factors are evident or when material supervisory concerns are disclosed, a more detailed off-site review or on-site targeted visitation should be conducted. The Reserve Bank should thus develop a supervisory strategy for dealing with any matters of concern.

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Bank Holding Company Supervision Manual
Supplement 18—June 2000

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new or revised supervisory guidance and instructions issued by the Division of Banking Supervision and Regulation since the publication of the December 1999 supplement.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
2090.7	2090.7	This section on nonbank banks has been revised to reflect the amendment of section 4(f) of the Bank Holding Company Act (BHC Act) by section 107 of the Gramm-Leach-Bliley Act (GLB Act). Cross-marketing, growth, and certain activity limitations and other provisions were eliminated to allow bank holding companies to affiliate with securities firms and insurance companies. New section 4(f)(3) provides details on the general overdraft prohibitions for controlled subsidiary banks of grandfathered holding companies of nonbank banks (those existing on March 5, 1987) and on when certain overdrafts are permissible, particularly overdrafts involving financial activities or activities incidental thereto. This section also details what happens if a company fails to continue qualifying for the nonbank bank exemption.
2128.06		This new section pertains to retained interests arising from assets sold to a securitization vehicle that, in turn, issues bonds to investors. Supervisory concerns exist about the methods and models that are used to value these interests and the difficulties involved in managing the risk of such volatile assets. Generally accepted accounting principles (GAAP) require recognition of an immediate gain (or loss) on the sale of assets by recording its retained interest at fair value. The retained interest is valued using the present value of future cash flows in excess of any amounts needed to service the bonds and to cover credit losses and other fees. Bank supervisors of banking organizations expect retained interests to have documented and verifiable fair values, otherwise they should be charged off. Other supervisory concerns include (1) a failure to recognize and hold sufficient capital against recourse obligations generated by securitization, and (2) the absence of adequate risk-management systems that include effective policies and limits, independent procedures to measure and assess risk, strong internal controls, and an independent audit function. See SR-99-37.
3000.0.3	3000.0.3	The list in appendix 2, nonbanking activities approved by Board order, is revised to include two more activities that were approved by the Board under section 4(c)(8) of the BHC Act. These activities were approved before the passage of the GLB Act, which prohibits Board approval of any additional section 4(c)(8) activities. Accordingly, these are the last nonbanking activities to be approved under this section.

New Section Number	*Previous Section Number*	*Description of the Change*
3600.0	3600.0	The nonbanking activities permissible by Board order under section 4(a)(2); 4(c)(8); or, for BHCs that also are FHCs, 4(k)(1)(B) of the BHC Act are revised. This section of the manual incorporates the current 60-day notice procedure and GLB Act changes. The Board is prohibited from approving any new nonbanking activities by regulation or order under section 4(a)(2) or 4(c)(8). BHCs that are qualified as FHCs under section 4(j)(4), and operating in accordance with section 4(k)(4), may engage in new activities that are ‘‘financial in nature or incidental to such activity’’ or ‘‘complementary to a financial activity.’’
3600.6		Operating a securities exchange is a new nonbank activity that was approved by Board order under section 4(c)(8) of the BHC Act. A BHC and a foreign banking organization (FBO) requested the Board’s approval to acquire, separately, interests in a group which intended to operate an electronic securities exchange, and thus engage in secondary trading of equity and equity-related securities. An office is to be located in the United States. See 2000 FRB 61.
3600.7		The new nonbanking activity of acting as a certification authority (CA) for digital signatures involves sending digitally signed encrypted messages, using a confidential private key. An FBO and several BHCs requested the Board’s approval to engage, through a joint venture, in acting as a rulemaking and coordinating body for a network of financial institutions acting as CAs. They would provide services designed to verify or authenticate the identity of customers conducting financial and nonfinancial transactions over the Internet and other ‘‘open’’ electronic networks. Digital certificates and digital signatures would involve using a pair of public/private keys to decrypt and confirm the sender’s electronic signature (referred to as issuing ‘‘digital certificates’’). See 2000 FRB 56.
3900.0		This new section introduces, generally, FHCs and the GLB Act. It details conditions that must be met for a BHC to become a qualifying FHC. An FHC may engage, or acquire a company that engages in, authorized activities deemed to be ‘‘financial in nature’’ or any activity that is incidental to a financial activity or complementary to a financial activity engaged in by the FHC. Notice requirements for becoming an FHC, and for engaging in such activities, are discussed generally.
3901.0		This new section details what a written declaration must include for a BHC to qualify as a domestic FHC. Acquisition, control, and other requirements are discussed with respect to engaging in financial activities. Applicable notice procedures and other requirements to engage in financial activities and activities incidental thereto also are specified. Divestiture requirements are detailed with respect to impermissible activities that are acquired together with permissible activities. If the Federal Reserve has supervisory concerns, it may limit or restrict the conduct of new activities or future acquisitions, or take other action, if it finds that

New Section Number	*Previous Section Number*	*Description of the Change*
		an FHC does not have the needed financial or managerial resources. See SR-00-01 and, in particular, Regulation Y at 12 C.F.R. 225.81–225.88.
3903.0		The qualification requirements for foreign banks to operate as FHCs and engage in activities that are financial in nature, or any activity that is incidental or complementary to a financial activity, are provided in this new section. This includes the ''well-managed'' and ''well-capitalized'' standards needed for certification as an FHC, as they pertain to *each* foreign bank, or to each company owning a foreign bank, operating in the United States and to each FBO. The process and requirements that apply when a foreign bank does not continue to satisfy the management and capital requirements are also discussed. See SR-00-01 and, especially, Regulation Y at 12 C.F.R. 225.91–225.94.
3905.0		Permissible activities of qualifying FHCs that are deemed under section 4(k)(4) of the GLB Act to be activities that are ''financial in nature'' and activities deemed to be incidental or complementary to a financial activity engaged in by the FHC are discussed in this new section. Included are activities authorized under section 4(c)(8) of the BHC Act that the Board has determined to be closely related to banking. See Regulation Y at 12 C.F.R. 225.28(b) and 225.86–225.89.
4060.3	4060.3	The risk-based capital measure section is revised to include the capital treatment for credit derivatives used to synthetically replicate collateralized loan obligations (CLOs). This guidance was developed jointly by the Federal Reserve and the Office of the Comptroller of the Currency. Credit derivatives allow an assumption or transfer of credit risk on a specified or ''referenced'' asset or pool of assets. CLOs represent asset-backed securities that are supported by various assets. The capital treatment for three synthetic CLO transactions is provided: (1) when the entire amount of the referenced portfolio is hedged, (2) when a high-quality senior risk position in the reference portfolio is retained, or (3) when a first-loss position is retained. Minimum conditions are specified for sponsoring institutions wishing to use the second type of transaction. See SR-99-32.

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Bank Holding Company Supervision Manual
Supplement 17—December 1999

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new or revised supervisory guidance and instructions issued by the Division of Banking Supervision and Regulation since the publication of the June 1999 supplement.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
2010.2.2 2010.2.3 2010.2.4 2010.10	2010.2.2 2010.2.3 2010.2.4 2010.10	The Federal Reserve has expressed concerns about the possible weakening of compliance with loan-underwriting standards, policies, and internal controls and loan-review procedures. A reduction of resources devoted to loan underwriting as a result of an undue reliance on continued favorable economic conditions and easy access to financial markets is also cause for concern. Banking organizations should exercise caution since such prosperity may not continue. Adherence to preestablished standards, policies, and procedures should provide protections from concentrations of weakening credit risk. The use of meaningful stress tests is encouraged in the lending-decision process to validate a borrower's financial capacity to repay (including alternative sources of repayment) according to the repayment terms over the short and long terms. Stress testing should be most beneficial to banking organizations as a safeguard against increased losses due to possible economic downturns. See SR-99-23. Appropriate inspection objectives and procedures are included.
2010.7	2010.7	This section has been revised to include consideration of evolving supervisory guidance that emphasizes the need for applying reserving practices that are balanced, yet conservative, with respect to the maintenance of an allowance for loan and lease losses. A discussion of accounting guidance is provided with respect to the Financial Accounting Standards Board's Statements No. 5 and 114. See SR-99-13 and SR-99-22.
2124.01		This section provides the Federal Reserve System's supervisory program for the risk-focused supervision of and inspection framework for large, complex banking organizations (LCBOs). The program endorses the concept of conducting, when appropriate, a series of targeted inspections/examinations during a supervisory cycle, focusing on a single activity, business line, and legal entity. The program centers on avoidance of duplication and continued close coordination and cooperation with federal and state supervisors. The findings and conclusions of such supervisors are incorporated into an overall assessment of the consolidated banking organization or banking group. The framework specifies six key steps in the risk-focused supervision of LCBOs. See SR-97-24 and its handbook, *Framework for Risk-Focused Supervision of Large,*

New Section Number	*Previous Section Number*	*Description of the Change*
		Complex Institutions, and also the handbook's appendixes. Previously issued risk-focused inspection/examination guidelines and procedures are considered and listed in an appendix. See also section 2124.04 and SR-99-15, which sets forth the continued, ongoing, supervisory approach for LCBOs.
2124.04		The Federal Reserve System's ongoing risk-focused supervision and monitoring program for LCBOs is set forth in this section. The program should be conducted at least quarterly. The guidance builds upon the existing risk-focused supervisory program, providing more specific guidance. Concerns are noted for certain environmental factors that could initiate swift and dramatic changes in the risk profiles of LCBOs, resulting in rapid changes in their financial condition. The ongoing program portrays and uses a continuous portfolio approach to supervision—the continuous assessment and evaluation of informational resources and banking practices across a group of institutions with similar business lines, characteristics, and risk profiles. Emphasis is placed on an organization's management of internal systems and controls, including rating systems, and the Federal Reserve System's use of a central point of contact and dedicated supervisory teams for each LCBO. See SR-99-15.
2126.3		This section sets forth the Federal Reserve System's supervisory guidance for examiners and supervisory staff on evaluating and monitoring counterparty risk-management functions and systems. Transaction testing is to be used on those activities, business lines, and products experiencing significant growth, above-normal profitability, or large future potential exposures. Particular attention should be focused on (1) the standards, methodologies, and techniques used to measure and control counterparty-credit-risk exposures; (2) the use and management of credit enhancements to mitigate counterparty credit risks; and (3) the use of risk limits and monitoring systems that are established to set meaningful limits on counterparty credit risk and to alert management when credit-risk exposures exceed their established limits. See SR-99-3.
2190.05		This section discusses the March 1999 interagency supervisory guidance on subprime lending. Banking organizations engaging in this lending must recognize the additional risks inherent in the activity, and must determine whether those risks are acceptable and manageable considering their staff, financial condition, size, and level of capital support. Subprime lending necessitates strong risk-management practices; board-approved policies and procedures; and internal controls that appropriately identify, measure, monitor, and control the risks. Bank holding companies should consider this guidance as they supervise their banking and nonbank subsidiaries. See SR-99-6.
3130.4.4.2	3130.4.4.2 3290.0	This revision incorporates former Board authorizations for futures commission merchants and commodity trading advisers to provide nonbanking advisory services.

New Section Number	*Previous Section Number*	*Description of the Change*
3320.0	3320.0	This revised section includes more recent Board order references involving check-guarantee and check-verification services. See 1999 FRB 582.
4060.7		Large and other complex banking organizations (BOs) must maintain strong internal processes to ensure that their capital is fully sufficient to support the underlying risks inherent in their activities and environment, as well as their need to comply with minimum regulatory capital adequacy standards, a critical element of a BO's safety and soundness. Due to the growing scope and complexity of business activities and ongoing financial innovation, simple ratios, including risk-based capital ratios, no longer suffice in assessing the overall capital adequacy of many BOs. Examiners are to evaluate internal capital-management processes to judge whether they meaningfully tie the identification, monitoring, and evaluation of risk to the determination of the BO's capital needs. Fundamental elements of a sound and comprehensive internal analysis of capital adequacy are stated along with the encompassing key areas of risk. BOs are encouraged to strengthen their risk-measurement capabilities and to integrate them more fully when evaluating their own capital adequacy. Some of the cited practices extend beyond those currently followed. Examiners should expect these BOs to make steady and meaningful progress toward initiating a comprehensive internal process for assessing capital adequacy in relation to risk, rather than immediate and full implementation. Examiners should expect those BOs involved in complex securitizations or other similar transfers of risk to have in place or immediately implement a comprehensive internal capital analysis process that fully reflects all risks. See SR-99-18.
4070.3		Guidance is provided on the use and assignment of supervisory ratings involving the ongoing risk-focused supervision of BOs. Supervisory ratings should be revised when there is strong evidence of a change in the financial condition or risk profile of a BO. Ratings are viewed as a continuum, not as a point-in-time assessment. When one supervisory rating component (for example, CAMELS, BOPEC, or other rating) is changed, the other components, and the composite and management ratings, must also be reaffirmed or revised. Rating changes are to be communicated to the board of directors of the affected BO (or to the senior U.S. management official) and to the appropriate state and federal supervisory agencies. Federal Reserve System staff are to review all inspections and examinations that are conducted by state supervisory agencies under the Alternate Examination Program. Any ratings or changes assigned by the Federal Reserve should be noted separately. See SR-99-17.

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Bank Holding Company Supervision Manual
Supplement 16—June 1999

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new or revised supervisory instructions issued by the Division of Banking Supervision and Regulation since the publication of the December 1998 supplement.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
2010.12		This section provides new examiner supervisory guidance with respect to fees that are derived from investments of fiduciary assets in mutual funds and concerns associated with any potential conflicts of interests. The section emphasizes that a due-diligence review is needed with regard to the acceptance of such fees. The review should consist of (1) a reasoned legal opinion, (2) established policies and procedures, and (3) regular and ongoing analyses supporting investment decisions. Inspection objectives and procedures are included with the guidance.
2020.1.1.8	2020.1.1.8	This intercompany transactions section is revised to incorporate the staff interpretation of January 21, 1999, for section 23A(b)(7)(D) of the Federal Reserve Act and the calculation of the quantitative limits for loans and extensions of credit that are secured by shares issued by an affiliate.
2070.0	2070.0	This consolidated taxes section is revised to incorporate an interagency policy statement on tax-allocation agreements for banking organizations and savings associations. The policy statement, effective November 23, 1998, stresses that an institution and its parent company should conduct intercorporate tax settlements in a manner that is no less favorable to a subsidiary than if it was a separate taxpayer. Topics such as the composition of the consolidated written tax sharing agreements, measurement of current and deferred income taxes, tax payments to the parent company, tax refunds from the parent company, and income tax forgiveness transactions are discussed. The inspection objectives and procedures also are revised. See SR-98-38.
2128.0	2128.0	This slightly revised section consists of general information on structured notes. The section was amended to provide references to SR-97-21, SR-95-17, and various sections of the *Trading and Capital-Markets Activities Manual* for more detailed guidance.
2231.0	2231.0	A footnote is added to this section on real estate appraisals and evaluations to accommodate the revision of section 225.63 of Regulation Y, effective December 28, 1998, involving the appraisal standards for federally related transactions. The amendment permits BHC subsidiaries to underwrite and deal in mortgage-backed securities without demonstrating that the loans underlying the securities are supported by appraisals that satisfy the Board's appraisal requirements.

New Section Number	*Previous Section Number*	*Description of the Change*
2241.0		This new section on retail credit classification discusses new expanded supervisory classification guidance for retail credit loans, the Uniform Retail-Credit Classification and Account-Management Policy. The policy focuses on classification of past-due loans, when loans should be charged off, and fraudulent loan treatment. Other supervisory issues addressed include well-secured loans; partial loan payments; loan extensions, deferrals, and re-aging; and examination considerations. See SR-99-5.
2250.0	2250.0	The domestic and other reports section is revised to eliminate the summaries of specific reports and to address only reporting issues. The current reports and instructions are now found on the Board's Internet public web site.
3000.0.3, appendix 2	3000.0.3, appendix 2	The list of nonbanking activities approved only by Board order was updated for private limited partnerships. Manual section references also were added for new nonbanking activities approved only by Board order.
3084.0	3600.15.3 3600.15.4	This is a new section that involves engaging in asset-management, asset-servicing, and collection under contract with a third party as currently found in section 225.28(b)(2)(vi) of Regulation Y. A bank holding company may engage under contract with a third party in such nonbanking activities, but only with respect to the types of assets that an insured depository institution can originate and own. Historical examples from Board orders are provided for such activities, reflecting how they originated and illustrating the factors that led to their incorporation in Regulation Y.
3104.0	3600.15.5	This new nonbanking section discusses the Regulation Y provision (section 225.28(b)(2)(vii)) and limitations for engaging in the acquisition of debt in default. A previous Board order is summarized and included in this section to illustrate how the nonbanking activity originated.
3130.1.4	3130.1.4	This revised section on investment or financial advisers includes a new reference to the new Uniform Interagency Trust Rating System. See SR-98-37.
3202.0	3200.0.2 3600.15.1	This new nonbanking section discusses employee benefits consulting services authorized by section 225.28(b)(9)(ii) of Regulation Y. A summary of a Board order approving these activities is provided.
3204.0	3200.0.2 3600.15.1.1	This new nonbanking section separately discusses career counseling services (including to whom they may be provided), as currently provided for in section 225.28(b)(9)(iii) of Regulation Y. A Board order summary is provided to illustrate how the activity originated and how it was incorporated within Regulation Y.

New Section Number	*Previous Section Number*	*Description of the Change*
3260.0	3260.0	This nonbanking section on investment transactions as principal has been revised to include a discussion on the permissibility of engaging in buying and selling bullion and related activities for a bank holding company's own account or for the account of others (see Regulation Y, section 225.28(b)(8)(iii)). It also discusses the permissibility of bank holding companies' investing in derivatives on financial and nonfinancial commodities, subject to the specified three conditions.
3270.0.2	3270.0.2	This real estate and personal property appraising section has been revised to include a footnote on the revised appraisal standards for federally related transactions involving the underwriting and dealing of mortgage-backed securities. The regulatory amendment (section 225.63 of Regulation Y) permits section 20 nonbanking subsidiaries to underwrite and deal in mortgage-backed securities without demonstrating that the loans underlying the securities are supported by adequate appraisals meeting those standards.
3600.8		This is a new nonbanking section on private limited investment partnerships summarizing several Board orders that authorized this activity. One Board order involved the private placement of limited partnership interests in a group of partnerships. A wholly owned subsidiary served as the sole general partner. The other partnership interests were to be sold to institutional investors. The partnerships would invest in limited amounts of debt and equity securities. Debt securities issued by the partnerships could not be privately placed without Federal Reserve approval. See 1994 FRB 736. A subsequent Board order is summarized that authorized an asset-management subsidiary to act as the general partner for each limited partnership. The partnerships would invest in a variety of commodity and exchange-traded and over-the-counter instruments. One or more of the partnerships could invest its assets in commodity pools, as a registered commodity pool operator. See 1995 FRB 1128. More recent Board orders are cited for private limited partnerships investing solely in permissible investments for a BHC. For example, see 1999 FRB 209, 1998 FRB 852, and 1998 FRB 361.
3600.13	3600.13	This nonbanking section is revised to indicate that the Board order authorizing the activities of a commodity pool operator (that invests solely in investments that a BHC is permitted to make directly) also involved control of a private limited partnership.
3600.25		This is a new nonbanking section involving a Board order authorizing a bank holding company to engage in certain government services (for example, providing postage, vehicle registration and license plates, public transportation tickets, and notary public services) that had not previously received Board approval.

New Section Number	*Previous Section Number*	*Description of the Change*
3600.28		This new nonbanking section summarizes the Board's order authorizing the development of broader marketing plans and advertising and sales literature materials for mutual funds. The summary discusses the delegation of responsibility of the distribution, advertising, and sales of the mutual funds to an independent distributor. It explores the various control issues, including management interlocks.
4060.3.2.2	4060.3.2.2	The risk-based capital adequacy section has been revised for investments in mutual funds. When risk weighting is applied to a mutual fund on the basis of the risk categories of the fund's assets, and the sum of the investment limits for all asset categories (as described in the funds prospectus) exceeds 100 percent, risk weights must be assigned based on the assumption that the fund invests the largest possible amount of its assets in the highest risk-weighted categories. The mutual fund's total risk weight must be at least 20 percent. The risk weighting will not increase from the prudent use of hedging to reduce risk. When a fund engages in speculative activities, or when any other characteristics are inconsistent with the preferential risk weighting of the fund's assets, the fund's holdings are to be assigned to the 100 percent risk category.
4060.3.5.2.3	4060.3.5.2.3	Loans to residential builders will be considered prudently underwritten only if sufficient documentation provides evidence of legally binding written sales contracts and commitments for permanent financing. When a first and junior lien(s) on a residential property are held (and no other party holds an intervening lien), the transaction is treated as a single loan secured by a first lien when determining the loan-to-value ratio and assigning a risk weight.

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Bank Holding Company Supervision Manual
Supplement 15—December 1998

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new or revised supervisory instructions issued by the Division of Banking Supervision and Regulation since the publication of the June 1998 supplement.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
2010.2.2		This new subsection has been added to convey supervisory guidance to examiners for evaluating the adequacy of lending standards for commercial loans; it consists of formal credit policies; formal credit-staff transaction approvals; loan-approval documentation, including the use of forward-looking financial analysis tools; and the use of management information systems that support the loan-approval process. Examiners are to determine whether adequate internal oversight exists and whether management has timely and accurate information. See SR-98-18. Inspection objectives and procedures are provided.
2010.11		This section provides examiners with guidance for reviewing private-banking activities. A functional review subsection is provided that contains basic ‘‘know-your-customer’’ principles. Examiners are to review the functional components of private banking across all production lines. The functional components consist of supervision and organization, risk management, operational controls, fiduciary standards, management information systems, audit, compliance, and the financial condition/business profile. See SR-97-19. Inspection objectives and procedures are provided.
2060.05		This new section discusses the internal audit function and its outsourcing. The section sets forth an interagency supervisory policy statement that focuses on issues dealing with organizational structure, internal audit management, staff and quality control, audit scope, and the communication of findings directly to the board of directors. Examiner guidance is provided for assessing the quality and effectiveness of an organization’s internal audit function and its management. Inspection considerations with regard to outsourcing the internal audit function are specified. Supervisory guidance is provided for managing an outsourced internal audit function. See SR-97-35. Inspection objectives and procedures are provided.

New Section Number	*Previous Section Number*	*Description of the Change*
2122.0		Certain essential elements of internal rating systems are necessary to support sophisticated credit-risk management. This section conveys supervisory guidance for financial institution supervisors and their examiners that needs to be emphasized as being important to the development and implementation of effective internal credit-rating systems. Such systems play critical roles in the credit-risk-management process, particularly at large sound banking institutions. Large banking institutions are to have strong risk-rating systems that take into account gradations in risk. Such systems should consider (1) the overall composition of portfolios in originating new loans, (2) the assessing of overall portfolio risks and concentrations of credit, and (3) the prompt reporting of risk profiles to directors and management. See SR-98-25, which expands upon issues raised in SR-98-18 (Lending Standards for Commercial Loans). See also section 2010.2.2. Examiners should specifically evaluate the adequacy of internal credit-risk-rating systems, including ongoing development efforts, when assessing both asset quality and the overall strength of risk management at large institutions. In so doing, examiners should be cognizant that an internal risk-identification and -monitoring system should be consistent with the nature, size, and complexity of the banking organization's activities. Inspection objectives and procedures are provided.
2124.1		This section sets forth risk-focused supervisory guidance to be applied when assessing the use of information technology, giving appropriate recognition to the characteristics, size, and business activities of the organization. The role of examiners in the risk-focused supervision of information technology is summarized within four primary inspection procedures (see subsection 2124.1.2). It provides a framework for evaluating information technology, consisting of information technology elements—the management processes, architecture, integrity, security, and availability of information to end-users. See SR-98-9. Inspection objectives and procedures are provided.
2126.0.2 (footnote 3) 2126.0.4.4 (footnote 6) 2126.0.8.1 2126.0.8.2 (footnote 10 deleted) 2130.0.13 2130.0.17 3070.0.5.1.1.2 3070.0.13	2126.0.2 (footnote 3) 2126.0.4.4 (footnote 6) 2126.0.8.1 2126.0.8.2 2130.0.13 2130.0.17 3070.0.5.1.1.2 3070.0.13	These sections have been amended to accommodate the April 1998 FFIEC Statement on Investment Securities and End-User Derivatives Activities, effective May 25, 1998. This statement replaced the 1992 Supervisory Policy Statement on Securities Activities. References to the 1992 minimum requirements for high-risk mortgage securities have been removed.

New Section Number	*Previous Section Number*	*Description of the Change*
2126.1		This new section consists of the April 23, 1998, FFIEC Statement on Investment Securities and End-User Derivatives Activities, effective May 25, 1998. The supervisory guidance applies to state member banks and Edge corporations. The basic principles also apply to bank holding companies, which should manage and control risk exposures on a consolidated basis, giving recognition to the legal distinctions and potential obstacles to cash movements among subsidiaries. The statement's principles set forth sound risk-management practices that are relevant to most portfolio-management endeavors. Instruments held for end-user reasons are considered, taking into consideration a variety of factors such as management's ability to manage and measure risk within an institution's holdings and the impact of those holdings on aggregate portfolio risk. The statement focuses on managing the market, credit, liquidity, operational, and legal risks of investment and end-user activities. When managing the interest-rate-risk component of market risk, institutions are informed of the merits of developing internal policies that specify the type of preacquisition analysis (stress testing) that is consistent with the scope, sophistication, and complexity of their investment securities and end-user derivative holdings. Institutions are advised to periodically monitor the price sensitivity of their portfolios, ensuring that they meet established limits of the board of directors. Institutions are further advised to fully assess the creditworthiness of their counterparties, including brokers and issuers. Institutions are to take proper account of the liquidity of the instruments they hold. See SR-98-12. The principles set forth within the interagency policy statement are generally those set forth in SR-95-17. See section 2126.0.
2129.05		This section sets forth supervisory guidance that identifies the more important risks associated with the more common types of secondary-market activities. The guidance discusses sound practices along with the special considerations financial institution supervisors should take into consideration when assessing the risk-management systems for secondary-market activities. A fundamental principle advanced by this guidance is that banking institutions should explicitly incorporate the full range of risks of their secondary-market credit activities into their overall risk-management systems. In particular, supervisors and examiners are to determine whether institutions are recognizing the risks of secondary-market credit activities by (1) adequately identifying, quantifying, and monitoring these risks; (2) clearly communicating the extent and depth of these risks in reports to senior management and the board of directors and in their regulatory reports; (3) conducting ongoing stress testing to identify

New Section Number	*Previous Section Number*	*Description of the Change*
2129.05 continued		potential losses and liquidity needs under adverse circumstances; and (4) setting adequate minimum internal standards for allowances or liabilities for losses, capital, and contingency funding. Incorporating secondary-market credit activities into a banking organization's risk-management systems and internal capital-adequacy allocations is particularly important since the current regulatory capital rules do not fully capture the economic substance of the risk exposures arising from many of these activities. Many secondary-market credit activities involve new and compounded dimensions of reputational, operational, and liquidity risks. Failure to understand adequately the risks inherent in secondary-market credit activities and to incorporate them into risk-management systems and internal capital allocations may constitute an unsafe and unsound banking practice. The risk-management systems used should include the identification, measurement, and monitoring of these risks as well as an appropriate methodology for the internal allocation of capital and reserves. See SR-97-21. Inspection objectives and procedures are provided.
2140.0.1 2140.0.3.5 (footnote 2 deleted) 2140.0.3.7 3700.8	2140.0.1 2140.0.3.5 2140.0.3.7 3700.8	These subsections have been revised to reflect changes resulting from the revision of the Board's Regulation T and, in some cases, the enactment of the National Securities Markets Improvement Act of 1996. Regulation T no longer determines whether specific types (or levels of collateral) are acceptable for securities borrowing and lending by broker-dealers.
2187.0 (footnote 1) 2187.0.2.1 (title and footnote 2) 2187.0.2.2 (footnote 4) 2187.0.4 2187.0.7 2187.0.8	2187.0 (footnote 1) 2187.0.2.1 (footnote 2) 2187.0.2.2 (now footnote 3) 2187.0.4 2187.0.7 2187.0.8	These subsections have been revised to reflect the merging of the Board's Regulation G into its Regulation U (which resulted in the elimination of Regulation G). The subsections have also been revised, as appropriate, to include the Board's adoption of amendments to Regulations U (effective April 1, 1998) and T (effective July 1, 1998).
2190.0.5 2190.0.5.1	2190.0.5 2190.0.5.1	These subsections have been revised to reflect a brief summary of the April 23, 1998, FFIEC Statement on Investment Securities and End-User Derivatives Activities that replaced the January 1992 FFIEC Policy Statement on Securities Activities.
3000.0.3, appendix 2	3000.0.3, appendix 2	The list of nonbanking activities approved by Board order has been revised to include title agency insurance activities.

New Section Number	*Previous Section Number*	*Description of the Change*
3070.0.6.7	3070.0.6.7	This section was revised for the August 4, 1998, change in the capital adequacy standards for bank holding companies. The Regulation Y change increased the amount of servicing assets, along with purchased credit-card relationships (PCCRs), that are includable in regulatory capital from 50 percent to 100 percent of tier 1 capital. Servicing assets consist of the aggregate amount of mortgage-servicing assets (MSAs) and the amount of nonmortgage-servicing assets (NMSAs). The amendment includes a further sublimit of 25 percent of tier 1 capital to the aggregate amount of NMSAs and PCCRs, and subjects the valuation of MSAs, NMSAs, and PCCRS to a 10 percent discount. The final rule was effective on October 1, 1998.
3165.1	3600.12.3	This section discusses the current Regulation Y authorization for bank holding companies to engage in printing and selling MICR-encoded items as a support-services nonbanking activity.
3210.0 3210.1	3210.0 3600.12	These sections were revised to reflect the incorporation of consumer payment instruments, without any limit as to the face amount, into the April 21, 1997, revision of Regulation Y, section 225.28(b)(13).
3073.0.1 3105.0 3107.0 3130.3.6 3160.5 3230.5 3230.6	3600.16.1 3600.14 3600.28 3600.16.2 3600.31 3600.7.1 3600.8	These sections or subsections were revised and/or relocated based on the restructuring of the April 1997 revision of Regulation Y.
3251.0	3600.13.1– 3600.13.12, 3600.13.14	This former section was relocated since certain futures commission merchant (FCM) nonbanking activities that were previously approved by Board order have been incorporated into Regulation Y, effective April 21, 1997. These subsections provide brief historical summaries of FCM Board decisions that may have resulted in their incorporation into Regulation Y. Former regulatory cites have either been deleted or updated.
3255.0 3255.0.1 3255.0.2 3255.0.3	 3600.6.1 3600.6.2 3600.6.3	This new section focuses on agency transactional services to customers with respect to swaps and similar transactions as specified in section 225.28(b)(7)(v) of Regulation Y. This authority includes any derivative or foreign-exchange transaction that the bank holding company is permitted to conduct for its own account. The relocated former sections comprise Board order decisions that involved the brokering of options on various securities, bullion, and foreign exchange. Such nonbanking activities were incorporated into Regulation Y, effective April 1997.

New Section Number	*Previous Section Number*	*Description of the Change*
3260.0 3260.0.3.1 3260.0.3.3 3260.0.3.2 3260.0.3.4 3260.0.3.5 3260.0.3.6	 3600.6.4 3600.6.5 3600.6.6 3600.7.2 3600.25 3600.3	This new section is for nonbanking activities involving investment transactions as principal. The section discusses the authority granted under Regulation Y, section 225.28(b)(8)(ii). Such proprietary trading was added to the regulation to clarify the permissibility of the nonbanking activity as a separate business activity. Before the inclusion of such transactions into the regulation, certain activities had been previously approved by Board order. The section provides, as historical examples, summaries of those decisions, giving the reader the opportunity to understand why certain activities were incorporated into Regulation Y.
	3600.4 3600.6 3600.7 3600.10	Sections deleted.
4060.3	4060.3	The section is revised for the new August 4, 1998, regulatory capital treatment (risk-based measure) of servicing assets for mortgage assets and financial assets other than mortgages with respect to bank holding companies. The Regulation Y appendix change (effective October 1, 1998) increased the amount of servicing assets, along with purchased credit-card relationships (PCCRs), that are includable in regulatory capital from 50 percent to 100 percent of tier 1 capital. Servicing assets consist of the aggregate amount of mortgage-servicing assets (MSAs) and the amount of nonmortgage-servicing assets (NMSAs). The amendment applies a further sublimit of 25 percent of tier 1 capital to the aggregate amount of NMSAs and PCCRs, and also subjects the valuation of MSAs, NMSAs, and PCCRs to a 10 percent discount. The section is also revised for the Board's August 25, 1998, adoption of capital rule changes that became effective October 1, 1998. Bank holding companies that hold equity securities are permitted to include up to 45 percent of the pretax net unrealized holding gains on available-for-sale equity securities with readily determinable fair values in supplementary capital (tier 2 capital). See the rule for any limitations or precautions pertaining to these amendments.

New Section Number	*Previous Section Number*	*Description of the Change*
4060.4	4060.4	This section has been revised for the May 29, 1998, amendment of the tier 1 leverage capital standard for bank holding companies (BHCs). The rule change (effective June 30, 1998) simplifies the Board's leverage capital standards for BHCs and incorporates the market-risk capital rule into the leverage standard. The revised rule set a minimum ratio of tier 1 capital to total assets (leverage ratio) of 3 percent for BHCs that are either rated composite ''1'' under the BOPEC rating system or have implemented the Board's risk-based capital market-risk measure. The minimum ratio for all other BHCs is 4.0 percent. BHCs are expected to maintain higher-than-minimum capital ratios if they have supervisory, financial, operational, or managerial weaknesses, or if they are anticipating or experiencing significant growth. The section is also revised for the August 4, 1998, change in the capital adequacy standards (tier 1 leverage measure) for bank holding companies, whereby the amount of servicing assets (mortgage-servicing assets and nonmortgage-servicing assets), along with purchased credit-card relationships (PCCRs), includable in regulatory capital, in the aggregate, increased from 50 percent to 100 percent of tier 1 capital. See the rule for any respective limitations regarding these amendments.

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Bank Holding Company Supervision Manual
Supplement 14—June 1998

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new or revised supervisory instructions issued by the Division of Banking Supervision and Regulation since the publication of the December 1997 supplement. Beginning with this supplement, more sublevel topics are included within the chapter tables of contents.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
2090.2	2090.2	This section has been revised to reflect the change from a one-bank to a small bank holding company policy statement that the Board included in Regulation Y, which was effective in April 1997. Small BHCs whose subsidiary banks are well managed and well capitalized and whose acquisition proposals result in parent company debt-to-equity of less than 1.0 to 1 are eligible for streamlined application processing. Those companies can pay dividends under certain conditions. Acquisition proposals involving higher parent company leverage or a bank in less-than-satisfactory condition can be subject to a focused review of the parent-level debt-servicing ability or any other issue. BHCs are expected to reach a debt-to-equity ratio of .30 to 1 or less within 12 years after the incurrence of the acquisition debt.
3000.0.3, appendix 2	3000.0.3, appendix 2	This listing of Board approvals of nonbanking activities by order under section 4(c)(8) of the BHC Act has been substantially reduced due to the nonbanking activities that have been included in the Regulation Y “laundry list” (section 225.28(b)), effective on April 21, 1997.
3130.0		This general financial and investment advisory section provides a discussion for the subsequent advisory activities sections that are based on section 225.28(b)(6) of Regulation Y. The rule permits bank holding companies and their subsidiaries to engage in financial and investment advisory activities without restriction. BHCs can engage in any combination of permissible activities. BHCs may provide financial and investment advice (including discretionary investment advice) jointly with permissible agency transactional services, investment or trading transactions as principal, or any other listed activity. The regulation clarifies that the examples of permissible financial and investment advisory activities are illustrative rather than exclusive. Inspection objectives and procedures are provided that apply generally to all such activities.
3130.1	3130.1 3130.3	This financial and investment advisory activities section has been revised to include the changes in Regulation Y (section 225.28(b)(6)) that became effective in April 1997. The rule change grouped such activities together and broadly permits acting as an investment or financial adviser to any person, without restriction. The Board’s investment advisory interpretation (section 225.125 of Regu-

New Section Number	*Previous Section Number*	*Description of the Change*
3130.1 continued	3130.1 3130.3 continued	lation Y) is discussed. Ownership, lending, and name restrictions were lessened. A detailed inspection checklist is provided for the examiner's review of financial and investment advisory activities.
3130.3	3130.2 3130.4 3130.6 3600.11	Advice in connection with organizational structurings, financing transactions, financial-feasibility studies, and valuation services is discussed in this section. It also includes inspection guidance on real estate investment trusts and on providing financial advice to foreign governments with respect to issuing their securities.
3130.4	3130.5 3130.7 3260.0 3600.18	This section discusses transactions in foreign exchange, structuring and arranging for swaps (including currency swaps), and similar transactions, commodities (including nonfinancial commodities), and forward contracts, options, futures, and options on a future, and similar instruments.
3130.5	3300.0	The consumer financial counseling section has been revised for the April 1997 Regulation Y changes that combined the activity with other financial and investment advisory activities. Regulation Y removed restrictions from promoting specific products and from obtaining or disclosing confidential customer information without the customer's consent.
3130.6	3310.0	Tax-planning and tax-preparation services are now included with financial and investment advisory activities The section reflects the Board's removal of restrictions as indicated above for section 3130.5.
3200.0	3200.0	This management consulting services section has been revised to indicate that bank holding companies may (1) provide management consulting services regarding financial, economic, accounting, or audit matters to any company, and (2) derive up to 30 percent of their management consulting revenue from management consulting services provided to any customer on any matter. See Regulation Y, section 225.28(b)(9). Management consulting services and counseling activities were combined within this Regulation Y provision.
3230.0 3230.05 3230.1 3230.2 3230.3	3230.0 3230.1 3230.2 3230.3	These securities brokerage sections have been revised and updated for the Regulation Y changes. As discussed in sections 3230.0 and 3230.05, the rule no longer distinguishes between discount and full-service brokerage. Further, certain disclosure requirements were deleted from the rules. They remain, however, in Board and interagency policy statements. Also, for subsection 3230.0.3, outdated information pertaining to Regulations G, T, or U was deleted due to the Board's amendment of these regulations, effective April 1, 1998. (See 1998 FRB 197).
3240.0	3240.0	The Regulation Y cites for underwriting and dealing in U.S. obligations, municipal securities, and money market instruments have been revised.

New Section Number	*Previous Section Number*	*Description of the Change*
3250.0	3250.0	This futures commission merchant section has been revised to incorporate a risk-focused inspection approach as well as the Board's changes to Regulation Y. (See SR-97-33.) The section includes revised inspection objectives and procedures and an updated examiner inspection checklist. The listing of laws, regulations, interpretations, and Board orders has been updated.
3500.0	3500.0	The tie-in arrangements section has been revised to reflect the Board's decision (1) to rescind the regulatory extension of bank anti-tying rules to BHCs and their nonbank subsidiaries under section 106 of the BHC Act Amendments; (2) to retain the limited prohibition on tying arrangements involving electronic benefit transfer services; (3) to treat interaffiliate tying arrangements the same as intrabank tying arrangements so that a tying arrangement is permissible if the tied product is a loan, discount, deposit, or trust service; and (4) to extend the regulatory extension of the ''traditional bank product'' exception to reciprocity arrangements. (See also the subsections beginning at 3070.0.7.4.)
3600.8	3600.8	The Regulation Y cites have been updated. Due to amendments effective April 1, 1998, outdated Regulation T information was deleted.
5000.0.3 5000.0.4.1 5000.0.4.5	5000.0.3 5000.0.4.1	Starting at 5000.0.4.1, see the references to the Board's November 3, 1997, ''Risk-Focused Supervision Policy for Small Shell Bank Holding Companies'' (S-2587) that became effective on November 30, 1997. (See SR-97-27.) The policy reflects the supervision and inspection program for small shell bank holding companies (SSBHCs) having less than $1 billion in consolidated assets The policy amended the inspection scope and frequency requirements of SR-85-28, ''Examination Frequency and Communicating with Directors.'' A risk assessment of each SSBHC and appropriate supervision strategy must be completed once each ''supervisory cycle.'' The supervisory cycle is determined by the examination frequency that is mandated for the lead subsidiary bank.
	3130.2 3130.7 3260.0 3300.0 3310.0 3600.2 3600.11 3600.18 3600.20 4060.8	These sections have been deleted from the manual.

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Bank Holding Company Supervision Manual
Supplement 13—December 1997

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new or revised supervisory instructions issued by the Division of Banking Supervision and Regulation since the publication of the June 1997 supplement.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
2010.10 2060.0 2060.1 2060.2 2060.3 2060.4	2060.6 2060.0 2060.1 2060.2 2060.3 2060.4	These sections were revised to include limited changes to management information systems (MIS) inspection guidelines and procedures developed by a designated (MIS) Federal Reserve System task force.
2090.0	2090.0	This section on control has been revised to reflect the repeal of section 2(g)(3) of the BHC Act and to provide current definitions of "company," "company covered in 1970," and "acting through others" under the Bank Holding Company Act or the 1970 amendments. Most of the changes resulted from passage of the Economic Growth and Regulatory Paperwork Reduction Act of 1996.
2090.05		This section on qualified family partnerships describes a new class of companies consisting of general or limited partnerships that are exempt from the definition of company in the BHC Act, and thus are not subject to many of the provisions of the act if certain conditions are met.
	2270.0	This section on criminal referral information is obsolete. See the *Suspicious Activity Report Manual* (July 1996) and the *Bank Secrecy Act Examination Manual* (September 1997).
3000.0, appendix 1	3000.0, appendix 1	This appendix has been updated to reflect nonbanking activities added to section 225.28(b) of Regulation Y (the "laundry list"), effective April 21, 1997.
3110.0	3110.0	This section is revised to reflect the April 1997 Regulation Y changes for owning, controlling, and operating nonbank depository institutions (industrial banking—the institutions are not banks) and savings associations.
3111.0	3185.0	This section has been revised to include more current Board orders on the owning, controlling, or operation of a savings association.
3140.0	3140.0	The personal and real property leasing section was revised for the April 1997 changes to Regulation Y. The changes consisted of (1) the removal of numerous restrictions in order to permit greater flexibility in acquiring leasable property in quantity and to sell or re-lease property and (2) clarifications on requirements for a nonoperating lease, especially automobiles.

New Section Number	*Previous Section Number*	*Description of the Change*
3150.0	3150.0	The community development activities section has been updated with Board orders and interpretations, as well as for the April 1997 inclusion of community development advisory and related services into Regulation Y.
3160.0	3160.0	This EDP servicing section has been revised for the April 1997 revision of Regulation Y by removing requirements for written agreements and providing for the limited processing and transmission of data that are not financial, banking, or economic.
3210.0	3210.0	This payment instruments section was revised to reflect the Board's removal of the limitation on the face amount of such instruments (see the April 1997 Regulation Y revision).
3220.0	3220.0	The arranging of real estate equity financing section reflects the removal of two limitations on the nonbanking activity (see the April 1997 Regulation Y revision).
	3600.22	This section is deleted since it is incorporated into section 3150.0
5030.0, page 4	5030.0, page 4	Illustrative report page—title change only.
5052.0		This section provides targeted inspection guidance for management information systems (MIS) for the examiner's use in determining whether adequate systems are in place that will provide senior management and the board of directors with sufficient, reliable, and timely data to make informed decisions for monitoring and managing the entity's risks.
2020.2 2190.0.7 3090.0 3090.1 3090.2 3100.0 3120.0 3160.1 3170.0 3180.0 3190.0 3270.0	2020.2 2190.0.7 3090.0 3090.1 3090.2 3100.0 3120.0 3160.1 3170.0 3180.0 3190.0 3270.0	These sections were revised to reflect revised Regulation Y section references and/or additional Board order references.

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Bank Holding Company Supervision Manual
Supplement 12— June 1997

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new or revised supervisory instructions issued by the Division of Banking Supervision and Regulation since the publication of the December 1996 supplement.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
2010.9		This section provides supervisory guidance pertaining to required absences from sensitive positions. See SR-96-37.
2050.0.3.2 2050.0.3.3	2050.0.3.2 2050.0.3.3	These subsections pertain to extensions of credit to BHC officials. They consist of two recent changes to Regulation O. The first change, effective November 4, 1996, permits insiders of a state member bank and of the bank's affiliates to obtain loans under company-wide employee benefit plans. The second change, effective April 1, 1997, states, subject to specified conditions, that Regulation O will not apply to extensions of credit by a member bank to an executive officer or director of an affiliate.
2070.0	2070.0	This section pertains to tax payments by bank holding companies. The section has been updated with current accounting standards. It also includes information derived from SR-96-26 on the new Subchapter S Internal Revenue Code elections for bank holding companies, initiated by the Small Business Protection Act of 1996.
2124.0		This section provides examination guidance as to risk-focused safety-and-soundness inspections. Risk-focused inspections emphasize effective planning and scoping (including advance risk assessments) to customize the work to correspond with the size and activities of the bank holding company, concentrating examiner resources and transaction testing on areas that focus on the greatest degree of risk. See SR-96-14.
2127.0		This section includes general inspection guidance for evaluating the management of interest-rate risk. It emphasizes the Board's adoption of a joint agency policy statement on interest-rate risk (effective June 26, 1996). See SR-96-13.
2185.0	2185.0	This section includes inspection guidance for section 20 nonbank company subsidiaries of bank holding companies. The section has been revised to include (1) a September 11, 1996, Board press release regarding the interest earned on debt securities that a member bank may hold for its own account; (2) a clarification detailed in an October 30, 1996, Board letter to the ABA Securities Association with respect to the Board's September 11, 1996, action; (3) the November 7, 1996, *Federal Register* notice on easing or removing restrictions on director, officer, and employee interlocks, cross-marketing activities, and the purchase and sale of financial assets; (4) the December 20, 1996, Board approval of a change (effective March 6, 1997) in the revenue limit from 10 to

New Section Number	*Previous Section Number*	*Description of the Change*
2185.0 continued	2185.0 continued	25 percent and the elimination of the alternative indexed-revenue test; and (5) the January 9, 1997, Board removal of a prudential limitation on prior Board approval for BHC funding of section 20 companies.
3000.0.3, appendix 2	3000.0.3, appendix 2	This appendix has been updated for new nonbanking activities approved by Board order on an individual basis under section 4(c)(8) of the BHC Act.
3000.0.4, appendix 3	3000.0.4, appendix 3	This appendix has a footnote added to item 24 indicating that the previously denied activity, clearing securities options and notes and other financial instruments for the accounts of professional floor traders, was recently approved by the Board on a very limited basis. See 1997 FRB 138.
3030.0	3030.0	This revised section discusses acquisition of DPC shares or assets. The revisions incorporate changes to section 4(c)(2) of the BHC Act, based on the Economic Growth and Regulatory Paperwork Reduction Act of 1996, as well as February 1997 changes to section 225.22(d) of Regulation Y. With System approval, shares and other assets may be held for up to five years. If a good faith effort is made to dispose of the shares, real estate, or other assets within five years, additional extensions for up to five years may be granted, for a maximum extension period of 10 years. Previously, only real estate could be held beyond the initial five years (with System approval).
3070.0	3070.0	This section provides inspection guidance on mortgage banking, updated for Statement of Financial Accounting Standards (SFAS) No. 125, ''Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities'' (issued in June 1996 and amended in December 1996). Mortgage-servicing rights and excess servicing-fee and certain interest-only strips receivables are now termed mortgage-servicing assets. SFAS 125 uses a consistent financial-components approach that emphasizes control. When financial assets are transferred, a BHC should recognize the financial and servicing assets it controls and the liabilities it has incurred. It should remove the financial assets from the balance sheet when control has been surrendered, and liabilities should also be removed from the balance sheet when they have been extinguished. SFAS 125 provides consistent standards for determining whether transfers of financial assets should be treated as sales or secured borrowings. The Financial Accounting Standards Board has deferred until January 1, 1998, the provisions that govern transactions such as secured borrowings and collateral arrangements, repurchase agreements, and securities lending. References to SFAS 122, ''Accounting for Mortgage Servicing Rights,'' have been deleted or revised based on SFAS 125.

New Section Number	*Previous Section Number*	*Description of the Change*
3160.2		This section supplements EDP servicing. It summarizes the Board's decision that electronic benefit transfer, stored-value card (open and closed systems), and electronic data interchange services (capturing, formatting, and furnishing merchant sales data) are activities that are closely related to banking, permissible under section 225.28(b)(14) of Regulation Y.
3160.3		This supplemental section to EDP servicing briefly summarizes the Board's decision that the withdrawal of funds from a bank account in the form of travelers' checks, money orders, and postage stamps, using an ATM card and an ATM machine, is an activity closely related to banking, permissible under section 225.28(b)(14) of Regulation Y.
3160.4		This supplemental section to EDP servicing summarizes the Board's decision that providing data processing services in connection with the distribution, through ATMs, of tickets, gift certificates, and prepaid telephone cards is an activity that is closely related to banking, permissible under section 228.25(b)(14) of Regulation Y.
3230.4	3600.19	This section discusses riskless-principal and private-placement nonbanking activities, including summaries of respective Board orders and the February 1997 revision to section 228.25(b)(7) of Regulation Y.
3600.13.14		Two new nonbanking activities, approved only by Board order, are discussed: (1) operating a primary clearing firm for a limited number of floor traders and (2) providing brokerage services for forward contracts on financial and nonfinancial commodities. See 1997 FRB 138.
4060.3.2	4060.3.2	This subsection provides an overview of the capital adequacy guidelines using the risk-based measure. Reference is made to the *Trading Activities Manual* for more detailed examiner guidance on evaluating the applicability and adequacy of capital charges for market risk resulting from trading activities.
4060.3.2.1.1.4		This revision conveys the Board's October 21, 1996, announcement that certain cumulative preferred stock instruments can be included in tier 1 capital for BHCs. The instruments are marketed under a variety of proprietary names and are issued from a special-purpose subsidiary that is wholly owned by the parent company. The proceeds are lent to the parent in the form of a very long-term, deeply subordinated note. Cumulative preferred stock of a bank holding company is limited to 25 percent of tier 1 capital.
4070.0.8 4070.0.8.1	4070.0.8 4070.0.8.1	These subsections address the rating of consolidated bank holding company capital under the BOPEC rating system. The subsections have been updated to reflect the application of the current capital measures.

New Section Number	*Previous Section Number*	*Description of the Change*
4070.0.9 5010.4	4070.0.9 5010.4	These sections have been revised to indicate that the BOPEC composite rating, as well as its components, will be disclosed, the latter beginning January 1, 1997. Section 5010.4 provides an example of how the information should be reported. See SR-96-26.
5010.5	5010.5	This section provides clarified nonbank loan-review reporting instructions for the Scope of Inspection and Abbreviations report page.
5010.7	5010.7	This section provides report instructions for the bank holding company's audit program. The section is revised to reflect a change for the asset threshold of $500 million or more for independent audits for the FR Y-6 annual report.
2010.2 2110.0.1.1 4010.2 4020.9 4070.04 4080.0 5000.0.4.2 5010.17 5010.41	2010.2 2110.0.1.1 4010.2 4020.9 4070.04 4080.0 5000.0.4.2 5010.17 5010.41	These sections were revised on a limited basis to reflect the Board's December 24, 1996, adoption of a revised Uniform Financial Institutions Rating System on an interagency basis. Included in that system is the revised CAMELS rating system for banks. The new "S" component will focus on an institution's ability to monitor and manage market risk. See SR-96-38.

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Bank Holding Company Supervision Manual
Supplement 11—December 1996

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new or revised supervisory instructions issued by the Division of Banking Supervision and Regulation since the publication of the June 1996 supplement.

To make the contents easier to use, a general table of contents and detailed contents pages for each of the major parts of the manual are included with this update.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
2129.0		This section consists of supervisory and examiner guidance on the use of credit derivatives by banking organizations. The guidance focuses on the use of credit derivatives for risk management, yield enhancement, reduction of credit concentrations, or diversification of overall risk. Emphasis is placed on establishing sound risk-management policies and procedures and effective internal controls with respect to credit derivatives. See SR-96-17. See also subsections 4060.3.5.3.9 and 4060.3.11 for information on the risk-based capital treatment for credit derivatives.
3000.0.3, appendix 2	3000.0.3, appendix 2	This appendix has been updated for new nonbanking activities approved by Board order on an individual basis under section 4(c)(8) of the BHC Act.
3000.0.4, appendix 3	3000.0.4, appendix 3	This section is revised to reflect Board orders that authorized the trading in platinum and palladium coin and bullion as nonbanking activities; these were nonbanking activities previously denied by the Board.
3130.1	3130.1	This section is revised for the Board's adoption of a final rule amending its interpretive rule, effective September 30, 1996, regarding investment adviser activities of bank holding companies. The new rule allows a bank holding company (and its bank and nonbank subsidiaries) to purchase, in a fiduciary capacity, securities of an investment company advised by the bank holding company if the purchase is specifically authorized by the terms of the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered.
3230.0.4 3230.0.11.1	3230.0.4 3230.0.11.1	These subsections have been revised to reflect the Board's decision to rescind a June 27, 1986, staff interpretive letter (the so-called ''Sovran Letter''). The letter set forth restrictions that a bank holding company had to abide by in selling mutual fund and unit investment trust shares through a nonbank subsidiary engaged in securities brokerage.
3600.3	3600.3	This section was revised to reflect the Board's order authorizing a bank holding company to trade in palladium coin and bullion.

New Section Number	*Previous Section Number*	*Description of the Change*
3600.13.12		This new subsection discusses the Board's order authorizing FCM execution, clearance, and advisory nonbanking services for contracts on financial and nonfinancial commodities for noninstitutional investors.
3600.13.13		This new subsection is a summary of the Board's order authorizing a bank holding company's wholly owned asset-management nonbank subsidiary to serve as a commodity pool operator of investment funds involved in purchasing and selling futures and options on futures on certain financial and nonfinancial commodities (''commodity pools'').
3600.15.5		This subsection reflects the Board's order authorizing a nonbanking activity involving the acquisition of defaulted debt.
3600.16.2		This new subsection discusses the Board's order authorizing education-financing and advisory services as a nonbanking activity for bank holding companies.
3600.21.6		This subsection summarizes the Board's order authorizing limited nonbanking activities to underwrite ''private ownership'' industrial development bonds issued for the provision of certain ''traditional governmental services.''
3600.29		This section summarizes the Board's order authorizing as a nonbanking activity a bank holding company's providing of employment histories to third parties for a fee.
3600.30		This section discusses the Board's authorization of real estate title abstracting as a nonbanking activity for bank holding companies.
3600.31		This section reflects the Board's order authorizing a bank holding company to engage in the nonbanking activity of transmitting money for customers located in the United States to third parties located in a foreign country.
4060.3.2	4060.3.2	This subsection has been revised to alert examiners to the existence of supplemental risk-based capital rules (Regulation Y, appendix E) that adjust the risk-based capital for market risk involved in trading activities.
4060.3.5.3.9 4060.3.11	 4060.3.11	These subsections address the risk-based capital treatment of credit derivatives. See section 2129.0 and SR-96-17.

FILING INSTRUCTIONS

Remove	*Insert*
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	2129.0, pages 1 through 7
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3000.0, pages 11 through 14	3000.0, pages 11 through 14
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Bank Holding Company Supervision Manual
Supplement 10—June 1996

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and supervisory instructions issued by the Division of Banking Supervision and Regulation since the publication of the December 1995 supplement.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
2020.1.1	2020.1.1	This subsection has been revised to include the Board's April 29, 1996, adoption of a definition of capital stock and surplus for purposes of section 23A of the Federal Reserve Act that is effective July 1, 1996. The definition conforms to the definition of unimpaired capital stock and unimpaired surplus used by the Federal Reserve Board in calculating the limits in Regulation O for insider lending and by the Office of the Comptroller of the Currency in calculating the limit on loans by a national bank to a single borrower.
2050.0.3.2	2050.0.3.2	This subsection has been amended for the Board's June 7, 1995, adoption of an amendment to Regulation O to conform the definition of unimpaired capital and unimpaired surplus to the definition of capital and surplus adopted by the OCC mentioned above. The final rule became effective on July 1, 1995.
3000.0, Appendix 2	3000.0, Appendix 2	This appendix has been updated for new nonbanking activities approved by Board order on an individual basis under section 4(c)(8) of the BHC Act.
3070.0	3070.0	This section has been completely revised to incorporate new mortgage banking inspection procedures for nonbanking subsidiaries of bank holding companies. The procedures were developed by a Federal Reserve System task force for use in conducting examinations or inspections of mortgage banking subsidiaries of state member banks or bank holding companies. The procedures primarily focus on board oversight and management, activities such as production, marketing, servicing/loan administration, financial analysis, mortgage-servicing rights, and intercompany transactions.
3240.0	3240.0	This section has been revised to delete information that is no longer applicable to underwriting and dealing in U.S. obligations, municipal securities, and money market instruments.
3600.3	3600.3	This section now includes the Board's order authorizing a BHC's section 20 subsidiary to trade platinum coin and bullion for its own account, a new nonbanking activity under section 4(c)(8) of the BHC Act. See 1995 FRB 190.

New Section Number	*Previous Section Number*	*Description of the Change*
3600.13.5		This new section reflects the Board's approval by order of a BHC's application for its section 20 subsidiary to engage as an FCM in executing and clearing, and clearing without executing, futures and options on futures on nonfinancial commodities as a nonbanking activity under section 4(c)(8) of the BHC Act. See 1993 FRB 1049.
3600.13.6		This new section discusses the Board's approval of an order authorizing a new FCM nonbanking activity under section 4(c)(8) of the BHC Act—providing FCM and related advisory services for options on Eurotop 100 index futures and one-month Canadian banker's acceptance futures. See 1995 FRB 188–189.
3600.13.7		This new section summarizes the Board's approval of an order for a section 20 company to act as an FCM in trading for its own account, for purposes other than hedging, in futures, options, and options on futures contracts based on certificates of deposit or other money market instruments per section 4(c)(8) of the BHC Act. See 1995 FRB 190.
3600.13.8		This new section reviews an order whereby the Board authorized, under section 4(c)(8) of the BHC Act, for a section 20 company to act as an originator, principal, agent, broker, or advisor with respect to commodity and index swap transactions. See 1995 FRB 185.
3600.13.9		This new section addresses the Board's approval of an order authorizing, under section 4(c)(8) of the BHC Act, an FCM to trade for one's own account, for purposes other than hedging, in futures, options, and options on futures contracts based on commodities or on stock, bond, or commodity indices. See 1995 FRB 192–193.
3600.13.10		This new section summarizes the prior-approval requirements for BHCs proposing to engage in FCM activities under section 4(c)(8) of the BHC Act. See SR-95-14.
3600.13.11		This new section reflects the Board's approval of a BHC's application to provide discretionary portfolio management services on futures and options on futures on financial commodities in combination with FCM transactional services under section 4(c)(8) of the BHC Act. See 1995 FRB 386.
3600.18.4		This new section discusses the Board's approval of a BHC's application to provide discretionary portfolio management services on futures and options on futures on nonfinancial commodities under section 4(c)(8) of the BHC Act. See 1995 FRB 803.
4070.1		This new section provides guidance for evaluating risk-management systems of BHCs. System examiners now assign a supervisory rating to the adequacy of a BHC's risk-management processes. See SR-95-51.

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Bank Holding Company Supervision Manual
Supplement 9—December 1995

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and supervisory instructions issued by the Division of Banking Supervision and Regulation since the publication of the June 1995 supplement.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
2010.6	2010.6	This section has been revised to include SR-95-46, a discussion of a September 12, 1995, joint interagency interpretation of the February 17, 1994, Interagency Statement on Retail Sales of Nondeposit Investment Products (SR-94-11) and on using abbreviated disclosures under certain circumstances.
2010.7 2065.1 2065.2	2010.7 2065.1 2065.2	These sections have been amended to provide examiner guidance on assessing the portion of the allowance for loan and lease losses (ALLL) for impaired loans (see SR-95-38). Examiners, however, should focus primarily on the assessment of the adequacy of the *overall* ALLL. The guidance gives recognition to revisions of Financial Accounting Standards Board Statement Nos. 114 and 118 (FAS 114 and FAS 118). FAS 114 and FAS 118 set standards for estimating the impairment of a loan for general financial reporting purposes.
4060.3.5.1.1.1 4060.3.5.1.1.2 4060.3.5.1.3	4060.3.5.1.1.1 4060.3.5.1.1.2 4060.3.5.1.3	These subsections have been revised to include the Board's adoption of an interim final rule on July 26, 1995 (effective August 1, 1995). The rule change was adopted in response to the Financial Accounting Standards Board's Statement No. 122, ''Accounting for Mortgage-Servicing Rights'' (FAS 122). FAS 122 requires originated mortgage-servicing rights (OMSRs) to be treated the same as purchased mortgage-servicing rights (PMSRs), that is, capitalized as balance-sheet assets (see section 4060.4 below). Under the interim rule, both OMSRs and PMSRs are ''included in'' (not deducted from) regulatory capital when determining Tier 1 (core) capital, subject to the regulatory capital limitations that previously applied only to PMSRs.
4060.3.5.2.4		This new subsection reflects the Board's August 25, 1995, adoption of a final rule (effective September 1, 1995) amending the risk-based measure of the capital adequacy guidelines. Risk-weighted assets used to calculate capital ratios can include only the amount of retained recourse for transfers of small-business loans and leases on personal property. The rule has the effect of lowering capital requirements for small-business loans and leases on personal property that have been transferred with recourse by qualified banking organizations.

New Section Number	*Previous Section Number*	*Description of the Change*
4060.3.5.3.4 4060.3.5.3.4.1 4060.3.5.3.4.2 4060.3.5.3.6	4060.3.5.3.4 4060.3.5.3.4.1 4060.3.5.3.4.2 4060.3.5.3.6	These subsections have been revised to include the Board's August 25, 1995, adoption of final rule amendments (effective October 1, 1995) to the risk-based measure of the capital adequacy guidelines for bank holding companies. The changes are threefold: First, new conversion factors have been added for long-dated interest-rate and exchange-rate contracts and for derivative contracts related to equities, precious metals, and other commodities. Second, recognition is given to the effects of netting arrangements in calculating potential future credit exposure for contracts subject to qualifying bilateral netting arrangements. Third, derivative contracts related to equities, precious metals, and other commodities are recognized in bilateral netting arrangements.
4060.4	4060.4	This section has also been revised to treat OMSRs the same as PMSRs for the leverage measure of the capital adequacy guidelines, in accordance with the Board's July 26, 1995, adoption of the above-mentioned interim rule.
4080.0	4080.0	This section has been substantially revised to include revisions to the Systemwide Bank Holding Company Surveillance Program. The changes (1) incorporate SEER and CAMEL ratings into the program, (2) vary the exceptions based on the condition of the banking industry, (3) incorporate supplemental screens, (4) provide a monitoring tool for BHCs with assets below $150 million, and (5) improve communication within the Reserve Bank System. See SR-95-43.

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Bank Holding Company Supervision Manual
Supplement 8—June 1995

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and supervisory instructions issued by the Division of Banking Supervision and Regulation since the publication of the December 1994 supplement.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
2010.8		This new section includes examiner guidance on the sharing of corporate facilities and staff within banking organizations. When officials and employees have responsibilities for offices or affiliates of a banking organization, particularly those that share facilities, those responsibilities should be clearly defined and, when appropriate, disclosed or made clear to customers and the public in general. Furthermore, in establishing staff responsibilities, management should ensure that they are within the scope of the entity's license or charter and that each staff member who makes a commitment to a counterparty on behalf of an entity has both the corporate legal authority and capacity to do so. See SR-95-34 (SUP).
2126.0		This new section pertains to the inspection of nontrading activities of BHCs and their subsidiaries. It provides examiner guidance on evaluating the risk-management practices and internal controls used by banking organizations in acquiring and managing securities and off-balance-sheet derivative contracts for ''nontrading'' purposes. When evaluating nontrading activities, examiners must ensure that banking organizations employ sound risk-management practices consistently across these varying product categories, regardless of legal characteristics or nomenclature. These basic principles emphasize controlling aggregate risk exposures on a consolidated basis, while recognizing legal distinctions and possible obstacles to cash movements among subsidiaries. More generally, the principles set forth fundamental risk-management practices that are relevant to most portfolio-management endeavors. See SR-95-17.
2185.0.5.2.1 2185.0.5.2.4.3	2185.0.5.2.1 2185.0.5.2.4.3	These Section 20 nonbank company inspection procedures have been enhanced for infrastructure inspections pertaining to equity underwriting and dealing. Further guidance is provided as to definitional and other issues relating to preferred stock, convertible debt securities, and the acquisition of voting shares of a nonbank company.
2185.0.5.4.7	2185.0.5.4.7	The Section 20 nonbank company inspection procedures are revised to emphasize that bank affiliates generally may not act as agent or engage in marketing activities for bank-ineligible securities underwriting. It is noted that the Board, by Order, has permitted Regulation K affiliates to act as an agent for a Section 20 company for bank-ineligible securities transactions.

New Section Number	*Previous Section Number*	*Description of the Change*
2185.0.7	2185.0.7	Condition 16 of the 1989 Board Order (equivalent to Condition 13 of the Board's 1987 Order) has been interpreted to permit Section 20 subsidiary personnel to participate in educational seminars (marketing) sponsored or cosponsored by affiliates. Condition 16 no longer precludes affiliate banks and thrifts from acting as agent for or engaging in marketing activities on behalf of an affiliate Section 20 company with respect to bank-eligible securities.
2185.0.8	2185.0.8	The 1987 Board Order discussion as to the types of securities that can be underwritten is revised to include unrated municipal revenue bonds under certain conditions. (See the Board's Norwest letter of December 5, 1994, now contained in Appendix G.)
2185.0.14		Appendix H has been added for the Board's December 14, 1994, Interpretation of the Limitation on Cross-Marketing Activities.
2231.0	2231.0	The Federal Reserve Board emphasizes the importance of administering sound appraisal policies and procedures in a banking organization. This revised section reflects the Board's changes to its Real Estate Appraisal Regulation, adopted in June 1994. The narrative, examiner guidance, and inspection procedures are revised. A banking organization's board of directors is responsible for adopting policies and procedures that establish effective real estate appraisal and evaluation programs. See SR-94-50 and SR-94-55.
3000.0	3000.0	Appendix 2 of this section is revised to incorporate 1994 and 1995 Board Order approvals of new nonbanking activities that pertain to data processing, futures commission merchant, trading, and underwriting and dealing activities.
3500.0	3500.0	This section is revised to for the Board's December 15, 1994, and April 20, 1995, exceptions to the anti-tying prohibitions of Regulation Y. One exception permits a BHC or its nonbank subsidiary to offer a discount on its product or service on the condition that a customer obtain any other product or service from that company or from any of its nonbank affiliates. The other new exception, the "safe harbor" exception, permits any bank or nonbank subsidiary of a bank holding company to offer a "combined-balance discount"—that is, a discount based on a customer maintaining a combined minimum balance in products specified by the company offering the discount.
4060.3	4060.3	This section includes the Board's December 1994 and February 1995 revisions to the Capital Adequacy Guidelines for bank holding companies (the December 1, 5, 16, 1994, and the February 7, 1995, Board approvals). The following comments summarize specific changes to each subsection.

New Section Number	*Previous Section Number*	*Description of the Change*
4060.3.2.1.1 4060.3.5.1.4	4060.3.2.1.1	These subsections are either revised or added for the December 5, 1994, Board approval for the definition of common stockholders' equity. The revised definition excludes net unrealized holding gains (losses) on securities available for sale in regulatory capital. Also discussed is the exclusion of revaluation reserves in capital ratio calculations (risk-based capital and leverage measures).
4060.3.5.1.3	4060.3.5.1.3	This subsection is revised for the Board's December 16, 1994, approval that established a limit on the amount of deferred-tax assets that can be included in Tier 1 capital for risk-based capital purposes.
4060.3.5.3.4 4060.3.5.3.4.2 4060.3.5.3.6	 4060.3.5.3.6	Under the December 1, 1994, approval, the Board recognized the risk-reducing benefits of qualifying bilateral netting contracts. Bank holding companies with such contracts are permitted to net positive and negative mark-to-market values of interest-rate and exchange-rate contracts in determining the current exposure portion of the credit-equivalent amount of such contracts to be included in risk-weighted assets. The change implements a revision to the Basle Accord that permits such netting arrangements.
4060.3.5.3.7	4060.3.5.3.7	A new footnote results from the Board's February 7, 1995, approval regarding the risk-based capital treatment of recourse transactions. Previously, a banking organization could have been required to hold capital in excess of the maximum amount of loss possible under the contractual terms of a recourse obligation.
4060.3.5.3.8		Additional risk-based capital guidance is provided for off-balance-sheet instruments, specifically financial standby letters of credit and performance standby letters of credit. See SR-95-20, issued March 30, 1995.
4060.4.1 4060.4.2.2	4060.4.1 4060.4.2.2	These subsections are revised for the Board's December 16, 1994, approval that establishes a limit on the amount of deferred-tax assets that can be included in Tier 1 capital for leverage capital purposes.
5000.0.9.2.1.1 5000.0.9.2.1.2	5000.0.9.2.1.1 5000.0.9.2.1.2	These subsections were revised based on the guidance of SR-95-19 pertaining to meetings by Reserve Bank officers and staff with BHC officials pertaining to the holding company's inspection.
5000.0.9.3 5010.1 5010.4 5010.6 5010.7 5010.30 5010.38 5030.0	5000.0.9.3 5010.1 5010.4 5010.5 5010.6 5010.30 5030.0	These sections are revised to reflect changes to the guidance for preparing the Bank Holding Company Inspection Reports and in the requirements for the issuance of Director's Summaries of Inspection Findings. The changes are the outgrowth of work done by the Task Force of the Supervision Efficiency Enhancement Project. See SR-95-12. Some reorganization of the sections was necessary to accommodate the changes. 5010.6 was combined with 5010.5; 5010.7 replaced 5010.6; and 5010.34 was moved to 5010.7. Similar changes were made to the illustrated report pages in 5030.0.

New Section Number	*Previous Section Number*	*Description of the Change*
5060.0		This is a new section that pertains to portions of BHC inspections that are conducted in Reserve Bank offices. See SR-95-13.

FILING INSTRUCTIONS

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2185.0, pages 3 through 8, 8.1, 9, and 10 pages 19 through 28 pages 49 and 50	2185.0, pages 3 through 10 and 10.1 pages 19 through 28 pages 49 through 56
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5010.8, page 1	5010.8, page 1
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5010.11, page 1	5010.11, page 1
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5010.30, page 1	5010.30, page 1
5010.34, page 1	5010.34, page 1
	5010.38, page 1
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	5060.0, pages 1 through 11
6000.0, pages 1 through 50	6000.0, pages 1 through 46

Bank Holding Company Supervision Manual
Supplement 7—December 1994

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and supervisory instructions issued by the Division of Banking Supervision and Regulation since the publication of the June 1994 supplement.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
2010.6.2		Section 2010.6 primarily addresses a BHC's supervision of its banking subsidiaries as it pertains to the retail sales of nondeposit investment products, including mutual funds and annuities. The section consists of a February 15, 1994, interagency policy statement that provides comprehensive guidance on retail sales of such products. A new subsection 2010.6.2 adds respective examination/inspection procedures applicable to state member banks and in some situations, BHCs and their depository institution and nonbanking subsidiaries (including their affiliate relationships).
2050.0	2050.0	This section was revised to incorporate a few technical amendments to Regulation O that became effective July 19, 1994. Regulation O was significantly amended by a final rule published in the *Federal Register* (59 FR 8831) on February 24, 1994.
2128.0		This new section discusses structured notes and their increased use by banking organizations. SR-94-45, dated August 17, 1994, instructs examiners to be mindful of these securities when examining banking organizations. Some structured notes can expose investors to significant losses as interest rates, foreign-exchange rates, and other market indices change. Examiners need to ensure that structured notes are held in accordance with the organization's investment policies and procedures that convey a full understanding of the risks and price sensitivities of structured notes under a broad range of market conditions.
3500.0	3500.0	This section addresses the tie-in considerations of the BHC Act. The section has been revised to include the Board's July 27, 1994, limited extension of a statutory exception to BHC affiliates (bank and nonbank) to offer package discounts on traditional bank products, which are already available to banks. The exception was approved through a revision to Regulation Y. The final rule also permits BHC affiliates to offer a discount on securities brokerage services on the condition that a customer obtain a traditional bank product from itself or from an affiliate.

New Section Number	*Previous Section Number*	*Description of the Change*
5000.0.1 5010.0 5010.1.3 5010.2 5030.0 5040.0 5050.0	5000.0.1 5010.0 5010.1.3 5010.2 5010.44 5030.0 5040.0 5050.0	These sections were revised as a result of changes to the Federal Reserve System's Supervisory Information System (SIS), effective July 18, 1994. The changes were conveyed to System staff by SR-94-38, June 20, 1994. Of particular note are the instructions pertaining to the assignment of BOPEC composite and component ratings for targeted BHC inspections in section 5050.0; changes made to the inspection report cover pages; and the elimination of the Inspection Summary (FR 1417 and FR 1417a [confidential page E]) from the inspection report.
5000.0.12		This new subsection discusses the conditions under which a combined examination/inspection report may be issued for BHCs with lead state member banks. The format for the report is attached to SR-94-46, August 17, 1994.
5030.0 (page 10)	5030.0 (page 10)	Core page 7 (Consolidated Classified & Special Mention Assets, & OTRP) of the BHC inspection report has been slightly revised so columnar information can be totalled. A separate total is also provided to report total classified assets (substandard, doubtful, loss, and value impaired).

FILING INSTRUCTIONS

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Title page	Title page
1010.0, pages 1 and 2 pages 9 and 10 pages 29 and 30 pages 39 through 43	1010.0, pages 1, 2, and 2.1 pages 9 and 10 pages 29 and 30 pages 39 through 43
2010.6, pages 5 and 6	2010.6, pages 5 through 18
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3500.0, pages 1 through 4	3500.0, pages 1 through 4
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5010.0, pages 1 and 2	5010.0, pages 1 and 2
5010.1, pages 1 through 3	5010.1, pages 1 through 3
5010.2, pages 1 and 2	5010.2, pages 1 and 2
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5030.0, pages 1 and 2	5030.0, pages 1 and 2
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5040.0, pages 1 through 4	5040.0, pages 1 through 4
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Bank Holding Company Supervision Manual
Supplement 6—June 1994

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and supervisory instructions issued by the Division of Banking Supervision and Regulation from January 1994 to June 1994. In addition to the changes described below, several pages are being reissued to correct typographical or formatting errors.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of Changes*
2010.6		This new section applies to a BHC's supervision of its banking subsidiaries as it pertains to the retail sales of nondeposit investment products, including mutual funds and annuities. The section consists of a February 15, 1994, interagency policy statement that provides comprehensive guidance on retail sales of such products. The statement applies to all depository institutions, including state member banks, and to the U.S. branches and agencies of foreign banks supervised by the Federal Reserve. See SR-94-11.
2010.7		This new section contains the text of a December 21, 1993, interagency joint policy statement on the maintenance of an adequate allowance for loan and lease losses and an effective loan review system, as adopted by the Board. Although the policy statement does not apply directly to bank holding companies, the board of directors and management of BHCs should consider this statement as they supervise the BHC's financial institution subsidiaries. BHC examiners should consider the guidance when evaluating the holding company's supervision of those subsidiaries.
2050.0	2050.0	This section pertains to extensions of credit to BHC officials. The section has been extensively revised to include changes resulting from the Board's February 18, 1994, revision of Regulation O (Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks). Subsection 2050.0.3.1 has been revised to provide an updated and more detailed summary of changes for the 1992 Regulation O revisions as well as for the 1994 revisions.

New Section Number	*Previous Section Number*	*Description of Changes*
2125.0		This new section addresses the review of risk management and internal controls with regard to the BHC inspection of trading activities. The guidance highlights key considerations when inspecting trading activities in both cash and derivative instruments. This guidance specifically targets trading, market making, and customer accommodation activities in cash and derivative instruments at state member banks, branches and agencies of foreign banks, and Edge corporations. The principles set forth in this guidance also apply to the risk management of BHCs, which should manage and control aggregate risk exposures on a consolidated basis while recognizing legal distinctions among subsidiaries. Many of the principles advanced can also be applied to banks' use of derivatives as end-users. Examiners should assess management's application of this guidance to the holding company and to a bank's end-user derivative activities where appropriate, given the nature of the institution's activities and current accounting standards. See SR-93-69 (December 20, 1993) and SR-94-17 (March 1, 1994).
3000.0	3000.0	This section was revised to discuss BHC nonbanking activities in foreign countries permissible under section 211.5 of Regulation K and any other nonbanking activities that must be approved by the Board. The paragraph discussing an Edge Act and agreement corporation has been revised and expanded to correctly reference permissible activities under section 4 of the BHC Act and Regulation K as they pertain to this entity. Also, appendix 2 in subsection 3000.0.3 has been updated for new nonbanking activities adopted by Board order.
3160.0	3160.0	This revised section describes the updated standards for data processing and transmission services as set forth in section 225.25(b)(7) of Regulation Y and its interpretation at section 225.123(e). Also, subsection 3160.0.13 has been revised to incorporate a December 22, 1993, Board order authorizing a BHC to engage in the processing and transmission of medical-payment data and to provide other incidental services (see 1994 FRB 139).

New Section Number	*Previous Section Number*	*Description of Changes*
3160.1		This new section summarizes the Board's approval of a BHC's application to provide a network for the processing and transmission of medical-payment data through its designated nonbank subsidiary. The December 22, 1993, Board order concludes that (1) the operation of a medical-payments network would constitute a permissible data processing and data transmission activity under section 4(c)(8) of the BHC Act and section 225.25(b)(7) of the Board's Regulation Y; (2) the provision of claims-adjudication software that processes medical and coverage data is permissible as an activity incidental to the proposed provision of software for the processing of banking and financial data and the proposed operation of a medical-payments network; and (3) the proposed electronic data interchange services would constitute permissible byproducts of the nonbank subsidiary's primary data processing activities, and that such services are therefore permissible as an incidental activity. See 1994 FRB 139.
3510.0	3510.0	This section has been revised to provide additional explanation of the regulatory framework governing the nonbanking activities of foreign banking organizations (FBOs) under 12 C.F.R. 211.23. The section discusses 1991–1993 revisions to Regulation K pertaining to the nonbanking activities of and investment in qualifying foreign banking organizations (QFBO). The definition of and the requirements under the QFBO test have been expanded. Also, the manual's discussion of nonbanking exemptions for QFBOs under section 4(c)(9) and section 2(h) of the BHC Act has been significantly expanded to discuss the limitations on investments in FBOs and permissible QFBO nonbanking activities. FBOs may also engage in certain otherwise nonpermissible activities under section 4(c)(9) if approved by Board order.
3600.12.5		This new subsection has been added to include the Board's November 12, 1992, approval of a BHC's application to issue and sell, through its nonbank subsidiary, variably denominated payment instruments without limitation as to face value. See 1993 FRB 42.
3600.15.1.1		This new subsection summarizes the Board's approval of a bank holding application to engage in career counseling services as a new nonbanking activity under section 4(c)(8) of the BHC Act, permissible only by Board order. The applicant proposed to expand its present career counseling services under section 4(c)(1)(C) of the BHC Act nationwide to unaffiliated companies and individuals in a wide array of industries. The Board approved the application, but indicated that the applicant was not to portray itself as a provider of general career counseling services for individuals seeking career opportunities outside the banking or financial industries. See 1994 FRB 51.

New Section Number	*Previous Section Number*	*Description of Changes*
3600.15.4		This new subsection includes the Board's December 21, 1992, approval under section 4(c)(8) of the BHC Act of an application by two BHCs to engage, through BHC nonbank subsidiaries, in asset management activities involving assets originated by nonfinancial institutions as well as by financial institutions. The originated assets are limited to the types of assets that a financial institution would have the authority to originate. See 1993 FRB 131.
3600.21.5		This new subsection discusses the Board's approval of a BHC's application for its section 20 nonbank subsidiary to underwrite and deal in all types of equity securities and to act as a dealer-manager in connection with cash-tender and exchange-offer transactions (see 1994 FRB 49, footnote 5). In addition, recent Board order references to debt and equity approvals have been updated.
4060.3.5.2.2, 4060.3.5.2.3, 4060.3.5.3.7	4060.3.5.2.2, 4060.3.5.2.3, 4060.3.5.3.7	This revised subsection reflects the Board's adoption of amendments to its risk-based capital guidelines for state member banks and bank holding companies. The revised guidelines lower the risk weight from 100 percent to 50 percent for multifamily housing loans meeting certain criteria. The changes became effective on December 31, 1993. This change was directed by a provision of section 618(b) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991.
4060.8.4.2, 5010.0, 5010.1.1, 5010.10, 5010.29, 5010.31, 5030.0, and 5040.0	4060.8.4.2, 5010.0, 5010.1.1, 5010.10, 5010.29, 5010.31, 5030.0, and 5040.0	References to ''criticized'' assets or risk exposures in these sections have been redesignated as ''classified,'' in accordance with the Board's adoption of the June 10, 1993, ''Interagency Statement on the Supervisory Definition of Special Mention Assets.'' See SR-93-30.

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	2125.0, pages 1 through 8
2187.0, pages 1 through 4	2187.0, pages 1 through 4

Remove	*Insert*
3000.0, pages 1 through 12	3000.0, pages 1 through 13
3160.0, pages 1 through 4	3160.0, pages 1 through 5
	3160.1, pages 1 and 2
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6000.0, pages 1 through 49	6000.0, pages 1 through 50

Bank Holding Company Supervision Manual
Supplement 5—December 1993

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and supervisory instructions issued by the Division of Banking Supervision and Regulation from July 1993 to December 1993. In addition to the changes described below, several pages are being reissued to correct typographical errors.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of Changes*
2020.6	2020.6	This section has been revised to indicate that fee assessments against subsidiary financial institutions may take many forms. Such assessments represent an area of potential abuse because they can directly affect the cash-flow position of the affiliate. The section emphasizes that examiners must judge the reasonableness of fees assessed based on the services provided. Fees should be based on the fair market value of the services provided (or cost of the service plus a reasonable profit). In addition, fee assessments should be supported by written agreements that specify the services to be provided, the basis for the fees, and the method of their allocation.
2020.8		This new section addresses the improper practice of a bank holding company's assessing trade-name or royalty fees on its subsidiary banks. This practice is viewed as a diversion of bank income. See SR-91-3.
2020.9		This new section discusses safety-and-soundness concerns with regard to split-dollar life insurance policy arrangements between BHCs and their subsidiary banks. Such arrangements may be inconsistent with the Federal Reserve Act, sections 23A and 23B. Inspection objectives and procedures are provided. See SR-93-37.
2065.1 2065.1.4.1 2065.1.4.2 2065.1.7 2065.1.8	2065.1	This section has been revised to include the June 10, 1993, interagency credit-availability initiatives. The initiatives supplement the March 10, 1993, policy to improve credit availability. The June 10 initiatives included in this section address in-substance foreclosures and returning nonaccrual loans to accrual status. Also included is a statement that it is *not* regulatory policy to value real estate collateral on a liquidation basis.
2187.0		This new section discusses day trading and free-riding schemes (purchasing and selling the same securities, paying for the purchase with the proceeds of the sale). Such schemes involve the opening of a custodial agency account into which a number of broker-dealers will deliver securities on a delivery-versus-payment basis. A bank extension of credit is created, subject to Regulation U, when there are not sufficient funds in the account to pay for the securities and the account is therefore overdrawn. A discussion of securities credit regulations is included. See SR-93-13.

New Section Number	*Previous Section Number*	*Description of Changes*
3000.0.3	3000.0.3	Appendix 2 has been revised to include additional nonbanking activities that have not been previously approved by the Board under section 4(c)(8) of the BHC Act. The new nonbanking activities involve certain futures commission merchant activities and providing administrative and other services to mutual funds.
3000.0.4	3000.0.4	Footnote 1 of appendix 3 was revised to reflect the Board's decisions regarding the provision of armored car services as a nonbanking activity. See also the summary of changes to section 3700.10.
3230.0.8	3230.0.8	This subsection has been revised to delete the reference to the Securities and Exchange Commission's rule (17 C.F.R. 240.3b-9). The courts have ruled that the rule is no longer enforceable.
3600.13.3		This new subsection discusses the Board's May 6, 1993, approval, by order, of a BHC application to engage in a new FCM nonbanking activity—limited FCM clearing-only and executing-only trades that the FCM itself executes. The application was approved based on (1) the established framework for limiting risk from the clearing-only activities; (2) the fact that the applicant represented that its FCM nonbanking subsidiary could restrict the number of types of positions held by customers and that it could refuse trades that posed unacceptable risks; and (3) the commitments made, as well as the other facts of record.
3600.13.4		This new subsection discusses the Board's August 2, 1993, approval of a BHC application to engage in a new FCM nonbanking activity—the acceptance for clearance of a customer's orders that are executed by preapproved execution groups pursuant to "give-up" agreements. The approval was based on the applicant's framework for limiting risk, including the applicant's representation that under the give-up agreements the company would have the contractual right to refuse a customer's trade if it exceeded established trading limits documented in the give-up agreement for that particular customer. Also, the FCM nonbanking subsidiary will approve an execution group only if the floor brokers, and their primary or qualifying clearing firms, satisfy the company's financial, managerial, and operational standards.
3600.27		This section summarizes the Board's April 21, 1993, approval for providing administrative and certain other nonbanking services to mutual funds under section 4(c)(8) of the BHC Act. Certain Glass-Steagall Act issues are discussed within the order, and the applicant made several commitments to address those issues. Special emphasis is placed on the fact that the affiliates of banks cannot act as a distributor to the mutual fund. A combination of advisory and administrative services was also proposed.

New Section Number	*Previous Section Number*	*Description of Changes*
3600.28		This new section discusses the Board's September 1993 approval of a BHC's proposal to provide stand-alone inventory-inspection services under section 4(c)(8) of the BHC Act. The inventory-inspection services are to be provided to customers (third-party lenders) and only with respect to inventory that is pledged as collateral for a loan.
3700.10	3700.10	This revised section discusses the Board's denial of a BHC's request to provide armored car services through a de novo non-bank subsidiary. For this application, the Board published an order requiring a formal hearing before an administrative law judge (ALJ) in 1989. The ALJ declined to provide a factual or legal determination concerning the proper-incident test and other unresolved issues. The Board again referred the case to an ALJ for a recommended decision in 1990. In 1993, the Board denied the application in accordance with the ALJ's recommendation. The applicant failed to support a finding that the proposed armored car activities would be a proper incident to banking or to managing or controlling banks. Of particular note is the discussion on potential violations of section 23B of the Federal Reserve Act. Although these were only potential violations noted in an application, they provide noteworthy examples of the nature of such violations.
4020.9		This new section briefly summarizes the supervisory capital standards for de novo state member banks of BHCs and restrictions on their funding of the parent company's debt. See SR-91-17.
5000.0.7.5 5000.0.7.5.1		These subsections set out guidelines that were issued in SR-93-48 to clarify the respective roles of the responsible and local Reserve Banks in conducting inspections of out-of-District second-tier BHCs and nonbank subsidiaries. The responsible Reserve Bank, should, to the extent possible, rely on the local Reserve Bank to provide the resources necessary to conduct these inspections. The guidelines supplement the inter-District inspection guidance issued in SR-89-25 and SR-79-464.
5000.0.8.3		This new subsection sets forth the June 10, 1993, interagency guidance on the coordination of examinations of insured depository institutions and holding companies by the federal financial regulatory agencies. The coordination program is a response to industry concerns about the increased burden on organizations supervised by multiple regulatory agencies. The guidelines have been issued to minimize the disruptions and burdens associated with the examination process. The program emphasizes full cooperation and coordination by the agencies in supervising large banking organizations and organizations that are in less-than-satisfactory condition. The program expands on existing inter-agency agreements.

New Section Number	*Previous Section Number*	*Description of Changes*
5010.23	5010.23	This revised section expands the commercial-paper inspection-reporting instructions to include information on ratings of investment-quality commercial paper that are issued by statistical rating agencies, master notes and sweep arrangements, credit-supported commercial paper, dealer versus direct paper, yields on commercial paper, and denominations of commercial paper.

FILING INSTRUCTIONS

Remove	*Insert*
Title page	Title page
1010.0, pages 1 through 12 pages 29 through 40	1010.0, pages 1 through 12 page 12.1 pages 29 through 41
2010.2, pages 1 and 2	2010.2, pages 1 and 2
2020.6, pages 1 through 3	2020.6, pages 1 through 4
	2020.8, page 1
	2020.9, pages 1 through 5
2050.0, pages 3 through 6	2050.0, pages 3 through 6
2065.1, pages 1 through 3	2065.1, pages 1 through 4
	2187.0, pages 1 through 4
3000.0, pages 9 through 12	3000.0, pages 9 through 12
3230.0, pages 3 and 4	3230.0, pages 3 and 4
3600.13, pages 1 and 2	3600.13, pages 1 through 4
	3600.27, pages 1 through 3
	3600.28, page 1
3700.10, page 1	3700.10, pages 1 through 3
	4020.9, page 1
5000.0, pages 5 and 6 pages 6.1 and 6.2 pages 7 and 8	5000.0, pages 5 through 8 pages 8.1 through 8.4
5010.23, pages 1 and 2	5010.23, pages 1 through 3
6000.0, pages 1 through 47	6000.0, pages 1 through 49

Bank Holding Company Supervision Manual
Supplement 4—June 1993

This supplement is the first revision of the reformatted December 1992 edition of the *Bank Holding Company Supervision Manual*. It is, however, numbered supplement 4 because it is the fourth supplement issued since the manual was totally revised in 1986. The revisions reflect decisions of the Board of Governors, new and revised statutory and regulatory provisions, and supervisory instructions issued by the Division of Banking Supervision and Regulation from January to June 1993.

Included in this supplement is a title page on the back of which is a grid for recording the filing of supplements. It is strongly recommended that you use this grid so that you can determine if your manual is up-to-date.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change(s)*
2010.2	2010.2	This section has been revised to include a discussion of the internal and external factors that should be considered in the formulation of loan policies. Also, the components that form the basis for a sound loan policy for all loans have been amended in light of the Board's December 23, 1992, adoption of a uniform rule and guidelines for state member banks on real estate lending. The section also includes a brief summary of the Board's March 30, 1993, adoption of an interagency policy to encourage small-business lending by state member banks.
2050.0.3.2 2050.0.3.3 2050.0.3.11	2050.0.3.2 2050.0.3.3 2050.0.3.11	The section was revised to implement amendments to Regulation O, effective December 17, 1992. The Board revised the definition of "principal shareholder" in section 215.2(*l*) of Regulation O to implement recent amendments to section 22(h) of the Federal Reserve Act contained in the Housing and Community Development Act of 1992. This section has been revised to include three exceptions to the aggregate insider lending limit, an amendment to the Board's Regulation O effective May 3, 1993.
2130.0	2130.0	The Supervisory Policy Statement on the Selection of Securities Dealers and Unsuitable Investment Practices, issued in 1988, was superseded by the Supervisory Policy Statement on Securities Activities, issued in 1992. References were revised accordingly.
2185.0	2185.0	The revisions of this section, and in particular subsection 2185.0.5.4.2, reflect the Board's adoption of an alternative indexed-revenue test in addition to the present unadjusted-revenue test that has been used over the past several years. Adopted by the Board by order on January 26, 1993, the indexed-revenue test adjusts dividend and interest revenue for the change in interest rates on Treasury securities since September 1989. The indexed-revenue test was to be applied prospectively (from the first 1993 calendar quarter forward). On February 23, 1993, the Board issued a supplement to its earlier order, indicating that if a section 20 subsidiary had the duration data available to begin measuring compliance with the test on an eight-quarter rolling-average basis immediately, it could do so after notifying its Federal Reserve Bank.

New Section Number	*Previous Section Number*	*Description of the Change(s)*
2190.0.5	2190.0.5	This section was revised to include a summary of a supervisory policy statement on securities activities adopted by the Board. The discussion focuses only on that portion dealing with mortgage-derivative securities products.
2250.0.3.2	2250.0.3.2	This subsection has been revised to reflect a 1992 change in report-submittal instructions. The FR Y-6A report, Bank Holding Company Report of Changes in Investments and Activities, must be submitted to the appropriate Reserve Bank within 30 calendar days of a reportable transaction.
3185.0	3185.0	This section was revised to reflect a FDICIA amendment (the Oakar II Amendment) that permits the merger of a savings association with a Bank Insurance Fund (BIF) member outside the holding company system.
3500.0	3500.0	This section, dealing with tie-in arrangements, has been further revised based on SR-82-41.
3600.8		This new section discusses a Board order authorizing a foreign bank holding company and its wholly owned subsidiary, a commercial banking organization, to engage de novo in various nonbanking activities, including an activity that was not previously approved by the Board—engaging in securities credit activities that include acting as a conduit or intermediary in securities borrowing and lending.
4030.0.2	4030.0.2	This subsection was revised to include the required written risk assessment of each active nonbank subsidiary, addressing specified financial and managerial concerns. This requirement was included as part of the supplementary guidance issued for the inspection of nonbank subsidiaries of BHCs, as set forth in SR-93-19.
4060.3.5.2.3	4060.3.5.2.3	This subsection has been revised based on an interim rule (effective December 29, 1992) and a final rule (effective April 26, 1993), amending the risk-based measure of the capital adequacy guidelines. Loans involving one- to four-family residential properties now include loans to builders involving substantial project equity for the construction of such residences, subject to certain qualifying criteria. The risk weight on loans to finance the construction of one- to four-family residences that have been presold has been lowered from 100 to 50 percent. The interim rule implements section 618(a) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 (RTCRRIA).

New Section Number	*Previous Section Number*	*Description of the Change(s)*
4060.3.5.3.1	4060.3.5.3.1	This section has been revised to include modifications (effective December 30, 1992) of the Board's risk-based capital guidelines involving transactions collateralized by cash. The risk weight was lowered from 20 percent to zero for certain transactions that are collateralized by cash and OECD central government securities, provided the transactions meet specified criteria.
4060.4	4060.4	This section has been revised to limit the discussion to the leverage measure of the capital adequacy guidelines for BHCs.
5000.0.4.4		This new subsection sets forth supplementary guidance regarding the on-site BHC inspection and the off-site review of BHC nonbank subsidiaries, as found in SR-93-19.
5000.0.11	5000.0.11	This subsection has been added to reflect the adoption of a maximum 60-calendar-day completion standard for inspection reports (SR-93-4).
5010.2	5010.2	The confidentiality statement on the cover of the inspection report has been revised in accordance with SR-93-9.
5010.7	5010.7	This section was revised to incorporate into the inspection report, as part of the ''Analysis of Financial Factors'' page, a combined risk assessment of the inspected BHC's nonbank subsidiaries (SR-93-19).
5010.31	5010.31	This revised section includes the requirement that examiners prepare a written risk assessment of each nonbank subsidiary, as set forth in SR-93-19. The risk assessment is to be documented on the ''Nonbank Subsidiary'' page of the inspection report or on another equivalent workpaper.
5030.0	5030.0	The ''Nonbank Subsidiary'' page of the inspection report has been revised to include a risk assessment, in accordance with SR-93-19.

FILING INSTRUCTIONS

Remove	*Insert*
	Protector sheet with checklist for supplements
Title page	Title page
1010.0, pages 11 through 14 pages 27 and 28 pages 31 through 40	1010.0, pages 11 through 14 pages 27 and 28 pages 31 through 40
2010.2, pages 1 through 4	2010.2, pages 1 through 5
2050.0, pages 1 through 9	2050.0, pages 1 through 9

Remove	*Insert*
2130.0, pages 19 and 20 page 27	2130.0, pages 19 and 20 page 27
2185.0, pages 1 through 8 pages 23 through 26	2185.0, pages 1 through 8 page 8.1 pages 23 through 26
2190.0, pages 1 through 8	2190.0, pages 1 through 9
2190.1, pages 1 through 4	2190.1, pages 1 through 4
2250.0, pages 1 and 2	2250.0, pages 1 and 2
3000.0, pages 9 and 10	3000.0, pages 9 and 10
3185.0, pages 1 and 2	3185.0, pages 1 and 2
3500.0, pages 1 through 3	3500.0, pages 1 through 4
	3600.8, pages 1 and 2
4030.0, page 1	4030.0, pages 1 and 2
4060.3, pages 1 through 24	4060.3, pages 1 through 26
4060.4, pages 1 through 3	4060.4, pages 1 and 2
5000.0, pages 5 and 6	5000.0, pages 5 and 6 pages 6.1 and 6.2 page 15
5010.2, pages 1 and 2	5010.2, pages 1 and 2
5010.7, pages 1 and 2	5010.7, pages 1 and 2
5010.14, pages 1 and 2	5010.14, pages 1 and 2
5010.31, page 1	5010.31, page 1
5030.0, pages 37 and 38	5030.0, pages 37 and 38
6000.0, pages 1 through 6 pages 19 through 26 pages 33 and 34 pages 37 and 38 pages 41 through 47	6000.0, pages 1 through 6 pages 19 through 26 pages 33 and 34 pages 37 and 38 page 41 through 47

Bank Holding Company Supervision Manual
Supplement 3—December 1992

This revised manual comprises the third revision of the Bank Holding Company Supervision Manual. It represents an updating of the Bank Holding Company Supervision Manual by the Division of Banking Supervision and Regulation for the period of July 1991 to December 1992. The revision includes decisions of the Board of Governors, new and revised statutory and regulatory changes, and other items of a supervisory nature.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change(s)*
2010.0.1	2010.1.1	The Board's Source of Strength Policy has been moved to this subsection for the general supervision of subsidiaries.
2010.0.2		This subsection was revised to include a discussion of the Board's denial of a December 1991 BHC request to waive any requirement of the Board that it serve as a source of financial strength to the subsidiary bank (the Board's "Source of Strength" policy).
2010.2	2010.2	This loan administration section, as it pertains to a BHC's supervision of subsidiaries, has been revised to include the supplementary guidance on real estate loans provided by SR 91–16 (July 1991). Sound lending policy components items 11 and 12 have been expanded with regard to the establishment, monitoring, and assessment of policies that control risk from asset concentrations. It also discusses the administration of real estate construction and mini-perm loans. In addition, sound lending policy component item 14 was revised to encourage management to dictate appropriate guidance as to the extent of overall disclosure of past due (nonaccrual) loans. Item 15 was also revised to include March 1991 guidance on using a comparison of the Allowance for loan and Lease losses to loans classified substandard.
2010.5		The new section discusses the liability associated with clean-up of hazardous substance contamination as it relates to the Comprehensive Environmental Response, Compensation and Liability Act. The Act addresses the problem of proper handling and disposal of hazardous substances. Reference: SR 91–20.
2020.5.4	2020.5.4	This section was amended to include a reference to the Board's December 1990 amendment of Regulation H for the payment of dividends by state member banks.
2020.6	2020.6	Section was amended with a provision of FDICIA as to the assessment of management fees that would result in a financial institution being undercapitalized.
2030.0.2		This new subsection has been added to discuss the two year extension for engaging in nonbanking activities and controlling voting securities or assets of a nonbank subsidiary (section 225.33(e) of Regulation Y).

New Section Number	*Previous Section Number*	*Description of the Change(s)*
2030.0.5	2030.0.5	This subsection, relating to the expansion of grandfather activities, was revised with regard to the discussion on Appendix 1 relating to the acquisition of assets. The criteria for a permissible purchase of an asset in the ''ordinary course of business,'' as stated in an interpretation of Regulation Y, section 12 C.F.R. 225.132, was revised by the Board, effective June 29, 1992. The criteria for determining whether an acquisition of nonbank assets would be presumed to be significant, based on the book value of nonbank assets being acquired, was changed from 20 to ''. . . 50 percent of the book value of the nonbank assets of the holding company or nonbank subsidiary comprising the same line of activity.''
2060.1	2060.1	This section was revised to instruct examiners to consider the size of audit staffs of peer banking organizations when evaluating the effectiveness of an internal audit program.
2060.1.4	2060.1.4	This revised subsection includes additional inspection procedures addressing the review of audit scope, audit scope limitations, the extent of reliance on internal audit staff by external auditors, and the independence of the external auditors including any potential conflicts of interest.
2065.1		A new section has been added to provide guidance dealing with disclosure, accounting, and reporting issues relating to nonaccrual loans and restructured debt. The discussion incorporates the July 1991 (SR 91–16) guidance that was issued to supplement the March 1, 1991 joint Federal bank and thrift regulatory agency statement that clarified certain supervisory and accounting policies.
2065.2		This new section relates to the need for management to apply fully documented and consistent methods of determining the adequacy of the allowance for loan and lease losses. The section discusses factors to consider in determining the outstanding amounts of this valuation allowance. Guidelines are also provided that the examiners should observe when they evaluate the adequacy of the allowance and the methods used to determine the account balance. Inspection objectives and procedures are included.
2070.0	2070.0	This revised section includes a general discussion of the new accounting standard for income taxes (FASB Statement No. 109) with respect to deferred tax assets. The revision also conveys the Federal Reserve's position that implementation of this new standard should not occur for reporting purposes (with the Federal Reserve) until a final evaluation is completed and further notice is given. The schedule of deadlines and due dates for tax estimate payments and filing extensions has been updated.
2090.0	2090.0	This section was revised to reflect the current provisions of Regulation Y as to the rebuttable presumptions of control.

New Section Number	*Previous Section Number*	*Description of the Change(s)*
2090.1	2090.1	This change in control section has been revised to reflect FIRREA provisions. Of particular note are the statutory corrective action measures that may be used for violations of the Change in Bank Control Act.
2090.2	2090.2	This section was revised to reflect the capital requirements for small one-bank holding company formations found in Appendix C of Regulation Y. Additional explanatory narrative is provided, discussing, from a historical perspective, how revisions to the capital adequacy guidelines have been applied to the policy statement. The benefits of filing a consolidated tax return for the bank holding company are briefly discussed.
2090.3	2090.3	This section was revised to reflect the current provisions of Regulation Y for treasury stock redemptions. This includes the Board's November 9, 1990 revision of Regulation Y to not require notices if regulatory clearance had already been received to acquire 10 percent or more of the voting shares of a state member bank or bank holding company, and subsequent ownership resulted in treasury stock redemptions of between 10 and 25 percent. Clarification has been provided as to when SEC registration is required under the 1934 SEC Act. The inspection procedures have been expanded to alert examiners as to treasury stock redemption practices that may result in the undermining of the banking organization's capital position.
2090.4	2090.4	This section was revised to add references for the discussed policy statement.
2090.5	2090.5	Section was revised to reflect the current provisions of section 225.12 of Regulation Y (transactions not requiring Board approval).
2090.6	2090.6	This section on divestiture control determinants was revised to reflect the current structuring of Regulation Y and to include additional references in subsection 2090.6.3.
2090.7	2090.7	Subsection 2090.7.1 was revised to include footnote no. 1 discussing FIRREA provisions that prohibit allowing an affiliate of a nonbank bank or industrial bank to incur overdrafts at the bank or Federal Reserve Bank. Subsection 2090.7.2 was added to provide respective references.
2100.0	2100.0	This section on foreign banking organizations was revised to reflect FDICIA's amendment of the International Banking Act of 1978. The Federal Reserve's authority over foreign bank operations (including representative offices in the U.S.) was increased.

New Section Number	*Previous Section Number*	*Description of the Change(s)*
2130.0	2130.0	This section has been revised to reflect current operational activities and terms that would be encountered in the futures, forwards, and options markets. The section has been expanded to include a discussion of option and other derivative financial contracts such as calls, puts, caps, floors, and collars. Various hedging and other contract strategies are also reviewed.
2175.0		Section incorporates examiner guidelines (SR 91–14) for reviewing the sale of uninsured annuities by BHCs and banks that have legal authority to act as agent in their sale.
2185.0	2185.0	The section has been revised to provide additional section 20 company inspection procedures and definitive guidance with regard to: 1) customer complaint files; 2) the gross revenue test; 3) extensions of credit and purchases and sales of assets; 4) the review of service agreements with affiliates; 5) making a market in securities; 6) directors of subsidiary banks serving as directors of a section 20 subsidiary; 7) the placement of advertising materials for a section 20 subsidiary in affiliated bank subsidiaries; 8) issues dealing with corporate separateness and measures that should be taken to avoid customer confusion as to the non-federally insured status of a section 20 subsidiary; 9) the section 20 subsidiary serving as agent for a bank or thrift affiliate; 10) bank officer bonuses versus section 20 subsidiary activities; 11) a section 20 subsidiary's purchase of syndicate securities from another syndicate member; 12) a section 20 subsidiary engaging in repurchase and reverse repurchase agreements with respect to U.S. Treasury securities with a foreign subsidiary of an affiliated bank; 13) revenue classification with regard to ''loans'' versus ''securities''; 14) the SEC's RULE 144A (safe harbor exemption from the 1933 Act for restricted securities that are sold in the ''private placement'' market to qualified ''institutional buyers);'' and 15) entering bid or ask quotations or publishing ''offering wanted'' or ''bid wanted,'' notices on trading systems other than an exchange or NASDAQ.
2190.1		This new section discusses credit supported and asset-backed commercial paper (SR 92–11). Along with a description of such programs, the policies and procedures that the banking organization should have for such a program are discussed. Included with the section are guidelines relating to the risk-based capital treatment for such programs. Inspection objectives and procedures are also provided.
	2230.0	The December 1987 Supervisory guidelines for real estate appraisal policies and review procedures have been removed from the manual. They have been replaced by the Board's September 1992 Guidelines for real estate appraisal and evaluation programs, now found in Appendix A of manual section 2231.0.

New Section Number	*Previous Section Number*	*Description of the Change(s)*
2231.0		This new section discusses provisions of Title IX of FIRREA as to real estate-related financial transactions requiring the services of an appraiser. Appraisals must be in writing and be prepared in accordance with uniform standards and be performed by individuals with demonstrated competency. The section discusses the Board's appraisal regulation (see Manual section 3270.0) and the need for banking organizations to adopt appraisal and evaluation policies. The Board's guidelines for real estate appraisal and evaluation programs are included in Appendix A.
2240.0	2240.0	This former section on ''Guidelines for the Review and Classification of Troubled Real Estate Loans'' has been revised to incorporate additional Examiner guidance resulting from the November 1991 interagency policy statement on the ''Review and Classification of Commercial Real Estate Loans'' (SR 91–25).
3000.0	3000.0	Appendix 1 has been revised to add the Board's April 22, 1992 approval of higher residual value leasing, the provision of full service brokerage services for institutional and retail customers, and certain financial advisory activities for inclusion on the Regulation Y permissible nonbanking activities ''laundry list''. Appendix 2 has been amended to include additional Board actions disseminated by Board order. Appendix 3 was amended to include the Board's January 9, 1991 denial of a request by three BHCs to engage in clearing securities options and other financial instruments for the accounts of professional floor traders.
3130.2	3130.2	Section was revised to reflect current tax treatment for REITs and to discuss their funding and their various types.
3130.4 3130.5 3130.6 3130.7	3600.12 3600.25 3600.35 3600.41	These sections were relocated and amended as the result of the Board's adding the provision of full service securities brokerage to section 225.25(b)(15) of Regulation Y, effective September 10, 1992.
3140.0	3140.0	This section has been revised to incorporate the Board's April 1992 adoption of higher residual value leasing as a nonbanking activity authorized for BHCs under section 225.25(b)(5) of Regulation Y. The section also has been revised to include current accounting guidance for lessors and lessees for operating and capitalized leases.
3230.1 3230.2 3230.3	3600.22 3600.32 3600.42	These sections were relocated and amended to accommodate the Board's adding of the advisory nonbanking activities to section 225.25(b)(4) of Regulation Y, effective September 10, 1992.
3240.0	3240.0	The introduction was revised to recognize section 20 subsidiary nonbanking activities. Subsections 3240.0.7.2 and 3240.0.12 have been revised to incorporate references to section 23B of the Federal Reserve Act.
3250.0.7	3250.0.7	Added a reference to section 23B of the FRA to FCM inspection procedure 6.c.

New Section Number	*Previous Section Number*	*Description of the Change(s)*
3500.0.6		This new subsection provides an inspection checklist for ensuring compliance with the prohibitions against tying arrangements. The checklist addresses written policies and procedures, training, and audit procedures.
3510.0	3510.0	This section has been revised to reflect provisions of the Board's Regulation K as of April 8, 1992, as it pertains to nonbanking activities of foreign banking organizations (12 C.F.R. 211.24).
3550.0	3550.0	This revised section includes a general discussion of requirements and limitations for U.S. banking organizations investing in or engaging in foreign banking activities. The section includes brief discussions of amendments to Regulation K by the Board that were effective May 24, 1991, expanding the scope of international activities. The Board expanded the existing authority to: 1) to engage, after March 27, 1991, with the Board's approval, in underwriting and dealing in equity securities outside the U.S.; 2) increase the current dollar limits under which U.S. banking organizations may make investments abroad without prior notice to the Board; 3) clarify the portfolio-investment authority under which U.S. banking organizations may make limited equity investments in any type of company outside the U.S.; 4) expand the range of permissible activities for U.S. banking organizations abroad to include futures commission merchant activities and life insurance underwriting; 5) modify the authority for debt-for-equity investments; and to 6) authorize case-by-case exemptions from the standard for qualifying banking organizations.
3560.0	3560.0	The discussion of section 23A of the FRA was amended to include section 23B of that Act. Subsection 3560.0.1.1 (item 7) was also amended with this change.
3600.5	3600.5 3600.8	The previous sections were combined for nonbank activities involving foreign branches.
3600.6.4		A new subsection discusses the Board's July 1991 order authorizing the applicants to trade, through a wholly owned nonbanking subsidiary, in futures, options, and options on futures (derivative instruments) that are based on U.S. government bank-eligible securities and certain money market instruments.
3600.6.5	3600.43 3600.47	These former sections were combined with Manual section 3600.6. The section was expanded to also include brokering, dealing, and specializing in options.
3600.7	3600.7 3600.44	These former sections were combined into one section for broker–dealer services.
	3600.9	This former section was deleted and reserved for future use.
3600.11	3600.12	Section was renumbered.

New Section Number	*Previous Section Number*	*Description of the Change(s)*
3600.12	3600.13 3600.20 3600.23 3600.34	These former sections were combined into one section for payment instruments.
3600.13	3600.14 3600.15	These former sections were combined into one section for FCM brokerage of securities.
3600.14	3600.17	This section was renumbered.
3600.15	3600.18 3600.37	These former sections have been combined into one section for consulting services.
3600.15.3		This new subsection discusses the Board's authorization for two BHCs to provide through a nonbank subsidiary, management consulting services to governmental agencies (i.e. FDIC and the RTC) and unaffiliated financial institutions with troubled assets.
3600.16	3600.19	Section was renumbered.
3600.17	3600.21 3600.39	These former sections have been combined into one section for insurance nonbanking activities.
3600.18	3600.26 3600.38 3600.51	These former sections were combined into one section for investment advice.
3600.20	3600.27	Section was renumbered.
3600.19	3600.24 3600.45	These former sections were combined into one section for private placement and riskless principal nonbanking activities.
3600.21	3600.28 3600.29 3600.30 3600.40	These former sections were combined into one section for underwriting and dealing nonbanking activities.
	3600.31	This former section was deleted.
3600.22 3600.23 3600.24 3600.25 3600.26	3600.33 3600.36 3600.49 3600.48 3600.50	These sections were renumbered.
3700.2	3700.3 3700.9 3700.10 3700.11 3700.14	These former sections are combined into one section for impermissible insurance activities.

New Section Number	*Previous Section Number*	*Description of the Change(s)*
3700.3 3700.4 3700.5 3700.6 3700.7 3700.8 3700.9 3700.10 3700.11	3700.4 3700.5 3700.6 3700.8 3700.12 3700.13 3700.15 3700.16 3700.17	These sections were renumbered.
3700.12		This new section discusses the Board's January 1991 denial of an application to engage, through a wholly owned subsidiary, in clearing securities options and options on other financial instruments for the accounts of professional floor traders. One issue centered on plans to provide only clearance services, rather than execution and clearance services where risk could be better controlled. Another issue centered on the absence of an effective means to monitor and limit the potential credit risk exposures to the parent bank holding company resulting from transactions initiated by professional floor traders.
4010.0	4010.0	This section was revised to reflect the April 1990 single inspection report format per SR 90–13 and to incorporate risk-based capital changes. Subsections 4010.0.3 and 4010.0.7 were amended to recognize Tier 1 capital instead of primary capital.
4020.1	4020.1	This section has been revised to recognize the risk-based and leverage bank capital measures of the capital adequacy guidelines. The examiner must analyze the adequacy of bank capital based on the guidelines. The examiner is referred to section 303.1 of the *Commercial Bank Examination Manual* for further guidance.
4020.3	4020.3	This section was revised to reflect the Boards amendment of Regulation H (section 208.19), as it pertains to the payment of dividends by state member banks.
	4020.6	This section was deleted.
	4060.2	This former section has been deleted. It represented the capital adequacy guidelines based on primary, secondary, and total capital.
4060.3.2.1 4060.3.6.1	4060.3.2.2 4060.3.6.2	These subsections were revised based on the Board's January 14, 1992 lifting of the limit on the amount of noncumulative perpetual preferred stock that BHCs may include in Tier 1 capital for the purposes of calculating their risk-based and Tier 1 leverage capital ratios.

New Section Number	*Previous Section Number*	*Description of the Change(s)*
4060.3.2.1.1.1		This subsection was added to reflect the Board's view that common equity should remain the dominant form of a banking organization's capital structure, as stated in its January 14, 1992 amendment to the risk-based and Tier 1 leverage capital measures. The situation is discussed when banking organizations are deemed to clearly have an overreliance on nonvoting equity elements in Tier 1 capital.
4060.3.2.1.1.2		This new subsection discusses perpetual preferred stock that is convertible to common stock. Generally such preferred stock is not included in Tier 1 capital.
4060.3.2.1.1.3		This new subsection states that excess minority interests in the form of a subsidiary's preferred stock would usually be excluded from capital.
4060.3.5.2.4		This new subsection is added to address the treatment of residential mortgages sold with recourse that are not already included on the balance sheet. Such assets are to be converted at 100 percent and assigned to the highest risk weight appropriate to the obligor or the nature of any collateral or guarantees. An exception applies to transfers of pools of residential mortgages.
4060.3.5.3.3	4060.3.5.3.2	This revised subsection discusses the zero conversion factor capital requirements for commitments that expire within one year but are subject to renewal (under a six to eight week renegotiation period).
4060.3.5.3.7		This subsection discusses the capital treatment of assets sold with recourse. Capital must be held against such assets when any risk of loss is retained.
4060.3.5.4.2		This subsection sets forth qualification criteria for subordinated debt of a BHC to be included in Tier 2 capital (Ref: SR 92–37). Also discussed, is the Board's August 28, 1992 Regulation Y interpretation that sets forth the criteria that subordinated debt must meet to be included in capital. The section refers to certain events, default clauses, or terms that could prevent subordinated debt from being included in capital. Certain acceptable terms are also included.
4060.3.6.2		This subsection discusses certain terms that may or *may not* qualify perpetual preferred stock for Tier 1 capital treatment.
4060.3.7	4060.3.7	This section was revised to include the Board's October 4, 1991 revision (effective November 7, 1991) to paragraph II.A.1.b. of the risk-based measure of the capital adequacy guidelines. The provision provides that any perpetual preferred stock with a feature permitting redemption at the option of the issuer qualifies as capital *only if* the redemption is subject to prior approval by the Federal Reserve.

New Section Number	*Previous Section Number*	*Description of the Change(s)*
4060.3.9	4060.3.9	This subsection was revised to include the 12 CFR 225, appendix B criteria for mandatory convertible debt securities and perpetual debt for inclusion as Tier 2 capital in the risk-based capital measure as referenced in section II.A.2.c. of the risk-based capital guidelines.
4060.3.9.1 4060.3.9.2		These subsections have been added based on the Board's August 18, 1992 interpretation of Regulation Y with regard to the limitations on the amount of subordinated debt that is to be included in Tier 2 capital. These sections discuss the capital treatment of such debt with dedicated proceeds or segregated funds.
4060.3.9.3	4060.2.3.5.1	This subsection was added to include the 12 CFR 225, appendix B criteria applicable to both types of mandatory convertible securities for inclusion as Tier 2 capital, as referenced in section II.A.2.c. of the risk-based capital guidelines.
4060.3.9.3.1	4060.2.3.5.2	This new subsection includes the additional criteria applicable to equity contract notes referenced in the risk-based capital guidelines, as described above.
4060.3.9.3.2	4060.2.3.5.3	This new subsection includes the additional criteria applicable to equity commitment notes referenced in the risk-based capital guidelines, as described above.
4060.8	4060.8	This section was revised to reflect the Board's February 1992 phasing out of the use of the formal HLT definition. The action was taken on an interagency basis (with the OCC and the FDIC). The formal definition had accomplished its original objectives of focusing attention on the need for internal controls and review mechanisms for monitoring and structuring HLTs, in a manner consistent with the associated risks. The revised section continues, and does not change, the general responsibilities of banking organizations for administering HLTs, the methods of HLT financing, and the HLT inspection guidelines and considerations.
4070.0.8	4070.0.8	This subsection was revised to make reference to the risk-based and leverage capital measures, discussed in more detail in sections 4060.3 and 4060.4. The section also acknowledges the September 18, 1992, issuance of final Prompt Corrective Action Measures for state member banks, as a result of FDICIA.
4090.0	4090.0	The section was revised to reflect the change from semiannual to quarterly reporting on the Country Exposure Report (Form FFIEC 009).
5000.0.1	5000.0.1	This subsection, representing the general instructions for the BHC inspection program, has been revised to incorporate Board and System Task Force changes to inspection reporting by SR 90–13 (April 1990). The inspection report was condensed to one basic format for all bank holding companies.

New Section Number	*Previous Section Number*	*Description of the Change(s)*
5010.1	5010.1	This section has been revised to indicate that the inspection report now consists of a Core section and a Confidential section. Additional supporting schedules are to be added to the open section when an existing area of concern or problem is addressed within the report. The section lists report pages that are to be included in the Core section of the inspection report for BHCs under or over $150 million or more in consolidated or total assets, as applicable. Also discussed are new or revised report pages that have been added to the confidential section (i.e. Liquidity and Debt Information and Administrative and Other Matters). A list of supporting report pages is also included.
5010.3	5010.3	The Table of Contents report form has been revised to list the core pages to be included in the report. Supporting report pages follow the core pages.
5010.4	5010.4	The Examiner's Comments instructions have been revised to indicate that the BOPEC financial composite rating is to be stated (SR 88–37).
5010.5	5010.5	The instructions for the Scope of the inspection were revised for identifying peer groups and for inclusion of source information as to the administration of policies and supervision over subsidiaries. The examiner is also to comment on the extent of reliance on internal or other regulatory agency classifications.
5010.6	5010.13	This revised report page and instructions for ''Structure and Abbreviations'' replaces the former ''History and Structure'' page. The instructions have been amended to include the April 1990 revisions of SR 90–13.
5010.7	5010.7	The consolidated portion of the instructions for the Analysis of Financial Factors core page have been amended to include an analysis of asset quality and the adequacy of valuation reserves. Subsection 5010.7.5 provides for the use of an alternate format for the analysis of financial factors for larger and more complex bank holding companies.
5010.10	5010.10	This section provides the form and instructions for the ''Summary of Consolidated Criticized Assets and Other Transfer Risk Problems'' set forth in SR 90–13 and revised for risk-based capital by AD 91–25. The form replaced the ''Summary of Examiner's Classifications of Parent Company and Nonbank Subsidiary Assets'' report page. The new form is to contain, by BHC organizational level, information and methods used by the examiner for determining consolidated asset quality. The report page summarizes criticized or classified assets, off-balance sheet risk (listed separately) and other transfer risk problems. Subsection 5010.10.1.1.1 includes the September 1981 (SR 91–18) classification guidelines for an asset when a substantial portion of the asset has been charged-off.

New Section Number	*Previous Section Number*	*Description of the Change(s)*
5010.10 continued	5010.10 continued	The reporting instructions have been revised as to the weighted classified asset treatment of ‘‘value impaired’’ assets. In accordance with SR 92–2, value impaired classifications are now weighted the same as substandard classifications at 20 percent. Previously, these assets were weighted the same as ‘‘doubtful’’ classifications at 50 percent, net of the allocated transfer risk reserves (ATRR).
5010.13	5010.32	The ‘‘Capital Structure’’ report page and instructions have been revised to reflect the capital adequacy guidelines based on the risk-based measure and the Tier 1 leverage measure. The report forms were derived from AD 91–25. The instructions are split between BHCs with consolidated assets of $150 million or more and those with a lesser amount, whereby the FR 1241 report form is used for the lead bank or comparable bank subsidiary(ies).
5010.13	5020.21	The ‘‘Capital Structure’’ (FR 1241) report page and instructions have been revised to reflect the capital adequacy guidelines based on the risk-based measure and the Tier 1 leverage measure (refer to AD 91–25). The instructions for this report page are included in Manual section 5010.32.
5010.14	5010.6	The ‘‘Policies and Supervision’’ page was revised to include a discussion and appraisal of the parent company’s policies with respect to dividends paid to stockholders.
5010.17	5010.11	The ‘‘Classified Assets and Capital Ratios of Subsidiary Banks’’ report page and instructions have been revised to incorporate changes from revisions to the capital adequacy guidelines—the risk-based measure and the leverage measure.
5010.37		The ‘‘Interest Rate Sensitivity—Assets and Liabilities’’ report page is a new page, accompanied by instructions, that was developed for reporting consolidated interest rate sensitivity based on pre-determined maturity categories.
5010.40	5010.39 5010.40	The ‘‘Principal Officers and Directors’’ confidential report page and instructions represents a condensing of former confidential page A—Principal Officers and former confidential page B—Directors per SR 90–13. For the revised report page, the salary, directors fees and other remuneration, and certain ownership information, was made optional and reserved for inclusion in other supporting schedules.

New Section Number	*Previous Section Number*	*Description of the Change(s)*
5010.41	5010.41	The confidential ‘‘Condition of the Bank Holding Company’’ report page and instructions have been revised to include additional ownership information. The review of ownership is to include a determination whether an individual or group of shareholders exercises significant influence over the BHC. Also the fiduciary holdings of the parent company stock are to be discussed. Management comments should include an assessment of the effectiveness and control of supervision over subsidiaries. Comments on risk evaluation and management information systems are also to be included.
5010.42	5010.31	The confidential ‘‘Liquidity and Debt Information’’ report page and instructions were derived from the former ‘‘Unaffiliated Borrowings’’ report page. The revised report page expands certain information on commercial paper borrowings and funding gap for the parent company.
5010.43	5010.42	The ‘‘Administrative and Other Matters’’ confidential page D is the fundamental successor to the former ‘‘Other Matters’’ confidential page. The records checklist and the internal revenue service audit statement have been removed. Space has been provided for suggestions for the next inspection. Planning information can also be provided for on-site work to be performed for the next inspection.
5010.44	5010.43	In accordance with SR 90–13, the former ‘‘Statistical Data Sheet’’ confidential report pages were replaced by the Inspection Summary FR 1417 and FR 1417a. These schedules provide the necessary statistical and other supporting data to give the reader a thorough, yet brief, summary of the financial condition and operations of the BHC. The final summary will comprise the last pages of the confidential section of the report. Reserve Banks can elect to provide the former ‘‘Statistical Data Sheet pages’’ in addition to the FR 1417/1417a. The inspection summary was revised by AD 91–25 to incorporate changes to the capital adequacy guidelines based on the risk-based measure and the Tier 1 leverage measure.
5020.1	5020.18	The ‘‘Bank Subsidiary’’ (FR 1241) report page and instructions were revised to include the ratio of weighted classified assets to Tier 1 capital plus the allowance for loan losses (ref. AD 91–25).
5030.0		This section contains all inspection reporting forms currently in use. A reference list of the forms is provided.

The *Bank Holding Company Supervision Manual* has been prepared by Federal Reserve supervision personnel to aid in the conduct of on-site inspections of bank holding companies (BHCs) and their nonbank subsidiaries and of financial holding companies (FHCs). The manual presents a compilation of formalized procedures and Board supervisory policies that supervision and inspection personnel should follow, and it includes new concepts introduced to keep pace with the ever-changing industry. An integral part of the Federal Reserve's overall program to supervise banking organizations under a holding company structure, the manual enhances the staff's ability to implement the Board's inspection and monitoring efforts.

The manual is designed to provide guidance to examination and supervision personnel. *It should not be considered a legal reference.* Questions concerning the applicability of and compliance with federal laws and regulations should be referred to appropriate legal counsel.

The Federal Reserve System conducts risk assessments and a full-scope inspection program for BHCs. At a minimum, full-scope inspections should include sufficient procedures to reach an informed judgment on the assigned ratings for the factors included in the BOPEC rating system for BHCs. The procedures of a full-scope inspection focus in part on assessing the types and extent of risks to which a BHC and its subsidiaries are exposed. Some of these types of risks include credit, market, liquidity, operational, legal, and reputational risks. Inspections also focus on evaluating the organization's policies and procedures for identifying, managing, and controlling such risk exposures, and determining whether the management and directors are actively involved in the oversight of the organization's risk-management program. Inspections or reviews also generally include transaction and compliance testing to determine whether the organization's policies and procedures for risk management are fully effective and being followed.

The inspection process commences with a preliminary risk assessment. The risk assessment highlights the strengths and weaknesses of the holding company and provides a basis for determining the procedures to be conducted during an inspection. Risk assessments identify the organization's principal business activities and the types and quantities of risks associated with the activities (including those conducted off-balance-sheet). The quality of management and control of risks is factored into the initial risk profile of the holding company. Sources of information for the risk assessment include prior bank and BHC inspection reports and workpapers, surveillance program reports, and regulatory reports. Other relevant supervisory materials derived from within the Federal Reserve System or other federal and state banking supervisors, as well as from other responsible regulatory agencies, such as the Securities and Exchange Commission and state insurance authorities, are also used. Other sources for the risk assessment may include the banking organization's publicly available reports, such as annual and other periodic reports and informational releases; strategic plans and budgets; internal management reports; information packages for the board of directors; correspondence; the board of directors executive and audit committee minutes; internal-audit workpapers and reports; and stock-analysis reports. The activities, transactions, and identified areas having the most significant risks, inadequate risk-management processes, or rudimentary internal controls will represent the banking organization's highest risks. The risk-assessment process will culminate in a formalized and structured supervisory strategy to be followed when conducting an inspection.

The banking organization's highest risks are expected to undergo the most rigorous scrutiny, analysis, and transaction testing by examiners and supervisors. Transaction testing is a reliable and essential inspection technique for assessing the banking organization's condition and verifying its adherence to internal policies, procedures, and controls. Transaction testing alone, however, is not sufficient for ensuring safe and sound operations in a highly dynamic banking environment. The changing financial instruments and markets allow institutions to rapidly reposition their portfolio risk exposures. To ensure that banking organizations have systems in place to identify, measure, monitor, and control their changing risk exposures, inspections focus further on evaluating the banking organization's risk-management processes. These risk-management evaluations determine the extent to which the banking organization's management processes can be relied on.

The full-scope inspection may be conducted at a point in time or through a series of targeted or limited-scope reviews conducted on an ongoing or continuous basis for the largest and most complex banking organizations. Irrespective of the duration of the inspection, planned supervisory activities should be coordinated well in advance with other responsible bank, thrift, and functional regulators to avoid duplication of effort and to minimize burden on the banking organization. Supervisory findings of inspections should be communicated to the banking organization's management or boards of directors, as well as to the banking organization's other bank supervisors and functional regulators, where relevant.

The inspection also measures the financial strength of the FHC or BHC and focuses on financial indices of both the consolidated entity and its component parts. In addition to the analysis of risk, the other principal indices appraised are quality of assets, earnings, capital adequacy, cash flow and liquidity, and the competency of management. In addition, an inspection or supervisory program should assess the banking organization's program for the transactions between insured subsidiaries and affiliates. The basic objective of this assessment is to determine the impact or consequences of transactions between the parent holding company or its nonbanking subsidiaries and the insured subsidiaries. Of particular importance is whether intercompany transactions result in a diversion of income or income opportunity from an insured subsidiary to a holding company affiliate.

The competency of BHC management in overseeing the banking organization's business activities, risk management, and financial condition is also evaluated. The FHC and BHC inspection process provides a vehicle for a comprehensive assessment of the effectiveness of management, resulting in a more open and informed dialogue between management and representatives of the Federal Reserve.

In summary, the inspection process is intended to increase the flow of information to the Federal Reserve System concerning the soundness of FHCs and BHCs. This information will permit the Federal Reserve to encourage sound banking practices and to take appropriate supervisory action when warranted.

This manual is updated periodically to reflect current supervisory policy and procedures and changing practices within the industry. The manual is also available on the Board's public web site at www.federalreserve.gov/boarddocs/supmanual/. We solicit the input and contribution of all supervisory staff and others in refining and modifying its contents. Please address all correspondence to Director of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

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1020.0.1 INTRODUCTION

This manual is designed to aid personnel of the Federal Reserve System in supervising bank holding companies. As such, it will review in considerable detail current policies and procedures for supervising the financial affairs of these banking organizations and will also discuss statutes, regulations, interpretations and orders that pertain to bank holding company supervision. Before proceeding, however, it is desirable to step back and view bank holding companies and their supervision in a broader perspective. This preface is designed to provide that perspective.

While the holding company form of organization exists in many industries, it is particularly prevalent in the regulated industries—telephone, electric and gas utility, railroad, savings and loan, and banking. Regulated industries have learned that a holding company structure allows certain entities to avoid some of the constraints of regulation. For example, regulation often limits the geographic area that a regulated firm can serve. By forming a holding company, many regulated organizations can serve a broader area, thereby potentially benefiting from economies of scale and risk reduction through geographic diversification.

A second purpose for the use of a holding company structure by regulated firms is to expand into other product markets, often ones that are not subject to regulation.

A third purpose for the use of a holding company structure is to increase the organization's financial flexibility, thereby avoiding some of the financing constraints imposed by regulation. These constraints can include limitations on leverage, the types of assets that the firm can acquire and the types of liabilities that it can issue. Another possible financial advantage of the holding company is to obtain tax benefits.

Bank holding companies were created for essentially the same reasons that holding companies were created in other industries; to expand geographically, to move into other product markets, and to obtain greater financial flexibility and tax benefits. The primary use of the bank holding company device prior to the late 1960's was to expand banking operations geographically. The holding company form was needed because many States either prohibited or sharply curtailed branching within the State. Moreover, banks generally did not have the authority to branch beyond the geographic limits of the State in which the bank was chartered. By employing the holding company form of organization, several banking organizations had succeeded by the 1950's in expanding over an entire region of the country, operating banks in several States.

During the 1960's many banks, especially the largest ones, desired to expand into new lines of activity. In most cases, these new activities were financial in nature and were closely related to traditional banking operations. While some banks were successful in obtaining supervisory approval to enter certain of these new activities, the courts subsequently voided many of these approvals. Unable to enter these activities as a bank, many of these organizations converted into the holding company form and entered these activities through the holding company.

In recent years banking organizations also have used the holding company device to increase their financial flexibility. For example, in order to avoid the reserve requirements and interest rate ceilings applicable to deposits of their bank subsidiaries, many banking organizations have utilized the parent company as a vehicle to fund the organization. Moreover, the holding company structure has allowed organizations to attain higher leverage levels than otherwise might have been permitted.

Historically, the Bank Holding Company Act sought to provide for the separation of banking from commerce. In order to avoid any detrimental effects on the public interest, the activities of bank holding companies have been limited by law and regulation and transactions with banking subsidiaries are virtually prohibited. This basic rationale is the cornerstone for regulating the financial affairs of bank holding companies.

1020.0.2 POSSIBLE CONSEQUENCES OF HOLDING COMPANY FORMATION

There are two primary ways that a holding company can have an adverse effect on the financial condition of a regulated subsidiary. The first is for the holding company (or its unregulated-regulated subsidiaries) to take excessive risks and fail. This failure could have a "ripple effect" on the regulated firm, impairing its access to financial markets. The classic case is the Insull empire in the electric utility industry, which involved the pyramiding of numerous highly leveraged holding companies. The collapse of this pyramid during the Depression of the 1930's severely impacted the regulated electric utility operating companies and impaired their ability to service the public.

A second major way that a holding company can have a harmful effect on the financial condition of a regulated subsidiary is through adverse intercompany transactions and excessive dividends. Adverse intercompany transactions typically involve either the purchase and sale of goods and services or financial transactions that are on nonmarket terms. Concern over the use of the holding company device to transfer financial resources from the regulated firm has been particularly prevalent. In this case, there has been a conflict of views between the government, and the firms which want to diversify in order to increase their return on investment.

In the mid 1970's, concern over holding companies forcing regulated firms into adverse transactions surfaced in the banking industry. In this instance, the objective was not to divert resources from the bank to more profitable areas, but rather to use bank resources to save a nonbank affiliate from failure.

1020.0.3 REGULATORY RESPONSE TO THE HOLDING COMPANY

Historically, public policymakers have recognized that holding companies can have both positive and negative effects on regulated subsidiaries. The fact that policymakers have permitted holding companies to exist in all of the major regulated industries indicates that the effects, on balance, have not been decidedly negative. However, there have been enough problems over the years that holding companies in most regulated industries are subject to at least some form of regulation. This regulation varies substantially from one regulated industry to another.

Until the mid-1970's, Congressional concerns with bank holding companies were primarily oriented to competition, concentration of financial resources and the proper range of banking activities. However, there was also some limited recognition of the possible impact of holding companies on the financial condition of banks. The earliest evidence was the Banking Act of 1935, in which Congress gave the Federal Reserve Board authority to issue permits to holding companies to vote the stock of their banks. In acting on permit applications, the Board was required to consider the holding company's financial condition, the character of its management, and the effect of granting the permit on the bank. Congress also gave the Federal Reserve the right to inspect bank holding companies.

About two decades later, Congress passed the Bank Holding Company Act of 1956. This legislation required the Federal Reserve, in passing on proposed bank acquisitions by holding companies, to consider the competitive, financial and managerial implications of the proposal. More recently, the Bank Holding Company Act Amendments of 1970 required the Federal Reserve to make a similar determination in applications by holding companies to acquire nonbanking companies. The amendments also brought one-bank holding companies into the Federal Reserve's jurisdiction.

Subsequently, Congress and the public became seriously concerned over the possible adverse impact of holding companies on the financial condition of subsidiary banks. These adverse developments led to two results; additional legislation and stepped-up holding company supervision. The major Congressional action was to give the Federal Reserve much needed cease and desist powers over bank holding companies. This authority now supplements certain statutes, such as dividend restrictions and limitations on bank transactions with affiliates, that tend to protect banks in a holding company organization.

In the mid-1970's, the Federal Reserve stepped up its supervision and monitoring of bank holding companies in a variety of ways. First, the Federal Reserve increased the scope and frequency of holding company inspections, and later introduced a bank holding company rating system designed to focus attention on those organizations having the most serious problems. Second, the Federal Reserve began to monitor transactions between bank subsidiaries and the rest of the holding company organization through quarterly intercompany transactions reports. Third, the Federal Reserve implemented a computer-based surveillance program designed to identify emerging financial problems. Finally, the Federal Reserve began to employ its new holding company cease and desist powers in an effort to curtail unsafe and unsound practices.

The period prior to 1980 marked a gradual decline in the ratio of equity capital to total assets within the United States Commercial banking system, particularly for the nation's largest banking organizations. In an effort to reverse that trend, the Federal Reserve System and the Comptroller adopted guidelines for national and state member banks and bank holding companies in December 1981. The guidelines established minimum capital levels and capital zones. The guidelines provided state member banks and bank holding companies with targets or objectives to be reached over time. As a result, many of the banks and bank holding companies improved their capital positions. However, other developments, including deregulation of interest rates on bank liabilities, weakening of loan portfolios (asset quality) of some banking institutions occasioned by economic shocks in certain industries or geographical areas, and increased competition in the financial services areas, combined to place additional pressures on the profitability of banking institutions and accentuate the potential demands on the capital positions of those institutions.

The Federal Reserve System continued to stress the importance of the capital guidelines in setting standards of capital adequacy. The Board thus amended its guidelines in June 1983, to set explicit minimum capital levels for multinational organizations.

In November 1983, congressional concern over existing conditions, prompted the enactment of the International Lending Supervision Act of 1983 (''ILSA''). The Act directed that the federal banking agencies cause banking institutions to establish minimum capital levels for banking organizations. In December 1983, the Board, therefore, published the guidelines as Appendix A to the totally revised Regulation Y (12 C.F.R. section 225). Then in April 1985, the Board adopted new capital adequacy guidelines to increase the required minimum primary and total capital levels for the larger regional and multinational bank holding companies and state member banks. This action, when considered in conjunction with the capital maintenance regulations of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, established uniform minimum capital levels for all federally supervised bank holding companies, regardless of size, type of charter, primary supervisor or membership in the Federal Reserve System.

The strengthening of supervision over banks and bank holding companies is an equally imposing supervisory concern. The Federal Reserve System adopted a number of supervisory policies in 1985 that directly affected the supervision of bank holding companies, such as the increased frequency and scope of inspections and the communicating of the results of inspections (refer to Manual section 5000). In addition, the scope of the inspection was expanded to provide for a comprehensive analysis of management's ability to direct and control the organization utilizing the basic assumption that the bank holding company is responsible for the direction and vitality of the organization. Overseeing the supervision of banking organizations entails evaluating management's policies and procedures, wherever they are established within the corporate structure, as part of the examination/inspection process. Such policy areas include the consolidated planning process, risk management, funding, liquidity, lending, management information systems, loan review, and audit and internal controls.

The Board, concerned with strengthening the supervision over member banks and bank holding companies, adopted a policy statement regarding cash dividends not fully covered by earnings on November 14, 1985. The policy statement addressed the situation when cash dividends are not fully covered by earnings, which represents a return of a portion of an organization's capital (refer to Manual section 2020.0 for a discussion regarding the policy statement).

The Board adopted a policy statement on April 24, 1987, also related to the strengthening of the supervision over subsidiary banks of bank holding companies. The Board reaffirmed its long-standing policy that a bank holding company should act as a source of financial and managerial strength to its subsidiary financial institutions. The policy statement provides that a bank holding company should not withhold financial support from a subsidiary bank in a weakened or failing condition when the holding company is in a position to provide the support. The Board emphasized that a bank holding company's failure to provide assistance to a troubled or failing subsidiary bank under these circumstances would generally be viewed as an unsafe and unsound banking practice or a violation of the Boards Regulation Y (refer to section 225.4 (a)(1)) or both.

Congress limited the expansion of nonbank banks with the passage of the Competitive Equality Banking Act of 1987. The legislation redefined the definition of ''bank'' in the Bank Holding Company Act so that an FDIC-insured institution is a bank. Existing nonbank banks were grandfathered but certain limitations were imposed on their operations.

In an effort to further strengthen the capital position in banks and bank holding companies, the Board of Governors of the Federal Reserve System, on January 19, 1989, issued final guidelines to implement risk-based capital requirements for state member banks and bank holding companies. The guidelines are based on the framework adopted July 11, 1988, by the Basle Committee on Banking Regulations and Supervisory Practices, which includes supervisory authorities from 12 major industrial countries. The guidelines are designed to achieve certain important goals:

- Establishment of a uniform capital framework, applicable to all federally supervised banking organizations (the guidelines were also adopted by the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation);
- Encouragement of international banking organizations to strengthen their capital positions; and,
- Reduction of a source of competitive inequality arising from differences in supervisory requirements among nations.

The guidelines establish a systematic analytical framework that: (1) makes regulatory capital requirements more sensitive to differences in risk profiles among banking organizations; (2) factors off-balance sheet exposures into explicit account in assessing capital adequacy, minimizes disincentives to holding liquid, low-risk assets; and achieves greater consistency in the evaluation of the capital adequacy of major banking organizations throughout the world.

The risk-based capital guidelines include both a definition of capital and a framework for calculating weighted risk assets by assigning assets and off-balance sheet items to broad risk categories. An institution's risk-based capital is calculated by dividing its qualifying total capital (the numerator of the ratio) by its weighted risk assets (the denominator).

The guidelines provide for phasing in of risk-based capital standards through the end of 1992, at which time the standards become fully effective. At that time, banking organizations will be required to have capital equivalent to 8 percent of assets, weighted by risk.

Banking organizations must have at least 4 percent Tier 1 capital, which consists of core capital elements, including common stockholder's equity, retained earnings, and noncumulative and limited amounts of cumulative perpetual preferred stock, to weighted risk assets. The other half of required capital (Tier 2), can include, among other supplementary capital elements, the non-Tier 1 portion of cumulative perpetual preferred stock, limited-life preferred stock and subordinated debt, and loan loss reserves up to certain limits.

The risk weights assigned to assets and credit equivalent amounts of off-balance sheet items are based primarily on credit risk. Other types of exposure, such as interest rate, liquidity, and funding risk, as well as asset quality problems, are not factored into the risk-based measure. Such risks will be taken into account in determining a final assessment of an organization's, capital adequacy, however.

Congress addressed the recent thrift crisis with the passage of thrift legislation, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which was signed into law on August 9, 1989. The legislation brought forth a number of important developments affecting bank holding companies. The legislation addressed:

1. acquisition of thrifts, in addition to failing ones;
2. conversion of thrifts to banks;
3. merger of thrifts with banks; and the
4. enhancement of enforcement authority.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) was signed into law on December 19, 1992. It was enacted to require the least-cost resolution of insured depository institutions, to improve supervision and examinations, to provide additional resources to the Bank Insurance Fund, and for other purposes. It required the federal banking agencies and their holding companies to prescribe standards for credit underwriting, loan documentation, as well as numerous other standards that are intended to preserve the safety and soundness of banking organizations.

FIDICIA further amended the International Banking Act of 1978. The Federal Reserve's authority over foreign bank operations (including representative offices in the U.S.) was significantly increased.

FIDICIA required the federal banking agencies to adopt standards for undercapitalized financial institutions. The Board, on September 18, 1992, issued Prompt Corrective Action Measures for state member banks.

During 1992, the Federal Reserve issued guidance on such issues as the monitoring and controlling of risk from asset concentrations, the disclosure, accounting, and reporting of past due (nonaccrual) loans, and the need for consistent methods in determining the amount of the allowance for loan and lease losses.

With the FIRREA and FIDICIA legislation, Congress re-emphasized the need for continued strengthening of the supervision over financial institutions. The strengthening of supervision over banks and bank holding companies will continue to be a primary objective of the Federal Reserve. As it is now, it will be continuously emphasized during the examination/inspection of member banks and bank holding companies during the 1990's and beyond.

The Manual is presented in "sections" which have been grouped together into "parts" that have in common a central theme pertaining to BHC supervision. For example, Part II is composed of sections which discuss topics of special interest for supervisory review. Part III is composed of sections which discuss the various exemptive provisions to the nonbank prohibitions of the BHC Act. Part IV presents sections on the preparation of a financial analysis while Part V discusses the methods used to prepare the inspection report forms.

In preparing to conduct an inspection and complete the inspection report forms, the examiner should review the information requirements presented in Part V which include a "section" for each page within the inspection report. Many of these sections contain cross-references to other sections within Parts II–IV of the Manual that present in greater detail the issues to be considered during the inspection process. The examiner assigned to complete a particular inspection report page should review the sections cross-referenced in Part V.

Given that the overall objective of the Manual is to standardize and formalize inspection objectives and procedures that provide guidance to the examiner and enhance the supervisory process, the content of the sections within Parts II–IV are grouped into broad categories. They are:

1030.0.1 INSPECTION OBJECTIVES; INSPECTION PROCEDURES; LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Not all of the categories are presented in each section. Where a particular topic is exclusively financially related and does not involve legal considerations, the subsection on "Laws, Regulations, . . ." may be omitted.

These procedures were designed for a full-scope, comprehensive inspection. It is recognized that in some instances the procedures may not apply in their entirety to all bank holding companies.

Examiners may exercise a measure of discretion depending upon the characteristics of the organization under inspection.

References to the "Examiner's Comments" inspection report page throughout this Manual are synonymous with Core Page 1 of the inspection report—"Examiner's Comments and Matters Requiring Special Board Attention"—as discussed in Part V of the Manual.

Part V of the Manual concerns the inspection program and report forms.

1030.0.2 NUMBERING SYSTEM

The Manual is arranged using a numerical coding system based on the Manual's parts, sections and subsections. Parts are differentiated using "thousands" notations, sections using "digits" notations, and subsections using "tenths" placed after a decimal point as follows:

Part II—Topics for Supervisory Review	2000.0
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1030.0.3 ABBREVIATION

The Bank Holding Company Act of 1956, as amended, is abbreviated as "the Act" throughout the Manual.

1030.0.4 AMENDMENTS TO THE MANUAL

Amendments will be published periodically as needed.

1040.0.1 BHC INSPECTIONS

The Gramm-Leach-Bliley Act (GLB Act) amended section 5(c) of the Bank Holding Company Act (BHC Act) pertaining to BHC reports and examinations (or inspections, in the case of BHCs). The GLB Act provides specific supervisory guidance to the Board of Governors of the Federal Reserve System (and the Federal Reserve Banks via delegated authority) with respect to the breadth of BHC inspections. It also emphasized the focus and scope of BHC inspections and the inspections of BHC subsidiaries. An inspection is to be conducted to—

1. inform the board of the nature of the operations and financial condition of each BHC and its subsidiaries, including—
   a. the financial and operational risks within the holding company system that may pose a threat to the safety and soundness of any depository institution (DI) subsidiary of such bank holding company, and
   b. the systems for monitoring and controlling such financial and operational risks; and
2. monitor compliance by any entity with the provisions of the BHC Act or any other federal law that the Board has specific jurisdiction to enforce against the entity, and to monitor compliance with any provisions of federal law governing transactions and relationships between any DI subsidiary of a BHC and its affiliates.

1040.0.2 FOCUS AND SCOPE OF BHC INSPECTIONS

The focus and scope of an inspection is limited, to the fullest extent possible, to the BHC and any subsidiary of the BHC that could have a materially adverse effect on the safety and soundness of any DI subsidiary of the holding company due to (1) the size, condition, or activities of the subsidiary, or (2) the nature or size of the transactions between the subsidiary and any DI subsidiary of the BHC.

The Board is to use, to the fullest extent possible, the bank examination reports of DIs prepared by the appropriate federal or state DI supervisory authority. The Board also is to use, to the fullest extent possible, the examination reports for non-DIs prepared by the following:

1. the Securities and Exchange Commission (SEC) for any registered broker or dealer
2. the SEC or any state for any investment adviser registered under the Investment Company Act of 1940
3. any state insurance regulatory authority for any licensed insurance company
4. any federal or state authority for any other subsidiary that the Board finds to be comprehensively supervised

1040.0.3 EXAMINATIONS OF FUNCTIONALLY REGULATED SUBSIDIARIES

The Board's ability to examine a functionally regulated subsidiary (FRS) is limited. The Board can examine an FRS only if the Board—

1. has reasonable cause to believe that the subsidiary is engaged in activities that pose a material risk to an affiliated DI;
2. has reasonably determined, after reviewing relevant reports, that an examination of the subsidiary is necessary to be adequately informed of the systems for monitoring and controlling the operational and financial risks posed to any DI; or
3. has reasonable cause to believe, based on reports and other available information, that a subsidiary is not in compliance with the BHC Act or any other federal law that the Board has specific jurisdiction to enforce against such subsidiary. This includes provisions relating to transactions with an affiliated DI, when the Board cannot make its determination by examining the affiliated DI or the BHC.

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Introduction To Topics For Supervisory Review

Section 2000.0

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2010.0.3 INSPECTION OBJECTIVES

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

2010.0.4 INSPECTION PROCEDURES

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

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

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

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

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

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

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

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

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

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

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

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

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

2010.1.1 INSPECTION OBJECTIVES

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

2010.1.2 INSPECTION PROCEDURES

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

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

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

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

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

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

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

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

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

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

1. A ''clean-up period'' is when a borrower is asked to repay the entire balance of a credit line and to refrain from further borrowing for a specified period of time.
2. This is often referred to as the loan-to-value ratio.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2010.2.1 UNIFORM REAL ESTATE LENDING STANDARDS

On December 23, 1992, the Board announced adoption of a uniform rule and guidelines on real estate lending, along with the FDIC, OCC, and OTS, as mandated by section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). The Board's Regulation H (12 C.F.R. 208, Membership of State Banking Institutions in the Federal Reserve System) was amended to implement the uniform real estate lending standards for state member banks. Although the Board did not directly apply the regulation to bank holding companies and their nonbank subsidiaries, those entities are expected to conduct and to supervise real estate lending activities prudently, consistent with safe and sound lending standards.

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

2010.2.2 LENDING STANDARDS FOR COMMERCIAL LOANS

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

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

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

2010.2.2.1 Sound Practices in Loan Standards and Approval

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

2010.2.2.1.1 Formal Credit Policies

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

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

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

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

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

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

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

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

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

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

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

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

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

2010.2.2.1.2 Formal Credit-Staff Approval of Transactions

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

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

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

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

undue reliance on the files maintained by individual loan officers.

2010.2.2.1.3 Loan-Approval Documents

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

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

2010.2.2.1.4 Use of Forward-Looking Tools in the Approval Process

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

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

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

Detailed analysis of industry performance and trends can be a useful supplement to such analyses. Such projections have the most value in maintaining credit discipline when, rather than only describing the single ‘‘most likely’’ scenario for future events, they characterize the kind of negative events that might impair the performance of the loan in the future.

2010.2.2.1.5 Stress Testing of the Borrower’s Financial Capacity

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

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

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

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

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

2010.2.2.1.6 Management and Lender Information

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

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

2010.2.3 LEVERAGED FINANCING

Leveraged financing is an important financing vehicle for mergers and acquisitions, business recapitalizations, and business expansions. These transactions are characterized by a degree of financial leverage that significantly exceeds industry norms, as measured by various debt, cash-flow, or other ratios. Consequently, leveraged borrowers generally have a diminished ability to respond to changing economic conditions or unexpected events, creating significant implications for an institution's overall credit-risk exposure and challenges for bank risk-management systems.

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

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

2010.2.3.1 Interagency Statement on Leveraged Financing

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

*   *   *   *   *

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

2010.2.3.1.1 Risk-Management Guidelines

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

2010.2.3.1.1.1 Loan Policy

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

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

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

2010.2.3.1.1.2 Underwriting Standards

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

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

2010.2.3.1.1.3 Limits

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

2010.2.3.1.1.4 Credit Analysis

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

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

2010.2.3.1.1.5 Enterprise Value

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

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

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

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

2010.2.3.1.1.6 Rating Leveraged-Finance Loans

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

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

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

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

2010.2.3.1.1.7 Problem-Loan Management

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

2010.2.3.1.1.8 Portfolio Analysis

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

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

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

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

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

2010.2.3.1.1.9 Internal Controls

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

2010.2.3.1.2 Distributions

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

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

2010.2.3.1.3 Participations Purchased

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

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

2010.2.3.1.4 Process to Identify Potential Conflicts

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

2010.2.3.1.4.1 Conflicts of Interest

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

2010.2.3.1.4.2 Securities Laws

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

2010.2.3.1.4.3 Compliance Function

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

* * * * *

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

2010.2.3.1.5 Examination Risk-Rating Guidance for Leveraged Financing

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

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

2010.2.3.1.5.1 Cash Flow/Debt-Service Coverage

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

2010.2.3.1.5.2 Enterprise Value

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

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

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

2010.2.3.1.5.3 Deal Sponsors

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

2010.2.4 INSPECTION OBJECTIVES

Loan Administration

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

Lending Standards for Commercial Loans

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

robust financial markets to support a borrower's capacity to service its debts.

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

2010.2.5 INSPECTION PROCEDURES

Loan Administration

1. Obtain an organizational chart and determine the various levels of responsibility and job functions of individuals involved with the lending function.
2. Obtain and review BHC loan policy; determine if it contains the appropriate components, as summarized in this section. Determine how the policy is communicated to subsidiaries. Also determine whether the loan policy reflects the December 1992 uniform interagency real estate lending standards and guidelines as they apply to subsidiary depository institutions.
3. Obtain a copy of the most recent management reports concerning the quality of loans and other aspects of the loan portfolio (delinquency list, concentrations, yield analysis, loan-distribution lists, watch loan reports, charge-off reports, participation listings, internal and external audit reports, etc.). Determine the scope and sufficiency of the work performed by any committees related to the lending function. Determine if the information provided to the directorate and senior management is sufficient for them to make judgments about the quality of the portfolio and to determine appropriate corrective action.
4. Determine further if an internal process has been established for the review and approval of loans that do not conform to internal lending policy. Establish whether such loans are supported by written documentation that clearly states all the relevant credit factors that culminated in the underwriting decision. Determine if exception loans of a significant size are reported to the board of directors of the subsidiary or to the holding company.
5. Review internal and external audit reports and bank examination reports for critical comments concerning loan-policy exceptions and administration. Determine whether action was taken in response to any identified exceptions. Determine who is responsible for follow-up, and the timeframes involved; seek rationale if no action was taken or if the action taken was halfhearted.
6. Review the organization's financial statements, the bank call reports, and the BHC FR Y-series reports submitted to the Federal Reserve and determine whether reporting is accurate and disclosure is sufficient to indicate the organization's financial position and the nature of its loan portfolios, including nonaccrual loans.
7. When reviewing lending policies, ascertain whether—
    a. the loan policies facilitate extensions of credit to sound borrowers and the workout of problem loans, and
    b. the loan policies control and reduce concentration risk by placing emphasis on effective internal policies, systems, and controls to monitor the risk.
8. Through interviews with, or review of reports submitted by, the internal auditor, lending officers, loan-review personnel, and senior management (1) evaluate the effectiveness of the BHC's self-monitoring of adherence to loan policy, (2) determine how changes to the loan policy occur, (3) determine how loans made in contradiction to the loan policy are explained, and (4) determine the various circumstances involving levels of approval and what specific consideration occurs at these levels.
9. Presuming the inspection is concurrent with a bank's primary regulator, on a random

basis coordinate the selection of loans subject to classification, and determine whether they conform to loan policy.
10. Review management's policies and procedures for their determination of an appropriate level of loan-loss reserves.
11. On the "Policies and Supervision" or equivalent page of the inspection report, evaluate the BHC's oversight regarding effective lending policy and procedures.

Lending Standards for Commercial Loans

1. Review formal credit policies for clear articulation of current lending standards, including—
   a. a description of the characteristics of acceptable loans and (if applicable) "guidance" minimum financial ratios,
   b. standards for the types of covenants to be imposed for specific loan types, and
   c. the treatment and reporting of policy exceptions, both for individual loans and for the entire portfolio.
2. Evaluate the role played by independent credit staff in loan approvals and, in particular, whether these credit professionals are adequately experienced, are independent of line lending functions, and have authority to reject loans either because of specific exceptions to policy or because the loan does not meet the institution's credit-risk appetite.
3. Review written policies and determine operating practice in preparing loan-approval documents to evaluate whether sufficient information is provided on the characteristics and risks of loans being considered, and whether such information is provided clearly and understandably.
4. Based on written policies and review of operating practice, evaluate whether loans being considered are evaluated not only on the basis of the borrower's current performance but on the basis of forward-looking analysis of the borrower.
   a. Determine whether financial projections or other forward-looking tools are an integral part of the preapproval analysis and loan-approval documents.
   b. Determine the extent to which alternative or "downside" scenarios are identified, considered, and analyzed in the loan-approval process.
5. Review credit-risk management information systems and reports to determine whether they provide adequate information to management and lenders about—
   a. the composition of the institution's current portfolio or exposure, to allow for consideration of whether proposed loans might affect this composition sufficiently to be inconsistent with the institution's risk appetite, and
   b. data sources, analytical tools, and other information to support credit analysis.
6. When appropriate, coordinate or conduct sufficient loan reviews and transaction testing in the lending function to determine accurately the quality of loan portfolios and other credit exposures. If deficiencies in lending practices or credit discipline are indicated as a result of the preexamination risk assessment, the inspection, or bank or other examinations, arrange for the commitment of sufficient supervisory resources to conduct in-depth reviews, including transaction testing, that are adequate to ensure that the Federal Reserve achieves a full understanding of the nature, scope, and implications of the deficiencies.
7. When reviewing loans, lending policies, and lending practices—
   a. observe and analyze loan-pricing policies and practices to determine whether the institution may be unduly weighting the short-term benefit of retaining or attracting new customers through price concessions, while not giving sufficient consideration to potential longer-term consequences;
   b. be alert for indications of insufficiently rigorous risk assessment, in particular for excessive reliance on strong economic conditions and robust financial markets to support the capacity of borrowers to service their debts, as well as inadequate stress testing;
   c. be attentive in reviewing an institution's assessment and monitoring of credit risk to ensure that undue reliance on favorable conditions does not lead that institution to delay recognition of emerging weaknesses in some loans or to lessen staff resources assigned to internal loan review;[10] and

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

d. give careful consideration to downgrading, under the applicable supervisory rating framework, a banking organization's risk-management, management, and/or asset-quality ratings and its capital adequacy rating (if sufficiently significant) when there is significant and undue reliance on favorable assumptions about borrowers or the economy and financial markets, or when that reliance has slowed the recognition of loan problems.

8. Discuss matters of concern with the senior management and the board of directors of the bank holding company and report those areas of concern on core page 1, ''Examiner's Comments and Matters Requiring Special Board Attention.''

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

2010.3.1 INSPECTION OBJECTIVES

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

2010.3.2 INSPECTION PROCEDURES

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

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

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

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

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

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

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

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

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

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

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

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

2010.4.1 INSPECTION OBJECTIVES

1. To determine if the board of directors at the parent company is cognizant of and performing its duties and responsibilities.

2. To determine if the level of supervision over subsidiaries is both adequate and beneficial.

3. To evaluate the consolidated plan for consistency, controls, and effectiveness.

4. To ascertain if the board of directors of the parent company is making judgments and decisions based on adequate information flowing from the management and financial reporting systems of the organization.

2010.4.2 INSPECTION PROCEDURES

1. Evaluate the participation by the board of directors of the parent company in giving overall direction to the organization.

2. Obtain and evaluate descriptions of all im-

portant management and financial policies, procedures, and practices.

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

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

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

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

7. Test compliance with policies at all levels.

2010.5.1 BACKGROUND INFORMATION ON ENVIRONMENTAL LIABILITY

Banking organizations are increasingly becoming exposed to liability associated with the clean-up of hazardous substance contamination pursuant to, the Comprehensive Environmental Response, Compensation and Liability Act (''CERCLA''), the federal superfund statute. It was enacted in response to the growing problem of improper handling and disposal of hazardous substances. CERCLA authorizes the Environmental Protection Agency (''EPA'') to clean-up hazardous waste sites and to recover costs associated with the clean-up from entities specified in the statute. The superfund statute is the primary federal law dealing with hazardous substance contamination. However, there are numerous other federal statutes, as well as state statutes, that establish environmental liability that could place banking organizations at risk. For example, underground storage tanks are also covered by separate federal legislation.[1]

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

The relevant provisions of CERCLA, the so-called ''superfund'' statute, as it pertains to banking organizations, indicate which persons or entities are subject to liability for clean-up costs of hazardous substance contamination. These include ''. . . the owner and operator of a vessel or a facility, (or) any person who at the time of disposal of any hazardous substance owned or operated any facility at which such hazardous substances were disposed of. . . .''[2] A person or entity that transports or arranges to transport hazardous substances can also be held liable for cleaning-up contamination under the superfund statute.

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

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

CERCLA provides a secured creditor exemption in the definition of ''owner and operator'' by stating that these terms do not include ''. . . a person, who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility.''[3] However, this exception has not provided banking organizations with an effective ''safe harbor'' because recent court decisions have worked to limit the application of this exemption. Specifically, courts have held that actions by lenders to protect their security interests may result in the banking organization ''participating in the management'' of a vessel or facility, thereby voiding the exemption. Additionally, once the title to a foreclosed property passes to the banking organization, courts have held that the exemption no longer applies and that the banking organization is liable under the superfund statute as an ''owner'' of the property. Under some circumstances, CERCLA may exempt landowners who acquire property without the knowledge of preexisting conditions (the so-called ''innocent landowner defense''). However, the courts have applied a stringent standard to qualify for this defense. Because little guidance is provided by the statute as to what constitutes the appropriate timing and degree of ''due diligence'' to successfully employ this defense, banking organizations should exercise caution before relying on it.

2010.5.2 OVERVIEW OF ENVIRONMENTAL HAZARDS

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

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

erated or handled hazardous substances, or otherwise having been associated with the aftermath of subsequent contamination. The following discussion highlights some common environmental hazards, but by no means covers all environmental hazards.

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

- Farmers and ranchers (use of fuel, fertilizers, herbicides, insecticides, and feedlot runoff).
- Dry cleaners (various cleaning solvents).
- Service station and convenience store operators (underground storage tanks).
- Fertilizer and chemical dealers and applicators (storage and transportation of chemicals).
- Lawn care businesses (application of lawn chemicals).
- Trucking firms (local and long haul transporters of hazardous substances such as fuel or chemicals).

The real estate industry has taken the brunt of the adverse affects of hazardous waste contamination. In addition to having land contaminated with toxic substances, construction methods for major construction projects, such as commercial buildings, have utilized materials that have been subsequently determined to be hazardous, resulting in significant declines in their value. For example, asbestos was commonly used in commercial construction from the 1950's to the late 1970's. Asbestos has since been found to be a health hazard and now must meet certain federal and, in many instances, state requirements for costly removal or abatement (enclosing or otherwise sealing off).

Another common source of hazardous substance contamination is underground storage tanks. Leaks in these tanks not only contaminate the surrounding ground, but often flow into ground water and travel far away from the original contamination site. As contamination spreads to other sites, clean-up costs escalate.

2010.5.3 IMPACT ON BANKING ORGANIZATIONS

Banking organizations may encounter losses arising from environmental liability in several ways. The greatest risk to banking organizations, resulting from the superfund statute and other environmental liability statutes, is the possibility of being held solely liable for costly environmental clean-ups such as hazardous substance contamination. If a banking organization is found to be a responsible party under CERCLA, the banking organization may find itself responsible for cleaning-up a contaminated site at a cost that far exceeds any outstanding loan balance. This risk of loss results from an interpretation of the superfund statute as providing for joint and several liability. Any responsible party, including the banking organization, could be forced to pay the full cost of any clean-up. Of course, the banking organization may attempt to recover such costs from the borrower, or the owner if different than the borrower, provided that the borrower or owner continues in existence and is solvent. Banking organizations may be held liable for the clean-up of hazardous substance contamination in situations where the banking organization:

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

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

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

Borrowers may have existing subsidiaries or may be involved in merger and acquisition activity that may place the borrower at risk for the activities of others that result in environmental liability. Some courts have held that for the purposes of determining liability under the superfund statute, the corporate veil may not protect parent companies that participate in the day-to-day operations of their subsidiaries from environmental liability and court imposed clean-up costs. Additionally, borrowers can be held liable for contamination which occurred prior to their owning or using real estate.

2010.5.4 PROTECTION AGAINST ENVIRONMENTAL LIABILITY

Banking organizations have numerous ways to identify and minimize their exposure to environmental liability. Because environmental liability is relatively recent, procedures used to safeguard against such liability are evolving. The following discussion briefly describes methods currently being employed by banking organizations and others to minimize potential environmental liability.

Banking organizations should have in place adequate safeguards and controls to limit their exposure to potential environmental liability. Loan policies and procedures should address methods for identifying potential environmental problems relating to credit requests as well as existing loans. The loan policy should describe an appropriate degree of due diligence investigation required for credit requests. Borrowers in high-risk industries or localities should be held to a more stringent due diligence investigation than borrowers in low-risk industries or localities. In addition to establishing procedures for granting credit, procedures should be developed and applied to portfolio analysis, credit monitoring, loan workout situations, and—prior to taking title to real property—foreclosures. Banking organizations may avoid or mitigate potential environmental liability by having sound policies and procedures designed to identify, assess and control environmental liability.

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

- having bank employees as members of the borrower's board of directors or actively participating in board decisions;
- assisting in day-to-day management and operating decisions; and
- actively determining management changes.

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

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

Where the environmental review reveals possible hazardous substance contamination, an environmental assessment or audit may be required. Environmental assessments are made by personnel trained in identifying potential environmental hazards and provide a more thorough review and inspection of the facility and property. Environmental audits differ markedly from environmental assessments in that independent environmental engineers are employed to investigate, in greater detail, those factors listed previously, and actually test for hazardous substance contamination. Such testing might require collecting and analyzing air samples, surface soil samples, subsurface soil samples, or drilling wells to sample ground water.

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

2010.5.5 CONCLUSION

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

Banking organizations must understand the nature of environmental liability arising from hazardous substance contamination. Additionally, they should take prudential steps to identify and minimize their potential environmental liability. Indeed, the common thread to environmental liability is the existence of hazardous substances, not types of borrowers, lines of business, or real property.

2010.5.6 INSPECTION OBJECTIVES

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

2010.5.7 INSPECTION PROCEDURES

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

4. Refer to SR-91-20.

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

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

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

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

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

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

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

6. Review loan agreements to determine if warranties, representations, and indemnifications have been included in loan agreements designed to protect the banking organization from losses stemming from hazardous substance contamination. (Although such provisions provide some protection for the lender, these agreements are not binding against the government or third parties. Such contractual protections are only as secure as the borrower's financial strength.)

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

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

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

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

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

2010.6.1 INTERAGENCY STATEMENT ON RETAIL SALES OF NONDEPOSIT INVESTMENT PRODUCTS

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

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

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

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

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

2010.6.1.1 Scope

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

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

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

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

not be affiliated with the institution,[2] occurring on the premises of the institution (including telephone sales or recommendations by employees or from the institution's premises and sales or recommendations initiated by mail from its premises); and
- sales resulting from a referral of retail customers by the institution to a third party when the depository institution receives a benefit for the referral.

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

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

2010.6.1.2 Adoption of Policies and Procedures

2010.6.1.2.1 Program Management

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

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

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

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

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

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

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

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

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

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

2010.6.1.2.2 Arrangements with Third Parties

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

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

2010.6.1.3 General Guidelines

2010.6.1.3.1 Disclosures and Advertising

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

2010.6.1.3.1.1 Content and Form of Disclosure

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

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

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

2010.6.1.3.1.2 Timing of Disclosure

The minimum disclosures should be provided to the customer—

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

A statement, signed by the customer, should be obtained at the time such an account is opened, acknowledging that the customer has received and understands the disclosures. Third-party vendors not affiliated with the depository institution need not make the minimum disclosures on confirmations and account statements that contain the name of the depository institution as long as the name of the depository institution is there only incidentally and with a valid business purpose, and as long as it is clear on the face of the document that the broker-dealer, and not the depository institution, has sold the nondeposit investment products. For investment accounts established prior to the issuance of these guidelines, the institution should consider obtaining such a signed statement at the time of the next transaction.

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

2010.6.1.3.1.3 Advertisements and Other Promotional Material

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

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

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

2010.6.1.3.1.4 Additional Disclosures

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

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

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

2010.6.1.3.2 Setting and Circumstances

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

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

2010.6.1.3.3 Qualifications and Training

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

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

2010.6.1.3.4 Suitability and Sales Practices

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

2010.6.1.3.5 Compensation

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

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

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

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

2010.6.1.3.6 Compliance

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

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

2010.6.1.4 Supervision by Banking Agencies

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2010.6.2.1 Program Management

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

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

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

2010.6.2.1.1 Types of Products Sold

When evaluating nondeposit investment products, management should consider what products best meet the needs of customers. Policies should outline the criteria and procedures that will be used to select and periodically review nondeposit investment products that are recommended or sold on a depository institution's premises. Institutions should periodically review products offered to ensure they meet their customers' needs.

2010.6.2.1.2 Use of Identical or Similar Names

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

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

2010.6.2.1.3 Permissible Use of Customer Information

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

2010.6.2.1.4 Arrangements with Third Parties

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

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

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

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

Notwithstanding the provisions of a third-party agreement, a bank should monitor the conduct of nondeposit investment product sales programs to ensure that sales of nondeposit investment products are distinct from other bank activities and are not conducted in a manner that could confuse customers about the lack of insurance coverage for such investments.

2010.6.2.1.5 Contingency Planning

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

2010.6.2.2 Disclosures and Advertising

2010.6.2.2.1 Content, Form, and Timing of Disclosure

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

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

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

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

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

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

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

2010.6.2.2.2 Advertising

The interagency statement provides that advertisements in all media forms that identify specific investment products must conspicuously include the minimum disclosures and must not suggest or convey any inaccurate or misleading impressions about the nature of a nondeposit investment product. Promotional material that contains information about both FDIC-insured products and nondeposit investment products should clearly segregate the information about the two product types. Displays of promotional sales materials related to nondeposit investment products in a bank's retail areas should be grouped separately from material related to insured bank products.

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

2010.6.2.2.3 Additional Disclosures

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

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

2010.6.2.3 Setting and Circumstances

2010.6.2.3.1 Physical Separation from Deposit Activities

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

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

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

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

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

2010.6.2.3.2 Hybrid Instruments and Accounts

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

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

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

2010.6.2.4.1 Hiring and Training of Sales Personnel

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

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

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

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

2010.6.2.4.2 Training of Bank Personnel Who Make Referrals

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

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

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

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

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

2010.6.2.4.3 Supervision of Personnel

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

2010.6.2.5 Suitability and Sales Practices

2010.6.2.5.1 Suitability of Recommendations

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

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

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

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

2010.6.2.5.2 Sales Practices

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

2010.6.2.5.3 Customer Complaints

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

2010.6.2.6 Compensation

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

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

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

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

2010.6.2.7 Compliance

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

Banking organizations should institute compliance programs for nondeposit investment products that are similar to those of securities broker-dealers. This includes a review of new accounts and a periodic review of transactions in existing accounts to identify any potential abusive practices such as unsuitable recommendations or churning or switching practices. Compliance personnel should also oversee the prompt resolution of customer complaints and review complaint logs for questionable sales practices. Compliance personnel should use MIS reports on early redemptions and sales patterns for specific sales representatives and products to identify any potentially abusive practices. In addition, referral activities of bank personnel should be reviewed to ensure that they are conducted in a manner that conforms to the guidelines in the interagency statement.

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

2010.6.2.8 Audit

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

2010.6.2.9 Joint Interpretations of the Interagency Statement

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

2010.6.2.9.1 Disclosure Matters

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

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

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

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

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

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

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

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

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

NOT FDIC-INSURED	May lose value No bank guarantee

2010.6.2.9.2 Joint Interpretations on Retail Sales of Nondeposit Investment Products

The banking agencies' joint statement also addressed the following:

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

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

2010.6.3 INSPECTION/EXAMINATION OBJECTIVES

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

agency statement or applicable laws and regulations.

2010.6.4 INSPECTION/EXAMINATION PROCEDURES

2010.6.4.1 Scope of the Procedures

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

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

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

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

Program Management and Organization

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

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

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

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

Disclosures and Advertising

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

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

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

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

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

Third-Party Agreements

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

Settings and Circumstances

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

Qualifications and Training

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

that provided to a securities registered representative.

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

Suitability and Sales Practices

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

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

Compensation

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

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

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

Compliance and Audit

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

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

2010.8.1 IDENTIFICATION OF FACILITIES AND STAFF

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

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

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

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

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

2010.8.2 EXAMINER GUIDANCE ON SHARING FACILITIES AND STAFF

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

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

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

2010.9.1 STATEMENT ON REQUIRED ABSENCES FROM SENSITIVE POSITIONS

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

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

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

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

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

If a banking organization's internal control procedures do not now include the above practices, they should be promptly amended. After the procedures have been enhanced, they should be disseminated to all employees, and the documentation regarding their receipt and acknowledgment maintained. Additionally, adherence to the procedures should be included in the appropriate audit schedules, and the auditors should be cognizant of potential electronic access or other circumventing opportunities.

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

2010.9.2 INSPECTION OBJECTIVES

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

2010.9.3 INSPECTION PROCEDURES

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

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

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

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

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

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

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

For larger multibank organizations, loan-review procedures are usually centralized and administered at the parent level, with loan-review staff employed by the parent company. In some cases, a centralized loan-review function may operate in the lead bank, covering all other affiliates in the organization. The parent company directors and senior management are ultimately accountable for supervision of the entire organization's asset quality. Therefore, it should be the System's responsibility to evaluate top management's loan-review policies and procedures as they relate to the subsidiaries, both bank and nonbank, no matter where the function is technically established within the corporate structure. The holding company examiner-in-charge should attempt to coordinate efforts and cooperate with the respective banks' primary supervisors to avoid unnecessary duplication, without compromising the independence of the appraisal process.

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

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

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

2010.10.1 INSPECTION OBJECTIVES

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

2010.10.2 INSPECTION PROCEDURES

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

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

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

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

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

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

In reviewing specific functional and product-inspection procedures, all aspects of the private-banking review should be coordinated with the rest of the inspection to eliminate unnecessary duplication of effort. Furthermore, this section has introduced the review of trust activities and fiduciary services, critical components of most private-banking operations, as part of the overall private-banking review. Although the product nature of these activities differs from that of other banking activities, such as lending and deposit taking, the functional components of private banking (supervision and organization, risk management, operational controls and management information systems, audit, compliance, and financial condition/business profile) should be reviewed across product lines. See SR-97-19.

2010.11.1 OVERVIEW OF PRIVATE BANKING AND ASSOCIATED ACTIVITIES

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

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

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

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

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

2010.11.1.1 Products and Services

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

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

Through their global network of affiliated entities, private banks often form PICs for their clients. These "shell" companies, which are incorporated in offshore secrecy jurisdictions such as the Cayman Islands, Channel Islands, Bahamas, British Virgin Islands, and Netherlands Antilles, are formed to hold the customer's assets as well as offer confidentiality by opening accounts in the PIC's name. The "beneficial owners" of the shell corporations are typically foreign nationals. The banking institution should know and be able to document that it knows the beneficial owners of such corporations and that it has performed the appropriate due diligence to support these efforts. Emphasis should be placed on verifying the source or origin of the customer's wealth. Similarly, offshore trusts established in these jurisdictions should identify grantors of the trusts and sources of the grantors' wealth. Anonymous relationships or relationships in which the RM does not know and document the beneficial owner should not be permitted.

2010.11.1.1.2 Deposit-Taking Activities of Subsidiary Institutions

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

Most private banks offer a broad spectrum of deposit products, including multicurrency deposit accounts that are used by clients who engage in foreign-exchange, securities, and derivatives transactions. The client's transaction activity, such as wire transfers, check writing, and cash deposits and withdrawals, is conducted through deposit accounts (including current accounts). Each bank holding company should provide adequate supervision of deposit-taking subsidiary activities to ensure that the transaction activity into and out of these private-banking deposit accounts is closely monitored for suspicious transactions. Transactions that are inconsistent with the client's profile of usual transactions may represent suspicious transactions that could warrant the filing of a suspicious-activity report.

2010.11.1.1.3 Investment Management

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

Unlike depository accounts, securities and other instruments held in the client's investment accounts are not reflected on the balance sheet of the institution because they belong to the client. These managed assets are usually accounted for on a separate ledger that is segregated by the customer who owns the assets. For regulatory reporting, domestic trust departments and foreign trust departments of U.S. banks are required to report trust assets annually using FFIEC Form 001 (Annual Report of Trust Assets) and FFIEC Form 006 (Annual Report of International Fiduciary Activities). On the other hand, the fiduciary activities of foreign banking organizations operating in the United States currently are not reported on any FFIEC regulatory report. With respect to bank holding companies, information on trust assets is not collected. However, the income from fiduciary activities is reported, on a consolidated income basis, on Schedule HC-I of the FR Y-9C report. Consultations should be made with Federal Reserve trust examiners and specialists with regard to uncertainties about procedures, transactions, and/or trust activities.

2010.11.1.1.4 Credit

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

2010.11.1.1.5 Payable-Through Accounts

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

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

2010.11.1.1.6 Personal Trust and Estates

Trust and estate accounts offer management services for assets. When dealing with trusts under will, or ''testamentary trusts,'' the institution may receive an estate appointment (executor) and a trustee appointment if the will provided for the trust from the probate. These accounts are fully funded at origination with no opportunity for an outside party to add to the account, and all activities are subject to review by the probate or surrogates' court. On the other hand, with living trusts, or ''grantor trusts,'' the customer (grantor) may continually add to and, in some instances, has control over the corpus of the account. Trusts and estates require experienced attorneys, money managers, and generally well-rounded professionals to set up and maintain the accounts. In certain cases, bankers may need to manage a customer's closely held business or sole proprietorship. In the case of offshore trust facilities, recent changes in U.S. law have imposed additional obligations on those banks who function as trustees or corporate management for offshore trusts and PICs.

A critical element in offering personal trust and estate services is the fiduciary responsibility of the institutions to their customers. This responsibility requires that institutions always act in the best interest of the clients pursuant to the trust documentation, perhaps even to the detriment of the institution. For these accounts, the institution is the fiduciary, and the trust officer serves as a representative of the institution. Fiduciaries are held to higher standards of conduct than other bankers. A bank holding company's supervision of its subsidiaries must include the application of proper controls and procedures to ensure each institution's proper administration of trusts and estates, including strict controls over assets, prudent investment and management of assets, and meticulous recordkeeping.

2010.11.1.1.7 Custody Services

Custodial services offered to private-banking customers include securities safekeeping, receipts and disbursements of dividends and interest, recordkeeping, and accounting. Custody relationships can be established in many ways, including by referrals from other departments in the institution or from outside investment advisors. The customer, or a designated financial advisor, retains full control of the investment management of the property subject to the custodianship. Sales and purchases of assets are made by instruction from the customer, and cash disbursements are prearranged or as instructed. Custody accounts involve no investment supervision and no discretion. However, the custodian may be responsible for certain losses if it fails to act properly according to the custody agreement. Therefore, bank holding company supervision of its subsidiaries must ensure that the procedures for proper administration of custody services have been initated, maintained, and regularly reviewed on a preset schedule.

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

2010.11.1.1.8 Funds Transfer

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

2010.11.1.1.9 Hold Mail

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

2010.11.1.1.10 Bill-Paying Services

Bill-paying services are often provided to private-banking customers for a fee. If this service is provided, an agreement between the institution and the customer should exist. Typically, a customer might request that the institution debit a deposit account for credit card bills, utilities, rent, mortgage payments, or other monthly consumer charges.

2010.11.2 FUNCTIONAL REVIEW

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

2010.11.2.1 Supervision and Organization

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

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

2010.11.2.2 Risk Management

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

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

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

1. *Reputational risk* is the potential that negative publicity regarding an institution's business practices and clients, whether true or not, could cause a decline in the customer base, costly litigation, or revenue reductions.
2. *Fiduciary risk* refers to the risk of loss due to the institution's failure to exercise loyalty; to safeguard assets; and, for trusts, to use assets productively and according to the appropriate standard of care. This risk generally exists in an institution to the extent that it exercises discretion in managing assets on behalf of a customer.
3. *Legal risk* arises from the potential of unenforceable contracts, client lawsuits, or adverse judgments to disrupt or otherwise negatively affect the operations or condition of a banking organization. One key dimension of legal risk is supervisory action that could result in costly fines or other punitive measures being levied against an institution for compliance breakdowns.
4. *Credit risk* arises from the potential that a borrower or counterparty will fail to perform on an obligation.
5. *Operational risk* arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.

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

2010.11.2.2.1 Know-Your-Customer Policy and Procedures

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

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

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

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

1. The customer's current address and telephone number for his or her primary residence, which should be corroborated at regular intervals, can be verified through a variety of methods, such as—
   a. visiting the residence, office, factory, or farm (with the RM recording the results of the visit or conversations in a memorandum);
   b. checking the information against the telephone directory; the client's residence, as indicated on his or her national ID card; a mortgage or bank statement or utility or property tax bill; or the electoral or tax rolls;
   c. obtaining a reference from the client's government or known employer or from another institution;
   d. checking with a credit bureau or professional corroboration organization; or
   e. using any other method verified by the RM.
2. Sufficient business information about the customer should be gathered so that the RM understands the profile of the customer's commercial transactions. This information should include a description of the nature of the customer's business operations or means of generating income, primary trade or business areas, and major clients and their geographic locations, as well as the primary business address and telephone number. These items can be obtained through a combination of any of the following sources:
   a. a visit to the office, factory, or farm
   b. a reliable third party who has a business relationship with the customer
   c. financial statements
   d. Dun and Bradstreet reports
   e. newspaper or magazine articles
   f. Lexis/Nexis reports on the customer or customer's business
   g. "Who's Who" reports from the home country
   h. private investigations
3. Although it is often not possible to get proof of a client's wealth, an RM can use his or her good judgment to derive a reasonable estimate of the individual's net worth.
4. As part of the ongoing KYC process, the RM should document in "call reports" the substance of discussions that take place during frequent visits with the client. Additional information about a client's wealth, business, or other interests provides insight into potential marketing opportunities for the RM and the institution, and updates and strengthens the KYC profile.

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

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

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

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

2010.11.2.2.1.1 Suspicious-Activity Reports

The proper and timely filing of suspicious-activity reports (SARs) is an important component of the institution's KYC program. Under the SAR regulations, institutions must report any suspicious transaction relevant to a possible violation of law or regulation if the transaction is conducted or attempted by, at, or through an institution; involves $5,000 or more; and if the institution's management or staff knows, suspects, or has reason to suspect the transaction involves funds from illegal activities or is conducted in order to hide or disguise assets; is designed to evade the Bank Secrecy Act recordkeeping or reporting requirements; or the transaction has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the institution's management and/or staff knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction.

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

2010.11.2.2.2 Credit

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

An extension of credit based solely on collateral, even if the collateral is cash, does not ensure repayment. While the collateral enhances an institution's position, it should not substitute for regular credit analyses and prudent lending practices. If collateral is derived from illegal activities, it is subject to forfeiture through the seizure of assets by a government agency. A bank holding company's supervision of its subsidiaries should include procedures and controls that ensure that the institution's managment and staff perform due diligence and that institution management and staff adequately and reasonably ascertain and document that the funds of its private-banking customers were derived from legitimate means. Institutions should also verify that the use of the loan's proceeds is for legitimate purposes.

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

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

2010.11.2.3 Fiduciary Standards

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

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

2010.11.2.4 Operational Controls

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

2010.11.2.4.1 Segregation of Duties

A bank holding company's supervision of its subsidiaries should include procedures and controls that require subsidiary institutions to have procedures and controls that ensure the segregation of the duties of employees. Institutions should have guidelines on the segregation of employees' duties to prevent the unauthorized waiver of documentation requirements, poorly documented referrals, and overlooked suspicious activities. Independent oversight by the back office helps to ensure compliance with account-opening procedures and KYC documentation. Control-conscious institutions may use independent units such as compliance, risk management, or senior management to fill this function in lieu of the back office. The audit and compliance functions of the private institution should be similarly independent so that they can operate autonomously from line management.

2010.11.2.4.2 Inactive and Dormant Accounts

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

2010.11.2.4.3 Pass-Through Accounts and Omnibus Accounts

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

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

2010.11.2.4.4 Hold Mail

Controls over hold mail are critical because the clients have relinquished their ability to detect unauthorized transactions in their accounts in a timely manner. Accounts with high volume or significant losses warrant further inquiry. Hold-mail operations should ensure that client accounts are subject to dual control and are reviewed by an independent party.

2010.11.2.4.5 Funds Transfer—Tracking Transaction Flows

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

1. indications of frequent overrides of established approval authority or other internal controls
2. intentional circumvention of approval authority by splitting transactions
3. wire transfers to and from known secrecy jurisdictions
4. frequent or large wire transfers for persons who have no account relationship with the institution, or funds being transferred into and out of an omnibus or general clearing account instead of the client's deposit account
5. wire transfers involving cash amounts in excess of $10,000
6. inadequate control of password access
7. customer complaints or frequent error conditions

2010.11.2.4.6 Custody—Detection of ''Free-Riding''

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

2010.11.2.5 Management Information Systems

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

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

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

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

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

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

2010.11.2.6 Audit

An effective audit function is vital to ensuring the strength of a private institution's internal controls. As a matter of practice, internal and external auditors should be independently verifying and confirming that the framework of internal controls is being maintained and operated in a manner that adequately addresses the risks associated with the activities within all levels of the organization (the bank holding company and all subsidiary institutions). Critical elements of an effective internal audit function are the strong qualifications and expertise of the internal audit staff and a sound risk-assessment process for determining the scope and frequency of specific audits. The audit process should be risk-focused and should ultimately determine the risk rating of business lines and client KYC procedures. Compliance with KYC policies and procedures and the detailed testing of files for KYC documentation are also key elements of the audit function. Finally, examiners should review and evaluate management's responsiveness to criticisms by the audit function.

2010.11.2.7 Compliance

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

2010.11.2.7.1 Office of Foreign Assets Control

The function of the Office of Foreign Assets Control (OFAC) in the U.S. Department of the Treasury is to promulgate and administer regulations dealing with the economic sanctions that the U.S. government imposes against certain foreign countries and the ‘‘specially designated nationals’’ of those countries. Under the International Emergency Economic Powers Act, the president can impose sanctions such as trade embargoes, freezing of assets, and import surcharges on these entities.

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

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

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

2010.11.2.7.2 Bank Secrecy Act

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

2010.11.3 PREPARATION FOR INSPECTION

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

2010.11.3.1 Pre-Inspection Review

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

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

2010.11.3.2 Inspection Staffing and Scope

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

2010.11.3.3 Reflection of Organizational Structure

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

2010.11.3.4 Risk-Focused Approach

Examiners reviewing the private-banking operations should implement the ''risk-focused'' inspection approach. The inspection scope and degree of testing of private-banking practices should reflect the degree of risk assumed, prior inspection findings on the implementation of policies and procedures, the effectiveness of controls, and an assessment of the adequacy of the internal audit and compliance functions. If initial inquiries into the institution's internal audit and other assessment practices raise doubts about the internal system's effectiveness, expanded analysis and review are required—and examiners should perform more transaction testing.

2010.11.3.5 First-Day Letter

As part of the inspection preparation, examiners should customize the first-day-letter (FDL) questionnaire to reflect the structure and type of private-banking activities of the institution and the scope of the inspection. The following is a list of requests regarding private banking that examiners should consider including in the FDL:

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

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

2010.11.4 INSPECTION OBJECTIVES

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

2010.11.5 INSPECTION PROCEDURES

Private Banking Pre-Inspection Procedures

1. As the examiner-in-charge, conduct a meeting with the lead members of the private banking inspection team and discuss—
   a. the private-banking inspection scope; *Comment: The inspection may need to extend beyond a rudimentary review of private-banking operations if the institution's business lines and services overlap, and its customer base and personnel are shared throughout the organization. Examiners will probably need to focus on the policies, practices, and risks within the different divisions of each particular institution and throughout each institution's global network of affiliated entities.*
   b. examiner assignments of the functional areas of private banking; and
   c. the supplemental reviews of specific private-banking products and services.
2. Review the prior report of inspection and the previous inspection workpapers; description of the inspection scope; structure and type of private-banking activities conducted; and findings, conclusions, and recommendations of the prior inspection. The prior inspection report and inspection plan should also provide information and insight as to key contacts at the institution and to the timeframe of the prior private-banking review.
3. Review relevant correspondence exchanged since the prior inspection, such as management's response to the report of inspection, any applications submitted to the Federal Reserve, and any supervisory actions.
4. Research press releases and published news stories about the institution and its private-banking activities.
5. Review internal and external audit reports and any internal risk assessments performed by the institution's internal-external auditors on its private-banking activities. Review information on any assessments of the internal controls and risk profile of the private-banking function.
6. Contact management at the institution to ascertain what changes in private-banking services have occurred since the last inspection or if there are any planned in the near future.
   a. Determine if the previous inspection/examination report(s) make no mention of private banking; ask management if they have commenced or plan to commence any private-banking activities within any part of the bank holding company organization.
   b. Determine if there have been any changes to the strategic plan; senior management; or the level and type of private-banking activities, products, and services offered.
   c. During the entire inspection of private-banking activities, be alert to the totality of the client relationship, product by product, in light of increasing client awareness and use of derivatives, emerging-market products, foreign exchange, and margined accounts.

Full-Inspection Phase

1. After reviewing the private-banking functional areas, draw sound conclusions about the quality and culture of management and stated private-banking policies.
2. Evaluate the adequacy of risk-management policies and practices governing private-banking activities.
3. Make an assessment of the private-banking organization and evaluate the quality of management's supervision of private-banking activities. An appraisal of management covers the—
   a. full range of functions (i.e., supervision and organization, risk management, fiduciary standards, operational controls, management information systems, audit, and compliance) and activities related to the operation of the private-banking activities; and
   b. discharge of responsibilities by the institution's directors through a long-range organizational plan that accommodates the volume and business services handled, local business practices and the institution's competition, and the growth and development of the institution's private-banking business.
4. Determine if management has effective procedures for ongoing reviews of client-account activity to detect, and protect the client from, any unauthorized activity and any account activity that is inconsistent with the client's profile (for example, frequent or sizeable unexplained transfers flowing through the account).
5. Determine if the bank holding company has initiated and maintained controls and procedures that require each subsidiary private-

banking institution to have account-opening procedures and documentation requirements that must be satisfied before an account can be opened.

6. Determine if the bank holding company requires its subsidiary institutions to maintain and adhere to well-structured KYC procedures.
7. Determine if the bank holding company has proper controls and procedures to ensure each institution's proper administration of trust and estates, including strict controls over assets, prudent investment and management of assets, and meticulous recordkeeping. Review previous trust examination reports and consult with the designated Federal Reserve System trust examiners.
8. Ascertain whether the bank holding company provides adequate supervision of its subsidiaries with respect to custody services, making certain that each institution has established and currently maintains procedures for the proper administration of custody services, including their regular review on a preset schedule.
9. Determine whether subsidiary institutions are required to and actually maintain strong controls and supervision over funds transfers.
10. Ascertain if institution management and staff are required to perform due diligence, verifying and documenting that the funds of its private-banking customers were derived through legitimate means, and, when extending credit, that the use of loan proceeds was also legitimate.
11. Review the institution's use of deposit accounts.
    a. Assess the adequacy of the institution's controls and whether they are appropriately used.
    b. Determine if client monies flow through client deposit accounts and whether the accounts function as the sole conduit and paper trail for client transactions.
12. Determine and ensure that each institution's approach to suspicious-activity reports (SARs) is proactive and that the bank holding company and each institution have well-established procedures covering the SAR process. Establish whether there is accountability within the organization for the analysis and follow-up of internally identified suspicious activity, which includes a sound decision on the need or applicable regulatory requirements to file an SAR.

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

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

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

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

2010.12.1 DUE-DILIGENCE REVIEW NEEDED BEFORE ENTERING INTO FEE ARRANGEMENTS

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

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

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

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

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

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

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

2010.12.2 INSPECTION OBJECTIVES

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

2010.12.3 INSPECTION PROCEDURES

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

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

a. historical performance comparisons with other mutual funds, engagement fees and expense ratios, and ratings by recognized mutual fund rating agencies;

b. an assessment that the investments are, and continue to be, appropriate for the individual account and in the best interests of its account beneficiaries; and

c. evidence of continued compliance with the provisions of the ‘‘prudent investor’’ or ‘‘prudent man rules.’’

The analysis of intercompany transactions between a parent company, its nonbank subsidiaries, and its bank subsidiaries is primarily intended to assess the nature of the relationships between these entities and the effect of the relationships on the subsidiary banks. Both the legal and financial ramifications of such transactions are areas of concern. Certain intercompany transactions are subject to the provisions of section 23A or 23B (or both) of the Federal Reserve Act. Several types of intercompany transactions and the primary regulatory concerns of each are presented below.

Dividends paid by subsidiaries to the parent. Dividends are a highly visible cash outflow by subsidiaries. If the dividend payout ratio exceeds the level at which the growth of retained earnings can keep pace with the growth of assets, the subsidiary's capital ratios will deteriorate. These dividends may also have a negative effect on the subsidiary's liquidity position.

Transactions with affiliates. Transactions with affiliates is another area of potential abuse of subsidiary banks. Regulatory concern centers on the quantitative limits and collateral restrictions on certain transactions by subsidiary banks with their affiliates. These restrictions are designed (1) to protect subsidiary banks from the potential jeopardy of being used as a source of financing by affiliates and (2) to ensure the collectibility of extensions of credit.

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

Fees paid by subsidiaries. Management or service fees are another cash outflow of bank subsidiaries. These fees may be paid to the parent, the nonbank subsidiaries, or, in some cases, to the other bank subsidiaries. Regulatory concern focuses on whether such fees are reasonable in relation to the services rendered and on the financial impact of the fees on the bank subsidiaries.

Tax allocation. How a bank holding company organization determines to allocate taxes among its component companies involves questions of both the magnitude and timing of the cash-flow effects. Unreasonable or untimely tax payments or refunds to the bank can have an adverse effect on the financial condition of the banking subsidiaries.

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

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

Other expense allocations. In general, a subsidiary bank should be adequately compensated for its services or for the use of its facilities and personnel by other parts of the holding company organization. Furthermore, a subsidiary bank should not pay for expenses for which it does not receive a benefit.

2020.0.1 ROLE OF THE EXAMINER

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

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

Violations of banking laws discovered during the inspection should be brought to management's attention and referred to the bank's primary supervisor. However, any action or criticism levied directly on the bank should come from the bank's primary supervisor. In the inspection report, violation of banking laws should be discussed only when the holding company or its nonbank subsidiaries were the cause of or a party to the violation.

2020.1.1 SECTION 23A OF THE FEDERAL RESERVE ACT

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

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

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

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

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

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

In addition to the quantitative limitations on covered transactions with affiliates, there are specific prohibitions on the substance of the transaction:

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

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

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

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

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

2020.1.1.1 Definition of an Affiliate

In general, companies that control or are under common control with a bank are defined by section 23A as "affiliates" of the bank.[2] The definition includes a bank subsidiary of a bank and any company that a bank, or its subsidiaries or affiliates, sponsors and advises.[3] For example, affiliates include bank, financial, and savings and loan holding companies and their subsidiaries. Banks, savings associations, and nonbanking companies that are under common individual control with the bank also are affiliates for the purposes of section 23A.

With respect to a bank, an affiliate means—

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

The definition of affiliate does not include—

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

The Gramm-Leach-Bliley Act (GLB Act) expanded the definition of affiliate to include financial subsidiaries of banks. A financial subsidiary is defined in the GLB Act as a subsidiary of a bank (1) that engages in activities that national banks are not permitted to engage in directly or that are conducted under terms and conditions that differ from those that govern the conduct of such activities by national banks, and (2) that a national bank is not specifically authorized to control by the express terms of a federal statute (other than section 23A of the FRA). (See 12 U.S.C. 371c(e)(2).)

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

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

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

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

2020.1.1.2 Covered Transactions

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

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

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

2020.1.1.2.1 Leases

Lease transactions that constitute the functional equivalent of a loan or an extension of credit may be subject to section 23A. Such lease arrangements, in effect, are equivalent to a loan by the bank and are essentially financing arrangements. Some of the characteristics that would normally cause a lease to be construed as a loan equivalent include the lessee's having responsibility for the servicing, maintenance, insurance, licensing, or risk of loss or damage, and the lessee's having the option to purchase the equipment.

2020.1.1.2.2 De Facto Extensions of Credit

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

2020.1.1.2.3 Limitations of Amount—Valuations of Transactions

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

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

Under section 23A(c)(4), the securities issued by an affiliate are not acceptable collateral for a

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

loan or extension of credit to any affiliate. Moreover, if the proceeds of the loan that are secured by the affiliate's shares are transferred to an affiliate by the third-party borrower to purchase assets or securities from the affiliate, the loan is treated as a loan to the affiliate. The loan must then be secured with collateral in an amount and of a type that meets the requirements of section 23A for loans by a bank to an affiliate. (See FRRS 3-1167.3.) Moreover, a loan that is secured with any amount of an affiliate's shares must be consistent with safe and sound banking practices.[6]

2020.1.1.2.4 Contributing Shares or Assets of a BHC Affiliate to a Bank

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

2020.1.1.3 Collateral for Certain Transactions with Affiliates

Section 23A also requires a bank's use of collateral for certain transactions between a bank and its affiliates.[7] Each loan or extension of credit to, or each guarantee, acceptance, or letter of credit issued on behalf of, an affiliate by a bank or its subsidiary must be secured at the time of the transaction by collateral having a market value equal to—

1. 100 percent of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit, if the collateral is composed of—
   a. obligations of the United States or its agencies;
   b. obligations fully guaranteed by the United States or its agencies as to principal and interest;
   c. notes, drafts, bills of exchange, or banker's acceptances that are eligible for rediscount or purchase by a Federal Reserve Bank;[8] or
   d. a segregated, earmarked deposit account with the bank;
2. 110 percent of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit if the collateral is composed of obligations of any state or political subdivision of any state;
3. 120 percent of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit if the collateral is composed of other debt instruments, including receivables; or
4. 130 percent of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit if the collateral is composed of stock, leases, or other real or personal property.

2020.1.1.4 Limitations on Collateral

Banks may accept as collateral for covered transactions receivables, leases, or other real or personal property.[9] The following are limitations and collateral restrictions:

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

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

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

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

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

acceptance, or letter of credit issued on behalf of, that affiliate or any other affiliate of the bank.

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

2020.1.1.5 Derivative Transactions with Affiliates and Intraday Extensions of Credit to Affiliates

The GLB Act required the Board of Governors of the Federal Reserve System to adopt, by May 12, 2001, final rules under section 23A of the FRA that would address as covered transactions (1) credit exposure arising out of derivative transactions between member banks and their affiliates and (2) intraday extensions of credit by member banks to their affiliates (12 U.S.C. 371c(f)(3)). The Board adopted interim final rules to address these matters on May 3, 2001. The interim rules are effective January 1, 2002.

2020.1.1.5.1 Derivative Transactions Between Insured Depository Institutions and Their Affiliates

Derivative transactions between an insured depository institution and its affiliates generally arise from the risk-management needs of the institution or the affiliate. Transactions arising from the bank's needs typically occur when an institution enters into a swap or other derivative contract with a customer but chooses not to hedge directly the market risk generated by the derivative contract, or when the institution is unable to hedge the risk directly because it is not authorized to hold the hedging asset. To manage the market risk, the institution may have an affiliate acquire the hedging asset. The institution would then do a bridging derivative transaction between itself and the affiliate maintaining the hedge.

Other derivative transactions between an insured depository institution and its affiliate are affiliate-driven. To accomplish its asset-liability-management goals, an institution's affiliate may enter into an interest-rate or foreign-exchange derivative with the institution. For example, an institution's holding company may hold a substantial amount of floating-rate assets but issue fixed-rate debt securities to obtain cheaper funding. The holding company may then enter into a fixed-to-floating interest-rate swap with its subsidiary insured depository institution to reduce the holding company's interest-rate risk.

Insured depository institutions and their affiliates that seek to enter into derivative transactions for hedging (or risk-taking) purposes could enter into the desired derivatives with unaffiliated companies. Institutions and their affiliates often choose to use each other as their derivative counterparties, however, to maximize the profits of and manage risks within the consolidated financial group.

Derivative transactions between an insured depository institution and an affiliate are subject to section 23B of the FRA under the express terms of the statute.[10] In many respects, derivative transactions between an insured depository institution and an affiliate resemble section 23A covered transactions. Such transactions may expose an insured depository institution to the credit risk of its affiliates. Although the typical institution-affiliate derivative transaction does not create actual credit exposure for the institution at the inception of the transaction, an institution may incur actual credit exposure to an affiliate during the term of a derivative transaction, and it nearly always faces some amount of potential future exposure on the transaction. The credit exposure of a derivative transaction with an affiliate poses a risk to the safety and soundness of the depository institution that is similar in many respects to the risk posed by a loan to an affiliate. In fact, this credit exposure may be more volatile and indeterminate than the credit exposure created by a loan.

Considering the potential complexities, the Board adopted the interim rule on institution-affiliate derivative transactions. The interim rule clarifies that the transactions are subject to the market-terms requirement of section 23B of the FRA. The rule also requires that, under section 23A, an institution establish and maintain policies and procedures that are reasonably designed to manage in a safe and sound manner the credit exposure arising from the institution's derivative transactions with affiliates. The poli-

10. In addition to applying to covered transactions, as defined in section 23A of the FRA, the market-terms requirement of section 23B of the FRA applies broadly to, among other things, ‘‘[t]he payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise’’ (12 U.S.C. 371c-1(a)(2)(C)). Institution-affiliate derivatives generally involve a contract or agreement to pay money to the affiliate or furnish risk-management services to the affiliate.

cies and procedures must, at a minimum, provide for monitoring and control of the credit exposure arising from the institution's derivative transactions with each affiliate, and from all affiliates in the aggregate, and ensure that the institution's derivative transactions with affiliates comply with section 23B (12 C.F.R. 250.247). In addition, the interim rule defines the term ''derivative transaction'' to mean any derivative contract that is subject to the Board's capital adequacy guidelines (which would include most interest-rate, currency, equity, and commodity derivative contracts) and any similar derivative contract, including credit derivative contracts (12 C.F.R. 225, appendix A, at III. E.1. a–d).

To comply with section 23B of the FRA, each institution should have in place credit limits on its derivatives exposure to affiliates that are at least as strict as the credit limits the institution imposes on unaffiliated companies that are engaged in similar businesses and are substantially equivalent in size and credit quality. Similarly, each institution should monitor derivatives exposure to affiliates at least as rigorously as it monitors derivatives exposure to comparable unaffiliated companies. In addition, each institution should price and require collateral in its derivative transactions with affiliates in a way that is at least as favorable to the institution as the way in which it would price or require collateral in a derivative transaction with comparable unaffiliated counterparties.

At this time, the Board has not determined to subject all institution-affiliate derivative transactions to all the requirements of section 23A of the FRA. However, credit derivatives between an institution and an unaffiliated third party that reference the obligations of an affiliate of the institution and that are the functional equivalent of a guarantee by the bank on behalf of an affiliate should be treated as a guarantee by the institution on behalf of an affiliate for the purposes of section 23A.

2020.1.1.5.2 Intraday Extensions of Credit

As noted previously, the GLB Act required the Board to address as covered transactions under section 23A of the FRA the credit exposure arising from intraday extensions of credit by insured depository institutions to their affiliates. Depository institutions regularly provide transaction accounts to their affiliates in conjunction with providing payment and securities clearing services. As in the case of unaffiliated commercial customers, these accounts are occasionally subject to overdrafts during the day that are repaid in the ordinary course of business.

The interim rule clarifies that intraday extensions of credit by an insured depository institution to an affiliate are subject to the market-terms requirement of section 23B. The rule also requires that, under section 23A, institutions establish and maintain policies and procedures that are reasonably designed to manage the credit exposure arising from an institution's intraday extensions of credit to affiliates. The policies and procedures must, at a minimum, provide for monitoring and control of the institution's intraday credit exposure to each affiliate, and to all affiliates in the aggregate, and ensure that the institution's intraday credit extensions to affiliates comply with section 23B. (See 12 C.F.R. 250.248.)

2020.1.1.6 Statutory Exemptions

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

1. Any transaction between banks when 80 percent or more of each bank's voting shares are controlled by the same company or one bank controls 80 percent or more of the voting shares of the other bank.[11] The purchase of a low-quality asset is prohibited.

   Credit card banks insured by the Bank Insurance Fund (BIF), savings associations, and savings banks are banks for purposes of section 23A. Foreign banks are not banks for purposes of section 23A, and thus a transaction between a domestic bank and a foreign bank is not eligible for this exemption.
2. Making deposits in an affiliated bank or affiliated foreign bank in the ordinary course

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

of correspondent business, subject to any restrictions that the Board may prescribe by regulation or order.

3. Giving immediate credit to an affiliate for uncollected items received in the ordinary course of business.
4. Making a loan or extension of credit to, or issuing a guarantee, acceptance, or letter of credit on behalf of, an affiliate that is fully secured by—
   a. obligations of the United States or its agencies,
   b. obligations fully guaranteed by the United States or its agencies as to principal and interest, or
   c. a segregated, earmarked deposit account with the bank.
5. Purchasing securities that are issued by any of the kinds of investments in entities described in section 4(c)(1) of the BHC Act.[12]
6. Purchasing assets that have a readily identifiable and publicly available market quotation, and that are purchased at that market quotation.
7. Subject to the prohibition on the purchase of low-quality assets, purchasing loans on a nonrecourse basis from affiliated banks.
8. Purchasing from an affiliate a loan or extension of credit that was originated by the bank and sold to the affiliate subject to a repurchase agreement or with recourse.[13]
9. A transaction between affiliated insured depository institutions if the transaction has been approved by the appropriate federal bank agency pursuant to the Bank Merger Act. (See 12 C.F.R. 250.241 (FRRS 3-1128).)

2020.1.1.7 Purchase of a Security by an Insured Depository Institution from an Affiliate

As discussed previously, section 23A of the FRA restricts the ability of a member bank to fund its affiliates through asset purchases, loans, or certain other transactions (referred to as ‘‘covered transactions’’). Paragraph (d)(6) of section 23A contains an exemption from the statute (the (d)(6) exemption) for ‘‘purchasing assets having a readily identifiable and publicly available market quotation,’’ if the purchase is at or below such quotation (item 6 above). Board staff traditionally has restricted the availability of the (d)(6) exemption to purchases of assets whose prices are routinely quoted in a widely disseminated publication, such as the *Wall Street Journal.* The Board adopted an interpretation of the (d)(6) exemption on May 3, 2001 (effective June 11, 2001), that expands the ability of an insured depository institution to purchase from a registered broker-dealer affiliate securities that, although not so widely traded as to warrant their prices being included in publications of general circulation, are actively traded and whose prices are quoted routinely on an unaffiliated electronic service that provides indicative data from real-time financial networks.

For a securities purchase to qualify under the interpretation, the security must be purchased from a broker-dealer affiliate that is registered with the Securities and Exchange Commission (SEC).[14] The following additional conditions must be met:

1. The security has a ‘‘ready market,’’ as defined in 17 C.F.R. 240.15c3-1(c)(11)(i).[15]
2. The security is eligible for a state member

12. This refers to the purchase of shares of a company that—

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

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

14. A purchase of securities or other assets from other types of affiliates would continue to be exempt under section 23A(d)(6) if the price of the asset is routinely quoted in a widely disseminated news source and the asset is purchased at or below its current market price. For example, gold is an asset that could meet the (d)(6) exemption.

15. The SEC defines a ‘‘ready market’’ to include a recognized established securities market (1) in which independent bona fide offers to buy and sell exist so that a price reasonably related to the last sales price or to current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously, and (2) in which payment will be received in settlement of a sale at such price within a relatively short time, conforming to trade custom. (See 17 C.F.R. 240.15c3-1(c)(11)(i).) The types of securities that meet this definition include obligations of the United States and its agencies, as well as many asset-backed, corporate debt, and sovereign debt securities.

bank to purchase directly, subject to the same terms and conditions that govern the investment activities of a state member bank, and the institution records the transaction as a purchase of securities for purposes of the bank call report, consistent with the requirements for a state member bank.[16]

3. The security is not a low-quality asset as defined in section 23A(a)(3).
4. The security is not purchased during an underwriting, or within 30 days of an underwriting, if an affiliate is an underwriter of the security, unless the security is purchased as part of an issue of obligations of, or as obligations fully guaranteed as to principal and interest by, the United States or its agencies.
5. The security's price is quoted routinely on an unaffiliated electronic service that provides indicative data from real-time financial networks, provided that—
   a. the price paid by the insured depository institution is at or below the current market quotation for the security and
   b. the size of the transaction executed by the insured depository institution does not cast material doubt on the appropriateness of relying on the current market quotation for the security.
6. The security is not issued by an affiliate, unless the security is an obligation fully guaranteed by the United States or its agencies as to principal and interest.

The purchase of the security also must comply with paragraph (a)(4) of section 23A, which requires that any covered transactions between an insured depository institution and an affiliate be on terms and conditions that are consistent with safe and sound banking practices. (See 12 C.F.R. 250.246.)

2020.1.1.8 Board-Approved Exemptions from Section 23A

Section 23A gives the Board the authority to grant exemptions from the statute's restrictions if such exemptions are "in the public interest and consistent with the purposes of this section" (12 U.S.C. 371c(f)(2)). The Board has approved several exemptions. (See FRRS 3-1125 et seq.)

2020.1.1.8.1 Exemptions from the Attribution Rule of Section 23A

The attribution rule of section 23A provides that "a transaction by a member bank with any person shall be deemed a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate" (12 U.S.C. 371c(a)(2)). One respective interpretation and two exemptions, approved by the Board on May 3, 2001 (effective June 11, 2001), are discussed below.

2020.1.1.8.1.1 Loans to a Nonffiliate That Purchases Securities or Other Assets Through a Depository Institution Affiliate Agent or Broker

The Board issued an interpretation on an insured depository institution's loan to a nonaffiliate that purchases assets through an institution's affiliate that is acting as agent. This interpretation confirms that section 23A of the FRA does not apply to extensions of credit that an insured depository institution grants to customers that use the loan proceeds to purchase a security or other asset through an affiliate of the depository institution, so long as (1) the affiliate is acting exclusively as an agent or broker in the transaction and (2) the affiliate retains no portion of the loan proceeds as a fee or commission for its services.

Under this interpretation, the Board concluded that when the affiliated agent or broker retains a portion of the loan proceeds as a fee or commission, the portion of the loan not retained by the affiliate as a fee or commission would still be outside the coverage of section 23A. On the other hand, the portion of the loan retained by the affiliate as a fee or commission would be subject to section 23A because it represents proceeds of a loan by a depository institution to a third party that are transferred to, and used for the benefit of, an affiliate of the institution. The Board thus granted an exemption from section 23A for that portion of a loan to a third party that an affiliate retains as a market-rate brokerage or agency fee.

The interpretation would not apply if the securities or other assets purchased by the third-

16. The security will be eligible for the expanded (d)(6) exemption if it is eligible for purchase by a state member bank under section 9 of the FRA. The purchase must be recorded by the insured depository institution as a security purchased, and not as a loan, pursuant to the instructions of the bank call report. The interpretation is restricted to purchases of assets (purchase of eligible asset-backed securities) that are not low-quality assets.

party borrower through the affiliate of the depository institution were issued or underwritten by, or sold from the inventory of, another affiliate of the depository institution. In that case, the proceeds of the loan from the depository institution would be transferred to, and used for the benefit of, the affiliate that issued, underwrote, or sold the assets on a principal basis to the third party.

The above-mentioned transactions are subject to the market-terms requirement of section 23B, which applies to ''any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or any other person'' (12 U.S.C. 371c-1(a)(2)(D)). A market-rate brokerage commission or agency fee refers to a fee or commission that is no greater than that prevailing at the same time for comparable agency transactions the affiliate enters into with persons who are neither affiliates nor borrowers from an affiliated depository institution. (See 12 C.F.R. 250.243.)

2020.1.1.8.1.2 Loans to a Nonaffiliate That Purchases Securities from a Depository Institution Securities Affiliate That Acts as a Riskless Principal

The Board has granted an exemption from section 23A of the FRA for extensions of credit by an insured depository institution to customers who use the loan proceeds to purchase a security that is issued by a third party through a broker-dealer affiliate of the institution that acts as riskless principal. The exemption for riskless-principal transactions would not apply if the broker-dealer affiliate sold to the third-party borrower securities that were issued or underwritten by, or sold out of the inventory of, an affiliate of the depository institution. Riskless-principal trades, although the functional equivalent of securities brokerage transactions, involve the purchase of a security by the depository institution's broker-dealer affiliate. Accordingly, the broker-dealer retains the loan proceeds at least for some moment in time.

There is negligible risk that loans a depository institution makes to borrowers to engage in riskless-principal trades through a broker-dealer affiliate of the depository institution would be used to fund the broker-dealer. For this reason, the Board adopted an exemption from section 23A to cover riskless-principal securities transactions engaged in by depository institution borrowers through broker-dealer affiliates of the depository institution. This exemption is applicable even if the broker-dealer retains a portion of the loan proceeds as a market-rate markup for executing the riskless-principal securities trade.

2020.1.1.8.1.3 Depository Institution Loan to a Nonaffiliate Pursuant to a Preexisting Line of Credit and the Proceeds Are Used to Purchase Securities

The Board approved an exemption from section 23A for a loan by an insured depository institution to a nonaffiliate pursuant to a preexisting line of credit, in which the loan proceeds are used to purchase securities from a broker-dealer affiliate. The Board exempted extensions of credit by an insured depository institution to its customers that use the credit to purchase securities from a registered broker-dealer affiliate of the institution, so long as the extension of credit is made pursuant to, and consistent with any conditions imposed in, a preexisting line of credit. This line of credit should not have been established in expectation of a securities purchase from or through an affiliate of the institution. The preexisting requirement is an important safeguard to ensure that the depository institution did not extend credit for the purpose of inducing a borrower to purchase securities from or issued by an affiliate. In addition, the line of credit must be ''preexisting,'' and the exemption may not be used in circumstances in which the line has merely been preapproved.

2020.1.1.9 Financial Subsidiaries and Section 23A

The GLB Act established several special rules for the application of section 23A to financial subsidiaries of a bank. First, the GLB Act provided that the 10 percent quantitative limit of section 23A does not apply to covered transactions between a bank and any individual financial subsidiary of the bank. A bank's covered transactions with its financial subsidiaries, however, are subject to the statutory 20 percent quantitative limit. Accordingly, a bank may engage in covered transactions with any individual financial subsidiary up to 20 percent of the bank's capital stock and surplus. For purposes of section 23A, the amount of a bank's investment in its financial subsidiary should not, however, include the retained earnings of the financial subsidiary.

Section 23A generally applies only to transactions between a bank and an affiliate of the bank and to transactions between a bank and a third party when some benefit of the transactions accrues to an affiliate of the bank. The statute generally does not apply to transactions between two affiliates. Section 23A establishes two special anti-evasion rules, however, that govern transactions between a financial subsidiary of a bank and another affiliate of the bank. First, the FRA provides that any purchase of or investment in the securities of a bank's financial subsidiary by an affiliate of the bank will be deemed to be a purchase of, or investment in, such securities by the bank itself. Second, the GLB Act authorizes the Board to deem a loan or other extension of credit made by a bank's affiliate to any financial subsidiary of the bank to be an extension of credit by the bank to the financial subsidiary, if the Board determines that such action is necessary or appropriate to prevent evasion.

2020.1.2 SECTION 23B OF THE FEDERAL RESERVE ACT

Section 23B of the FRA became law on August 10, 1987, as part of the Competitive Equality Banking Act of 1987. This section also regulates transactions with affiliates. Section 23B applies to any covered transaction with an affiliate, as that term is defined in section 23A, but excludes banks from the term ''affiliate.'' Thus, transactions between sister banks and banks that are part of a chain banking organization are exempt from section 23B.[17] FIRREA made section 23B of the Federal Reserve Act, as well as section 23A, applicable to savings associations. The transactions covered by section 23B consist of the following:

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

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

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

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

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

17. Although transactions between banks are exempt from section 23B, the safety-and-soundness provisions of section 23A(a)(4) apply and generally require that transactions be conducted on terms similar to those terms and standards outlined in section 23B.

2020.1.3 INSPECTION OBJECTIVES

1. To analyze and assess the financial impact of transactions (including loans and purchases of assets) between the subsidiary banks and their subsidiaries and all affiliates.
2. To determine whether covered transactions between a subsidiary bank (and its subsidiaries) and its affiliates in the holding company are conducted consistent with sections 23A and 23B of the FRA.
3. To determine if transactions between a subsidiary bank and its affiliates in the holding company are on terms and conditions and under circumstances, including credit standards, that are consistent with safe and sound banking practices and whether the terms and conditions of the transactions are the same as those that would be offered or applied to nonaffiliated companies.
4. To determine whether a subsidiary bank or its subsidiary has purchased low-quality assets or has purchased, as fiduciary, any securities or other assets from an affiliate in the holding company.
5. To determine whether a subsidiary bank, or any subsidiary or affiliate of the bank, has published any advertisement or has entered into any agreement that states or suggests that it will, in any way, be responsible for the obligations of affiliates.
6. To determine if securities were purchased or acquired by the subsidiary bank or its subsidiaries from an underwriting or selling syndicate affiliated with the bank and, if so, if the majority of outside directors of the bank approved the purchase or acquisition of securities before they were offered for sale to the public.
7. To confirm that the subsidiary bank or its subsidiary has not purchased as fiduciary any securities or other assets from a nonbank affiliate in the holding company unless the purchase was permitted in accordance with the instrument creating the fiduciary relationship, by court order, or by the law governing the fiduciary relationship.
8. To ascertain if any subsidiary bank (or its subsidiary) had knowingly purchased or acquired any security from an affiliate in which the principal underwriter of that security was a nonbank affiliate within the holding company organization.
9. To determine if the subsidiary bank and its subsidiaries have conducted transactions with their parent holding company or any other company affiliated in the holding company organization that are not in compliance with the restrictions in sections 23A and 23B of the FRA (for FDIC-insured nonmember banks, section 18(j) of the Federal Deposit Insurance Act (FDIA)).

2020.1.4 INSPECTION PROCEDURES

1. During the pre-inspection, perform the following activities:
   a. Review examination reports of subsidiary banks for comments on loans to affiliates, intercompany transactions, other transactions with affiliates, and violations of the restrictions of sections 23A or 23B of the FRA or, for FDIC-insured nonmember banks, section 18(j) of the FDIA.
   b. Review the most current FR Y-8 (Report of Intercompany Transactions) and interim reports for information on transactions with affiliates.
2. In the officer's questionnaire, request a list of subsidiary bank (and the subsidiaries of the bank) transactions with affiliates since the previous inspection, including the terms and any collateral, consisting of—
   a. a loan or extension of credit to the affiliate;
   b. a purchase or sale of an investment in securities issued by or sold to the affiliate, or a purchase or sale of other assets, including assets subject to an agreement to repurchase;
   c. the acceptance of securities issued by the affiliate as collateral security for a loan or extension of credit;
   d. the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit on behalf of an affiliate;
   e. the payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise;
   f. transactions in which an affiliate acts as agent or broker or receives a fee for its services to the bank or to any other person;
   g. any transaction or series of transactions with a third party if—
      - the affiliate has a financial interest in the third party or
      - the affiliate is a participant in such transactions; and
   h. any transaction by a subsidiary bank or its subsidiary with any person, if the pro-

ceeds of that transaction are used for the benefit of, or transferred to, the affiliate.

3. During the inspection, perform the following activities:
   a. Review the listed transactions with affiliates provided in response to the officer's questionnaire.
   b. Review and determine that all transactions within the holding company organization comply with the restrictions on transactions with affiliates in sections 23A and 23B of the FRA (or in section 18(j) of the FDIA for FDIC-insured nonmember banks).
   c. Review all related documentation, terms, conditions, and circumstances for each transaction, including any resolutions for securities purchased (or established standards for securities purchased from affiliates).
   d. Determine the purpose and use of the proceeds.
   e. Review all outstanding guarantees, endorsements, or pledge agreements by the bank to support the affiliates' borrowings.
   f. Review, on a test-sample basis, advertisements and written agreements to ascertain whether the bank or any subsidiary or affiliate of the bank has stated or suggested that it shall be responsible for the obligations of any affiliates in the holding company organization.
   g. Review the holding company's policies and procedures regarding intercompany transactions of subsidiary banks.
4. Give additional attention to the following problems involving the BHC and its subsidiaries:
   a. The subsidiary bank would not have made the loan or would not have made the loan with such favorable terms and conditions, or engaged in any other covered transaction, except for the parent holding company's insistence due to the affiliate relationship.
   b. The bank's condition is weakened due to the extension of credit or the nature of the transaction with the affiliate.
   c. The affiliate has not provided adequate qualifying collateral to support the loan or extension of credit provided by the subsidiary bank.
   d. The loan, extension of credit, or transaction with an affiliate is not in compliance with the limits and restrictions in sections 23A or 23B of the FRA.
   e. Purchases of low-quality assets by a subsidiary bank or its subsidiaries from an affiliate, unless previously exempted by Board regulation or order, or unless the bank subsidiary or subsidiary affiliate, pursuant to an independent credit evaluation, had committed itself to purchase the low-quality assets before the time such asset was acquired by the affiliate.
   f. During the existence of any underwriting or selling syndicate, a subsidiary bank or its subsidiary has purchased or acquired a security from a bank affiliate or bank holding company affiliate, including an affiliated broker-dealer, and the principal underwriter of that security is an affiliate of the bank.
   g. The purchase or acquisition of securities (1) was not approved by a majority of the outside board of directors before the bank's securities were offered for sale to the public and (2) was not, in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would have been offered to, or would have applied to, nonaffiliated companies.
   h. The existence of advertisements or agreements that state or suggest that the bank, its subsidiaries, or affiliate will be responsible for the obligations of its affiliates.
5. Review any checking accounts and bank statements to check for overdrafts the parent company or any of its nonbank subsidiaries may have with a subsidiary bank.
6. Review the accounts payable to the subsidiary bank (or banks) and other accounts payable accounts for servicers, contractors, lessors, and other affiliates to determine if they arose as the equivalent of an extension of credit, purchase of securities or other assets, or as a liability to third parties. Ascertain whether those transactions were listed in response to the officer's questionnaire and whether the transactions were in accordance with the restrictions in sections 23A and 23B of the FRA.
7. Review the accounts receivable from the subsidiary bank (or banks) and other accounts receivable of other affiliates for sales of securities or other assets and for the payment of money or the furnishing of services. Ascertain whether those transactions were reported in response to the officer's

questionnaire and whether they are in accordance with the section 23A and 23B restrictions placed on transactions with affiliates.
8. Determine if subsidiary depository institutions have established and maintain policies and procedures to manage, in a safe and sound manner, the credit exposures of derivative transactions with affiliates and all affiliates in the aggregate.
9. Ascertain if the institution's credit limits, collateral requirements, and monitoring of its exposures to affiliates are at least as strict as those it imposes on unaffiliated companies.
10. Determine if the institution has policies and procedures to monitor and control the institution's intraday credit exposure to each affiliate and to all affiliates in the aggregate.
11. Determine if the institutions intraday extensions of credit to affiliates are on comparable market terms and that they comply with section 23B of the FRA.
12. Review all other transactions that the holding company organization has engaged in with its affiliated bank (or banks) and their subsidiaries, including lease arrangements, to determine whether they are subject to the restrictions in sections 23A and 23B, and, if so, whether they are in compliance.
13. Discuss the findings with appropriate senior management and, if findings are significant, the board of directors.
14. a. Determine management's actions regarding any comments raised by the bank's primary regulator in an examination report. If violations are disclosed in a subsidiary bank's examination report or during an inspection of the holding company, the examiner may criticize management on the ''Examiner's Comments and Matters Requiring Special Board Attention'' page of the inspection report for causing the bank to be in violation or for engaging in unsafe and unsound practices.
    b. If loans to or transactions with affiliates within the holding company organization appear to adversely affect a subsidiary bank, request management's assessment of such effects and its rationale for the transactions. Use of the ''Examiner's Comments and Matters Requiring Special Board Attention'' report page may be appropriate.

2020.1.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*FRRS* [3]	*Orders*
Definition of affiliate, subsidiary, bank, company, and covered transaction	371c, FRA section 23A(b)		3–1111	
Treatment of transactions with financial subsidiaries of banks	371c(e), FRA section 23A	208.73(d)	3–1114.1	
Limitations and collateral requirements	371c, FRA section 23A(c)		3–1112 3–1199	
Applicability to FDIC-insured banks	1828(j), FDIA section 18(j)		1–398	
Restrictions on transactions with affiliates	371c-1, FRA section 23B		3–1116	

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

Subject	*Laws*[1]	*Regulations*[2]	*FRRS*[3]	*Orders*
Undivided profits as part of "capital and surplus"		250.162	3–1505.1	
Derivative transactions with affiliates		250.247	3–1137	
Intraday extensions of credit to affiliates		250.248	3–1137.1	
Insured depository institution's purchase of securities from registered broker-dealer affiliates				
Broker/riskless-principal exemption		250.244		
Preexisting-line-of-credit exemption		250.245	3–1128.1	
Loan to a nonaffiliate to purchase asset through an affiliate as an agent or broker		250.243		

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

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

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

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

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

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

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

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

Loans and loan participations by the various members of the holding company family to individual borrowers or to the same or related interests may represent concentrations of credit which are large in relation to the holding company's consolidated capital position. These concentrations of credit should be assessed for potentially harmful exposure to the holding company's financial condition.

2020.2.1 INSPECTION OBJECTIVES

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

2020.2.2 INSPECTION PROCEDURES

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

2020.2.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

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

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

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

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

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

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

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

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

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

2020.3.1 INSPECTION OBJECTIVES

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

2020.3.2 INSPECTION PROCEDURES

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

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

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

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

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

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

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

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

2020.4.1 INSPECTION OBJECTIVES

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

2020.4.2 INSPECTION PROCEDURES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2020.5.1 POLICY STATEMENT ON CASH DIVIDEND PAYMENTS

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

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

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

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

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

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

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

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

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

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

2020.5.2 INSPECTION OBJECTIVES

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

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

In some cases dividends which comply with the regulations still may not be in the best interest of the bank. It is the examiner's responsibility to assess the reasonableness of dividend payments in relation to each subsidiary's capital needs. Evaluation of the holding company's dividend policy and payment requires a review at both the parent company and the consolidated levels. On a consolidated basis the holding company's capital level in relation to the quantity and quality of total assets, earnings history and potential, and growth rates are important in the assessment of a reasonable dividend payout. At the parent level, the method of funding dividends should be reviewed. For example, a well capitalized corporation with strong earnings might pay dividends which could be considered unreasonable if the organization were in a strained liquidity position.

2020.5.3 INSPECTION PROCEDURES

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

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

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

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

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

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

When dividends paid by the holding company are funded by the bank subsidiary, it is possible to control indirectly the holding company's dividend payout level when it is determined to be detrimental to the bank subsidiary. It is important to remember that the primary responsibility of bank regulators is the promotion of safe and sound banking operations. Other than the mentioned policy statement there are no specific federal laws restricting dividends paid by bank holding companies; however, the System's cease and desist authority over bank holding companies does afford the ability to curb excessive dividend payouts.

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

2020.5.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

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

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

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

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

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

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

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

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

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

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

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

2020.6.1 TRANSACTIONS SUBJECT TO FEDERAL RESERVE ACT SECTION 23B

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

2020.6.2 INSPECTION OBJECTIVES

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

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

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

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

2020.6.3 INSPECTION PROCEDURES

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

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

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

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

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

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

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

2020.6.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

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

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

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

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

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

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

2020.7.1 INSPECTION OBJECTIVES

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

2020.7.2 INSPECTION PROCEDURES

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

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

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

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

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

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

Intercompany Transactions (Trade Name or Royalty Fees) Section 2020.8

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

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

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

2020.9.1 SPLIT-DOLLAR LIFE INSURANCE POLICY ARRANGEMENTS

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

2020.9.1.1 Split-Dollar Life Insurance Endorsement Plan

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

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

2020.9.1.2 Split-Dollar Life Insurance Collateral Assignment Plan

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

2020.9.2 COMPLIANCE WITH APPLICABLE LAWS

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

Both of the aforementioned types of split-dollar life insurance policy arrangements may be inappropriate if they are inconsistent with sections 23A or 23B of the Federal Reserve Act (FRA). Section 23A places quantitative restrictions and other requirements on certain transactions, including loans, between banks and their affiliates. The statute also requires that loans between banks and their affiliates be secured with collateral having a specified market value that depends on the type of collateral used to secure the loan. Under an endorsement plan, where the subsidiary bank pays all or substantially all of the insurance premiums, an unsecured extension of credit from the subsidiary bank to its parent holding company generally results because the subsidiary bank has paid the bank holding company's portion of the premium, and the bank will not be reimbursed fully for its payment until sometime in the future.

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

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

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

2020.9.2.2 Investment Authority Under the National Bank Act

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

2020.9.3 SAFETY-AND-SOUNDNESS CONCERNS

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

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

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

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

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

2020.9.4 EXAMINER REVIEW OF SPLIT-DOLLAR LIFE INSURANCE

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

2020.9.5 INSPECTION OBJECTIVES

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

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

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

2020.9.6 INSPECTION PROCEDURES

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

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

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

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

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

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

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

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

2020.9.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

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

2020.9.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

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

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

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

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

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

2030.0.1 INDEFINITE GRANDFATHER PRIVILEGES

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

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

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

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

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

2030.0.2 ACTIVITIES AND SECURITIES OF NEW BANK HOLDING COMPANIES

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

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

Refer to Manual section 3170.0.3.4.1.

2030.0.4 SUCCESSOR RIGHTS

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

2030.0.5 EXPANSION OF GRANDFATHER ACTIVITIES

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

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

2030.0.6 DIVESTITURES *(also see Manual section 2090.6)*

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

As mentioned earlier, reviews of a company’s grandfather privileges may be precipitated by such circumstances as: (1) a subsidiary bank of an indefinitely grandfathered company attaining assets in excess of $60 million (reviewed within two years); (2) a company seeking approval to engage in another activity or acquire another bank; (3) a company which violates the Act; or (4) a company operating in a manner which results in an undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices.

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

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

2030.0.7 INSPECTION OBJECTIVES

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

2030.0.8 INSPECTION PROCEDURES

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

2030.0.9 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

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

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

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

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

2030.0.10 APPENDIX 1—EXPANSION OF GRANDFATHERED ACTIVITIES

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

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

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

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

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

2040.0.1 INSPECTION OBJECTIVES

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

2040.0.2 INSPECTION PROCEDURES

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

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

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

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

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

In addition to the above supervisory considerations, the Sarbanes-Oxley Act of 2002 (Pub. L. No. 107-204) (the act) imposed certain insider lending restrictions on public companies, including BHCs that are public companies. A BHC generally is considered a public company for these purposes if it has a class of securities registered under section 12 of the Securities Exchange Act of 1934 (the 1934 act) or is required to file reports with the Securities and Exchange Commission (SEC) under section 15 of the 1934 act. The Sarbanes-Oxley Act[1] prohibits a publicly owned BHC (public BHC) and its subsidiaries from extending credit, or arranging for another entity to extend credit, in the form of a personal loan to any director or executive officer of the public BHC.[2] This prohibition does not apply to any extension of credit made before July 30, 2002, so long as the loan is not renewed or materially modified after that date.

The Sarbanes-Oxley Act includes two exceptions to this loan prohibition. First and most importantly, the prohibition does not apply to any loan made by an insured depository institution that is subject to the insider lending restrictions of section 22(h) of the Federal Reserve Act, as implemented by the Board's Regulation O. Thus, loans by the insured depository institution subsidiaries of a public BHC to a director or executive officer of the BHC likely are exempt from the prohibition, although they would be subject to Regulation O as discussed below. The second exception permits the directors and executive officers of a public BHC to obtain home improvement and manufactured home loans, consumer loans, and loans under open-end credit plans or charge cards from the public BHC or its subsidiaries, so long as the credit (1) is extended in the ordinary course of the company's consumer credit business, (2) is a kind of credit generally made available to the public, and (3) is made on market terms or on terms that are no more favorable than those offered to the general public.[2a]

2050.0.2 TRANSACTIONS INVOLVING OTHER PROPERTY OR SERVICES

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

1. purchase of assets or services from the BHC or nonbank subsidiary, particularly if at a discount or on preferential terms;
2. sale of assets or services to the BHC

1. See 15 U.S.C. 78m (section 402 of the act).

2. The act does not restrict lending by a subsidiary of a public BHC to the subsidiary's own directors and executive officers, so long as these persons are not also directors or executive officers of the public BHC.

2a. A registered broker-dealer that is a public company, or a subsidiary of a public company, also is not prohibited from providing margin credit to its employees to buy, trade, or carry securities if the credit is made in accordance with the margin rules; is not made to purchase stock of the broker-dealer; and complies with the requirements set forth in (1), (2), and (3) above.

or nonbank subsidiary, particularly if at a premium;
3. lease of property to or from the BHC or nonbank subsidiary; and
4. use of BHC or nonbank subsidiary property or personnel by a BHC official or related interest.

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

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

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

2050.0.3 REGULATION O

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

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

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

2050.0.3.1 FDICIA and BHC Inspection Guidance for Regulation O

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

The following are some of the more significant changes that were made effective May 18, 1992:[2b]

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

2. *Lending limits for directors and related interests (section 215.4(c)).* Loans to directors (and their related interests) are subject to the same lending limit that is applicable to executive officers and principal shareholders (and their related interests).

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

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

2b. The Regulation O cites are to the February 18, 1994, amendment.

2c. The term ''insider'' refers to an executive officer, director, or principal shareholder, and includes any related interest of such a person.

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

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

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

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

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

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

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

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

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

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

c. a segregated deposit account with the lending bank.

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

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

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

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

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

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

2050.0.3.2 Definitions in Regulation O (abbreviated listing)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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and the director does not actually participate in those functions;

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

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

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

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

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

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

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

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

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

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

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

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

2050.0.3.2.1 Extension of Credit

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

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

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

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

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

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

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

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

An extension of credit *does not* include—

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

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

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

extension by the appropriate federal banking agency for good cause;

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

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

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

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

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

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

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

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

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

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

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

2050.0.3.3 General Prohibitions and Limitations of Regulation O

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

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

1. is widely available to employees of the member bank, and in the case of extensions of credit to an insider of its affiliates, is widely available to employees of the affiliates at which that person is an insider; and

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

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

The board of directors’ approval is not required for an extension of credit that is made pursuant to a line of credit that was approved by the board of directors within 14 months of the date of the extension of credit. Participation in the discussion, or any attempt to influence the voting, by the board of directors regarding an extension of credit constitutes indirect participation in the voting by the board of directors on an extension of credit.

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

(d) *Aggregate lending limit.*

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2050.0.3.4 Additional Restrictions on Loans to Executive Officers of Member Banks

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2050.0.3.5 Grandfathering Provisions

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

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

2050.0.3.6 Reports by Executive Officers

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

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

2050.0.3.7 Report on Credit to Executive Officers

Each member bank must include with (but not as part of) each report of condition (and copy thereof) filed pursuant to 12 U.S.C. 1817(a)(3) a report of all extensions of credit made by the member bank to its executive officers since the date of the bank's previous report of condition.

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

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

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

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

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

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

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

2050.0.3.9 Civil Penalties of Regulation O

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

2050.0.3.10 Records of Member Banks (and BHCs)

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

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

10. See footnote 3.

2050.0.3.10.1 Recordkeeping for Insiders of the Member Bank's Affiliates

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

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

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

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

2050.0.3.10.2 Special Rule for Noncommercial Lenders

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

2050.0.3.11 Section 23A Ramifications

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

2050.0.4 REMEDIAL ACTION

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

2050.0.5 INSPECTION OBJECTIVES

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

2050.0.6 INSPECTION PROCEDURES

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

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

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

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

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

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

2050.0.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Loans and extensions of credit to executive officers, directors, and principal shareholders	375a and 375b (sections 22(g) and 22(h) of F.R. Act)	215.4 215.5 (Reg. O)		
Granting of below-market interest rate mortgage loans to executives of BHC subsidiaries as compensation			4–514 3–1094	
Loans from correspondents		215.22 215.23		
Loans to correspondents	1972	215.20		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Management Information Systems (General) Section 2060.0

Management Information Systems refers to the policies and operating procedures, including systems of internal control, that the board of directors of a bank holding company initiates to monitor and ensure control of its operations and activities, while maintaining and improving the financial strength and objectives of the overall organization. These policies should focus on the overall organizational structure with respect to identifying, monitoring, and managing risks. Subsequent sections of the manual focus on the essential elements of various management information systems. Included are inspection objectives and procedures to be used by Federal Reserve Bank examiners when conducting inspections of bank holding companies.

See 2060.05 Internal Audit Function and Its Outsourcing
2060.1 Audit
2060.2 Budget
2060.3 Records and Statements
2060.4 Reporting
2060.5 Insurance
5052.0 Targeted MIS Inspection

Effective internal control[1] is a foundation for the safe and sound operation of a financial institution (institution).[2] 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. The federal banking agencies'[3] (agencies) longstanding inspection policies call for examiners to review an institution's internal audit function and recommend improvements, if needed. In addition, pursuant to section 39 of the Federal Deposit Insurance Act (FDI Act) (12 U.S.C. 1831p-1), the agencies have adopted Interagency Guidelines Establishing Standards for Safety and Soundness that apply to insured depository institutions.[4] Under these guidelines and policies, each institution should have an internal audit function that is appropriate to its size and the nature and scope of its activities.

In addressing various quality and resource issues, many institutions have been engaging independent public accounting firms and other outside professionals (outsourcing vendors) in recent years to perform work that traditionally has been done by internal auditors. These arrangements are often called "internal audit outsourcing," "internal audit assistance," "audit co-sourcing," and "extended audit services" (hereafter collectively referred to as outsourcing). Typical outsourcing arrangements are more fully illustrated in part II below.

Outsourcing may be beneficial to an institution if it is properly structured, carefully conducted, and prudently managed. However, the agencies have concerns that the structure, scope, and management of some internal audit outsourcing arrangements do not contribute to the institution's safety and soundness. Furthermore, the agencies want to ensure that these arrangements with outsourcing vendors do not leave directors and senior management with the erroneous impression that they have been relieved of their responsibility for maintaining an effective system of internal control and for overseeing the internal audit function.

The Sarbanes-Oxley Act of 2002 (the act) became law on July 30, 2002.[5] The act addresses weaknesses in corporate governance and the accounting and auditing professions, and includes provisions addressing audits, financial reporting and disclosure, conflicts of interest, and corporate governance at publicly owned companies. The act, among other things, requires public companies to have an audit committee composed entirely of independent directors. Public banking organizations that are listed on the New York Stock Exchange (NYSE) and Nasdaq must also comply with those exchanges' listing requirements, which include audit committee requirements.

The act also established a Public Company Accounting Oversight Board (PCAOB) that has the authority to set and enforce auditing, attestation, quality-control, and ethics (including independence) standards for auditors of public com-

1. In summary, 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 *Internal Control—Integrated Framework*. In addition, under the COSO framework, financial reporting is defined in terms of published financial statements, which, for purposes of this policy statement, encompasses both financial statements prepared in accordance with generally accepted accounting principles and regulatory reports (such as the Reports of Condition and Income). Institutions are encouraged to evaluate their internal control against the COSO framework.

2. The term "institution" includes depository institutions insured by the Federal Deposit Insurance Corporation (FDIC), U.S. financial holding companies and bank holding companies supervised by the Federal Reserve System, thrift holding companies supervised by the Office of Thrift Supervision (OTS), and the U.S. operations of foreign banking organizations.

3. The Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision.

4. For national banks, appendix A to part 30; for state member banks, appendix D-1 to part 208; for insured state nonmember banks and insured state-licensed branches of foreign banks, appendix A to part 364; for savings associations, appendix A to part 570.

5. Pub. L. No. 107-204.

panies, subject to SEC review. (See SR-02-20.) Accounting firms that conduct audits of public companies (i.e., registered accounting firms) must register with the PCAOB and be subject to its supervision. The PCAOB is also empowered to inspect the auditing operations of public accounting firms that audit public companies, as well as impose disciplinary and remedial sanctions for violations of its rules, securities laws, and professional auditing and accounting standards.

2060.05.05 APPLICATION OF THE SARBANES-OXLEY ACT TO NONPUBLIC BANKING ORGANIZATIONS

In May 2003, the Federal Reserve, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision announced that they did not expect to take actions to apply the corporate-governance and other requirements of the Sarbanes-Oxley Act generally to nonpublic banking organizations that are not otherwise subject to them.[5a] (See SR-03-08.) The agencies, however encouraged nonpublic banking organizations to periodically review their policies and procedures relating to corporate-governance and auditing matters. This review should ensure that such policies and procedures are consistent with applicable law, regulations, and supervisory guidance and remain appropriate in light of the organization's size, operations, and resources. Furthermore, the agencies stated that a banking organization's policies and procedures for corporate governance, internal controls, and auditing will be assessed during the supervisory process, and the agencies may take appropriate supervisory action if there are deficiencies or weaknesses in these areas that are inconsistent with sound corporate-governance practices or safety-and-soundness considerations.

5a. As discussed below, some aspects of the auditor-independence rules established by the Sarbanes-Oxley Act apply to all federally insured depository institutions with $500 million or more in total assets. See part 363 of the FDIC's regulations.

2060.05.06 INTERAGENCY POLICY STATEMENT ON THE INTERNAL AUDIT FUNCTION AND ITS OUTSOURCING

The Federal Reserve and other federal banking agencies[6] adopted on March 17, 2003, an interagency policy statement addressing the internal audit function and its outsourcing. The policy statement revises and replaces the former 1997 policy statement and incorporates recent developments in internal auditing. In addition, the revised policy incorporates guidance on the independence of accountants who provide institutions with both internal and external audit services in light of the Sarbanes-Oxley Act of 2002 and associated SEC rules. (See also sections 2124.0.2.4, 2060.1, 3230.0.10.2.5, 5010.7, and 5030.0 (page 7) pertaining to internal and external audits.)

The act prohibits an accounting firm from acting as the external auditor of a public company during the same period that the firm provides internal audit services to the company. The policy statement discusses the applicability of this prohibition to institutions that are public companies, insured depository institutions with assets of $500 million or more that are subject to the annual audit and reporting requirements of section 36 of the Federal Deposit Insurance Act, and also nonpublic institutions that are not subject to section 36.

2060.05.1 INTERNAL AUDIT FUNCTION (PART I)

2060.05.1.1 Director and Senior Management Responsibilities for Internal Audit

The board of directors and senior management are responsible for having an effective system of internal control and an effective internal audit function in place at their institution. They are also responsible for ensuring that the importance of internal control is understood and respected throughout the institution. This overall responsibility cannot be delegated to anyone else. They may, however, delegate the design, implementation, and monitoring of specific internal controls to lower-level management and the testing and assessment of internal controls to others. Accordingly, directors and senior management should have reasonable assurance that the system of internal control prevents or detects

6. The FDIC, OCC, and OTS.

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.[7]

Some institutions have chosen to rely on so-called management self-assessments or control self-assessments, wherein business-line managers and their staff evaluate the performance of internal controls within their purview. Such reviews help to underscore management's responsibility for internal control, but they are not impartial. Directors and members of senior management who rely too much on these reviews may not learn of control weaknesses until they have become costly problems, particularly if directors are not intimately familiar with the institution's operations. Therefore, institutions generally should also have their internal controls tested and evaluated by units without business-line responsibilities, such as internal audit groups.

Directors should be confident that the internal audit function addresses the risks and meets the demands posed by the institution's current and planned activities. To accomplish this objective, 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 matters are reflected in their institution's internal audit function.

2060.05.1.1.1 Internal Audit Placement and Structure Within the Organization

Careful thought should be given to the placement of the audit function in the institution's

7. As noted above, under section 36 of the FDI Act, as implemented by part 363 of the FDIC's regulations (12 C.F.R. 363), FDIC-insured depository institutions with total assets of $500 million or more must submit an annual management report signed by the chief executive officer (CEO) and chief accounting or chief financial officer. This report must discuss management's responsibility for financial reporting controls and assess the effectiveness of those controls as well as the institution's compliance with designated laws and regulations.

management structure. The internal audit function should be positioned so that the board has confidence that the internal audit function will perform its duties with impartiality and not be unduly influenced by managers of day-to-day operations. The audit committee,[8] using objective criteria it has established, should oversee the internal audit function and evaluate its performance.[9] The audit committee should assign responsibility for the internal audit function to a member of management (that is, the manager of internal audit or internal audit manager) who understands the function and has no responsibility for operating the system of internal control. The ideal organizational arrangement is for this manager to report directly and solely to the audit committee regarding both audit issues and administrative matters, e.g., resources, budget, appraisals, and compensation. Institutions are encouraged to consider the IIA's *Practice Advisory 2060-2: Relationship with the Audit Committee*, which provides more guidance on the roles and relationships between the audit committee and the internal audit manager.

Many institutions place the manager of internal audit under a dual reporting arrangement: functionally accountable to the audit committee on issues discovered by the internal audit function, while reporting to another senior manager on administrative matters. Under a dual reporting relationship, the board should consider the potential for diminished objectivity on the part of the internal audit manager with respect to audits concerning the executive to whom he or she reports. For example, a manager of internal audit who reports to the chief financial officer (CFO) for performance appraisal, salary, and approval of department budgets may approach audits of the accounting and treasury operations controlled by the CFO with less objectivity than if the manager were to report to the chief executive officer. Thus, the chief financial officer, controller, or other similar officer should ideally be excluded from overseeing the internal audit activities even in a dual role. The objectivity and organizational stature of the internal audit function are best served under such a dual arrangement if the internal audit manager reports administratively to the CEO.

Some institutions seek to coordinate the internal audit function with several risk-monitoring functions (for example, loan review, market-risk assessment, and legal compliance departments) by establishing an administrative arrangement under one senior executive. Coordination of these other monitoring activities with the internal audit function can facilitate the reporting of material risk and control issues to the audit committee, increase the overall effectiveness of these monitoring functions, better utilize available resources, and enhance the institution's ability to comprehensively manage risk. Such an administrative reporting relationship should be designed so as to not interfere with or hinder the manager of internal audit's functional reporting to and ability to directly communicate with the institution's audit committee. In addition, the audit committee should ensure that efforts to coordinate these monitoring functions do not result in the manager of internal audit conducting control activities nor diminish his or her independence with respect to the other risk-monitoring functions. Furthermore, the internal audit manager should have the ability to independently audit these other monitoring functions.

In structuring the reporting hierarchy, the board should weigh the risk of diminished independence against the benefit of reduced administrative burden in adopting a dual reporting organizational structure. The audit committee should document its consideration of this risk and mitigating controls. The IIA's *Practice Advisory 1110-2: Chief Audit Executive Reporting Lines* provides additional guidance regarding functional and administrative reporting lines.

2060.05.1.1.2 Internal Audit Management, Staffing, and Audit Quality

In managing the internal audit function, the manager of internal audit is responsible for control risk assessments, audit plans, audit programs, and audit reports.

1. A control risk assessment (or risk-assessment methodology) documents the internal auditor's understanding of the institution's sig-

8. Depository institutions subject to section 36 of the FDI Act and part 363 of the FDIC's regulations must maintain independent audit committees (i.e., consisting of directors who are not members of management). Consistent with the 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations, the agencies also encourage the board of directors of each depository institution that is not otherwise required to do so to establish an audit committee consisting entirely of outside directors. Where the term "audit committee" is used in this policy statement, the board of directors may fulfill the audit committee responsibilities if the institution is not subject to an audit committee requirement.

9. For example, the performance criteria could include the timeliness of each completed audit, comparison of overall performance to plan, and other measures.

nificant business activities and their associated risks. These assessments typically analyze the risks inherent in a given business line, the mitigating control processes, and the resulting residual risk exposure of the institution. They should be updated regularly to reflect changes to the system of internal control or work processes and to incorporate new lines of business.

2. An internal audit plan is based on the control risk assessment and typically includes a summary of key internal controls within each significant business activity, the timing and frequency of planned internal audit work, and a resource budget.
3. An internal audit program describes the objectives of the audit work and lists the procedures that will be performed during each internal audit review.
4. An audit report generally presents the purpose, scope, and results of the audit, including findings, conclusions, and recommendations. Workpapers 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. Internal auditors increasingly have taken a consulting role within institutions on new products and services and on mergers, acquisitions, and other corporate reorganizations. This role typically includes helping design controls and participating in the implementation of changes to the institution's control activities. The audit committee, in its oversight of the internal audit staff, should ensure that the function's consulting activities do not interfere or conflict with the objectivity it should have with respect to monitoring the institution's system of internal control. In order to maintain its independence, the internal audit function should not assume a business-line management role over control activities, such as approving or implementing operating policies or procedures, including those it has helped design in connection with its consulting activities. The agencies encourage internal auditors to follow the IIA's standards, including guidance related to the internal audit function acting in an advisory capacity.

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. The manager of internal audit should oversee the staff assigned to perform the internal audit work and should establish policies and procedures to guide the audit staff. The form and content of these policies and procedures should be consistent with the size and complexity of the department and the institution. Many policies and procedures may be communicated informally in small internal audit departments, while larger departments would normally require more formal and comprehensive written guidance.

2060.05.1.1.3 Internal Audit Frequency and Scope

The frequency and extent of internal audit review and testing should be consistent with the nature, complexity, and risk of the institution's on- and off-balance-sheet activities. At least annually, the audit committee should review and approve internal audit's control risk assessment and the scope of the audit plan, including how much the manager relies on the work of an outsourcing vendor. It should also periodically review internal audit's adherence to the audit plan. The audit committee should consider requests for expansion of basic internal audit work when significant issues arise or when significant changes occur in the institution's environment, structure, activities, risk exposures, or systems.[10]

2060.05.1.1.4 Communication of Internal Audit Findings to the Directors, Audit Committee, and Management

To properly carry out their responsibility for internal control, directors and senior management should foster forthright communications and critical inspection of issues to better understand the importance and severity of internal control weaknesses identified by the internal auditor and operating management's solutions

10. Major changes in an institution's environment and conditions may compel changes to the internal control system and also warrant additional internal audit work. These include (1) new management; (2) areas or activities experiencing rapid growth or rapid decline; (3) new lines of business, products, or technologies or disposals thereof; (4) corporate restructurings, mergers, and acquisitions; and (5) expansion or acquisition of foreign operations (including the impact of changes in the related economic and regulatory environments).

to these weaknesses. Internal auditors should report internal control deficiencies to the appropriate level of management as soon as they are identified. Significant matters should be promptly reported directly to the board of directors (or its audit committee) and senior management. In periodic meetings with management and the manager of internal audit, the audit committee should assess whether management is expeditiously resolving internal control weaknesses and other exceptions. 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.[11] In addition, the audit committee should set up procedures for the timely investigation of complaints received and the retention for a reasonable time period of documentation concerning the complaint and its subsequent resolution.

2060.05.1.1.5 Contingency Planning

As with any other function, the institution should have a contingency plan to mitigate any significant discontinuity in audit coverage, particularly for high-risk areas. Lack of contingency planning for continuing internal audit coverage may increase the institution's level of operational risk.

2060.05.1.2 U.S. Operations of Foreign Banking Organizations

The internal audit function of a foreign banking organization (FBO) should cover its U.S. operations in its risk assessments, audit plans, and audit programs. Its U.S.-domiciled audit function, head-office internal audit staff, or some combination thereof normally performs the internal audit of the U.S. operations. Internal audit findings (including internal control deficiencies) should be reported to the senior management of the U.S. operations of the FBO and the audit department of the head office. Significant adverse findings also should be reported to the head office's senior management and the board of directors or its audit committee.

11. Where the board of directors fulfills the audit committee responsibilities, the procedures should provide for the submission of employee concerns to an outside director.

2060.05.1.3 Internal Audit Systems and the Audit Function for Small Financial Institutions

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. Each institution should have an internal audit function that is appropriate to its size and the nature and scope of its activities. The procedures assigned to this function should include adequate testing and review of internal controls and information systems.

It is 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 costs 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 outweigh 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 responsible 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.

2060.05.2 INTERNAL AUDIT OUTSOURCING ARRANGEMENTS (PART II)

2060.05.2.1 Examples of Internal Audit Outsourcing Arrangements

An outsourcing arrangement is a contract between an institution and an outsourcing vendor to provide internal audit services. Outsourcing arrangements take many forms and are used by institutions of all sizes. 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. The internal audit services under contract can be limited to helping internal audit staff in an assignment for which they lack expertise. Such an arrangement is typically under the control of the institution's manager of internal audit, and the outsourcing vendor reports to him or her. Institutions often use outsourcing vendors for audits of areas requiring more technical expertise, such as electronic data processing and capital-markets activities. Such uses are often referred to as ''internal audit assistance'' or ''audit co-sourcing.''

Some outsourcing arrangements may require an outsourcing vendor to perform virtually all the procedures or tests of the system of internal control. Under such an arrangement, a designated manager of internal audit oversees the activities of the outsourcing vendor and typically is supported by internal audit staff. The outsourcing vendor may assist the audit staff in determining risks to be reviewed and may recommend testing procedures, but the internal audit manager is responsible for approving the audit scope, plan, and procedures to be performed. Furthermore, the internal audit manager is responsible for the results of the outsourced audit work, including findings, conclusions, and recommendations. The outsourcing vendor may report these results jointly with the internal audit manager to the audit committee.

2060.05.2.2 Additional Inspection and Examination Considerations for Internal Audit Outsourcing Arrangements

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. In any outsourced internal audit arrangement, the institution's board of directors and senior management 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, often taking the form of an engagement letter.[12] Contracts between the institution and the vendor typically include provisions that—

1. define the expectations and responsibilities under the contract for both parties;
2. set the scope and frequency of, and the fees to be paid for, the work to be performed by the vendor;
3. set the responsibilities for providing and receiving information, such as the type and frequency of reporting to senior management and directors about the status of contract work;
4. establish the process for changing the terms of the service contract, especially for expansion of audit work if significant issues are found, and stipulations for default and termination of the contract;
5. state that internal audit reports are the property of the institution, that the institution will be provided with any copies of the related workpapers it deems necessary, and that employees authorized by the institution will have reasonable and timely access to the workpapers prepared by the outsourcing vendor;
6. specify the locations of internal audit reports and the related workpapers;
7. specify the period of time (for example, seven years) that vendors must maintain the workpapers;[13]
8. state that outsourced internal audit services provided by the vendor are subject to regulatory review and that examiners will be granted full and timely access to the internal audit reports and related workpapers prepared by the outsourcing vendor;

12. The engagement letter provisions described are comparable to those outlined by the American Institute of Certified Public Accountants (AICPA) for financial statement audits (see AICPA Professional Standards, AU section 310). These provisions are consistent with the provisions customarily included in contracts for other outsourcing arrangements, such as those involving data processing and information technology. Therefore, the federal banking agencies consider these provisions to be usual and customary business practices.

13. If the workpapers are in electronic format, contracts often call for the vendor to maintain proprietary software that enables the bank and examiners to access the electronic workpapers for a specified time period.

9. prescribe 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
10. state that the outsourcing 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, SEC, PCAOB, or regulatory independence guidance.

2060.05.2.2.1 Management of the Outsourced Internal Audit Function

Directors and senior management should ensure that the outsourced internal audit function is competently managed. For example, larger institutions should employ sufficient competent staff members in the internal audit department to assist the manager of internal audit in overseeing the outsourcing vendor. Small institutions that do not employ a full-time audit manager should appoint a competent employee who ideally has no managerial responsibility for the areas being audited to oversee the outsourcing vendor's performance under the contract. This person should report directly to the audit committee for purposes of communicating internal audit issues.

2060.05.2.2.2 Communication of Outsourced Internal Audit Findings to Directors and Senior Management

Communication between the internal audit function and the audit committee and senior management should not diminish because the institution engages an outsourcing vendor. All work by the outsourcing vendor 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.

2060.05.2.2.3 Competence of Outsourced Internal Audit Vendor

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. The staff's qualifications may be demonstrated, for example, through prior experience with financial institutions. Because the outsourcing arrangement is a personal-services contract, the institution's internal audit manager should have confidence in the competence of the staff assigned by the outsourcing vendor and receive timely notice of key staffing changes. Throughout the outsourcing arrangement, management should ensure that the outsourcing vendor maintains sufficient expertise to effectively perform its contractual obligations.

2060.05.2.2.4 Contingency Planning to Avoid Discontinuity of Internal Audit Coverage

When an institution enters into an outsourcing arrangement (or significantly changes the mix of internal and external resources used by internal audit), it may increase its operational risk. Because the arrangement may be terminated suddenly, the institution should have a contingency plan to mitigate any significant discontinuity in audit coverage, particularly for high-risk areas.

2060.05.3 INDEPENDENCE OF THE INDEPENDENT PUBLIC ACCOUNTANT (PART III)

The following discussion applies only when a financial instituion is considering using a public accountant to provide both external audit and internal audit services to the institution.

When one accounting firm performs both the external audit and the outsourced internal audit function, the firm risks compromising its independence. These concerns arise because, rather than having two separate functions, this outsourcing arrangement places the independent public accounting firm in the position of appearing to audit, or actually auditing, its own work. For example, in auditing an institution's financial statements, the accounting firm will consider the extent to which it may rely on the internal control system, including the internal audit function, in designing audit procedures. . .

2060.05.3.1 Applicability of the SEC's Auditor Independence Requirements

2060.05.3.1.1 Institutions That Are Public Companies

To strengthen auditor independence, Congress passed the Sarbanes-Oxley Act of 2002 (the act). Title II of the act applies to any public company—that is, any company that has a class of securities registered with the SEC or the appropriate federal banking agency under section 12 of the Securities Exchange Act of 1934 or that is required to file reports with the SEC under section 15(d) of that act.[14] The act 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 to the company.[15] In addition, if a public company's external auditor will be providing auditing services and permissible nonaudit services, such as tax services, the company's audit committee must preapprove each of these services.

According to the SEC's final rules (effective May 6, 2003) implementing the act's nonaudit service prohibitions and audit committee preapproval requirements, an accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides internal audit outsourcing or other prohibited nonaudit services to the public company audit client. The SEC's final rules generally become effective May 6, 2003, although a one-year transition period is provided if the accountant is performing prohibited nonaudit services and actual audit services for a public company pursuant to a contract in existence on May 6, 2003. The services provided during this transition period, however, must not have impaired the auditor's independence under the preexisting independence requirements of the SEC, the Independence Standards Board, and the AICPA. Although the SEC's pre-Sarbanes-Oxley independence requirements (issued November 2000 (effective August 2002)) did not prohibit the outsourcing of internal audit services to a public company's independent public accountant, they did place conditions and limitations on internal audit outsourcing.

2060.05.3.1.2 Depository Institutions Subject to the Annual Audit and Reporting Requirements of Section 36 of the FDI Act

Under section 36, as implemented by part 363 of the FDIC's regulations, each FDIC-insured depository institution with total assets of $500 million or more is required to have an annual audit performed by an independent public accountant.[16] The part 363 guidelines address the qualifications of an independent public accountant engaged by such an institution by stating that "[t]he independent public accountant should also be in compliance with the AICPA's *Code of Professional Conduct* and meet the independence requirements and interpretations of the SEC and its staff."[17]

Thus, the guidelines provide for each FDIC-insured depository institution with $500 million or more in total assets, whether or not it is a public company, and its external auditor to comply with the SEC's auditor independence requirements that are in effect during the period covered by the audit. These requirements include the nonaudit-service prohibitions and audit committee preapproval requirements implemented by the SEC's January 2003 auditor independence rules, once the rules come into effect.[18]

14. 15 U.S.C. 78*l* and 78o(d).

15. In addition to prohibiting internal audit outsourcing, the Sarbanes-Oxley Act (15 U.S.C. 78j-1) also identifies other nonaudit services that an external auditor is prohibited from providing to a public company whose financial statements it audits. The legislative history of the act indicates that three broad principles should be considered when determining whether an auditor should be prohibited from providing a nonaudit service to an audit client. These principles are that an auditor should not (1) audit his or her own work, (2) perform management functions for the client, or (3) serve in an advocacy role for the client. To do so would impair the auditor's independence. Based on these three broad principles, the other nonaudit services . . . referred to in this section . . . that an auditor is prohibited from providing to a public company audit client include bookkeeping or other services related to the client's accounting records or financial statements; financial information systems design and implementation; appraisal or valuation services, fairness opinions, or contribution-in-kind reports; actuarial services; management functions or human resources; broker or dealer, investment adviser, or investment banking services; legal services and expert services unrelated to the audit; and any other service determined to be impermissible by the PCAOB.

16. 12 C.F.R. 363.3(a). (See FDIC Financial Institutions Letter, FIL-17-2003 (Corporate Governance, Audits, and Reporting Requirements), Attachment II, March 5, 2003.)

17. Appendix A to part 363, Guidelines and Interpretations, paragraph 14, Independence.

18. If a depository institution subject to section 36 and part 363 satisfies the annual independent audit requirement by relying on the independent audit of its parent holding com-

2060.05.3.1.3 Institutions Not Subject to Section 36 of the FDI Act That Are Neither Public Companies Nor Subsidiaries of Public Companies

The agencies have long encouraged each institution not subject to section 36 of the FDI Act that is neither a public company nor a subsidiary of a public company[19] to have its financial statements audited by an independent public accountant.[20] The agencies also encourage each such institution to follow the internal audit outsourcing prohibition in the Sarbanes-Oxley Act, as discussed above for institutions that are public companies. As previously mentioned, some institutions seek to enhance the quality of their control environment by obtaining the services of an outsourcing vendor who can critically assess their internal control system and recommend improvements. The agencies believe that a small nonpublic institution with less complex operations and limited staff can, in certain circumstances, use the same accounting firm to perform both an external audit and some or all of the institution's internal audit activities. These circumstances include, but are not limited to, situations where—

1. splitting the audit activities poses significant costs or burden,
2. persons with the appropriate specialized knowledge and skills are difficult to locate and obtain,
3. the institution is closely held and investors are not solely reliant on the audited financial statements to understand the financial position and performance of the institution, and
4. the outsourced internal audit services are limited in either scope or frequency.

In circumstances such as these, the agencies view an internal audit outsourcing arrangement between a small nonpublic institution and its external auditor as not being inconsistent with their safety-and-soundness objectives for the institution.

When a small nonpublic institution decides to hire the same firm to perform internal and external audit work, the audit committee and the external auditor should pay particular attention to preserving the independence of both the internal and external audit functions. Furthermore, the audit committee should document both that it has preapproved the internal audit outsourcing to its external auditor and has considered the independence issues associated with this arrangement.[21] In this regard, the audit committee should consider the independence standards described in parts I and II of the policy statement, the AICPA guidance discussed below, and the broad principles that the auditor should not perform management functions or serve in an advocacy role for the client.

Accordingly, the agencies will not consider an auditor who performs internal audit outsourcing services for a small nonpublic audit client to be independent unless the institution and its auditor have adequately addressed the associated independence issues. In addition, the institution's board of directors and management must retain ownership of and accountability for the internal audit function and provide active oversight of the outsourced internal audit relationship.

A small nonpublic institution may be required by another law or regulation, an order, or another supervisory action to have its financial statements audited by an independent public accountant. In this situation, if warranted for safety-and-soundness reasons, the institution's primary federal regulator may require that the institution and its independent public accountant comply with the auditor independence requirements of the Act.[22]

2060.05.3.1.4 AICPA Guidance

As noted above, the independent public accountant for a depository institution subject to section 36 of the FDI Act also should be in compliance with the AICPA's *Code of Professional Conduct*. This code includes professional ethics standards, rules, and interpretations that are

pany, once the SEC's January 2003 regulations prohibiting an external auditor from performing internal audit outsourcing services for an audit client take effect May 6, 2003, or May 6, 2004, depending on the circumstances, the holding company's external auditor cannot perform internal audit outsourcing work for that holding company or the subsidiary institution.

19. FDIC-insured depository institutions with less than $500 million in total assets are not subject to section 36 of the FDI Act. Section 36 does not apply directly to holding companies, but it provides that, for an insured depository institution that is a subsidiary of a holding company, its audited financial statements requirement and certain of its other requirements may be satisfied by the holding company.

20. See, for example, the 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Institutions.

21. If a small nonpublic institution is considering having its external auditor perform other nonaudit services, its audit committee may wish to discuss the implications of the performance of these services on the auditor's independence.

22. 15 U.S.C. 78j-1.

binding on all certified public accountants (CPAs) who are members of the AICPA in order for the member to remain in good standing. Therefore, this code applies to each member CPA who provides audit services to an institution, regardless of whether the institution is subject to section 36 or is a public company.

The AICPA has issued guidance indicating that a member CPA would be deemed not independent of his or her client when the CPA acts or appears to act in a capacity equivalent to a member of the client's management or as a client employee. The AICPA's guidance includes illustrations of activities that would be considered to compromise a CPA's independence. Among these are activities that involve the CPA authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of the client. For additional details, refer to Interpretation 101-3, Performance of Other Services, and Interpretation 101-13, Extended Audit Services, in the AICPA's *Code of Professional Conduct.*

2060.05.4 INSPECTION GUIDANCE (PART IV)

2060.05.4.1 Review of the Internal Audit Function and Outsourcing Arrangements

Examiners should have full and timely access to an institution's internal audit resources, including personnel, workpapers, risk assessments, work plans, programs, reports, and budgets. A delay may require examiners to widen the scope of their inspection work and may subject the institution to follow-up supervisory actions.

Examiners should assess the quality and scope of an institution's internal audit function, regardless of whether it is performed by the institution's employees or by an outsourcing vendor. Specifically, examiners should consider whether—

1. the internal audit function's control risk assessment, audit plans, and audit programs are appropriate for the institution's activities;
2. the internal audit activities have been adjusted for significant changes in the institution's environment, structure, activities, risk exposures, or systems;
3. the internal audit activities are consistent with the long-range goals and strategic direction of the institution and are responsive to its internal control needs;
4. the audit committee promotes the internal audit manager's impartiality and independence by having him or her directly report audit findings to it;
5. the internal audit manager is placed in the management structure in such a way that the independence of the function is not impaired;
6. the institution has promptly responded to significant identified internal control weaknesses;
7. the internal audit function is adequately managed to ensure that audit plans are met, programs are carried out, and results of audits are promptly communicated to senior management and members of the audit committee and board of directors;
8. workpapers adequately document the internal audit work performed and support the audit reports;
9. management and the board of directors use reasonable standards, such as the IIA's *Standards for the Professional Practice of Internal Auditing*, when assessing the performance of internal audit; and
10. the audit function provides high-quality advice and counsel to management and the board of directors on current developments in risk management, internal control, and regulatory compliance.

The examiner should assess the competence of the institution's internal audit staff and management by considering the education, professional background, and experience of the principal internal auditors. In addition, when reviewing outsourcing arrangements, examiners should determine whether—

1. the arrangement maintains or improves the quality of the internal audit function and the institution's internal control;
2. key employees of the institution and the outsourcing vendor clearly understand the lines of communication and how any internal control problems or other matters noted by the outsourcing vendor are to be addressed;
3. the scope of the outsourced work is revised appropriately when the institution's environment, structure, activities, risk exposures, or systems change significantly;
4. the directors have ensured that the outsourced internal audit activities are effectively managed by the institution;
5. the arrangement with the outsourcing vendor satisfies the independence standards

described in this policy statement and thereby preserves the independence of the internal audit function, whether or not the vendor is also the institution's independent public accountant; and
6. the institution has performed sufficient due diligence to satisfy itself of the vendor's competence before entering into the outsourcing arrangement and has adequate procedures for ensuring that the vendor maintains sufficient expertise to perform effectively throughout the arrangement.

2060.05.4.2 Inspection Concerns About the Adequacy of the Internal Audit Function

If the examiner concludes that the institution's internal audit function, whether or not it is outsourced, does not sufficiently meet the institution's internal audit needs; does not satisfy the Interagency Guidelines Establishing Standards for Safety and Soundness, if applicable; or is otherwise inadequate, he or she should determine whether the scope of the inspection should be adjusted. The examiner should also discuss his or her concerns with the internal audit manager or other person responsible for reviewing the system of internal control. If these discussions do not resolve the examiner's concerns, he or she should bring these matters to the attention of senior management and the board of directors or audit committee. Should the examiner find material weaknesses in the internal audit function or the internal control system, he or she should discuss them with appropriate agency staff in order to determine the appropriate actions the agency should take to ensure that the institution corrects the deficiencies. These actions may include formal and informal enforcement actions.

The institution's management and composite ratings should reflect the examiner's conclusions regarding the institution's internal audit function. The report of inspection should contain comments concerning the adequacy of this function, significant issues or concerns, and recommended corrective actions.

2060.05.4.3 Concerns About the Independence of the Outsourcing Vendor

An examiner's initial review of an internal audit outsourcing arrangement, including the actions of the outsourcing vendor, may raise questions about the institution's and its vendor's adherence to the independence standards described in parts I and II of the policy statement, whether or not the vendor is an accounting firm, and in part III if the vendor provides both external and internal audit services to the institution. In such cases, the examiner first should ask the institution and the outsourcing vendor how the audit committee determined that the vendor was independent. If the vendor is an accounting firm, the audit committee should be asked to demonstrate how it assessed that the arrangement has not compromised applicable SEC, PCAOB, AICPA, or other regulatory standards concerning auditor independence. If the examiner's concerns are not adequately addressed, the examiner should discuss the matter with appropriate agency staff prior to taking any further action.

If the agency staff concurs that the independence of the external auditor or other vendor appears to be compromised, the examiner will discuss his or her findings and the actions the agency may take with the institution's senior management, board of directors (or audit committee), and the external auditor or other vendor. In addition, the agency may refer the external auditor to the state board of accountancy, the AICPA, the SEC, the PCAOB, or other authorities for possible violations of applicable independence standards. Moreover, the agency may conclude that the institution's external auditing program is inadequate and that it does not comply with auditing and reporting requirements, including sections 36 and 39 of the FDI Act and related guidance and regulations, if applicable.

2060.05.5 INSPECTION OBJECTIVES

1. To determine with reasonable assurance whether the institution[23] has an adequate system of internal controls that ensures efficient and effective operations, including the safeguarding of assets, reliable financial reporting, and compliance with applicable laws and regulations.
2. To determine if the internal audit function and the internal audit outsourcing arrangements of the parent company and its subsidiaries are adequately and competently managed by the board of directors and senior management.

23. The term ‘‘institution’’ is used to maintain consistency with the interagency policy statement, but these inspection objectives and procedures apply to financial holding companies, bank holding companies, and their bank and nonbank subsidiaries.

3. To ascertain that the banking organization's internal audit function monitors, reviews, and ensures the continued existence and maintenance of sound and adequate internal controls over the management process: the control environment, risk assessment, control activities, information and communication, and monitoring activities.
4. To determine whether the internal audit function reports vital information about weaknesses in the system of internal control to the board of directors (or its audit committee) and senior management and that expeditious remedial action is taken to resolve the internal control weaknesses as well as any other exceptions.
5. To determine that the audit committee has established and maintains procedures for employees of the institution to confidentially and anonymously submit concerns to the committee about questionable accounting, internal control, or auditing matters, and that the audit committee has procedures for the timely investigation of complaints received and the retention for a reasonable time period of documentation concerning the complaint and its subsequent resolution.
6. To determine the adequacy of the internal audit function (including its use of outsourced internal audit vendors) as to organizational structure, prudent management, staff having sufficient expertise, audit quality, and the ability of auditors to directly and freely communicate internal audit findings to the board of directors, its audit committee, and senior management.
7. To review and evaluate internal audit outsourcing arrangements and the actions of the outsourcing vendor, under standards established in the Interagency Policy Statement on the Internal Audit Function and Its Outsourcing.

2060.05.6 INSPECTION PROCEDURES

Examiners should obtain assurances from the audit committee and senior management that they will have full and timely access to an institution's internal audit resources, including personnel, workpapers, risk assessments, work plans, programs, reports, and budgets. Examiners should consider widening the scope of their inspection work when such assurances are not provided or if there are any significant delays in gaining access to the internal audit resources. Such a delay may subject the institution to follow-up supervisory action.

2060.05.6.1 Internal Audit Function Inspection Procedures

1. Assess the quality and scope of the internal audit work, regardless of whether it is performed by the institution's employees or by an outsourcing vendor. Consider whether—
   a. the board of directors (or audit committee) promotes the internal audit manager's impartiality and independence by having him or her directly report audit findings to it;
   b. the internal audit function's risk assessment, plans, and programs are appropriate for the institution's activities;
   c. the internal audit function is adequately managed to ensure that audit plans are accomplished, programs are carried out, and results of audits are promptly communicated to the managers and directors;
   d. the institution has promptly responded to identified internal control weaknesses;
   e. management and the board of directors use reasonable standards when assessing the performance of internal audit;
   f. the internal audit plan and program have been adjusted for significant changes in the institution's environment, structure, activities, risk exposures, or systems;
   g. the activities of internal audit are consistent with the long-range goals of the institution and are responsive to its internal control needs; and
   h. the audit function provides high-quality advice and counsel to management and the board of directors on current developments in risk management, internal control, and regulatory compliance.
2. Assess the competence of the institution's internal audit staff and management by considering the education and professional background of the principal internal auditors.
3. Broaden the scope of the inspection if the institution's internal audit function, whether or not it is outsourced, does not sufficiently meet its internal audit needs, does not satisfy the Interagency Guidelines Establishing Standards for Safety and Soundness, or is otherwise inadequate.
4. Discuss supervisory concerns and outstanding internal-external audit report comments with the internal audit manager or other person responsible for reviewing the system of

internal control. If these discussions do not resolve the examiner's comments and concerns, bring these matters to the attention of senior management and the board of directors or audit committee.

5. If material weaknesses in the internal audit function or the internal control system exist, discuss them with appropriate Federal Reserve Bank supervisory staff to determine the appropriate actions that should be taken to ensure that the institution corrects the deficiencies (including formal and informal enforcement actions).
6. Incorporate conclusions about the institution's internal audit function into its management and composite supervisory ratings.
7. Include in the inspection report comments concerning the adequacy of the internal audit function, significant issues or concerns, and recommended corrective actions.

2065.05.6.2 Additional Aspects of the Examiner's Review of an Outsourcing Arrangement

1. Review the internal audit outsourcing arrangement and determine if the institution has a written contract or an engagement letter with the vendor.
2. Determine whether the written contract or engagement letter includes provisions that—
   a. define the expectations and responsibilities under the contract for both parties;
   b. set the scope and frequency of, and the fees to be paid for, the work to be performed by the vendor;
   c. set the responsibilities for providing and receiving information, such as the type and frequency of reporting to senior management and directors about the status of contract work;
   d. establish the process for changing the terms of the service contract, especially for expansion of audit work if significant issues are found, and establish stipulations for default and termination of the contract;
   e. state that internal audit reports are the property of the institution, that the institution will be provided with any copies of the related workpapers it deems necessary, and that employees authorized by the institution will have reasonable and timely access to the workpapers prepared by the outsourcing vendor;
   f. specify the locations of internal audit reports and the related workpapers;
   g. specify the period of time (for example, seven years) that vendors must maintain the workpapers;[24]
   h. state that outsourced internal audit services provided by the vendor are subject to regulatory review and that examiners will be granted full and timely access to the internal audit reports and related workpapers prepared by the outsourcing vendor;
   i. prescribe 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
   j. state that the outsourcing 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, SEC, PCAOB, or regulatory independence guidance.
3. Determine whether—
   a. the outsourcing arrangement maintains or improves the quality of the internal audit function and the institution's internal control;
   b. key employees of the institution and the outsourcing vendor clearly understand the lines of communication and how any internal control problems or other matters noted by the outsourcing vendor are to be addressed;
   c. the scope of work is revised appropriately when the institution's environment, structure, activities, risk exposures, or systems change significantly;
   d. the directors have ensured that the outsourced internal audit function is effectively managed by the institution;
   e. the arrangement with the outsourcing vendor satisfies the independence standards described in the Policy Statement on the Internal Audit Function and Its Outsourcing and thereby preserves the independence of the internal audit function, whether or not the vendor is also the institution's independent public accountant;

24. If the workpapers are in electronic format, contracts often call for the vendor to maintain proprietary software that enables the banking organization and examiners to access the electronic workpapers for a specified time period.

f. the institution has performed sufficient due diligence to satisfy itself of the vendor's competence before entering into the outsourcing arrangement and whether there are adequate procedures for ensuring that the vendor maintains sufficient expertise to perform effectively throughout the arrangement; and
g. the institution has a contingency plan to ensure continuity in audit coverage, especially for high-risk areas.

4. Adjust the scope of the inspection if the outsourcing arrangement has diminished the quality of the institution's internal audit. If the quality of the internal audit is diminished, inform senior management and the board of directors and consider it in the institution's management and composite ratings.

2060.05.6.3 Assessment of Auditor Independence

1. If the initial review of an internal audit outsourcing arrangement, including the actions of the outsourcing vendor, raises questions about the institution's and its vendor's adherence to the independence standards discussed in parts I, II, and III of the Interagency Policy Statement on the Internal Audit Function and Its Outsourcing, and if the vendor provides both external and internal audit services to the institution—
   a. question the institution and the outsourcing vendor about how the audit committee determined that the vendor was independent; and
   b. if the vendor is an accounting firm, ask the audit committee how it assessed that the arrangement has not compromised applicable SEC, PCAOB, AICPA, or other regulatory standards concerning auditor independence.
2. If the answers to the above raise supervisory concern, or are not adequately addressed, discuss the matter with appropriate Reserve Bank management and supervisory staff.
3. If the Reserve Bank management and supervisory staff concurs that the independence of the external auditor or other vendor appears to be compromised, discuss the examination findings and what appropriate supervisory actions the Federal Reserve should take, and discuss the actions to be taken with the bank's senior management, board of directors (or audit committee), and the external auditor or other vendor.

Audit is an independent appraisal activity that serves as a managerial control within an organization. The primary responsibility for the maintenance of sound systems of internal controls and an adequate internal audit program rests with the directorate of the bank holding company. Included among the objectives of a comprehensive audit program are the detection of irregularities; the determination of compliance with applicable laws and regulations; and the appraisal of the soundness and adequacy of accounting, operating, and administrative controls designed to ensure prompt and accurate recording of transactions and proper safeguarding of assets. At a minimum, an audit program should ensure that adequate systems of checks and balances are in effect to deter fraud and detect control deficiencies.

The size and complexity of a bank holding company operation are major determinants in the scope and extent of the audit program that is developed. In the smaller, less sophisticated organizations, such as holding company shells for small banks, it may not be feasible to employ an auditor or implement an audit program. In some cases, such as those in which banking assets represent virtually all of the parent company's assets and a comprehensive, effective audit program is being implemented in the various subsidiaries, neither an internal nor an external audit program may be necessary at the parent company level.

The development and implementation of an internal audit program should be delegated to a qualified staff large enough to meet the functional requirements of the job under the guidance and leadership of the auditor. When evaluating the effectiveness of an internal audit program, the examiner may want to consider the size of audit staffs of banking organizations of a similar size and complexity. To ensure freedom of access to corporate records and complete independence and objectivity in administering the audit program, the auditor should report directly to the directorate or a committee thereof. Administratively, the internal auditor is usually responsible to an officer at a major policymaking level.

To supplement the internal audit activities, external accountants-auditors may be engaged to certify or audit the financial statements or specified activities of the bank holding company and its subsidiaries. Each top-tier bank holding company with total consolidated assets of $500 million or more must engage independent public accountants to perform audits and report on its annual financial statements in accordance with generally accepted accounting principles. The scope of the audit engagement must be sufficient to permit such accountant to determine and report whether the financial statements are presented fairly and in accordance with generally accepted accounting principles. Bank holding companies do not have to submit audited financial statements as part of the requirements for the FR Y-6 annual report. The Federal Reserve may request audited consolidated financial statements from any bank holding company with total consolidated assets of less than $500 million if deemed warranted for supervisory purposes.

The internal and external auditors should work together in establishing the scope and frequency of audits to be performed. In addition to performing some of the basic functions of the internal auditor, the external auditor should review the internal auditing program to assess its scope and adequacy. When a bank holding company is perhaps too small to employ an internal audit staff, but when the complexities and activities of the organization suggest the need for an audit, the holding company should consider hiring an external auditor. Independence and objectivity are mandatory in any audit program, and these are difficult to maintain if the audit function is a part-time responsibility. When external auditors are employed to perform the internal audit function, they should be permitted to establish the scope of their audits and schedule surprise audits. They also should be given responsibility for suggesting systems and organizational duty assignments for maximum control consistent with the size of the organization.

2060.1.1 EXTERNAL AUDITORS AND THE RELEASE OF REQUIRED INFORMATION

The enactment of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) on August 9, 1989, requires that FDIC-insured depository institutions that are being audited provide their independent auditors with information concerning their financial condition and any supervisory actions being taken against them. Specifically, section 36(h)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1831m(h)(1)) (the FDI Act) requires an insured depository institution that has engaged the services of an independent auditor to perform an audit within the past two years to provide the auditor with—

1. a copy of the most recent report of condition made by the institution (pursuant to the FDI Act or any other provision of law) and a copy of the most recent report of examination received by the institution;
2. a copy of any supervisory memorandum of understanding with such institution and any written agreement between a federal or state banking agency and the depository institution that is in effect during the period covered by the audit; and
3. a report of any action initiated or taken by a federal banking agency during the period covered by the audit under subsection (a), (b), (c), (e), (g), (i), (s), or (t) of section 8 of the FDI Act or of any similar action taken by a state banking agency under state law, or any other civil money penalty assessed under any other provision of law with respect to the depository institution or any affiliated party.

External auditors who are serving as agents of a bank holding company may, with the approval of the organization, review examination or inspection reports and supervisory correspondence received and communicate with examiners. Examiners should remind external auditors of their responsibility to maintain the confidentiality of the reports and other supervisory communications reviewed as part of their engagement. See also the Board's rules on the release of confidential supervisory information (12 C.F.R. 261, subpart C).

2060.1.2 EXTERNAL AUDITOR INQUIRIES

In some situations, examiners may not be able to fully respond to external auditors' inquiries on certain matters relating to examinations still in progress. The examiners' findings may be incomplete or may be under review by higher supervisory authorities within the Federal Reserve System. In addition, as a general practice, examiners will normally only discuss with external auditors issues and inspection findings that have been presented to the bank holding company's management. These situations relate primarily to the timing of the auditors' inquiries in relation to the stage of inspection work and, thus, should not automatically preclude an auditor from expressing an opinion on the organization's financial statements.

2060.1.3 INSPECTION OBJECTIVES

1. To review the operations of bank holding companies that do not have an audit program to ascertain if such a program should be developed.
2. To determine the adequacy of the scope and frequency of the audit program.
3. To determine that audit reports and findings receive appropriate attention, including follow-up responses to exceptions or weaknesses disclosed during an audit.
4. To determine the respective roles of internal and external auditors and to evaluate the procedures employed in carrying out their assigned responsibilities.
5. To determine the independence of those who administer the audit function.
6. To determine compliance with section 36(h)(1) of the FDI Act with regard to FDIC-insured depository institution examinations and other designated supervisory reports and correspondence that are required to be released to external auditors.

2060.1.4 INSPECTION PROCEDURES

The primary thrust of the inspection should be directed toward the audit activities that relate to the parent company and all subsidiaries. An assessment of the audit function as it pertains to the bank (or banks) is primarily the responsibility of the regulatory agency that examines that particular bank. The examiner should review the latest bank examination reports to note comments and deficiencies cited concerning internal controls and the audit function. In addition to providing an input into the overall assessment of the audit function, review of the bank examination reports may provide a basis for determining areas of investigation during the inspection. Further, if matters cited in the latest bank examination report are deemed to be significant and indications are that corrective action has not been taken, the examiner should mention the facts to senior management of the bank holding company and note the details in the inspection report.

To judge the adequacy of the audit program, including its scope and frequency, the following procedures, with equal emphasis being placed on the parent, bank, and nonbank subsidiaries, are recommended as minimum guidelines for the inspection.

1. Review the parent company and nonbank operations and the audit comments in the bank examination reports to ascertain the adequacy of the existing audit program or the need for developing such a program, if the organization currently lacks one.
2. Review the scope of the audit function to ensure that procedures are in place to cover adequately those areas that may be susceptible to exposure. When reviewing the audit scope, determine whether the auditor was able to perform all the procedures necessary to complete the audit. If not—
   a. establish whether the scope limitations were imposed by the directorship or management and
   b. determine whether the auditor established and documented the reasons why the scope limitations were imposed.
      (1) Was the auditor able to quantify the effects of the scope limitation on the financial statements and the audit results, and, if not pervasive, was a qualified opinion or disclaimer of opinion issued?
      (2) Did the auditor evaluate all possible effects on his ability to express an opinion on the financial statements?
      (3) Were there any external circumstances that imposed limitations on the audit's scope?
      (4) Were alternative procedures used to accomplish the same audit objectives? If so, did the use of the alternative procedures justify issuance of an unqualified opinion?
3. Review the audit schedule to determine that the audits are satisfactorily spaced and that all functions are audited with adequate frequency.
4. Review audit workpapers and reports on a test-check basis for adequacy of content, satisfactory maintenance, and conformance to audit guidelines outlined by the board of directors.
5. Determine the qualifications and background of the auditor and others participating in the audit function.
6. To establish that the auditor has a direct communication line to the board of directors and freedom of access to all records for audit purposes, review audit reports and minutes of meetings held by directors or a committee thereof.
7. Determine the entity responsible for maintaining the audit function. If a bank provides audit services to affiliates, indicate the manner in which the bank is reimbursed for the cost of such services.
8. Determine whether audit reports are submitted on a timely basis to—
   a. the directors and senior management and
   b. management in the area being audited.
9. Review responses to exceptions and recommendations noted in audit reports.
10. Check on the relationship between the internal and external auditors to determine whether their activities are coordinated in a manner that effects comprehensive coverage of the organization and at the same time avoids duplication of effort.
11. Review the letter addressed to management by the external auditor and determine that steps have been taken to correct any deficiencies noted. If no deficiencies were noted in the letter, inquire as to whether such comments were communicated to management by any other means.
12. Ascertain that the audit program is annually reviewed and approved by the directors.
13. Scan the external auditor's engagement letter and reports, noting any qualifications contained therein. If new external auditors have been engaged, ascertain the reasons for such change.
14. Determine if the parent company or nonbank subsidiaries have reported any defalcations. If so, determine if adequate controls have been initiated to lessen any further risk and exposure.
15. Determine if the external auditors received copies of the FDIC-insured institution's examination and other designated supervisory reports and correspondence required by section 36(h)(1) of the FDI Act.
16. Review the engagement letter between the board of directors and the external auditor to determine the scope of the audit and the degree of reliance on internal audit staff. Letters requesting opinions from external auditors should also be reviewed to determine that the opinion obtained was not influenced by management.
17. Determine the degree of independence of the external audit firm by reviewing any financial ties between the bank, audit firm, and any of its partners or employees. Also

review any other relationships or potential conflicts of interest that may exist.[1]

The independence of the internal auditor should be evaluated by ascertaining whether the following conditions exist: (1) reports are distributed directly to the board or a committee thereof or, less desirably, to an officer not connected with the area being reviewed; (2) there are no relationships within the organization that are incompatible with the internal audit function; and (3) severe restrictions are not placed on the program or its scheduling by management. In order to maintain the degree of objectivity essential to the audit function, the examiner should establish that the internal auditor does not install procedures, originate and approve entries, or otherwise engage in any activity that would be subject to audit review and appraisal.

The examiner should consider meeting with the auditor and, subsequently, with senior bank holding company management to communicate conclusions concerning the adequacy of the scope and frequency of the audit program. During the discussions, the examiner should concentrate on detailing criticisms or deficiencies noted. The auditor and senior bank holding company management should be made fully cognizant of the examiner's analyses and the comments concerning the audit function that will appear on the relevant pages in the inspection report.

1. The Securities and Exchange Commission (SEC) has also released guidance relating to the independence of auditors for public institutions. According to SEC Rule 101, the independence of an auditor would be impaired if there are financial, employment, or business relationships between auditors and audit clients, or if there are relationships between auditors and audit clients in which the auditors provide certain nonaudit services to their audit clients. Much of the language found in the SEC's independence rules is incorporated in the Interagency Policy Statement on the Internal Audit Function and Its Outsourcing. (See section 2060.05.)

An assessment of management's strategic plans and its success in meeting previously established budgetary goals is one of the factors considered in evaluating a BHC's management, operations, financial condition, and prospects.[1] Through review of the budget figures, insight can be gained concerning an organization's future plans and other matters such as capital adequacy, liquidity, sources and applications of funds, level and quality of earnings, and performance of management.

The budget is a coordinated financial plan used to estimate and control all or a few of the activities of the various divisions or subsidiaries in a bank holding company. Based on an assessment of future economic developments and conditions, management formulates a plan of action and indicates anticipated changes in the balance-sheet accounts and profitability (predicated on implementation of the plan). The budget is a significant management tool in that it projects expected results and also serves as an important check on management decisions and performance by providing a basis for comparison and corrective action on a timely basis. The comparison of actual performance to budget allows management to give careful attention to various possible courses of action and to choose the course which should result in the greatest benefit. Budgeting is also useful in measuring the performance of individuals and the departments they manage. Further, the comparison of budget totals to actual changes in activities such as loans, investments, and deposits assists in decision making and can promote coordination and cooperation among affiliates. The variance indicated by the comparison process may be construed as a measure of management's performance and planning record and its relationship to the organization's goals and objectives. It should be noted that some significant variances may be caused by factors beyond management's control or factors that could not reasonably be anticipated.

1. The *stragetic planning process* focuses on intermediate and long-term strategic goals and is the vehicle used to determine the overall direction and focus of the organization. The *budgeting process* refers to the tactical decisions required to meet goals and objectives. The budget is a subset of the strategic plan. While smaller bank holding company organizations may not always have formal written budgets, all organizations should have a strategic planning process, which determines overall corporate direction, general resource allocation, and balance-sheet relationships with respect to capital needs, growth, asset mix, and risk.

While various individuals may be responsible for input to the budget process, the chief executive officer typically has the ultimate responsibility for preparation and implementation of the formal budget. The time period covered by a budget typically encompasses one year, although it often covers longer periods in the larger, more sophisticated bank holding companies. The longer the budget period, the greater are the prospects for increased variances from original budget figures. In some cases in which four- or five-year projections are made, bank holding companies may formulate several forecasts based on different sets of assumptions. In such instances, the examiner should work with the ''most likely'' situation that may evolve based on economic trends, history, and experience of the organization, but should also give serious consideration to the ''worst-case'' projections.

Many bank holding companies, particularly the smaller organizations, may not have formal written budgets or plans. In small shell companies, while it is not essential to have a formal budget, budgeting procedures should be encouraged where appropriate. Budgeting at the parent level could be appropriately limited to debt-servicing and dividend considerations.

2060.2.1 INSPECTION OBJECTIVES

1. To determine the extent of an organization's financial planning and budget program.
2. To indicate to management of organizations that are without formal planning procedures the advantages of adopting a budget.
3. To understand the institution's decision-making process as it relates to the budget.
4. To determine the causes of significant variances between the budget and actual performance.
5. To assess the reasonableness of projected figures, including controls over the data throughout the budgeting process.
6. To assess the impact of the budget on the present condition and future prospects of the bank holding company.
7. To determine whether the plan outlined in the budget is supported by the financial and managerial resources of the holding company.

2060.2.2 INSPECTION PROCEDURES

1. Familiarity with a bank holding company's financial condition and results of operations should begin before the start of the inspection with a review of the annual report to shareholders, financial reports submitted to the Federal Reserve System, and other financial documentation contained in the files. The more significant accounts, statistical data, and pertinent ratios should be compared on a period-to-period basis to highlight significant changes and discern trends.

2. The examiner also should become familiar with current and projected economic conditions, both nationally and locally, including general industry conditions.

3. Based on a review of the aforementioned data, the examiner should be in a position to substantiate the reasonableness of budgeted figures without a systematic examination of all of the transactions affecting the figures presented. Further, such an analysis provides a better understanding of the operation and highlights matters of interest and potential problem areas to be investigated during the inspection.

4. Throughout the review process, the examiner must maintain a sense of perspective to avoid spending excessive time on relatively immaterial amounts.

5. The examiner should meet with the officer responsible for the preparation of the budget to determine the scope of the organization's financial plans. The extent of senior management's and the board of directors' involvement in the strategic planning and budgeting process should also be ascertained in this preliminary meeting.

6. Workpapers which document or illustrate the rationale for the budget data should be reviewed and discussed with budget personnel, including the existence and extent of internal controls over the data.

7. The examiner should evaluate plans, projections, and forecasts in light of market-area characteristics and the present condition and history of the organization.

8. The examiner should determine whether the accounting principles of major importance have been applied consistently and, if not, the impact of the alternative accounting treatment on the budget totals.

9. The sources of input for the budget should be reviewed and the frequency and procedures for effecting revision should be ascertained.

10. When there are significant budget variances, the examiner should seek documented explanations. Review any such documentation to determine if management policy or factors beyond management control were responsible for the variances.

11. A final summary discussion should be held with management to discuss goals which the examiner believes may be unattainable and to communicate conclusions concerning the budget. Due consideration should be given to management's views, whether or not in concurrence with the examiner's conclusions. If management indicates future changes which could have a significant impact on the organization, the matter should be noted in the inspection report. Further, management's assessment of the effect of contemplated action on the operations and financial condition of the bank holding company should be noted.

12. For those bank holding companies that do not have formal written plans, the examiner should obtain from senior management information on their plans for matters such as growth and expansion, capital injections, debt retirement, and changes in sources of funding. Except for small, shell companies, the examiner should recommend adoption of a budget program and emphasize the need for strategic planning by indicating how management methods may be improved as a result of a logically conceived and properly operated budget. Budgets and planning are especially important in cases in which a bank holding company is losing its share of the market or in which inefficiencies are depressing profitability.

Adequate and accurate records and financial statements are an integral part of a sound bank holding company operation. Records should be maintained to allow preparation of financial statements in accordance with generally accepted accounting principles and to ensure proper accountability for all assets, liabilities, income, and expenses. Generally, an independently certified statement inspires greater confidence than a statement prepared internally. Moreover, an unqualified, independently certified statement may act as a check on management recordkeeping policies and procedures, and provide more assurance that transactions are being properly recorded and that books accurately reflect overall financial condition.

Management may exercise reasonable discretion in selecting and adopting the type of books and records it uses and in formulating accounting systems and bookkeeping procedures. From the examiner's viewpoint, the test of a bank holding company's records is one of adequacy, consistency, and accuracy. The financial statements of every bank holding company must accurately reflect financial condition and operating results. This principle is applicable whether a bank holding company is small and has a relatively simple bookkeeping system or whether it is a larger institution with a fully automated system. A recordkeeping system that is capable of generating a wide variety of pertinent internal data and other information facilitates problem solving and decision making and, thus, contributes to the efficiency of a bank holding company's operations. Further, such a system serves as a convenient tool to provide directors, stockholders, and other interested parties with information on conditions in a bank holding company.

2060.3.1 INSPECTION OBJECTIVES

1. To determine whether financial statements are prepared in accordance with generally accepted accounting principles and are sufficiently detailed to accurately portray the company's financial condition.
2. To determine that sufficient records are maintained to provide detail on material balance-sheet items, income-statement items, and various contingent liabilities and off-balance-sheet risks that permit the preparation of appropriate financial information.
3. To recommend corrective action when policies and procedures employed have resulted in inadequate or inaccurate records and financial statements.

2060.3.2 INSPECTION PROCEDURES

1. The examiner should review the sections relating to audit and records in the prior inspection report and the latest examination reports of the subsidiary banks to note any comments or deficiencies cited concerning records, including any MIS deficiencies. In addition to providing an input into the overall assessment of the quality of records, the review may provide a basis for determining areas of emphasis and follow-up during the inspection.
2. The examiner should discuss recommendations and criticisms contained in such reports with an appropriate officer to ascertain what changes, if any, have taken place.
3. The examiner should review the external auditing firm's management letter, giving particular attention to comments concerning recordkeeping. Determine if any corrective actions were recommended by the external auditors and the extent to which the cited items have been corrected.
4. In those situations when it appears that records are deficient or financial statements are inaccurate, a thorough investigation of applicable transactions may be required. The purpose of the investigation is to obtain information needed in outlining improved controls over MIS, accounting methods, and records so that the financial data presented are in accordance with generally accepted accounting principles. Thus, information is provided which will better serve bank holding company management. The investigation should not necessarily involve a review of every transaction, but should involve a check of a sufficient number of transactions to ensure the examiner that the records, as checked, reflect an accurate financial condition. The extent of the review will depend largely on the procedures and controls over MIS and the condition and adequacy of the books and underlying records. During the investigative process, the examiner should be careful to distinguish between documented facts and statements of intent or interpretations set forth by company representatives.

The directorate and management of bank holding companies have a responsibility to contribute to the health and growth of the organization they serve. To carry out this responsibility effectively, they must be kept fully informed of conditions throughout the organization and trends within the banking industry. Reporting is the process of developing and communicating information internally to directors and management and externally to shareholders and regulatory authorities. Management and the board of directors must recognize that as a company develops and grows, its environment, strategic goals, and information needs change. The guidelines and requirements for reports flowing to management and the board of directors should be established and allow for change, recognizing the fact that informational needs can vary, including those at different levels of the organization.

Informational needs will also be dictated by the particular type of management structure in place—centralized, decentralized, legal entity, or business line. The ultimate decision-making responsibility rests with the corporation's board of directors, and the responsibility for implementing their decisions rests with designated board committees, executive management, or other designated management committees or individuals. As such, examiners should make an assessment of the qualifications of the persons on the board of directors, executive management staff, and the board and executive management committees to ensure that they have the necessary knowledge, experience, and expertise to understand the information presented and to act on it constructively. The assessment should include a review of reporting lines to identify information flows and the various decision-making levels involved or needed.

All reports flowing to executive management, board committees, and the board of directors should be analyzed for clarity, consistency, timeliness, quality, and coverage of crucial areas of the organization. A review of board and committee minutes should reveal if participants had any questions or whether there were any uncertainties as to the meaning of the data presented.

Each bank holding company prepares various reports for submission to its management and directors; an effective internal reporting system facilitates their ability to analyze a situation and to make informed decisions. Although such reports may vary in content from company to company, emphasis is generally placed on the financial data generated. The important consideration is whether each company is providing sufficient data to keep the interested parties informed of the financial condition and performance of all the divisions or entities. The frequency of the reporting and the detail of information provided can be categorized as being on a need-to-know basis. The form of reports ranges from consultations and meetings to submission of printed material for study and review. The scope and size of the operations will have an effect on the frequency and detail of the information submitted. In the larger, more sophisticated companies, frequent meetings and consultations are held to discuss the performance of various entities, the impact of performance on the organization's goals and objectives, and policies and strategies to be followed. Written reports outlining important matters and summarizing various financial data are typically reviewed and discussed regularly.

The number and variety of reports depends on the size and sophistication of the bank holding company operation. For smaller bank holding companies, the extent of their reports may be limited to annual statements, as more frequent periodic reports may not be necessary under normal conditions. The larger holding companies normally prepare monthly comparative balance sheets and income statements covering similar periods for two consecutive years. Thus, any significant deviation from the prior year's data can be readily detected. Generally, reports detailing the extent of delinquent and nonaccrual loans are prepared monthly. Facts and figures pertaining to the adequacy of the loan-loss provision are presented periodically. Additional reports containing information on budgets, cash flow, liquidity, and capital adequacy are prepared to assist management in assessing the organization's overall financial condition and performance. Summaries of internal audit reports and reports of examinations of subsidiary banks are brought to management's attention. Data relative to other bank holding companies or banks in the same peer groups are assembled, when available, so that comparisons with similarly sized organizations are possible. All of the aforementioned information may be prepared for directors, although not necessarily in as much detail as that submitted to management. On occasion, key management personnel of the holding company attend directors' meetings to expand on the topics being discussed.

Reports to shareholders usually consist of quarterly and annual reports which detail the company's financial condition and results of operations. Additional information may include the chief executive officer's overall assessment of the company, future plans, and other financial and analytical data. The financial information is used for public disclosure and enables investors, depositors, and creditors to make informed judgments concerning the financial condition of the bank holding company. Bank holding companies whose securities have been registered pursuant to the Securities and Exchange Act of 1934 are required to prepare various reports containing specific financial information.

2060.4.1 INSPECTION OBJECTIVES

1. To review the organizational structure to determine the various levels of decision-making and reporting lines, including board and executive management committees.
2. To determine whether the bank holding company has written policies and procedures, and internal controls covering the types of reports required to be submitted to management and the directors.
3. To determine that the required reports are adequate to accurately reflect the financial condition and performance within the organization's divisions and units and whether the reporting systems and reports are adequate to monitor the risks therein.
4. To evaluate whether the reports and reporting systems are adequate to measure and reflect the company's financial position and performance in all areas, to measure the company's progress in meeting its financial and business goals, and to monitor inherent risks.
5. To determine that the contents of the reports are complete and submitted on a timely basis.
6. To recommend corrective action when reporting practices, policies, or procedures are deficient.
7. To evaluate management's procedures for reacting to elevated risk, weaknesses, or deficiencies disclosed by reporting systems, and to evaluate the system's ability to adapt to change caused by regulatory and accounting issues or other market conditions.

2060.4.2 INSPECTION PROCEDURES

1. Review the organizational structure to determine reporting lines and the various levels of decision making, risk assessment, and controls.
2. Ascertain whether any corporate policies address risk managment or internal reporting requirements and determine:
   a. the types of reports required to be submitted and
   b. the adequacy of such reporting requirements in light of a company's particular circumstances.

   Comment: In a holding company with a decentralized system of control over subsidiaries, the existence of written policies and procedures is important since each subsidiary operates as a relatively autonomous unit.
3. Obtain a listing of internal reports that are submitted to corporate executive management and the board of directors (including packages for the board of directors and executive committees).
4. Randomly sample, based on a material risk focus, the individual as well as the various types of management reports and determine whether they are adequately prepared in accordance with established policies and procedures and submitted to the appropriate individuals on a timely basis. Determine whether the management reports are sufficient to measure the company's progress in achieving its financial and business goals and forecasts.
5. Identify and document management procedures for reacting to elevated risk, weaknesses, or deficiencies disclosed by MIS. Also evaluate the ability of the information system to handle regulatory and accounting issues and to adapt to change.
6. At the conclusion of the review process, the examiner should discuss with management, as appropriate, topics such as—
   a. the lack of established policies and procedures and internal controls,
   b. inadequate reporting requirements, and
   c. noncompliance with reporting requirements and/or the untimely submission of reports.

2060.4.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Registration, reports, and examinations or inspections		225.5		
Reporting requirements emanating from the Securities Exchange Act of 1934	15 USC 78a et seq.			

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

2060.5.1 INTRODUCTION

In establishing an insurance program, a bank holding company should be aware of where it is exposed to loss, the extent to which insurance is available to cover potential losses and the cost of such insurance. These various factors should be weighed to determine how much risk the bank holding company will assume directly. In assessing the extent of risk an organization is willing to assume, it is important to analyze the impact of an uninsured loss not only on the entity where the loss occurs, but also on the affiliates and the parent. Once appropriate coverage has been acquired, procedures should be established for the periodic review of the program to assure the continuing adequacy of the coverage. Particularly for larger BHCs, these procedures should include at least an annual review of the program by the board of directors of the parent organization.

Insurance is a highly specialized field and no attempt is made here to discuss all the various types and forms of insurance coverage that are available to financial institutions. Examiners are not expected to be insurance experts; however, examiners should recognize that a financial organization's primary defenses against loss include adequate internal controls and procedures and that insurance is intended to complement, not replace, an effective system of internal controls. Thus, an overall appraisal of the control environment becomes a significant consideration in assessing the adequacy of the insurance program. To the extent controls are lacking, the need for additional coverage increases.

2060.5.2 BANKER'S BLANKET BOND

The most important and comprehensive insurance coverage available is the bankers' blanket bond which is usually extended to encompass all the entities in a bank holding company structure. Generally, the scope of the blanket bond contract is intended to cover risks of loss due to criminal acts, such as embezzlement, burglary, robbery, theft, larceny, forgery, etc., but in addition it provides indemnity for loss of property through damage, destruction, misplacement and mysterious, unexplainable disappearance. The most important item of protection under the bond, however, is the blanket fidelity coverage for officers and employees.

2060.5.3 TYPES OF BLANKET BONDS

While there are several similar forms of blanket bonds in use, those commonly found are the Financial Institutions Bond Standard Form No. 24, the Bankers Blanket Bond Standard Form No. 2, and Lloyd's Banks' and Trust Companies' Policy HAN Form (C). Under these blanket forms, every employee is usually covered for the total amount of the bond. Typically, new employees and new offices are automatically covered and no notice is required for an increase in the number of employees or in the number of offices established, unless such increases result from a merger or consolidation with another institution. The word "blanket," however, refers to the over-all amount that applies to the several specified risks covered under the bond and is not intended to mean "all risks" coverage. A most important feature of the bankers' blanket bond is the "discovery rider." The rider, which converts the blanket bond from a "loss sustained basis" to a "discovery basis," provides indemnity against any loss sustained by the insured entity at any time but discovered after the effective date of the bond and prior to the termination or cancellation of the bond, even though lower amounts of insurance and more restrictive coverage may have been carried when the loss was actually sustained.

2060.5.4 DETERMINING THE COVERAGE NEEDED

One of the most difficult insurance problems management faces is the determination of the amount of blanket bond coverage that should be maintained. An estimate of the maximum amount of money and securities that may be lost through burglary or robbery can be calculated with reasonable accuracy, but the potential loss resulting from dishonest acts of officers and employees is not easily measured. The Insurance and Protective Committee of the American Bankers Association has conducted several studies of the problems of determining adequate coverage and has concluded that total deposits represent the most appropriate item in bank financial statements upon which to base an estimate of a reasonable or suitable amount of blanket bond coverage.

In a bank holding company structure, the amount of blanket bond coverage is generally determined by the deposits of the largest bank and the amount of suggested coverage in the ABA's schedule. Such an amount is considered to be a minimum and other factors such as a rapidly expanding operation, excessive cash on hand, or inferior audit and control practices may suggest the need for larger coverage. Since coverages are generally extended to include the nonbank subsidiaries and such subsidiaries usually operate on a smaller scale than their affiliated banks, the question concerning the adequacy of the amount of the blanket bond coverage for a nonbank subsidiary is more easily addressed and is typically a function of the parent's and the bank's coverage.

2060.5.5 NOTIFICATION OF LOSS

When submitting a claim, most blanket bonds have provisions which require a report to be submitted within a specified period after a reportable item comes to the attention of management. Occasionally, items are not reported to the bonding company because of uncertainty as to whether the incident constitutes a reportable item. Failure to report in a timely manner could invalidate the claim and jeopardize existing coverages. Thus, it should be emphasized to management that any questionable items should be reported.

2060.5.6 DIRECTORS' AND OFFICERS' LIABILITY INSURANCE

Directors' and Officers' Liability Insurance (''DOL Insurance'') insures the Directors and Officers against *personal* liability resulting from claims of alleged negligence, wrongful acts, errors and omissions, etc. This insurance is not included in the blanket bond or other standard fidelity coverage.

2060.5.7 INSPECTION OBJECTIVES

1. To determine the scope and extent of insurance coverages for the various entities in the organization.
2. To determine the adequacy of insurance coverage after giving due consideration to the overall control environment and factors such as the organization's claim experience and costs associated with various coverages.
3. To ascertain that a comprehensive review of the insurance program is conducted periodically by management and at least annually by the board of directors and entered into the minutes.
4. To determine the entity(ies) responsible for paying the premiums and the manner in which such payments are allocated among the affiliates that receive the coverage benefits.
5. To determine if procedures are in place to assure that claims are filed promptly.

2060.5.8 INSPECTION PROCEDURES

1. The prior year's inspection report should be reviewed for comments relative to controls and insurance. The examiner should note the types and extent of coverages, comments concerning the control environment and any deficiencies related to the administration of the insurance program and the coverages in force.
2. A similar review encompassing the latest examination reports of all major affiliated banks should be conducted. The review process is intended to provide a basis for determining areas of emphasis and follow-up during the inspection. The examiner need not re-examine the insurance program or the controls in force in the individual banks.
3. The examiner should meet with the officer responsible for maintaining the insurance policies and related documentation and ascertain the location of such policies and documentation. Review any independent review of coverages and any deficiencies that may have been cited by the internal or external auditors.
4. Review the manner and frequency of presentations to the board of directors of the insurance coverage.

Working with borrowers who are experiencing financial difficulties may involve formally restructuring their loans and taking other measures to conform the repayment terms to the borrowers' ability to repay. Such actions, if done in a way that is consistent with prudent lending principles and supervisory practices, can improve the prospects for collection. Generally accepted accounting principles (GAAP) and regulatory reporting requirements provide a framework for reporting that may alleviate certain concerns that lenders may have about working constructively with borrowers who are having financial difficulties.

Interagency policy statements and guidance, issued on March 1, 1991; March 10, 1993; and June 10, 1993, clarified supervisory policies regarding nonaccrual assets, restructured loans, and collateral valuation (additional clarification guidance may be found in SR-95-38 and in the glossary of the reporting instructions for the bank call report and the FR-Y-9C, the consolidated bank holding company report). When certain criteria[1] are met, (1) interest payments on nonaccrual assets can be recognized as income on a cash basis without first recovering any prior partial charge-offs; (2) nonaccrual assets can be restored to accrual status when subject to formal restructurings, according to Financial Accounting Standards Board (FASB) Statement Nos. 15 and 114, "Accounting by Debtors and Creditors for Troubled Debt Restructurings" (FAS 15) and "Accounting by Creditors for Impairment of a Loan" (FAS 114); and (3) restructurings that specify a market rate of interest would not have to be included in restructured loan amounts reported in the years after the year of the restructuring. These supervisory policies apply to federally supervised financial institutions. The board of directors and management of bank holding companies should therefore incorporate these policies into the supervision of their federally supervised financial institution subsidiaries.

2065.1.1 CASH-BASIS INCOME RECOGNITION ON NONACCRUAL ASSETS

Current regulatory reporting requirements do not preclude the cash-basis recognition of income on nonaccrual assets (including loans that have been partially charged off), if the remaining book balance of the loan is deemed fully collectible. Interest income recognized on a cash basis should be limited to that which would have been accrued on the recorded balance at the contractual rate. Any cash interest received over this limit should be recorded as recoveries of prior charge-offs until these charge-offs have been fully recovered.

2065.1.2 NONACCRUAL ASSETS SUBJECT TO FAS 15 AND FAS 114 RESTRUCTURINGS

A loan or other debt instrument that has been formally restructured to ensure repayment and performance need not be maintained in nonaccrual status. When the asset is returned to accrual status, payment performance that had been sustained for a reasonable time before the restructuring may be considered. For example, a loan may have been restructured, in part, to reduce the amount of the borrower's contractual payments. It may be that the amount and frequency of payments under the restructured terms do not exceed those of the payments that the borrower had made over a sustained period, within a reasonable time before the restructuring. In this situation, if the lender is reasonably assured of repayment and performance according to the modified terms, the loan can be immediately restored to accrual status.

Clearly, a period of sustained performance, whether before or after the date of the restructuring, is very important in determining whether there is reasonable assurance of repayment and performance. In certain circumstances, other information may be sufficient to demonstrate an improvement in the borrower's condition or in economic conditions that may affect the borrower's ability to repay. Such information may reduce the need to rely on the borrower's performance to date in assessing repayment prospects. For example, if the borrower has obtained substantial and reliable sales, lease, or rental contracts or if other important developments are expected to significantly increase the borrower's cash flow and debt-service capacity and strength, then the borrower's commitment to repay may be sufficient. A preponderance of such evidence may be sufficient to warrant

1. A discussion of the criteria is found within the corresponding subsections that follow.

returning a restructured loan to accrual status. The restructured terms must reasonably ensure performance and full repayment.

It is imperative that the reasons for restoring restructured debt to accrual status be documented. A restoration should be supported by a current, well-documented evaluation of the borrower's financial condition and prospects for repayment. This documentation will be reviewed by examiners.

The formal restructuring of a loan or other debt instrument should be undertaken in ways that will improve the likelihood that the credit will be repaid in full in accordance with reasonably restructured repayment terms.[2] Regulatory reporting requirements and GAAP do *not* require a banking organization that restructures a loan to grant excessive concessions, forgive principal, or take other steps not commensurate with the borrower's ability to repay in order to use the reporting treatment specified in FAS 15. Furthermore, the restructured terms may include prudent contingent payment provisions that permit an institution to obtain appropriate recovery of concessions granted in the restructuring, if the borrower's condition substantially improves.

2065.1.3 RESTRUCTURINGS RESULTING IN A MARKET INTEREST RATE

A FAS 114 restructuring that specifies an effective interest rate that is equal to or greater than the rate the lending banking organization is willing to accept at the time of the restructuring, for a new loan with comparable risk (assuming the loan is not impaired by the restructuring agreement), does not have to be reported as a troubled-debt restructuring after the year of restructuring.

2065.l.4 NONACCRUAL TREATMENT OF MULTIPLE LOANS TO ONE BORROWER

As a general principle, whether to place an asset in nonaccrual status should be determined by an assessment of the individual asset's collectibility. One loan to a borrower being placed in nonaccrual status does not automatically have to result in all other extensions of credit to that borrower being placed in nonaccrual status. When a single borrower has multiple extensions of credit outstanding and one meets the criteria for nonaccrual status, the lender should evaluate the others to determine whether one or more of them should also be placed in nonaccrual status.

2065.1.4.1 Troubled-Debt Restructuring—Returning a Multiple-Note Structure to Accrual Status

On June 10, 1993, interagency guidance was issued to clarify a March 10, 1993, interagency policy statement on credit availability. The guidance addresses a troubled-debt restructuring (TDR) that involves multiple notes (sometimes referred to as A/B note structures). An example of a multiple-note structure is when the first, or A, note would represent the portion of the original-loan principal amount that would be expected to be fully collected along with contractual interest. The second part of the restructured loan, or B note, represents the portion of the original loan that has been charged off.

Such TDRs generally may take any of three forms: (1) In certain TDRs, the B note may be a contingent receivable that is payable only if certain conditions are met (for example, if there is sufficient cash flow from the property). (2) For other TDRs, the B note may be contingency-forgiven (note B is forgiven if note A is paid in full). (3) In other instances, an institution would have granted a concession (for example, a rate reduction) to the troubled borrower but the B note would remain a contractual obligation of the borrower. Because the B note is not reflected as an asset on the institution's books and is unlikely to be collected, the B note is viewed as a contingent receivable for reporting purposes.

Financial institutions may return the A note to accrual status provided the following conditions are met:

1. *The restructuring qualifies as a TDR as defined by FAS 15, and there is economic substance to the restructuring.* (Under FAS 15, a restructuring of debt is considered a TDR if "the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.")

2. A restructured loan may not be restored to accrual status unless there is reasonable assurance of repayment and performance under its modified terms in accordance with a reasonable repayment schedule.

2. *The portion of the original loan represented by the B note has been charged off.* The charge-off must be supported by a current, well-documented evaluation of the borrower's financial condition and prospects for repayment under the revised terms. The charge-off must be recorded before or at the time of the restructuring.
3. *The institution is reasonably assured of repayment of the A note and of performance in accordance with the modified terms.*
4. *In general, the borrower must have demonstrated sustained repayment performance (either immediately before or after the restructuring) in accordance with the modified terms for a reasonable period before the date on which the A note is returned to accrual status.* Sustained payment performance generally would be for a minimum of six months and involve payments in the form of cash or cash equivalents.

The A note would be initially disclosed as a TDR. However, if the A note yields a market rate of interest and performs in accordance with the restructured terms, the note would not have to be disclosed as a TDR in the year after the restructuring. To be considered a market rate of interest, the interest rate on the A note at the time of the restructuring must be equal to or greater than the rate that the institution is willing to accept for a new receivable with comparable risk. (See SR-93-30.)

2065.1.4.2 Nonaccrual Loans That Have Demonstrated Sustained Contractual Performance

Certain borrowers have resumed paying the full amount of scheduled contractual interest and principal payments on loans that are past due and in nonaccrual status. Although prior arrearages may not have been eliminated by payments from the borrowers, some borrowers have demonstrated sustained performance over a time in accordance with contractual terms. The interagency guidance of June 10, 1993, announced that such loans may henceforth be returned to accrual status, even though the loans have not been brought fully current. They may be returned to accrual status if (1) there is reasonable assurance of repayment of all principal and interest amounts contractually due (including arrearages) within a reasonable period and (2) the borrower has made payments of cash or cash equivalents over a sustained period (generally a minimum of six months) *in accordance with the contractual terms.* When the federal financial institution regulatory reporting criteria for restoration to accrual status are met, previous charge-offs taken would not have to be fully recovered before such loans are returned to accrual status. Loans that meet this criteria should continue to be disclosed as past due as appropriate (for example, 90 days past due and still accruing) until they have been brought fully current. (See SR-93-30.)

2065.1.5 ACQUISITION OF NONACCRUAL ASSETS

Banking organizations (or the receiver of a failed institution) may sell loans or debt securities maintained in nonaccrual status. Such loans or debt securities that have been acquired from an unaffiliated third party should be reported by the purchaser in accordance with AICPA Practice Bulletin No. 6. When the criteria specified in this bulletin are met, these assets may be placed in nonaccrual status.[3]

2065.1.6 TREATMENT OF NONACCRUAL LOANS WITH PARTIAL CHARGE-OFFS

Whether partial charge-offs associated with a nonaccrual loan that has not been formally restructured must first be fully recovered before the loan can be restored to accrual status is an issue that has not been explicitly addressed by GAAP and bank regulatory reporting requirements. In accordance with the instructions for the bank call report and the bank holding company reports (FR-Y series), restoration to accrual status is permitted when (1) the loan has been brought fully current with respect to principal and interest and (2) it is expected that the full contractual balance of the loan (including any amounts charged off) plus interest will be fully collectible under the terms of the loan.[4]

3. AICPA Practice Bulletin No. 6, ''Amortization of Discounts on Certain Acquired Loans,'' American Institute of Certified Public Accountants, August 1989.

4. The instructions for the call reports and FR-Y reports discuss the criteria for restoration to accrual status in the glossary entries for ''nonaccrual status.'' This guidance also permits restoration to accrual status for nonaccrual assets that are both well secured *and* in the process of collection. In addition, this guidance permits restoration to accrual status, when certain criteria are met, of formally restructured debt and acquired nonaccrual assets.

Thus, in determining whether a partially charged-off loan that has been brought fully current can be returned to accrual status, it is important to determine whether the banking organization expects to receive the full amount of principal and interest called for by the terms of the loan.

When a loan has been brought fully current with respect to contractual principal and interest, and when the borrower's financial condition and economic conditions that could affect the borrower's ability to repay have improved to the point that repayment of the full amount of contractual principal (including any amounts charged off) and interest is expected, the loan may be restored to accrual status even if the charge-off has not been recovered. However, this treatment would not be appropriate if the charge-off reflects continuing doubt about the collectibility of principal or interest. Because loans or other assets are required to be placed in nonaccrual status when full repayment of principal or interest is not expected, such loans could not be restored to accrual status.

It is imperative that the reasons for the restoration of a partially charged-off loan to accrual status be supported by a current, well-documented evaluation of the borrower's financial condition and prospects for full repayment of contractual principal (including any amounts charged off) and interest. This documentation will be subject to review by examiners.

A nonaccrual loan or debt instrument may have been formally restructured in accordance with FAS 15 so that it meets the criteria for restoration to accrual status presented in section 2065.1.2 addressing restructured loans. Under GAAP, when a charge-off was taken before the date of the restructuring, it does not have to be recovered before the restructured loan can be restored to accrual status. When a charge-off occurs after the date of the restructuring, the considerations and treatments discussed earlier in this section are applicable.

2065.1.7 IN-SUBSTANCE FORECLOSURES

FAS 114 addresses the accounting for impaired loans and clarifies existing accounting guidance for in-substance foreclosures. Under the impairment standard and related amendments to FAS 15, a collateral-dependent real estate loan[5] would be reported as ''other real estate owned'' (OREO) only if the lender had taken possession of the collateral. For other collateral-dependent real estate loans, loss recognition would be based on the fair value of the collateral if foreclosure is probable.[6] Such loans would remain in the loan category and would not be reported as OREO. For depository institution examinations, any portion of the loan balance on a collateral-dependent loan that exceeds the fair value of the collateral and that can be identified as uncollectible would generally be classified as a loss and be promptly charged off against the ALLL.

A collateralized loan that becomes impaired is not considered ''collateral dependent'' if repayment is available from reliable sources other than the collateral. Any impairment on such a loan may, at the depository institution's option, be determined based on the present value of the expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, based on the loan's observable market price. (See SR-95-38.)

Losses must be recognized on real estate loans that meet the in-substance foreclosure criteria with the collateral being valued according to its fair value. Such loans do not have to be reported as OREO unless possession of the underlying collateral has been obtained. (See SR-93-30.)

2065.1.8 LIQUIDATION VALUES OF REAL ESTATE LOANS

In accordance with the March 10, 1993, interagency policy statement Credit Availability, loans secured by real estate should be based on the borrower's ability to pay over time, rather than on a presumption of immediate liquidation. Interagency guidance issued on June 10, 1993, emphasizes that it is *not* regulatory policy to value collateral that underlies real estate loans on a liquidation basis. (See SR-93-30.)

5. A collateral-dependent real estate loan is a loan for which repayment is expected to be provided solely by the underlying collateral and there are no other available and reliable sources of repayment.

6. The fair value of the assets transferred is the amount that the debtor could reasonably expect to receive for them in a current sale between a willing buyer and a willing seller, other than in a forced or liquidation sale.

The adequacy of a banking organization's allowance for loan and lease losses (ALLL) (including amounts based on an analysis of the commercial real estate portfolio) must be based on a careful, well-documented, and consistently applied analysis of the loan and lease portfolio.[1] The determination of the adequacy of the ALLL should be based on management's consideration of all current significant conditions that might affect the ability of borrowers (or guarantors, if any) to fulfill their obligations to the institution. While historical loss experience provides a reasonable starting point, historical losses or even recent trends in losses are not sufficient, without further analysis, to produce a reliable estimate of anticipated loss.

In determining the adequacy of the ALLL, management should consider factors such as changes in the nature and volume of the portfolio; the experience, ability, and depth of lending management and staff; changes in credit standards; collection policies and historical collection experience; concentrations of credit risk; trends in the volume and severity of past-due and classified loans; and trends in the volume of nonaccrual loans, specific problem loans, and commitments. In addition, this analysis should consider the quality of the organization's systems and management in identifying, monitoring, and addressing asset-quality problems. Furthermore, management should consider external factors such as local and national economic conditions and developments, competition, and legal and regulatory requirements, as well as reasonably foreseeable events that are likely to affect the collectibility of the loan portfolio.

Management should adequately document the factors that were considered, the methodology and process that were used in determining the adequacy of the ALLL, and the range of possible credit losses estimated by this process. The complexity and scope of this analysis must be appropriate to the size and nature of the organization and provide for sufficient flexibility to accommodate changing circumstances.

1. The estimation process described in this section permits a more accurate estimate of anticipated losses than could be achieved by assessing the loan portfolio solely on an aggregate basis. However, it is only an estimation process and does not imply that any part of the ALLL is segregated for, or allocated to, any particular asset or group of assets. The ALLL is available to absorb overall credit losses originating from the loan and lease portfolio. The balance of the ALLL is management's estimation of potential credit losses, synonymous with its determination as to the adequacy of the *overall* ALLL.

Examiners will evaluate the methodology and process that management has followed in arriving at an overall estimate of the ALLL to ensure that all of the relevant factors affecting the collectibility of the portfolio have been appropriately considered. In addition, the overall estimate of the ALLL and the range of possible credit losses estimated by management will be reviewed for reasonableness in view of these factors. The examiner's analysis will also consider the quality of the organization's systems and management in identifying, monitoring, and addressing asset-quality problems. (See sections 2065.3, 2065.4, and 2128.08.)

The value of the collateral will be considered by examiners in reviewing and classifying a commercial real estate loan. However, for a performing commercial real estate loan, the supervisory policies of the agencies do not require automatic increases to the ALLL solely because the value of the collateral has declined to an amount that is less than the loan balance.

In assessing the ALLL, it is important to recognize that management's process, methodology, and underlying assumptions require a substantial degree of judgment. Even when an organization maintains sound loan-administration and -collection procedures and effective internal systems and controls, the estimation of losses may not be precise due to the wide range of factors that must be considered. Further, the ability to estimate losses on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. When management has (1) maintained effective systems and controls for identifying, monitoring, and addressing asset-quality problems and (2) analyzed all significant factors affecting the collectibility of the portfolio, examiners should give considerable weight to management's estimates in assessing the adequacy of the overall ALLL.

Examiners and bank holding company management should consider the impact of the Financial Accounting Standards Board's (FASB) Statement No. 114, "Accounting by Creditors for Impairment of a Loan" (FAS 114) (as amended by FASB Statement No. 118, "Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures"), on the ALLL-estimating process. FAS 114 sets forth guidance for estimating the impairment of a loan for general financial reporting purposes. Under FAS 114, a loan is *impaired* when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement.

When a creditor has determined that a loan is impaired, FAS 114 requires that an allowance be established based on the present value of the expected future cash flows of the loan discounted at the loan's effective interest rate (that is, the contract rate, as adjusted for any net deferred loan fees or costs, premiums, or discounts) or, as a practical expedient, at the loan's observable market price or at the fair value of the collateral if the loan is collateral dependent. Since the allowances under FAS 114 apply only to a subset of loans,[2] FAS 114 does not address the adequacy of a creditor's *overall* ALLL or how the creditor should assess the adequacy of its ALLL. Examiners should not focus unduly on the adequacy of this or any other portion of the ALLL established for a subset of loans. Bank holding companies are required to follow FAS 114 (as amended by FAS 118) when reporting in the FR Y-9C report for the holding company on a consolidated basis.

2065.2.1 INSPECTION OBJECTIVES

1. To evaluate the methodology and process that management employs in compiling an *overall* estimate of the ALLL.
2. To understand and evaluate the nature of the external (economic and social climate, the extent of competition) and internal (credit strategies, levels of acceptable credit risk, and lending policies and procedures) lending environment and how they might influence management's estimate of the ALLL.
3. To determine the accuracy and reasonableness of management's estimate of the *overall* ALLL.
4. To evaluate the quality of the BHC's systems and management performance in identifying, monitoring, and resolving asset-quality problems.

2. The guidance on impairment in FAS 114 does not apply to "large groups of smaller balance homogeneous loans that are collectively evaluated for impairment," loans that are measured at fair value or at the lower of cost or fair value, or leases and debt securities as defined in FAS 115, "Accounting for Certain Investments in Debt and Equity Securities." FAS 114 does apply to loans that are restructured in a troubled-debt restructuring involving a modification of terms.

2065.2.2 INSPECTION PROCEDURES

1. Determine whether the banking organization has carefully documented and applied an accurate and consistent method of analysis for estimating the *overall* ALLL. When making such a determination, ascertain whether—
   a. management has considered all significant factors and conditions that might affect the collectibility of the loan, including the borrower's repayment practices, the value of accessible underlying collateral, and other factors (that is, those factors listed in this section);
   b. management has documented all factors that were considered and the methodology and process that were used to evaluate the adequacy of the allowance; and
   c. the complexity and scope of the analysis are appropriate for the size and nature of the organization.
2. Evaluate the methodology and process that management has followed in arriving at an overall estimate of the ALLL.
3. Determine the reasonableness of management's consolidated estimate of the ALLL, including the range of possible credit losses. Determine whether management has properly evaluated the overall composition of the loan portfolio at all organizational levels by—
   a. identifying potential problem loans, including loans classified by all bank regulatory agencies;
   b. determining trends with respect to loan volume (growth (in particular, rapid growth), levels of delinquencies, nonaccruals, and nonperforming loans);
   c. considering the previous loss and recovery experience including the timeliness of charge-offs;
   d. evaluating the performance of concentrations of credit (related interests, geographic regions, industries, lesser-developed countries (LDCs), highly leveraged loans, and the size of credit exposures (few large loans versus numerous small loans));
   e. determining the amount of loans and problem loans (delinquent, nonaccrual, and nonperforming) by lending officer or committee; and
   f. evaluating the levels and performance of loans involving related parties.
4. For each level of the organization, determine the percentage of past-due loans to the loan portfolio and compare it with prior periods.

The examiner may find it beneficial to compute the ratio for groups of loans by type, size, or risk levels.

5. Compare the loans classified during regulatory examinations or BHC inspections with the previous examinations or inspections and also with those classified by management before the regulatory examinations or inspections. Investigate the current status of previously classified loans.
6. Compute the percentage of the ALLL to average outstanding loans and compare those results with those of the previous inspection. Investigate the reasons for variations between those periods.
7. Assess the quality of the organization's systems and internal controls in identifying, monitoring, and addressing asset-quality problems.

The Federal Reserve Board and the other federal regulators of banks and savings associations issued a joint policy statement that provides comprehensive guidance on the maintenance of an adequate allowance for loan and lease losses (ALLL) and on an effective loan-review system. The statement, effective December 23, 1993, is designed to further promote consistency in supervisory policies among banks and thrifts.

This policy statement applies to all depository institutions insured by the Federal Deposit Insurance Corporation (FDIC) except for FDIC-insured branches and agencies of foreign banks. The statement also does not apply to nonfederally insured branches and agencies of foreign banks. FDIC-insured and nonfederally insured branches and agencies of foreign banks continue to be subject to separate guidance issued by their primary supervisory agency. *The policy statement does not apply directly to bank holding companies. However, the boards of directors and management of bank holding companies should consider the statement as they supervise and administer policies and procedures pertaining to the financial institution subsidiaries of the bank holding company. Bank holding company examiners should consider the guidance of the policy statement when evaluating a bank holding company's supervisory policies as they pertain to its financial institution subsidiaries.*

The policy statement discusses the nature and purpose of the ALLL; defines an adequate ALLL; and covers the responsibilities of the board of directors, the institution's management, and the examiner. The policy statement emphasizes that it is the responsibility of the board of directors and management of each institution to maintain the ALLL at an adequate level. The policy statement also discusses the analysis of the loan and lease portfolio, factors to consider in estimating credit losses, and the characteristics of an effective loan-review system.

In addition, the statement includes a section on examiner responsibilities. The section consists of quantitative guidance the examiner should use to identify those institutions whose ALLL levels and related ALLL-evaluation processes should be subject to closer review by examiners. Although this examination guidance does not pertain directly to the inspection of bank holding companies, it keeps the holding company management and Federal Reserve System bank holding company examiners apprised of the methods used by federal financial institution examiners to assess and evaluate the adequacy of the ALLL for bank holding company bank and thrift subsidiaries. (See SR-93-70.)

The policy statement reiterates existing policy that Federal Reserve state member bank examiners will generally accept bank management's estimates in their assessment of the adequacy of the ALLL when management has (1) maintained effective systems and controls for identifying, monitoring, and addressing asset-quality problems in a timely manner; (2) analyzed all significant factors that affect the collectibility of the portfolio in a reasonable manner; and (3) established an acceptable ALLL-evaluation process that meets the objectives for an adequate ALLL.[1]

The Financial Accounting Standards Board (FASB) Statement No. 114 (FAS 114), "Accounting by Creditors for Impairment of a Loan," as amended by FASB Statement No. 118 (FAS 118), "Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures," sets forth standards for estimating the impairment of a loan for general financial-reporting purposes. According to FAS 114, a loan is *impaired* when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement. FAS 118 eliminated the former income-recognition provisions of FAS 114.

FAS 114 and FAS 118 became effective for fiscal years beginning after December 15, 1994, with earlier application permitted. FAS 114 requires that an allowance be established based on the present value of expected future cash flows of the loan discounted at the loan's effective interest rate (that is, the contract rate, as adjusted for any net deferred loan fees or costs, premiums, or discounts) or, as a practical expedient, at the loan's observable market price or at the fair value of the collateral if the loan is collateral dependent. Since allowances under

1. SR-99-13 reemphasizes the need for balanced, yet conservative, reserving practices. Banking organizations may reserve conservatively at the higher end of the range of estimated losses when those levels are management's best estimate. They may also reflect a margin for imprecision. Unallocated reserves are acceptable when they are determined in accordance with GAAP.

FAS 114 apply only to a subset of loans (those that are subject to the standard and that are deemed to be impaired), FAS 114 does not address the adequacy of a creditor's overall ALLL or how the creditor should assess the adequacy of its ALLL. In addition to the allowance for credit losses calculated under FAS 114, a creditor should continue to recognize an ALLL necessary to comply with FASB Statement No. 5 (FAS 5), ''Accounting for Contingencies.'' Furthermore, the guidance in FAS 114 applies only to a subset of the loan and lease portfolio as the term is used in this policy statement.[2]

FAS 114, as amended by FAS 118, has been adopted by the Federal Financial Institutions Examination Council (FFIEC) for purposes of reporting by banks in call reports, subject to the additional regulatory reporting guidelines discussed below. Furthermore, the FFIEC concluded that FAS 114 sets forth methods for establishing only a portion of an institution's ALLL. Accordingly, while banks must use the methods set forth in FAS 114 to determine the portion of the ALLL attributable to impaired loans as defined by the statement for purposes of reporting in call reports, no separate reporting of the portion established under FAS 114 has been required in these reports. The overall ALLL should continue to be reported on existing call report line items. The text of the interagency policy statement follows.[3] (Footnotes have been renumbered.) (See also sections 2065.1, 2065.2, and 2065.4.)

2. In 1999, FASB considered the interaction between the two primary accounting standards on the ALLL, FAS 5 and FAS 114. An allowance calculated under FAS 5 may be required for loans that are not individually identified as being impaired under FAS 114. Reserve calculations for specific impaired loans under FAS 114 should incorporate an evaluation of environmental factors (such as industry, geographic, economic, and political factors). Reserves calculated under FAS 5 should not be required for loans that are determined to be impaired under FAS 114. (See SR-99-13.)

SR-99-22 reaffirms the principles in SR-99-13. It indicates that the Securities and Exchange Commission (SEC) does not have a policy of seeking reductions in financial institutions' loan-loss allowance levels and that it will consult with the banking agencies as it considers whether to take a significant action regarding an institution's ALLL-accounting practices.

3. For savings associations, the ALLL is included in ''general valuation allowances'' (GVAs). GVAs may also be required on assets other than loans and leases.

2065.3.1 1993 INTERAGENCY POLICY STATEMENT ON THE ALLOWANCE FOR LOAN AND LEASE LOSSES

The text in brackets was not part of the 1993 policy statement.

2065.3.1.1 Nature and Purpose of the ALLL

Federally insured depository institutions (''institutions'') must maintain an ALLL at a level that is adequate to absorb estimated credit losses associated with the loan and lease portfolio, including all binding commitments to lend.[4] To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated credit losses associated with off-balance-sheet credit instruments such as standby letters of credit.[5]

For purposes of this policy statement, the term ''estimated credit losses'' means an estimate of the current amount of the loan and lease portfolio (net of unearned income) that is not likely to be collected; that is, net charge-offs that are likely to be realized for a loan or pool of loans given facts and circumstances as of the evaluation date. These estimated credit losses should meet the criteria for accrual of a loss contingency (i.e., a provision to the ALLL) set forth in generally accepted accounting principles (GAAP). When available information confirms specific loans and leases, or portions thereof, to be uncollectible, these amounts should be promptly charged off against the ALLL.

Estimates of credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. For individually analyzed loans, these estimates should reflect consideration of the facts and circumstances that affect the repayment of such loans as of the evaluation date. For pools of loans, estimated credit losses should reflect consideration of the institution's historical net charge-off rate on pools of similar loans,

4. In the case of binding commitments to lend and off-balance-sheet credit instruments, such losses represent the amount of loans and leases that will likely not be collected (given facts and circumstances as of the evaluation date) and, thus, will be charged off. For purposes of this policy statement, the loan and lease portfolio, binding commitments to lend, and off-balance-sheet credit commitments are referred to as ''loans,'' ''loans and leases,'' the ''loan and lease portfolio,'' or the ''portfolio.''

5. Recourse liability accounts (that arise from recourse obligations for any transfers of loans that are reported as sales for regulatory reporting purposes) should be reported as liabilities that are separate and distinct from the ALLL.

adjusted for changes in trends, conditions, and other relevant factors that affect repayment of the loans in these pools as of the evaluation date. Methodologies for the determination of the historical net charge-off rate on a pool of loans can range from a simple average of an institution's net charge-off experience over a relevant period of years—coupled with appropriate adjustments as noted above for factors that affect repayment—to more complex techniques, such as migration analysis.

As discussed more fully below, for analytical purposes, an institution may attribute portions of the ALLL to individual loans or groups of loans. However, the ALLL is available to absorb all credit losses that arise from the loan and lease portfolio and is not segregated for, or allocated to, any particular loan or group of loans.

2065.3.1.2 Responsibility of the Board of Directors and Management

2065.3.1.2.1 Adequate ALLL Level

It is the responsibility of the board of directors and management of each institution to maintain the ALLL at an adequate level.[6] For purposes of the Reports of Condition and Income (call report) and the Thrift Financial Report (TFR), an adequate ALLL should be no less than the sum of the following items *given facts and circumstances as of the evaluation date* (after deduction of all portions of the portfolio classified loss):

1. for loans and leases *classified substandard or doubtful*, whether analyzed and provided for individually or as part of pools, all estimated credit losses over the remaining effective lives of these loans;
2. for components of the loan and lease portfolio that are *not classified*, all estimated credit losses over the upcoming 12 months;[7] and
3. amounts for estimated losses from transfer risk on international loans.

Furthermore, when determining the appropriate level for the ALLL, management's analysis should be conservative so that the overall ALLL appropriately reflects a margin for the imprecision inherent in most estimates of expected credit losses. This additional margin for imprecision might be incorporated into the ALLL through the amounts attributed for analytical purposes to individual loans or groups of loans or in a portion of the ALLL that is not attributed to specific components of the loan portfolio.[8]

The adequacy of the ALLL should be evaluated as of the end of each quarter, or more frequently if warranted, and appropriate provisions made to maintain the ALLL at an adequate level as of each call report or Thrift Financial Report date. This evaluation will be subject to review by examiners.

2065.3.1.2.2 Related Responsibilities

In carrying out their responsibility for maintaining an adequate ALLL, the board of directors and management are expected to—

1. ensure that the institution has an effective loan-review system and controls (which

6. Financial Accounting Standards Board (FASB) Statement No. 114, ''Accounting by Creditors for Impairment of a Loan,'' provides that an ''allowance for credit losses'' must be calculated on a present-value basis when a loan is impaired. FASB Statement No. 114 states that it ''does *not* address how a creditor should assess the *overall adequacy* of the allowance for credit losses'' (emphasis added), and that, in addition to the allowance for credit losses calculated under FASB Statement No. 114, a creditor should continue to recognize an ALLL necessary to comply with FASB Statement No. 5, ''Accounting for Contingencies.'' Furthermore, the guidance in FASB Statement No. 114 only applies to a subset of the loan and lease portfolio as the term is used in this policy statement (e.g., the FASB standard does *not* apply to leases, binding commitments to lend, and large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment). In contrast, this policy statement provides guidance on assessing the *overall adequacy* of the ALLL.

7. In certain circumstances, subject to examiner review, a net charge-off horizon of less than one year from the balance-sheet date may be employed for components of the portfolio that have not been classified. For institutions with conservative charge-off policies, a charge-off horizon of less than one year might be appropriate for pools of loans that are neither classified nor subject to greater-than-normal credit risk and that have well-documented and highly predictable cash flows and loss rates, such as pools of certain smaller consumer installment or credit card loans. On the other hand, a net charge-off horizon of more than one year for loans that have not been classified might be appropriate until an institution's loan-review function and credit-grading system results in accurate and timely assessments of the portfolio. In such situations, an institution should expeditiously correct deficiencies in its loan-review function and credit-grading system.

8. As discussed later in this policy statement, institutions are encouraged to segment their loan and lease portfolios into as many components as practical when analyzing the adequacy of the ALLL. Therefore, institutions are encouraged to reflect the margin for imprecision in amounts attributable for analytical purposes to these components of the portfolio, to the extent possible.

include an effective credit-grading system) that identify, monitor, and address asset-quality problems in an accurate and timely manner (to be effective, the institution's loan-review system and controls must be responsive to changes in internal and external factors affecting the level of credit risk in the portfolio);
2. ensure the prompt charge-off of loans, or portions of loans, that available information confirms to be uncollectible; and
3. ensure that the institution's process for determining an adequate level for the ALLL is based on a comprehensive, adequately documented, and consistently applied analysis of the institution's loan and lease portfolio that considers all significant factors that affect the collectibility of the portfolio and supports the range of credit losses estimated by this process.

As discussed more fully in appendix 1, it is essential that institutions maintain effective loan-review systems, although smaller institutions would not be expected to maintain separate loan-review departments. An effective loan-review system should work to ensure the accuracy of internal credit-grading systems and, thus, the quality of the information used to assess the adequacy of the ALLL. The complexity and scope of the institution's ALLL-evaluation process, loan-review system, and other relevant controls should be appropriate in view of the size of the institution and the nature of its lending activities, and provide for sufficient flexibility to accommodate changes in the factors that affect the collectibility of the portfolio.

2065.3.1.2.3 Analysis of the Loan and Lease Portfolio

In determining the appropriate level of the ALLL, the institution should rely primarily on an analysis of the various components of its portfolio, including all significant credits on an individual basis. When analyzing the adequacy of the ALLL, institutions should segment their loan and lease portfolios into as many components as practical. Each component would normally have similar characteristics, such as risk classification, past-due status, type of loan, industry, or collateral. A depository institution may, for example, analyze the following components of its portfolio and provide for them in the ALLL:

1. all significant credits on an individual basis that are classified doubtful (or the institution's equivalent)
2. all other significant credits reviewed individually (If no allocation can be determined for such credits on an individual basis, they should be provided for as part of an appropriate pool below.)
3. all other loans and leases that are not included by examiners or by the institution's credit-grading system in the population of loans reviewed individually, but are delinquent or are classified or designated special mention (e.g., pools of smaller delinquent, special-mention, and classified commercial and industrial loans; real estate loans; consumer loans; and lease-financing receivables)
4. homogeneous loans that have not been reviewed individually or are not delinquent, classified, or designated as special mention (e.g., pools of direct consumer loans, indirect consumer loans, credit card loans, home equity lines of credit, and residential real estate mortgages)
5. all other loans that have not been considered or provided for elsewhere (e.g., pools of commercial and industrial loans that have not been reviewed, classified, or designated special mention; standby letters of credit; and other off-balance-sheet commitments to lend)

In addition to estimated credit losses, the losses that arise from the transfer risk associated with an institution's cross-border lending activities require special consideration. Over and above any minimum amount that is required by the Interagency Country Exposure Review Committee to be provided in the allocated transfer-risk reserve[8a] (or charged against the ALLL), the institution must determine that the ALLL is adequate to absorb all estimated losses from transfer risk associated with its cross-border lending exposure. (See appendix 2 for factors to consider.)

[8a. The ATRR is a special reserve established and maintained for specified international assets pursuant to the International Lending Supervision Act of 1983. (See 12 U.S.C. 3904(a).) At least annually, the Federal Reserve and the other federal banking agencies determine jointly (1) which international assets that are subject to transfer risk warrant establishment of an ATRR, (2) the amount of the ATRR for the specified assets, and (3) whether an ATRR previously established for specified assets may be reduced.]

[When determining whether an ATRR is required for particular international assets, the federal banking agencies consider if the quality of a banking institution's assets has been impaired by a protracted inability of public or private obligors in a foreign country to make payments on their external indebtedness as indicated by factors as to whether—

1. such obligors have failed to make full interest payments on external indebtedness, or
2. such obligors have failed to comply with the terms of any restructured indebtedness, or
3. a foreign country has failed to comply with any International Monetary Fund or other suitable adjustment program, or
4. no definite prospects exist for the orderly restoration of debt service.

Also, when determining the amount of the ATRR, the federal banking agencies consider—

1. the length of time the quality of the asset has been impaired,
2. what recent actions have been taken to restore debt-service capability,
3. the prospects for restored asset quality, and
4. any other factors relevant to the quality of the asset.

The initial year's provision for the ATRR shall be 10 percent of the principal amount of each specified international asset, or such greater or lesser percentage determined by the federal banking agencies. Additional provisions, if any, in subsequent years will be 15 percent of the principal amount of each specified international asset, or such greater or lesser percentage determined by the federal banking agencies.

The ATRR is established only by a charge to current income. The amounts charged cannot be included in the banking institution's capital or surplus. For these and other requirements, as well as certain other accounting procedures for the ATTR, the reporting and disclosure of international assets, and the accounting for fees on international loans, see sections 211.43, 211.44, and 211.45 of Regulation K. A banking institution does not have to establish an ATRR if it writes down in the period in which the ATRR is required, or has written down in prior periods, the value of the specified international assets in the requisite amount for each such asset.]

2065.3.1.2.4 Factors to Consider in the Estimation of Credit Losses

As previously mentioned, estimates of credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. While historical loss experience provides a reasonable starting point for the institution's analysis, historical losses, or even recent trends in losses are not, by themselves, a sufficient basis to determine the appropriate level for the ALLL. Management should also consider any factors that are likely to cause estimated credit losses associated with the institution's current portfolio to differ from historical loss experience, including but not limited to—

1. changes in lending policies and procedures, including underwriting standards and collection, charge-off, and recovery practices;
2. changes in national and local economic and business conditions and developments, including the condition of various market segments;[9]
3. changes in the nature and volume of the portfolio;
4. changes in the experience, ability, and depth of lending management and staff;
5. changes in the trend of the volume and severity of past-due and classified loans, and trends in the volume of nonaccrual loans, troubled-debt restructurings, and other loan modifications;
6. changes in the quality of the institution's loan-review system and the degree of oversight by the institution's board of directors;
7. the existence and effect of any concentrations of credit and changes in the level of such concentrations; and
8. the effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution's current portfolio.

Institutions are also encouraged to use ratio analysis as a supplemental check or tool for evaluating the overall reasonableness of the ALLL. Ratio analysis can be useful in identifying divergent trends (compared with the institution's peer group and its own historical practices) in the relationship of the ALLL to classified and nonclassified loans and leases, to past-due and nonaccrual loans and leases, to total loans and binding commitments, and to historical gross and net charge-offs. However, while such comparisons can be helpful as a supplemental check of the reasonableness of management's assumptions and analyses, they are not, by themselves, a sufficient basis for determining the adequacy of the ALLL. In particular, such comparisons do not obviate the need for a comprehensive analysis of the loan and lease portfolio and the factors affecting its collectibility.

9. Credit-loss and -recovery experience may vary significantly depending upon the business cycle. For example, an overreliance on recent credit-loss experience during a period of economic growth will not result in realistic estimates of credit losses during a period of economic downturn.

2065.3.1.3 Examiner Responsibilities

Examiners will assess the asset quality of an institution's loan and lease portfolio and the adequacy of the ALLL. In the review and classification of the loan and lease portfolio, examiners should consider all significant factors that affect the collectibility of the portfolio, including the value of any collateral. In reviewing the adequacy of the ALLL, examiners will—

1. consider the quality of the institution's loan-review system and management in identifying, monitoring, and addressing asset-quality problems (this will include a review of the institution's credit-grading system and loan-review function);[10]
2. evaluate the ALLL-evaluation process that management has followed to arrive at an overall estimate of the ALLL and the related assumptions made by management in order to ensure that the institution's historical loss experience and all significant factors that affect the collectibility of the portfolio (including changes in the quality of the institution's loan-review function and other factors previously discussed) have been appropriately considered;
3. review the overall level of the ALLL and the range of credit losses estimated by management for reasonableness in view of the factors discussed in the prior sections of this policy statement;
4. perform a quantitative analysis (e.g., using the types of ratio analysis previously discussed) as a check of the reasonableness of the ALLL; and
5. review the adequacy of the documentation that has been maintained by management to support the adequacy of the ALLL.

10. The review of an institution's loan-review system (including credit grading) by an examiner will usually include tests involving a sample of the institution's loans. If differences noted between examiner credit grades and those of the institution's loan-review system indicate problems with the loan-review system, especially where the credit grades assigned by the institution are more liberal than those assigned by the examiner, the institution would be expected to make appropriate adjustments to the assignment of its credit grades to the loan and lease portfolio and to its estimate of the ALLL. Furthermore, the institution would be expected to improve its loan-review system. (Appendix 1 discusses effective loan-review systems.)

After analyzing an institution's policies, practices, and historical credit-loss experience, the examiner should further check the reasonableness of management's ALLL methodology by comparing the reported ALLL (after the deduction of all loans, or portions thereof, classified as loss) against the sum of the following amounts:

1. 50 percent of the portfolio that is classified doubtful
2. 15 percent of the portfolio that is classified substandard
3. for the portions of the portfolio that have not been classified (including those loans designated special mention), estimated credit losses over the upcoming 12 months *given facts and circumstances as of the evaluation date* (based on the institution's average annual rate of net charge-offs experienced over the previous two or three years on similar loans, adjusted for current conditions and trends)[11]

This amount is neither a "floor" nor a "safe-harbor" level for an institution's ALLL. However, examiners will view a shortfall relative to this amount as indicating a need to more closely review management's analysis to determine whether it is reasonable and supported by the weight of reliable evidence and that all relevant factors have been appropriately considered.[12]

In assessing the adequacy of the ALLL, it is important to recognize that the related process, methodology, and underlying assumptions require a substantial degree of judgment. Even when an institution maintains sound loan-administration and -collection procedures and effective internal systems and controls, the estimation of credit losses will not be precise due to the wide range of factors that must be considered. Further, the ability to estimate credit losses on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. Therefore, examiners will generally accept management's estimates in their assessment of the adequacy of the ALLL when management has (1) maintained effective systems and controls for identifying, monitoring, and addressing asset-quality problems in a timely manner, (2) analyzed all significant factors that affect the collectibility of the portfolio in a reasonable manner, and (3) established an acceptable ALLL-evaluation process that meets the objectives for an adequate ALLL.

After the completion of all aspects of the ALLL review described in this section, if the examiner does not concur that the reported ALLL level is adequate or if the ALLL-evaluation process is deficient or based on the results of an unreliable loan-review system, recommendations for correcting these problems, including any examiner concerns regarding an appropriate level for the ALLL, should be noted in the report of examination.

11. In cases where the institution has an insufficient basis for determining this amount, the examiner may use the industry-average net charge-off rate for nonclassified loans and leases.

12. The weights of 50 percent and 15 percent for doubtful and substandard loans, respectively, are estimates of the industry's average loss experience over time on similarly classified credits. Because they represent the average industry experience, these weights do not take into account idiosyncratic factors that may be important for estimating expected credit losses for a particular institution, such as the composition of its portfolio; the quality of underwriting, collection, and loan-review systems; and current economic conditions and trends. *Nor do these weights incorporate any additional margin to reflect the imprecision inherent in estimates of expected credit losses.* Due to such institution-specific factors, including an institution's historical loss experience adjusted for current conditions and trends, in many cases an ALLL exceeding the sum of 1, 2, and 3 above might still be inadequate, while in other cases, the weight of evidence might indicate that an ALLL less than this amount is adequate. In all circumstances, for purposes of the call report or Thrift Financial Report, the reported ALLL should meet the standard for an adequate ALLL set forth in the section entitled "Responsibility of the Board of Directors and Management."

2065.3.1.4 ALLL Level Reflected in Regulatory Reports

The agencies believe that an ALLL established in accordance with this policy statement will fall within the range of acceptable estimates developed in accordance with GAAP. When an institution's reported ALLL does not meet the objectives for an adequate ALLL, the institution will be required to increase its provision for loan and lease losses expense sufficiently to restore the level of the ALLL reported on its call report or TFR to an adequate level as of the evaluation date.

2065.3.1.5 Appendix 1—Loan-Review Systems

The nature of loan-review systems may vary based on an institution's size, complexity, and management practices. For example, a loan-review system may include components of a traditional loan-review function that is independent of the lending function, or it may place some reliance on loan officers. In addition, the use of the term ''loan-review system'' can refer to various responsibilities assigned to credit administration, loan administration, problem-loan workout, or other areas of an institution. These responsibilities may range from administering the internal problem-loan reporting process to maintaining the integrity of the credit-grading process (e.g., ensuring that changes are made in credit grades as needed) and coordinating the information necessary to assess the adequacy of the allowance for loan and lease losses (ALLL). Regardless of the structure of the loan-review system in an institution, at a minimum, an effective loan-review system should have the following objectives:

1. To promptly identify loans having potential credit weaknesses and appropriately classify loans with well-defined credit weaknesses that jeopardize repayment so that timely action can be taken and credit losses can be minimized.
2. To project relevant trends that affect the collectibility of the portfolio and isolate potential problem areas.
3. To provide essential information to determine the adequacy of the ALLL.
4. To assess the adequacy of and adherence to internal credit policies and loan-administration procedures and to monitor compliance with relevant laws and regulations.
5. To evaluate the activities of lending personnel
6. To provide senior management and the board of directors with an objective and timely assessment of the overall quality of the loan portfolio.
7. To provide management with accurate and timely information related to credit quality that can be used for financial and regulatory reporting purposes.

2065.3.1.5.1 Credit-Grading Systems

The foundation for any loan-review system is accurate and timely credit grading, which involves an assessment of credit quality and leads to the identification of problem loans. An effective credit-grading system provides important information on the collectibility of the portfolio for use in the determination of an adequate level for the ALLL.

Regardless of the particular type of loan-review system employed, an effective credit-grading framework generally places primary reliance on loan officers to identify emerging loan problems. However, given the importance and subjective nature of credit grading, a loan officer's judgment regarding the assignment of a particular credit grade to a loan may be subject to review by (1) peers, superiors, or loan committee(s); (2) an independent, qualified part-time or full-time person(s); (3) an internal department staffed with credit-review specialists; or (4) outside credit-review consultants. A credit-grading review that is independent of the lending function is the preferred approach because it typically provides a more conservative and realistic assessment of credit quality. Because accurate and timely credit grading is a critical component of an effective loan-review system, each institution should ensure that its loan-review system includes the following attributes:

1. a formal credit-grading system that can be reconciled with the framework used by the federal regulatory agencies[13]
2. an identification or grouping of loans that warrant the special attention of management
3. documentation supporting the reason(s) why a particular loan merits special attention
4. a mechanism for direct, periodic, and timely reporting to senior management and the board of directors on the status of loans identified as meriting special attention and the action(s) taken by management
5. appropriate documentation of the institution's credit-loss experience for various components of its loan and lease portfolio[14]

An institution should maintain a written description of its credit-grading system, including a discussion of the factors used to assign appropriate credit grades to loans. Loan credit grades should reflect the risk of credit losses.

13. An institution may have a credit-grading system that differs from the credit-grading framework used by the federal banking agencies. However, each institution that maintains a credit-grading system that differs from the agencies' framework should maintain documentation that translates its credit-grading system into the pass/special-mention/substandard/doubtful/loss credit-grading framework used by the federal regulatory agencies. This documentation should be sufficient to enable examiners to reconcile the totals for the various credit grades under the institution's system to the agencies' categories listed above.

14. Institutions are encouraged to maintain records of net credit-loss experience for credits in each of the following categories: items not classified or designated as special-mention, special-mention, substandard, doubtful, and loss.

In addition, the loan-review program should be in writing and reviewed and approved at least annually by the board of directors to evidence their support of and commitment to the system.

2065.3.1.5.2 Loan-Review-System Elements

The following discussion refers to the primary activities comprising a loan-review system that were previously addressed, ranging from the credit-administration function to the independent internal loan-review function. An institution's written policy and documentation for its loan-review system should address the following elements:

1. qualifications of loan-review personnel
2. independence of loan-review personnel
3. frequency of reviews
4. scope of reviews
5. depth of reviews
6. review of findings and follow-up
7. workpaper and report distribution, including distribution of reports to senior management and the board of directors

Qualifications of loan-review personnel. Persons involved in the loan-review function should be qualified based on level of education, experience, and extent of formal credit training, and should be knowledgeable in both sound lending practices and the institution's lending guidelines for the types of loans offered by the institution. In addition, these persons should be knowledgeable of relevant laws and regulations affecting lending activities.

Independence of loan-review personnel. An effective loan-review system utilizes both the initial identification of emerging problem loans by loan officers and the credit review of loans by individuals independent of the credit-approval decisions. An important element of an effective system is to place responsibility on loan officers for continuous portfolio analysis and prompt identification and reporting of problem loans. Because of their frequent contact with borrowers, loan officers can usually identify potential problems before they become apparent to others. However, institutions should be careful to avoid overreliance upon loan officers for identification of problem loans. Institutions should ensure that loans are also reviewed by individuals that do not have control over the loans they review and are not part of, or influenced by anyone associated with, the loan-approval process.

While larger institutions typically establish a separate department staffed with credit-review specialists, cost and volume considerations may not justify such a system in smaller institutions. In many smaller institutions, an independent committee of outside directors may fill this role. Whether or not the institution has an independent loan-review department, the loan-review function should report *directly* to the board of directors or a committee thereof (though senior management may be responsible for appropriate administrative functions so long as they do not compromise the independence of the loan-review function).

Frequency of reviews. Optimally, the loan-review function can be used to provide useful continual feedback on the effectiveness of the lending process in order to identify any emerging problems. For example, the frequency of review of significant credits could be at least annually, upon renewal, or more frequently when internal or external factors indicate a potential for deteriorating credit quality in a particular type of loan or pool of loans. A system of ongoing or periodic portfolio reviews is particularly important to the ALLL-determination process, which is dependent on the accurate and timely identification of problem loans.

Scope of reviews. The review should cover all loans that are significant. Also, the review typically includes, in addition to all loans over a predetermined size, a sample of smaller loans; past-due, nonaccrual, renewed, and restructured loans; loans previously classified or designated as special-mention by the institution or by its examiners; insider loans; and concentrations and other loans affected by common repayment factors. The percentage of the portfolio selected for review should provide reasonable assurance that the results of the review have identified the major problems in the portfolio and reflect its quality as a whole. Management should document that the scope of its reviews continues to identify major problems in the portfolio and reflects the portfolio's quality as a whole. The scope of loan reviews should be approved by the institution's board of directors on an annual basis or when any significant changes to the scope of reviews are made.

Depth of reviews. These reviews should analyze a number of important aspects of selected loans, including—

1. credit quality,
2. sufficiency of credit and collateral documentation,
3. proper lien perfection,
4. proper approval by the loan officer and loan committee(s),
5. adherence to any loan-agreement covenants, and
6. compliance with internal policies and procedures and laws and regulations.

Furthermore, these reviews should consider the appropriateness and timeliness of the identification of problem loans by loan officers.

Review of findings and follow-up. Findings should be reviewed with appropriate loan officers, department managers, and members of senior management, and any existing or planned corrective action should be elicited for all noted deficiencies and identified weaknesses, including the time frames for correction. All noted deficiencies and identified weaknesses that remain unresolved beyond the assigned time frames for correction should be promptly reported to senior management and the board of directors.

Workpaper and report distribution. A list of loans reviewed, the date of the review, and documentation (including summary analyses) to substantiate assigned classifications or designations of loans as special-mention should be prepared on all loans reviewed. A report that summarizes the results of the loan review should be submitted to the board of directors on at least a quarterly basis.[15] In addition to reporting current credit-quality findings, comparative trends can be presented to the board of directors that identify significant changes in the overall quality of the portfolio. Findings should also address the adequacy of and adherence to internal policies, practices, and procedures, and compliance with laws and regulations so that any noted deficiencies can be remedied in a timely manner.

15. The board of directors should be informed more frequently than quarterly when material adverse trends are noted.

2065.3.1.6 Appendix 2—International Transfer Risk Considerations

With respect to international transfer risk,[16] an institution should support its determination of the adequacy of its allowance for loan and lease losses by performing an analysis of the transfer risk, commensurate with the size and composition of the institution's exposure to each country. Such analyses should take into consideration the following factors, as appropriate:

1. the institution's loan-portfolio mix for each country (e.g., types of borrowers, loan maturities, collateral, guarantees, special credit facilities, and other distinguishing factors)
2. the institution's business strategy and its debt-management plans for each country
3. each country's balance-of-payments position
4. each country's level of international reserves
5. each country's established payment-performance record and its future debt-servicing prospects
6. each country's sociopolitical situation and its effect on the adoption or implementation of economic reforms, in particular those affecting debt-servicing capacity
7. each country's current standing with multilateral and official creditors
8. the status of each country's relationships with bank creditors
9. the most recent evaluations distributed by the Interagency Country Exposure Review Committee (ICERC) of the federal banking agencies

[16. For additional information on international transfer risk, a subset of country risk, see section 4090.0 of this manual, SR-02-5, and section 7040.3 of the *Commercial Bank Examination Manual*.]

A supplemental interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions[1] was issued by the Federal Financial Institutions Examination Council (FFIEC) on July 2, 2001.[2] The policy statement clarifies the agencies' expectations for documentation that supports the ALLL methodology. Additionally, the statement emphasizes the need for appropriate ALLL policies and procedures, which should include an effective loan-review system. The guidance also provides examples of appropriate supporting documentation, as well as illustrations on how to implement this guidance. (See SR-01-17.) While this policy statement, by its terms, applies only to depository institutions insured by the Federal Deposit Insurance Corporation (which includes state member banks), the Federal Reserve believes this guidance is broadly applicable to bank holding companies. Accordingly, examiners should apply the policy, as appropriate, in their inspections of bank holding companies and their nonbank subsidiaries. This policy, however, does not apply to federally insured branches and agencies of foreign banks. Federally insured branches and agencies of foreign banks continue to be subject to separate guidance issued by their primary supervisory agency.

The guidance requires that a financial institution's ALLL methodology be in accordance with generally accepted accounting principles (GAAP) and all outstanding supervisory guidance. An ALLL methodology should be systematic, consistently applied, and auditable. The methodology should be validated periodically and modified to incorporate new events or findings, as needed. The guidance specifies that management, under the direction of the board of directors, should implement appropriate procedures and controls to ensure compliance with the institution's ALLL policies and procedures. Institution management should (1) segment the portfolio to evaluate credit risks; (2) select loss rates that best reflect the probable loss; and (3) be responsive to changes in the organization, the economy, or the lending environment by changing the methodology, when appropriate. Furthermore, supporting information should be included on summary schedules, whenever feasible. Under this policy, institutions with less complex loan products or portfolios, such as community banks, may use a more streamlined approach to implement this guidance.

The policy statement is consistent with the Federal Reserve's long-standing policy to promote strong internal controls over an institution's ALLL process. It supplements and does not affect or modify the guidance in the interagency policy statement on the ALLL issued in December 1993. (See SR-93-70.) In this regard, the new policy statement recognizes that determining an appropriate allowance involves a high degree of management judgment and is inevitably imprecise. Accordingly, an institution may determine that the amount of loss falls within a range. In accordance with GAAP, an institution should record its best estimate within the range of credit losses. (See also sections 2065.2 and 2065.3.)

The policy statement is provided below. Some wording has been slightly modified for this manual, as indicated by asterisks or text enclosed in brackets. Some footnotes have also been renumbered.

2065.4.1 2001 POLICY STATEMENT ON ALLL METHODOLOGIES AND DOCUMENTATION

Boards of directors of banks * * * are responsible for ensuring that their institutions have controls in place to consistently determine the allowance for loan and lease losses (ALLL) in accordance with the institutions' stated policies and procedures, generally accepted accounting principles (GAAP), and ALLL supervisory guidance.[3] To fulfill this responsibility, boards of directors instruct management to develop and maintain an appropriate, systematic, and consistently applied process to determine the amounts of the ALLL and provisions for loan losses. Management should create and implement suitable policies and procedures to communicate the ALLL process internally to all applicable personnel. Regardless of who develops and implements these policies, procedures, and

1. See 66 *Fed. Reg.* 35629–35639 (July 6, 2001).

2. The guidance was developed in consultation with Securities and Exchange Commission staff, who are issuing parallel guidance in the form of Staff Accounting Bulletin No. 102.

3. [The actual policy statement includes a bibliography] that lists applicable ALLL GAAP guidance, interagency statements, and other reference materials that may assist in understanding and implementing an ALLL in accordance with GAAP. See [the appendix] for additional information on applying GAAP to determine the ALLL.

underlying controls, the board of directors should assure themselves that the policies specifically address the institution's unique goals, systems, risk profile, personnel, and other resources before approving them. Additionally, by creating an environment that encourages personnel to follow these policies and procedures, management improves procedural discipline and compliance.

The determination of the amounts of the ALLL and provisions for loan and lease losses should be based on management's current judgments about the credit quality of the loan portfolio, and should consider all known relevant internal and external factors that affect loan collectibility as of the reporting date. The amounts reported each period for the provision for loan and lease losses and the ALLL should be reviewed and approved by the board of directors. To ensure the methodology remains appropriate for the institution, the board of directors should have the methodology periodically validated and, if appropriate, revised. Further, the audit committee[4] should oversee and monitor the internal controls over the ALLL- determination process.[5]

The [Federal Reserve and other] banking agencies[6] have long-standing examination policies that call for examiners to review an institution's lending and loan-review functions and recommend improvements, if needed. Additionally, in 1995 and 1996, the banking agencies adopted interagency guidelines establishing standards for safety and soundness, pursuant to section 39 of the Federal Deposit Insurance Act (FDI Act).[7] The interagency asset-quality guidelines and [this guidance will assist] an institution in estimating and establishing a sufficient ALLL supported by adequate documentation, as required under the FDI Act. Additionally, the guidelines require operational and managerial standards that are appropriate for an institution's size and the nature and scope of its activities.

For financial-reporting purposes, including regulatory reporting, the provision for loan and lease losses and the ALLL must be determined in accordance with GAAP. GAAP requires that allowances be well documented, with clear explanations of the supporting analyses and rationale.[8] This [2001] policy statement describes but does not increase the documentation requirements already existing within GAAP. Failure to maintain, analyze, or support an adequate ALLL in accordance with GAAP and supervisory guidance is generally an unsafe and unsound banking practice.[9]

This guidance [the 2001 policy statement] applies equally to all institutions, regardless of the size. However, institutions with less complex lending activities and products may find it more efficient to combine a number of procedures (e.g., information gathering, documentation, and internal-approval processes) while continuing to ensure the institution has a consistent and appropriate methodology. Thus, much of the supporting documentation required for an institution with more complex products or portfolios may be combined into fewer supporting documents in an institution with less complex products or portfolios. For example, simplified documentation can include spreadsheets, checklists, and other summary documents that many institutions currently use. Illustrations A and C provide specific examples of how less complex institutions may determine and document portions of their loan-loss allowance.

2065.4.1.1 Documentation Standards

Appropriate written supporting documentation for the loan-loss provision and allowance facili-

4. All institutions are encouraged to establish audit committees; however, at small institutions without audit committees, the board of directors retains this responsibility.

5. Institutions and their auditors should refer to Statement on Auditing Standards No. 61, "Communication with Audit Committees" (as amended by Statement on Auditing Standards No. 90, "Audit Committee Communications"), which requires certain discussions between the auditor and the audit committee. These discussions should include items, such as accounting policies and estimates, judgments, and uncertainties that have a significant impact on the accounting information included in the financial statements.

6. The [other] banking agencies are the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

7. Institutions should refer to the guidelines *** for state member banks, appendix D to part 208***.

8. The documentation guidance within this [2001] policy statement is predominantly based upon the GAAP guidance from Financial Accounting Standards Board (FASB) Statement No. 5 and No. 114 (FAS 5 and FAS 114, respectively); Emerging Issues Task Force Topic No. D-80 (EITF Topic D-80 and attachments), "Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio" (which includes the *Viewpoints* article—an article issued in 1999 by FASB staff providing guidance on certain issues regarding the ALLL, particularly on the application of FAS 5 and FAS 114 and how these statements interrelate); Chapter 7, "Credit Losses," the American Institute of Certified Public Accountants' (AICPA) Audit and Accounting Guide, *Banks and Savings Institutions*, 2000 edition (AICPA Audit Guide); and the Securities and Exchange Commission's (SEC) Financial Reporting Release No. 28 (FRR 28).

9. Failure to maintain adequate supporting documentation does not relieve an institution of its obligation to record an appropriate ALLL.

tates review of the ALLL process and reported amounts, builds discipline and consistency into the ALLL-determination process, and improves the process for estimating loan and lease losses by helping to ensure that all relevant factors are appropriately considered in the ALLL analysis. An institution should document the relationship between the findings of its detailed review of the loan portfolio and the amount of the ALLL and the provision for loan and lease losses reported in each period.[10]

At a minimum, institutions should maintain written supporting documentation for the following decisions, strategies, and processes:

- policies and procedures—
  - — over the systems and controls that maintain an appropriate ALLL and
  - — over the ALLL methodology
- loan-grading system or process
- summary or consolidation of the ALLL balance
- validation of the ALLL methodology
- periodic adjustments to the ALLL process

2065.4.1.2 Policies and Procedures

Financial institutions utilize a wide range of policies, procedures, and control systems in their ALLL process. Sound policies should be appropriately tailored to the size and complexity of the institution and its loan portfolio.

In order for an institution's ALLL methodology to be effective, the institution's written policies and procedures for the systems and controls that maintain an appropriate ALLL should address but not be limited to—

- the roles and responsibilities of the institution's departments and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, audit committee, board of directors, and others, as applicable) who determine, or review, as applicable, the ALLL to be reported in the financial statements;
- the institution's accounting policies for loans, [leases, and their loan losses], including the policies for charge-offs and recoveries and for estimating the fair value of collateral, where applicable;
- the description of the institution's systematic methodology, which should be consistent with the institution's accounting policies for determining its ALLL;[11] and
- the system of internal controls used to ensure that the ALLL process is maintained in accordance with GAAP and supervisory guidance.

An internal-control system for the ALLL-estimation process should—

- include measures to provide assurance regarding the reliability and integrity of information and compliance with laws, regulations, and internal policies and procedures;
- reasonably assure that the institution's financial statements (including regulatory reports) are prepared in accordance with GAAP and ALLL supervisory guidance;[12] and
- include a well-defined loan-review process containing—
  - — an effective loan-grading system that is consistently applied, identifies differing risk characteristics and loan-quality problems accurately and in a timely manner, and prompts appropriate administrative actions;
  - — sufficient internal controls to ensure that all relevant loan-review information is appropriately considered in estimating losses. This includes maintaining appropriate reports, details of reviews performed, and identification of personnel involved; and
  - — clear formal communication and coordination between an institution's credit-administration function, financial-reporting group, management, board of directors, and others who are involved in

10. This position is fully described in the SEC's FRR 28, in which the SEC indicates that the books and records of public companies engaged in lending activities should include documentation of the rationale supporting each period's determination that the ALLL and provision amounts reported were adequate.

11. Further explanation is presented in the "Methodology" section that appears below.

12. In addition to the supporting documentation requirements for financial institutions, as described in interagency asset-quality guidelines, public companies are required to comply with the books and records provisions of the Securities Exchange Act of 1934 (Exchange Act). Under sections 13(b)(2)–(7) of the Exchange Act, registrants must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant. Registrants also must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP. See also SEC Staff Accounting Bulletin No. 99, *Materiality.*

the ALLL-determination or -review process, as applicable (e.g., written policies and procedures, management reports, audit programs, and committee minutes).

2065.4.1.3 Methodology

An ALLL methodology is a system that an institution designs and implements to reasonably estimate loan and lease losses as of the financial statement date. It is critical that ALLL methodologies incorporate management's current judgments about the credit quality of the loan portfolio through a disciplined and consistently applied process.

An institution's ALLL methodology is influenced by institution-specific factors, such as an institution's size, organizational structure, business environment and strategy, management style, loan-portfolio characteristics, loan-administration procedures, and management information systems. However, there are certain common elements an institution should incorporate in its ALLL methodology. A summary of common elements is provided in [the appendix].[13]

2065.4.1.3.1 Documentation of ALLL Methodology in Written Policies and Procedures

An institution's written policies and procedures should describe the primary elements of the institution's ALLL methodology, including portfolio segmentation and impairment measurement. In order for an institution's ALLL methodology to be effective, the institution's written policies and procedures should describe the methodology—

- for segmenting the portfolio:
  - — how the segmentation process is performed (i.e., by loan type, industry, risk rates, etc.),
  - — when a loan-grading system is used to segment the portfolio:
    - the definitions of each loan grade,
    - a reconciliation of the internal loan grades to supervisory loan grades, and
    - the delineation of responsibilities for the loan-grading system.
- for determining and measuring impairment under FAS 114:
  - — the methods used to identify loans to be analyzed individually;
  - — for individually reviewed loans that are impaired, how the amount of any impairment is determined and measured, including—
    - procedures describing the impairment-measurement techniques available and
    - steps performed to determine which technique is most appropriate in a given situation.
  - — the methods used to determine whether and how loans individually evaluated under FAS 114, but not considered to be individually impaired, should be grouped with other loans that share common characteristics for impairment evaluation under FAS 5.
- for determining and measuring impairment under FAS 5—
  - — how loans with similar characteristics are grouped to be evaluated for loan collectibility (such as loan type, past-due status, and risk);
  - — how loss rates are determined (e.g., historical loss rates adjusted for environmental factors or migration analysis) and what factors are considered when establishing appropriate time frames over which to evaluate loss experience; and
  - — descriptions of qualitative factors (e.g., industry, geographical, economic, and political factors) that may affect loss rates or other loss measurements.

The supporting documents for the ALLL may be integrated in an institution's credit files, loan-review reports or worksheets, board of directors' and committee meeting minutes, computer reports, or other appropriate documents and files.

2065.4.1.4 ALLL Under FAS 114

An institution's ALLL methodology related to FAS 114 loans begins with the use of its normal loan-review procedures to identify whether a loan is impaired as defined by the accounting standard. Institutions should document—

- the method and process for identifying loans to be evaluated under FAS 114 and
- the analysis that resulted in an impairment decision for each loan and the determination of the impairment-measurement method to be

13. Also, refer to paragraph 7.05 of the AICPA Audit Guide.

used (i.e., present value of expected future cash flows, fair value of collateral less costs to sell, or the loan's observable market price).

Once an institution has determined which of the three available measurement methods to use for an impaired loan under FAS 114, it should maintain supporting documentation as follows:

- When using the present-value-of-expected-future-cash-flows method—
  - — the amount and timing of cash flows,
  - — the effective interest rate used to discount the cash flows, and
  - — the basis for the determination of cash flows, including consideration of current environmental factors and other information reflecting past events and current conditions.
- When using the fair-value-of-collateral method—
  - — how fair value was determined, including the use of appraisals, valuation assumptions, and calculations,
  - — the supporting rationale for adjustments to appraised values, if any,
  - — the determination of costs to sell, if applicable, and
  - — appraisal quality, and the expertise and independence of the appraiser.
- When using the observable-market-price-of-a-loan method—
  - — the amount, source, and date of the observable market price.

Illustration A describes a practice used by a small financial institution to document its FAS 114 measurement of impairment using a comprehensive worksheet.[14] [Examples 1 and 2 provide examples of applying and documenting impairment-measurement methods under FAS 114. Some loans that are evauluated individually for impairment under FAS 114 may be fully collateralized and therefore require no ALLL. Example 3 presents an institution whose loan portfolio includes fully collateralized loans. It describes the documentation maintained by that institution to support its conclusion that no ALLL was needed for those loans.]

14. The [referenced] illustrations are presented to assist institutions in evaluating how to implement the guidance provided in this document. The methods described in the illustrations may not be suitable for all institutions and are not considered required processes or actions. For additional descriptions of key aspects of ALLL guidance, a series of [numbered examples is provided. These examples were included in appendix A of the policy statement as questions and answers. The wording of the examples has been slightly modified for this format.]

Illustration A

Documenting an ALLL Under FAS 114

Comprehensive worksheet for the impairment-measurement process

A small institution utilizes a comprehensive worksheet for each loan being reviewed individually under FAS 114. Each worksheet includes a description of why the loan was selected for individual review, the impairment-measurement technique used, the measurement calculation, a comparison to the current loan balance, and the amount of the ALLL for that loan. The rationale for the impairment-measurement technique used (e.g., present value of expected future cash flows, observable market price of the loan, fair value of the collateral) is also described on the worksheet.

Example 1: ALLL Under FAS 114—Measuring and Documenting Impairment

Facts. Approximately one-third of Institution A's commercial loan portfolio consists of large-balance, nonhomogeneous loans. Due to their large individual balances, these loans meet the criteria under Institution A's policies and procedures for individual review for impairment under FAS 114. Upon review of the large-balance loans, Institution A determines that certain of the loans are impaired as defined by FAS 114.

Analysis. For the commercial loans reviewed under FAS 114 that are individually impaired, Institution A should measure and document the impairment on those loans. For those loans that are reviewed individually under FAS 114 and considered individually impaired, Institution A must use one of the methods for measuring impairment that is specified by FAS 114 (that is, the present value of expected future cash flows, the loan's observable market price, or the fair value of collateral).

An impairment-measurement method other than the methods allowed by FAS 114 cannot be used. For the loans considered individually impaired under FAS 114, under the circumstances described above, it would not be appropriate for Institution A to choose a measurement method not prescribed by FAS 114. For example, it would not be appropriate to measure loan impairment by applying a loss rate to each loan based on the average historical loss percentage for all of its commercial loans for the past five years.

Institution A should maintain, as sufficient, objective evidence, written documentation to support its measurement of loan impairment under FAS 114. If it uses the present value of expected future cash flows to measure impairment of a loan, it should document (1) the amount and timing of cash flows, (2) the effective interest rate used to discount the cash flows, and (3) the basis for the determination of cash flows, including consideration of current environmental factors[15] and other information reflecting past events and current conditions. If Institution A uses the fair value of collateral to measure impairment, it should document (1) how it determined the fair value, including the use of appraisals, valuation assumptions and calculations; (2) the supporting rationale for adjustments to appraised values, if any, and the determination of costs to sell, if applicable; (3) appraisal quality; and (4) the expertise and independence of the appraiser. Similarly, Institution A should document the amount, source, and date of the observable market price of a loan, if that method of measuring loan impairment is used.

Example 2: ALLL Under FAS 114—Measuring Impairment for a Collateral-Dependent Loan

Facts. Institution B has a $10 million loan outstanding to Company X that is secured by real estate, which Institution B individually evaluates under FAS 114 due to the loan's size. Company X is delinquent in its loan payments under the terms of the loan agreement. Accordingly, Institution B determines that its loan to Company X is impaired, as defined by FAS 114. Because the loan is collateral dependent, Institution B measures impairment of the loan based on the fair value of the collateral. Institution B determines that the most recent valuation of the collateral was performed by an appraiser 18 months ago and, at that time, the estimated value of the collateral (fair value less costs to sell) was $12 million.

Institution B believes that certain of the assumptions that were used to value the collateral 18 months ago do not reflect current market conditions and, therefore, the appraiser's valuation does not approximate current fair value of the collateral. Several buildings, which are comparable to the real estate collateral, were recently completed in the area, increasing vacancy rates, decreasing lease rates, and attracting several tenants away from the borrower. Accordingly, credit-review personnel at Institution B adjust certain of the valuation assumptions to better reflect the current market conditions as they relate to the loan's collateral.[16] After adjusting the collateral-valuation assumptions, the credit-review department determines that the current estimated fair value of the collateral, less costs to sell, is $8 million. Given that the recorded investment in the loan is $10 million, Institution B concludes that the loan is impaired by $2 million and records an allowance for loan losses of $2 million.

Analysis. Institution B should maintain documentation to support its determination of the allowance for loan losses of $2 million for the loan to Company X. It should document that it measured impairment of the loan to Company X by using the fair value of the loan's collateral, less costs to sell, which it estimated to be $8 million. This documentation should include (1) the institution's rationale and basis for the $8 million valuation, including the revised valuation assumptions it used; (2) the valuation calculation; and (3) the determination of costs to sell, if applicable. Because Institution B arrived at the valuation of $8 million by modifying an earlier appraisal, it should document its rationale and basis for the changes it made to the valuation assumptions that resulted in the collateral value declining from $12 million 18 months ago to $8 million in the current period.[17]

15. Question 16 in Exhibit D-80A of EITF Topic D-80 and [its] attachments indicates that environmental factors include existing industry, geographical, economic, and political factors.

16. When reviewing collateral-dependent loans, Institution B may often find it more appropriate to obtain an updated appraisal to estimate the effect of current market conditions on the appraised value instead of internally estimating an adjustment.

17. In accordance with the FFIEC's *Federal Register*

Example 3: ALLL Under FAS 114—Fully Collateralized Loans

Facts. Institution C has $10 million in loans that are fully collateralized by highly rated debt securities with readily determinable market values. The loan agreement for each of these loans requires the borrower to provide qualifying collateral sufficient to maintain a loan-to-value ratio with sufficient margin to absorb volatility in the securities' market prices. Institution C's collateral department has physical control of the debt securities through safekeeping arrangements. In addition, Institution C perfected its security interest in the collateral when the funds were originally distributed. On a quarterly basis, Institution C's credit-administration function determines the market value of the collateral for each loan using two independent market quotes and compares the collateral value to the loan carrying value. If there are any collateral deficiencies, Institution C notifies the borrower and requests that the borrower immediately remedy the deficiency. Due in part to its efficient operation, Institution C has historically not incurred any material losses on these loans. Institution C believes these loans are fully collateralized and therefore does not maintain any ALLL balance for these loans.

Analysis. To adequately support its determination that no allowance is needed for this group of loans, Institution C must maintain the following documentation:

- The management summary of the ALLL must include documentation indicating that, in accordance with the institution's ALLL policy, (1) Institution C has verified the collateral protection on these loans, (2) no probable loss has been incurred, and (3) no ALLL is necessary.
- The documentation in Institution C's loan files must include (1) the two independent market quotes obtained each quarter for each loan's collateral amount, (2) the documents evidencing the perfection of the security interest in the collateral and other relevant supporting documents, and (3) Institution C's ALLL policy, including guidance for determining when a loan is considered "fully collateralized," which would not require an ALLL. Institution C's policy should require the following factors to be considered and fully documented:
  - — volatility of the market value of the collateral
  - — recency and reliability of the appraisal or other valuation
  - — recency of the institution's or third party's inspection of the collateral
  - — historical losses on similar loans
  - — confidence in the institution's lien or security position including appropriate—
    - type of security perfection (e.g., physical possession of collateral or secured filing);
    - filing of security perfection (i.e., correct documents and with the appropriate officials);
    - relationship to other liens; and
    - other factors as appropriate for the loan type.

notice, Implementation Issues Arising from FASB No. 114, "Accounting by Creditors for Impairment of a Loan," published February 10, 1995 (60 *Fed. Reg.* 7966), impaired, collateral-dependent loans must be reported at the fair value of collateral, less costs to sell, in regulatory reports. This treatment is to be applied to all collateral-dependent loans, regardless of type of collateral.

2065.4.1.5 ALLL Under FAS 5

2065.4.1.5.1 Segmenting the Portfolio

For loans evaluated on a group basis under FAS 5, management should segment the loan portfolio by identifying risk characteristics that are common to groups of loans. Institutions typically decide how to segment their loan portfolios based on many factors, which vary with their business strategies as well as their information system capabilities. Smaller institutions that are involved in less complex activities often segment the portfolio into broad loan categories. This method of segmenting the portfolio is likely to be appropriate in only small institutions offering a narrow range of loan products. Larger institutions typically offer a more diverse and complex mix of loan products. Such institutions may start by segmenting the portfolio into major loan types but typically have more detailed information available that allows them to further segregate the portfolio into product-line segments based on the risk characteristics of each portfolio segment. Regardless of the segmentation method used, an institution should maintain documentation to support its conclusion that the loans in each segment have similar attributes or characteristics.

As economic and other business conditions change, institutions often modify their business strategies, which may result in adjustments to the way in which they segment their loan portfolio for purposes of estimating loan losses. Illustration B presents an example in which an institution refined its segmentation method to more effectively consider risk factors and maintains documentation to support this change.

Illustration B

Documenting Segmenting Practices

Documenting a refinement in a segmentation method

An institution with a significant portfolio of consumer loans performed a review of its ALLL methodology. The institution had determined its ALLL based upon historical loss rates in the overall consumer portfolio. The ALLL methodology was validated by comparing actual loss rates (charge-offs) for the past two years to the estimated loss rates. During this process, the institution decided to evaluate loss rates on an individual-product basis (e.g., auto loans, unsecured loans, or home equity loans). This analysis disclosed significant differences in the loss rates on different products. With this additional information, the methodology was amended in the current period to segment the portfolio by product, resulting in a better estimation of the loan losses associated with the portfolio. To support this change in segmentation practice, the credit-review committee records contain the analysis that was used as a basis for the change and the written report describing the need for the change.

Institutions use a variety of documents to support the segmentation of their portfolios. Some of these documents include—

- loan trial balances by categories and types of loans,
- management reports about the mix of loans in the portfolio,
- delinquency and nonaccrual reports, and
- a summary presentation of the results of an internal or external loan-grading review.

Reports generated to assess the profitability of a loan-product line may be useful in identifying areas in which to further segment the portfolio.

2065.4.1.5.2 Estimating Loss on Groups of Loans

Based on the segmentation of the loan portfolio, an institution should estimate the FAS 5 portion of its ALLL. For those segments that require an ALLL,[18] the institution should estimate the loan and lease losses, on at least a quarterly basis, based upon its ongoing loan-review process and analysis of loan performance. The institution should follow a systematic and consistently applied approach to select the most appropriate loss-measurement methods and support its conclusions and rationale with written documentation. Regardless of the methods used to measure losses, an institution should demonstrate and document that the loss-measurement methods used to estimate the ALLL for each segment are determined in accordance with GAAP as of the financial statement date.[19]

One method of estimating loan losses for groups of loans is through the application of loss rates to the groups' aggregate loan balances. Such loss rates typically reflect the institution's historical loan-loss experience for each group of loans, adjusted for relevant environmental factors (e.g., industry, geographical, economic, and political factors) over a defined period of time. If an institution does not have loss experience of its own, it may be appropriate to reference the loss experience of other institutions, provided that the institution demonstrates that the attributes of the loans in its portfolio segment are similar to those of the loans included in the portfolio of the institution providing the loss experience.[20] Institutions should maintain supporting documentation for the technique used to develop their loss rates, including the period of time over which the losses were incurred. If a range of loss is determined, institutions should maintain documentation to support the identified range and the rationale used for determining which estimate is the best estimate within the range of loan losses. An example of

18. An example of a loan segment that does not generally require an ALLL is loans that are fully secured by deposits maintained at the lending institution.

19. Refer to paragraph 8(b) of FAS 5***.

20. Refer to paragraph 23 of FAS 5.

how a small institution performs a comprehensive historical loss analysis is provided as the first item in illustration C.

Before employing a loss-estimation model, an institution should evaluate and modify, as needed, the model's assumptions to ensure that the resulting loss estimate is consistent with GAAP. In order to demonstrate consistency with GAAP, institutions that use loss-estimation models typically document the evaluation, the conclusions regarding the appropriateness of estimating loan losses with a model or other loss-estimation tool, and the support for adjustments to the model or its results.

In developing loss measurements, institutions should consider the impact of current environmental factors and then document which factors were used in the analysis and how those factors affected the loss measurements. Factors that should be considered in developing loss measurements include the following:[21]

- levels of and trends in delinquencies and impaired loans
- levels of and trends in charge-offs and recoveries
- trends in volume and terms of loans
- effects of any changes in risk-selection and underwriting standards, and other changes in lending policies, procedures, and practices
- experience, ability, and depth of lending management and other relevant staff
- national and local economic trends and conditions
- industry conditions
- effects of changes in credit concentrations

21. Refer to paragraph 7.13 in the AICPA Audit Guide.

For any adjustment of loss measurements for environmental factors, the institution should maintain sufficient, objective evidence to support the amount of the adjustment and to explain why the adjustment is necessary to reflect current information, events, circumstances, and conditions in the loss measurements.

The second item in illustration C provides an example of how an institution adjusts its commercial real estate historical loss rates for changes in local economic conditions. Example 4 provides an example of maintaining supporting documentation for adjustments to portfolio-segment loss rates for an environmental factor related to an economic downturn in the borrower's primary industry. Example 5 describes one institution's process for determining and documenting an ALLL for loans that are not individually impaired but have characteristics indicating there are loan losses on a group basis.

Illustration C

Documenting the Setting of Loss Rates

Comprehensive loss analysis in a small institution

A small institution determines its loss rates based on loss rates over a three-year historical period. The analysis is conducted by type of loan and is further segmented by originating branch office. The analysis considers charge-offs and recoveries in determining the loss rate. The institution also considers the loss rates for each loan grade and compares them to historical losses on similarly rated loans in arriving at the historical loss factor. The institution maintains supporting documentation for its loss-factor analysis, including historical losses by type of loan, originating branch office, and loan grade for the three-year period.

Adjustment of loss rates for changes in local economic conditions

An institution develops a factor to adjust loss rates for its assessment of the impact of changes in the local economy. For example, when analyzing the loss rate on commercial real estate loans, the assessment identifies changes in recent commercial building occupancy rates. The institution generally finds the occupancy statistics to be a good indicator of probable losses on these types of loans. The institution maintains documentation that summarizes the relationship between current occupancy rates and its loss experience.

Example 4: ALLL Under FAS 5—Adjusting Loss Rates

Facts. Institution D's lending area includes a metropolitan area that is financially dependent upon the profitability of a number of manufacturing businesses. These businesses use highly specialized equipment and significant quantities of rare metals in the manufacturing process. Due to increased low-cost foreign competition, several of the parts suppliers servicing these manufacturing firms declared bankruptcy. The foreign suppliers have subsequently increased prices, and the manufacturing firms have suffered from increased equipment maintenance costs and smaller profit margins. Additionally, the cost of the rare metals used in the manufacturing process increased and has now stabilized at double last year's price. Due to these events, the manufacturing businesses are experiencing financial difficulties and have recently announced downsizing plans.

Although Institution D has yet to confirm an increase in its loss experience as a result of these events, management knows that it lends to a significant number of businesses and individuals whose repayment ability depends upon the long-term viability of the manufacturing businesses. Institution D's management has identified particular segments of its commercial and consumer customer bases that include borrowers highly dependent upon sales or salary from the manufacturing businesses. Institution D's management performs an analysis of the affected portfolio segments to adjust its historical loss rates used to determine the ALLL. In this particular case, Institution D has experienced similar business and lending conditions in the past that it can compare to current conditions.

Analysis. Institution D should document its support for the loss-rate adjustments that result from considering these manufacturing firms' financial downturns. It should document its identification of the particular segments of its commercial and consumer loan portfolio for which it is probable that the manufacturing business' financial downturn has resulted in loan losses. In addition, it should document its analysis that resulted in the adjustments to the loss rates for the affected portfolio segments. As part of its documentation, Institution D should maintain copies of the documents supporting the analysis, including relevant newspaper articles, economic reports, economic data, and notes from discussions with individual borrowers.

Since Institution D has had similar situations in the past, its supporting documentation should also include an analysis of how the current conditions compare to its previous loss experiences in similar circumstances. As part of its effective ALLL methodology, a summary should be created of the amount and rationale for the adjustment factor, which management presents to the audit committee and board for their review and approval prior to the issuance of the financial statements.

Example 5: ALLL Under FAS 5—Estimating Losses on Loans Individually Reviewed for Impairment but Not Considered Individually Impaired

Facts. Institution E has outstanding loans of $2 million to Company Y and $1 million to Company Z, both of which are paying as agreed upon in the loan documents. The institution's ALLL policy specifies that all loans greater than $750,000 must be individually reviewed for impairment under FAS 114. Company Y's financial statements reflect a strong net worth, good profits, and ongoing ability to meet debt-service requirements. In contrast, recent information indicates Company Z's profitability is declining and its cash flow is tight. Accordingly, this loan is rated substandard under the institution's loan-grading system. Despite its concern, management believes Company Z will resolve its problems and determines that neither loan is individually impaired as defined by FAS 114.

Institution E segments its loan portfolio to estimate loan losses under FAS 5. Two of its loan portfolio segments are Segment 1 and Segment 2. The loan to Company Y has risk characteristics similar to the loans included in Segment 1, and the loan to Company Z has risk characteristics similar to the loans included in Segment 2.[22]

In its determination of the ALLL under FAS 5, Institution E includes its loans to Company Y and Company Z in the groups of loans with similar characteristics (i.e., Segment 1 for Company Y's loan and Segment 2 for Company Z's loan). Management's analyses of Segment 1 and Segment 2 indicate that it is probable that each segment includes some losses, even though the losses cannot be identified to one or more specific loans. Management estimates that the use of its historical loss rates for these two segments, with adjustments for changes in environmental factors, provides a reasonable estimate of the institution's probable loan losses in these segments.

22. These groups of loans do not include any loans that have been individually reviewed for impairment under FAS 114 and determined to be impaired as defined by FAS 114.

Analysis. Institution E should adequately document an ALLL under FAS 5 for these loans that were individually reviewed for impairment but are not considered individually impaired. As part of its effective ALLL methodology, Institution E documents the decision to include its loans to Company Y and Company Z in its determination of its ALLL under FAS 5. It should also document the specific characteristics of the loans that were the basis for grouping these loans with other loans in Segment 1 and Segment 2, respectively. Institution E maintains documentation to support its method of estimating loan losses for Segment 1 and Segment 2, including the average loss rate used, the analysis of historical losses by loan type and by internal risk rating, and support for any adjustments to its historical loss rates. The institution also maintains copies of the economic and other reports that provided source data.

2065.4.1.6 Consolidating the Loss Estimates

To verify that ALLL balances are presented fairly in accordance with GAAP and are auditable, management should prepare a document that summarizes the amount to be reported in the financial statements for the ALLL. The board of directors should review and approve this summary.

Common elements in such summaries include—

- the estimate of the probable loss or range of loss incurred for each category evaluated (e.g., individually evaluated impaired loans, homogeneous pools, and other groups of loans that are collectively evaluated for impairment);
- the aggregate probable loss estimated using the institution's methodology;
- a summary of the current ALLL balance;
- the amount, if any, by which the ALLL is to be adjusted;[23] and
- depending on the level of detail that supports the ALLL analysis, detailed subschedules of loss estimates that reconcile to the summary schedule.

Illustration D describes how an institution documents its estimated ALLL by adding comprehensive explanations to its summary schedule.

Generally, an institution's review and approval process for the ALLL relies upon the data provided in these consolidated summaries. There may be instances in which individuals or committees that review the ALLL methodology and resulting allowance balance identify adjustments that need to be made to the loss estimates to provide a better estimate of loan losses. These changes may be due to information not known at the time of the initial loss estimate (e.g., information that surfaces after determining and adjusting, as necessary, historical loss rates, or a recent decline in the marketability of property after conducting a FAS 114 valuation based upon the fair value of collateral). It is important that these adjustments are consistent with GAAP and are reviewed and approved by appropriate personnel. Additionally, the summary should provide each subsequent reviewer with an understanding of the support behind these adjustments. Therefore, management should document the nature of any adjustments and the underlying rationale for making the changes. This documentation should be provided to those making the final determination of the ALLL amount. Example 6 addresses the documentation of the final amount of the ALLL.

23. Subsequent to adjustments, there should be no material differences between the consolidated loss estimate, as determined by the methodology, and the final ALLL balance reported in the financial statements.

Illustration D

Summarizing Loss Estimates

Descriptive comments added to the consolidated ALLL summary schedule

To simplify the supporting documentation process and to eliminate redundancy, an institution adds detailed supporting information to its summary schedule. For example, this institution's board of directors receives, within the body of the ALLL summary schedule, a brief description of the institution's policy for selecting loans for evaluation under FAS 114. Additionally, the institution identifies which FAS 114 impairment-measurement method was used for each individually reviewed impaired loan. Other items on the schedule include a brief description of the loss factors for each segment of the loan portfolio, the basis for adjustments to loss rates, and explanations of changes in ALLL amounts from period to period, including cross-references to more detailed supporting documents.

Example 6: Consolidating the Loss Estimates—Documenting the Reported ALLL

Facts. Institution F determines its ALLL using an established systematic process. At the end of each period, the accounting department prepares a summary schedule that includes the amount of each of the components of the ALLL, as well as the total ALLL amount, for review by senior management, the credit committee, and, ultimately, the board of directors. Members of senior management and the credit committee meet to discuss the ALLL. During these discussions, they identify changes that are required by GAAP to be made to certain of the ALLL estimates. As a result of the adjustments made by senior management, the total amount of the ALLL changes. However, senior management (or its designee) does not update the ALLL summary schedule to reflect the adjustments or reasons for the adjustments. When performing their audit of the financial statements, the independent accountants are provided with the original ALLL summary schedule that was reviewed by senior management and the credit committee, as well as a verbal explanation of the changes made by senior management and the credit committee when they met to discuss the loan-loss allowance.

Analysis. Institution F's documentation practices supporting the balance of its loan-loss allowance, as reported in its financial statements, are not in compliance with existing documentation guidance. An institution must maintain supporting documentation for the loan-loss allowance amount reported in its financial statements. As illustrated above, there may be instances in which ALLL reviewers identify adjustments that need to be made to the loan-loss estimates. The nature of the adjustments, how they were measured or determined, and the underlying rationale for making the changes to the ALLL balance should be documented. Appropriate documentation of the adjustments should be provided to the board of directors (or its designee) for review of the final ALLL amount to be reported in the financial statements. For institutions subject to external audit, this documentation should also be made available to the independent accountants. If changes frequently occur during management or credit committee reviews of the ALLL, management may find it appropriate to analyze the reasons for the frequent changes and to reassess the methodology the institution uses.

2065.4.1.7 Validating the ALLL Methodology

An institution's ALLL methodology is considered valid when it accurately estimates the amount of loss contained in the portfolio. Thus, the institution's methodology should include procedures that adjust loss-estimation methods to reduce differences between estimated losses and actual subsequent charge-offs, as necessary.

To verify that the ALLL methodology is valid and conforms to GAAP and supervisory guidance, an institution's directors should establish internal-control policies, appropriate for the size of the institution and the type and complexity of its loan products. These policies should include procedures for a review, by a party who is independent of the ALLL-estimation process, of the ALLL methodology and its application in order to confirm its effectiveness.

In practice, financial institutions employ numerous procedures when validating the reasonableness of their ALLL methodology and determining whether there may be deficiencies in their overall methodology or loan-grading process. Examples are—

- a review of trends in loan volume, delinquencies, restructurings, and concentrations;
- a review of previous charge-off and recovery history, including an evaluation of the timeliness of the entries to record both the charge-offs and the recoveries;
- a review by a party that is independent of the ALLL-estimation process (this often involves the independent party reviewing, on a test basis, source documents and underlying assumptions to determine that the established methodology develops reasonable loss estimates); and
- an evaluation of the appraisal process of the underlying collateral. (This may be accomplished by periodically comparing the appraised value to the actual sales price on selected properties sold.)

2065.4.1.7.1 Supporting Documentation for the Validation Process

Management usually supports the validation process with the workpapers from the ALLL-review function. Additional documentation often includes the summary findings of the independent reviewer. The institution's board of directors, or its designee, reviews the findings and acknowledges its review in its meeting minutes. If the methodology is changed based upon the findings of the validation process, documentation that describes and supports the changes should be maintained.

2065.4.1.8 Appendix—Application of GAAP

[This appendix was designated appendix B in the policy statement.] An ALLL recorded pursuant to GAAP is an institution's best estimate of the probable amount of loans and lease-financing receivables that it will be unable to collect based on current information and events.[24] A creditor should record an ALLL when the criteria for accrual of a loss contingency as set forth in GAAP have been met. Estimating the amount of an ALLL involves a high degree of management judgment and is inevitably imprecise. Accordingly, an institution may determine that the amount of loss falls within a range. An institution should record its best estimate within the range of loan losses.[25]

Under GAAP, Statement of Financial Accounting Standards No. 5, ''Accounting for Contingencies'' (FAS 5), 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. Statement of Financial Accounting Standards No. 114, ''Accounting by Creditors for Impairment of a Loan'' (FAS 114) provides more specific guidance about the measurement and disclosure of impairment for certain types of loans.[26] 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

24. This appendix provides guidance on the ALLL and does not address allowances for credit losses for off-balance-sheet instruments (e.g., loan commitments, guarantees, and standby letters of credit). Institutions should record liabilities for these exposures in accordance with GAAP. Further guidance on this topic is presented in the American Institute of Certified Public Accountants' Audit and Accounting Guide, *Banks and Savings Institutions,* 2000 edition (AICPA Audit Guide). Additionally, this appendix does not address allowances or accounting for assets or portions of assets sold with recourse, which is described in Statement of Financial Accounting Standards No. 140, ''Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a Replacement of FASB Statement No. 125'' (FAS 140).

25. Refer to FASB Interpretation No. 14, ''Reasonable Estimation of the Amount of a Loss,'' and Emerging Issues Task Force Topic No. D-80, ''Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio'' (EITF Topic D-80).

26. EITF Topic D-80 includes additional guidance on the requirements of FAS 5 and FAS 114 and how they relate to each other.***

effect of existing environmental factors. The following illustration provides an example of an institution estimating a loan's impairment when the loan has been partially charged off.

Illustration

Interaction of FAS 114 with an Adversely Classified Loan, Partial Charge-Off, and the Overall ALLL

An institution determined that a collateral-dependent loan, which it identified for evaluation, was impaired. In accordance with FAS 114, the institution established an ALLL for the amount that the recorded investment in the loan exceeded the fair value of the underlying collateral, less costs to sell.

Consistent with relevant regulatory guidance, the institution classified as ''Loss,'' the portion of the recorded investment deemed to be the confirmed loss and classified the remaining recorded investment as ''Substandard.'' For this loan, the amount classified ''Loss'' was less than the impairment amount (as determined under FAS 114). The institution charged off the ''Loss'' portion of the loan. After the charge-off, the portion of the ALLL related to this ''Substandard'' loan (1) reflects an appropriate measure of impairment under FAS 114, and (2) is included in the aggregate FAS 114 ALLL for all loans that were identified for evaluation and individually considered impaired. The aggregate FAS 114 ALLL is included in the institution's overall ALLL.

Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment are not included in the scope of FAS 114.[27] 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 ensure that they do 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.[28]

27. In addition, FAS 114 does not apply to loans measured at fair value or at the lower of cost or fair value, leases, or debt securities.

28. According to the Federal Financial Institutions Examination Council's *Federal Register* notice, Implementation Issues Arising from FASB Statement No. 114, ''Accounting by Creditors for Impairment of a Loan,'' published February 10, 1995, institution-specific issues should be reviewed when estimating loan losses under FAS 114. This analysis should be conducted as part of the evaluation of each individual loan reviewed under FAS 114 to avoid potential ALLL layering.

While different institutions may use different methods, there are certain common elements that should be included in any loan-loss allowance methodology. Generally, an institution's methodology should—

- include a detailed analysis of the loan portfolio, performed on a regular basis;
- 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.[29]

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.[30]

2065.4.2 INSPECTION OBJECTIVES

1. To evaluate internal controls over the loan-loss estimation process by evaluating the ALLL written policy and the process used to create and maintain the policy, loan-grading systems, and other associated internal controls over credit risk.
2. To determine the existence of an ALLL balance and review the summary schedule supporting it.
3. To analyze and review the evaluation for Statement of Financial Accounting Standards No. 114 (FAS 114) (for individually listed loans).
4. To analyze and review the evaluation for Statement of Financial Accounting Standards No. 5 (FAS 5) (for groups of loans).
5. To determine if the BHC has adequately developed a range of loss and a margin for imprecision.
6. To determine that the ALLL reflects estimated credit losses for specifically identified loans (or groups of loans) and any estimated *probable* credit losses inherent in the remainder of the loan portfolio at the balance-sheet date.
7. To analyze and review the ALLL-documentation support.
8. To determine the adequacy of the BHC's process to evaluate the ALLL methodology and to adjust the methodology, as needed.

2065.4.3 INSPECTION PROCEDURES

1. Determine if the board of directors has developed and maintained an appropriate, systematic, and consistently applied process to determine the amounts of the ALLL and provision for loan losses, or if it has instructed management to do so. Determine if the ALLL policies specifically address the BHC's goals, risk profile, personnel, and other resources.
2. Determine if the board of directors has approved the written ALLL policy.
3. Determine if the BHC's loan-loss estimate, in accordance with its methodology, is consistent with generally accepted accounting principles and supervisory guidance. Additionally, ensure that the BHC's loan-loss estimate is materially consistent with the reported balance of the BHC's ALLL account.
4. Determine if the ALLL methodology is periodically validated by an independent party and, if appropriate, revised.
5. Ascertain whether the audit committee is overseeing and monitoring the internal controls over the ALLL-documentation process.
6. Ascertain that the BHC maintains adequate written documentation of its ALLL, including clear explanations of the supporting analyses and rationale. The documentation should consist of—
   - policies and procedures over the systems and controls that maintain an appropriate ALLL and over the ALLL methodology,
   - the loan-grading system or process,
   - a summary or consolidation (including losses) of the ALLL balance,
   - a validation of the ALLL methodology, and
   - periodic adjustments to the ALLL process.
7. Determine if the amount reported for the ALLL for each period and the provisions for loan and leases losses are reviewed and approved by the board of directors.

29. Refer to paragraph 7.05 of the AICPA Audit Guide.
30. Institutions should refer to the guidance on materiality in SEC Staff Accounting Bulletin No. 99, *Materiality*.

A holding company and its depository institution subsidiaries may generally file a consolidated group income tax return. For bank regulatory purposes, however, each depository institution is viewed as, and reports as, a separate legal and accounting entity. Each holding company subsidiary that participates in filing a consolidated tax return should record its tax expenses or tax benefits as though it had filed a tax return as a separate entity. The amount and timing of any intercompany payments or refunds to the subsidiary that result from its being a part of the consolidated return group should be no more favorable than if the subsidiary was a separate taxpayer. A consolidated return permits the parent's and other subsidiaries' taxable losses to be offset against other subsidiaries' taxable income, with the parent most often providing the principal loss. This can be illustrated with the following example:

	Parent Only	*Bank*	*Non-bank A*	*Non-bank B*	*Consolidated*
Contribution to consolidated net taxable income (loss):	$(100)	$2,000	$500	$(50)	$2,350
Assumed tax rate	40%	40%	40%	40%	40%
Tax payment/ (benefit)	$(40)	$ 800	$200	$(20)	$ 940

In this example, the parent, as the representative of the consolidated group to the Internal Revenue Service, would collect $800 from the bank subsidiary and $200 from Nonbank Subsidiary A, and pay $20 to Nonbank Subsidiary B. In return, the parent would remit to the tax authorities $940, resulting in a net cash retention of $40 by the parent.

Bank holding companies employ numerous methods to determine the amount of estimated payments to be received from their subsidiaries. Although the tax-accounting methods to be used by bank holding companies are not prescribed by the Federal Reserve System, the method employed must afford subsidiaries equitable treatment compared with filing separate returns. In general terms, tax transactions between any subsidiary and its parent should be conducted as though the subsidiary was dealing directly with state or federal taxing authorities.

In 1978 the Board of Governors addressed the issue of intercorporate income tax settlements by issuing a formal Policy Statement Regarding Intercorporate Income Tax Accounting Transactions of Bank Holding Companies and State-Chartered Banks That Are Members of the Federal Reserve System. The statement was revised and replaced by the December 1998 Policy Statement on Income Tax Allocation in a Holding Company Structure, which does not materially change any of the guidance previously issued.

The tax structure of bank holding companies becomes more complicated when deferred taxes are considered in the intercorporate tax settlements.[1] Deferred taxes occur when taxable income, for financial reporting purposes, differs from taxable income as reported to the taxing authorities. This difference is due to timing differences between financial-statement income and tax income for loan-loss provisions and other items, such as foreign tax credits. In addition, differences result from the use of the cash basis of accounting for tax purposes, as opposed to the accrual basis of accounting used in financial reporting. The different bases are chosen by management.

An example of deferred income taxes follows, using an estimated tax rate of 40 percent.

	Financial Reporting	*Tax Return*
Pre-tax income	$200	$150
Currently payable	60	60
Deferred portion	20	—
TOTAL	80	60
Net income	$120	$90

The deferred portion represents the tax effect of delaying the recognition of income or taking more of a deduction for tax-return purposes (40% x $50). This is a temporary difference since over the ''life'' of the bank holding company, income and deductions should theoretically equalize for both book and tax purposes.

Financial Accounting Standards Board State-

1. The issue becomes more complex because of GAAP-based tax expenses versus actual taxes paid under relevant tax laws (the difference between the two expenses is either a deferred tax liability or asset on the balance sheet). If the sharing agreement is based on the tax expense on the statement of income, more funds may be transferred to the paying agent than are required to settle the actual taxes owed.

ment No. 109 (FASB 109), "Accounting for Income Taxes," provides guidance on many aspects of accounting for income taxes, including the accounting for deferred tax liabilities and assets. FASB 109 describes how a bank holding company should record (1) taxes payable or refundable for the current year and (2) deferred tax liabilities and assets for the future tax consequences of events that have been recognized in the banking organization's financial statements or tax returns.

Generally, all bank holding companies must file annual income tax returns. The bank holding company can pay the entire amount of tax (that is, the amount still due after estimated tax payments) on or before the due date for filing, or it can elect to pay by the extension deadline if one is granted. Bank holding companies may receive extensions from taxing authorities to file their returns later. For the federal tax return, a six-month extension may be granted.

Bank holding companies generally pay estimated taxes throughout the year. The most common payment dates will be as follows (assuming calendar period):

April 15	—first estimate (25%)
June 15	—second estimate (25%)
September 15	—third estimate (25%)
December 15	—fourth estimate (25%)
March 15	—Due date for income tax return for U.S. corporations or foreign corporations with offices in the United States. Last day for filing for the automatic six-month extension.
September 15	—Due date of return if six-month extensions were granted.

The bank holding company will calculate the amount of the estimated payments to the Internal Revenue Service by using one of two methods: (1) prior year's tax liability (most commonly used) or (2) 90 percent of the estimated tax based on the current year's estimated taxable income.

Bank holding companies have engaged in intercorporate income tax settlements that have the effect of transferring assets and income from a bank subsidiary to the parent company in excess of those settlements that would be consistent with the Board's 1978 policy statement. The Board will apply appropriate supervisory remedies to situations that are considered inequitable or improper. These remedies may include, under certain circumstances, the Board's cease-and-desist powers.

On occasion, bank holding companies have used deferred tax assets as a vehicle to transfer cash or other earning assets of subsidiaries, principally from the bank, into the parent company. The Board's opinion is that each deferred tax asset or liability must remain on the books of the subsidiary. If deferred tax assets have been transferred to the parent, regardless of when the transfer may have occurred, immediate arrangements must be made to return the asset to the appropriate subsidiary. Instances of transferring deferred tax assets to the parent are worthy of inclusion in the Examiner's Comments and Matters Requiring Special Board Attention, page one of the inspection report.

2070.0.1 INTERAGENCY POLICY STATEMENT ON INCOME TAX ALLOCATION IN A HOLDING COMPANY STRUCTURE

The federal bank and savings association's regulatory agencies (the agencies) issued the following policy statement to provide guidance to banking organizations and savings associations regarding the allocation and payment of taxes among a holding company and its subsidiaries. A holding company and its subsidiaries will often file a consolidated group income tax return. However, for bank regulatory purposes, each depository institution of the consolidated group is viewed as, and reports as, a separate legal and accounting entity. Accordingly, each depository institution's applicable income taxes, reflecting either an expense or benefit, should be recorded as if the institution had filed as a separate tax-paying entity.[2] The amount and timing of payments or refunds should be no less favorable to a subsidiary than if it was a separate taxpayer. Any practice that is not consistent with this policy statement may be viewed as an unsafe and unsound practice prompting either informal or formal corrective action. See SR-98-38.

2070.0.1.1 Tax-Sharing Agreements

A holding company and its subsidiary institutions are encouraged to enter into a written,

2. Throughout the policy statement, the terms "separate entity" and "separate taxpayer" are used synonymously. When a depository institution has subsidiaries of its own, the institution's applicable income taxes on a separate-entity basis include the taxes of the subsidiaries *of the institution* that are included with the institution in the consolidated group return.

comprehensive tax-allocation agreement tailored to their specific circumstances. The agreement should be approved by the respective boards of directors. Although each agreement will be different, tax-allocation agreements usually address certain issues common to consolidated groups.

Therefore, such an agreement should—

1. require a subsidiary depository institution to compute its income taxes (both current and deferred) on a separate-entity basis;
2. discuss the amount and timing of the institution's payments for current tax expense, including estimated tax payments;
3. discuss reimbursements to an institution when it has a loss for tax purposes; and
4. prohibit the payment or other transfer of deferred taxes by the institution to another member of the consolidated group.

2070.0.1.2 Measurement of Current and Deferred Income Taxes

Generally accepted accounting principles, instructions for the preparation of both the Thrift Financial Report and the federally supervised bank Reports of Condition and Income, and other guidance issued by the agencies require depository institutions to account for their current and deferred tax liability or benefit.

When the depository-institution members of a consolidated group prepare separate bank regulatory reports, each subsidiary institution should record current and deferred taxes as if it files its tax returns on a separate-entity basis, regardless of the consolidated group's tax-paying or -refund status. Certain adjustments for statutory tax considerations that arise in a consolidated return, e.g., application of graduated tax rates, may be made to the separate-entity calculation as long as they are made on a consistent and equitable basis among the holding company affiliates.

In addition, when an organization's consolidated income tax obligation arising from the alternative minimum tax (AMT) exceeds its regular tax on a consolidated basis, the excess should be consistently and equitably allocated among the members of the consolidated group. The allocation method should be based upon the portion of tax preferences, adjustments, and other items generated by each group member which causes the AMT to be applicable at the consolidated level.

2070.0.1.3 Tax Payments to the Parent Company

Tax payments from a subsidiary institution to the parent company should not exceed the amount the institution has properly recorded as its current tax expense on a separate-entity basis. Furthermore, such payments, including estimated tax payments, generally should not be made before the institution would have been obligated to pay the taxing authority had it filed as a separate entity. Payments made in advance may be considered extensions of credit from the subsidiary to the parent and may be subject to affiliate transaction rules, i.e., sections 23A and 23B of the Federal Reserve Act.

A subsidiary institution should not pay its deferred tax liabilities or the deferred portion of its applicable income taxes to the parent. The deferred tax account is not a tax liability required to be paid in the current reporting period. As a result, the payment of deferred income taxes by an institution to its holding company is considered a dividend subject to dividend restrictions,[3] not the extinguishment of a liability. Furthermore, such payments may constitute an unsafe and unsound banking practice.

2070.0.1.4 Tax Refunds from the Parent Company

An institution incurring a loss for tax purposes should record a current income tax benefit and receive a refund from its parent in an amount no less than the amount the institution would have been entitled to receive as a separate entity. The refund should be made to the institution within a reasonable period following the date the institution would have filed its own return, regardless of whether the consolidated group is receiving a refund. If a refund is not made to the institution within this period, the institution's primary federal regulator may consider the receivable as either an extension of credit or a dividend from the subsidiary to the parent. A parent company may reimburse an institution more than the

3. These restrictions include the prompt-corrective-action provisions of section 38(d)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1831o(d)(1)) and its implementing regulations: for insured state nonmember banks, 12 CFR 325, subpart B; for national banks, 12 CFR section 6.6; for savings associations, 12 CFR 565; and for state member banks, 12 CFR 208.45.

refund amount it is due on a separate-entity basis. Provided the institution will not later be required to repay this excess amount to the parent, the additional funds received should be reported as a capital contribution.

If the institution, as a separate entity, would not be entitled to a current refund because it has no carry-back benefits available on a separate-entity basis, its holding company may still be able to utilize the institution's tax loss to reduce the consolidated group's current tax liability. In this situation, the holding company may reimburse the institution for the use of the tax loss. If the reimbursement will be made on a timely basis, the institution should reflect the tax benefit of the loss in the current portion of its applicable income taxes in the period the loss is incurred. Otherwise, the institution should not recognize the tax benefit in the current portion of its applicable income taxes in the loss year. Rather, the tax loss represents a loss carry-forward, the benefit of which is recognized as a deferred tax asset, net of any valuation allowance.

Regardless of the treatment of an institution's tax loss for regulatory reporting and supervisory purposes, a parent company that receives a tax refund from a taxing authority obtains these funds as agent for the consolidated group on behalf of the group members.[4] Accordingly, an organization's tax-allocation agreement or other corporate policies should not purport to characterize refunds attributable to a subsidiary depository institution that the parent receives from a taxing authority as the property of the parent.

2070.0.1.5 Income-Tax-Forgiveness Transactions

A parent company may require a subsidiary institution to pay it less than the full amount of the current income tax liability that the institution calculated on a separate-entity basis. Provided the parent will not later require the institution to pay the remainder of the current tax liability, the amount of this unremitted liability should be accounted for as having been paid with a simultaneous capital contribution by the parent to the subsidiary.

In contrast, a parent cannot make a capital contribution to a subsidiary institution by "forgiving" some or all of the subsidiary's deferred tax liability. Transactions in which a parent "forgives" any portion of a subsidiary institution's deferred tax liability should not be reflected in the institution's regulatory reports. These transactions lack economic substance because each member of the consolidated group is jointly and severally liable for the group's potential future obligation to the taxing authorities. Although the subsidiaries have no direct obligation to remit tax payments to the taxing authorities, these authorities can collect some or all of a group liability from any of the group members if tax payments are not made when due.

4. See 26 CFR 1.1502-77(a).

2070.0.2 QUALIFYING SUBCHAPTER S CORPORATIONS

The Small Business Job Protection Act of 1996 made changes to the Internal Revenue Code (the code). On October 29, 1996, the FFIEC issued a bulletin notifying all federally insured banks and thrifts of the impact of these changes. Thrift organizations may qualify for Subchapter S corporation status under the code's revisions and could generally receive pass-through tax treatment for federal income tax purposes if certain criteria are met.

The bulletin states that no formal application is required to be filed with the federal bank and thrift regulatory agencies merely as a result of an election by a bank, thrift, or parent holding company to become a Subchapter S corporation. However, if an institution takes certain steps to meet the criteria to qualify for this tax status, particularly the code's limitations on the number and types of shareholders, applications or notices to the agencies may be required.

The FFIEC bulletin also states that any distributions made by the Subchapter S banking organization to its shareholders, including distributions intended to cover shareholders' personal tax liabilities for their shares of the income of the institution, will continue to be regarded as dividends and subject to any limitations under relevant banking law. See SR-96-26.

2070.0.3 INSPECTION OBJECTIVES

1. To determine whether the supervisory and accounting guidance set forth in FASB 109, other tax-accounting standards, and the 1998 interagency policy statement on income tax allocation has been appropriately, equitably, and consistently applied.

2. To verify that the parent's intercorporate tax policy contains a provision requiring the subsidiaries to receive an appropriate refund from the parent when they incur a loss, and that such a refund would have been receivable from the tax authorities if the subsidiary was filing a separate return.
3. To ascertain that tax payments and tax refunds between financial institution subsidiaries and the parent company have been limited to no more than what the institution might have paid to or received from the tax authorities, if it had filed its tax returns on a timely, separate-entity basis.[5]
4. To determine that no deferred tax liability, corresponding asset, or the deferred portion of its applicable income taxes has been transferred from a bank subsidiary to the parent company.
5. To verify that there has been proper accountability for tax-forgiveness transactions between the parent company and its financial institution subsidiaries.
6. To substantiate that corporate practices are consistent with corporate policies.

2070.0.4 INSPECTION PROCEDURES

1. Obtain and discuss with the bank holding company's management its intercorporate income tax policies and tax-sharing agreements. Obtain and retain a copy of the intercorporate tax policies and agreements in the workpaper files. Review the written intercorporate tax-settlement policy and ascertain that it includes the following:
   a. a description of the method(s) used in determining the amount of estimated taxes paid by each subsidiary to the parent
   b. an indication of when payments are to be made
   c. a statement that deferred taxes are maintained on the affiliate's general ledger
   d. procedures for handling tax claims and refunds

Bank holding companies should also have written tax-sharing agreements with their subsidiaries that specify intercorporate tax-settlement policies. The Board encourages bank holding companies to develop such agreements. For tax-sharing agreements, the following inspection procedures should be followed:
   a. Determine whether each subsidiary is required to compute its income taxes (current and deferred) on a separate-entity basis.
   b. Ascertain if the amount and timing of payments for current tax expense, including estimated tax payments, are discussed.
   c. Determine if reimbursements are discussed when an institution has a loss for tax purposes.
   d. Determine if there is a prohibition on the payment or other transfer of deferred taxes by an institution to another member of the consolidated group.
2. Review briefly the parent's intercompany transaction report; general ledger income tax accounts; cash receipts and disbursements; and, if necessary, tax-return workpapers and other pertinent corporate documents.
   a. Ascertain that the taxes collected by the parent company from each depository institution subsidiary do not exceed the amount that would have been paid if a separate return had been filed.
   b. When depository institution subsidiaries are making their tax payments directly to the taxing authorities, determine whether other subsidiaries are paying their proportionate share.
3. Review the separate regulatory reports for depository institution members of the holding company that are included in the filing of a consolidated tax return.
   a. Verify that each subsidiary institution is recording current and deferred taxes as if it was filing its own tax returns on a separate-entity basis.
   b. Ascertain that any adjustments for statutory tax considerations, arising from filing a consolidated return, are also made to the separate-entity calculations consistently and equitably among the holding company affiliates.
4. Determine if any excess amounts (tax benefits), resulting from the filing of a consolidated return, are consistently and equitably allocated among the members of the consolidated group.
5. Review the tax payments that are made from the bank and the nonbank subsidiaries to the parent company.

5. The term ''separate-entity basis'' recognizes that certain adjustments, in particular tax elections in a consolidated return, may, in certain periods, result in higher payments by the bank than would have been made if the bank was unaffiliated.

a. Determine that payments, including estimated payments, that are being requested do not significantly precede the time that a consolidated or estimated current tax liability would be due and payable by the parent to the tax authorities.
b. Verify with management that the tax payments to the parent company were not in excess of the amounts recorded by its depository institution subsidiaries as current tax expense on a separate-entity basis.
c. Determine that subsidiary institutions are not paying their deferred tax liabilities on the deferred portions of their applicable income taxes to the parent company.
d. Ascertain that the parent company is not deriving tax monies from depository institution subsidiaries that are used for other operating needs.

6. When a subsidiary incurs a loss, review the tax system to determine that bank and nonbank subsidiaries are receiving an appropriate refund from the parent company, that is, an amount that is no less than what would have been received if the tax return had been filed on a separate-entity basis.
   a. Verify that the refund(s) are received no later than the date the institutions would have filed their own returns and that the refund is not characterized as the parent company's property.
   b. If the parent company does not require a subsidiary to pay its full amount of current tax liability, ascertain that the amount of the tax liability is recorded as having been paid and that the corresponding credit is recorded as a capital contribution from the parent company to the subsidiary.
7. Determine that the deferred tax accounts of each bank subsidiary are maintained on its books and that they are not transferred to the parent organization.
8. Determine if the Internal Revenue Service or other tax authorities have assessed any additional tax payments on the consolidated group, and whether the holding company has provided an additional reserve to cover the assessment.
9. Complete the Other Supervisory Issues page of the Report of Bank Holding Company Inspection (FR 1225 and FR 1241).
10. Verify the accuracy of the FR Y-8, Report of Intercompany Transactions, pertaining to the information on tax settlements.

2070.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
FFIEC Policy Statement on Income Tax Allocation in a Holding Company Structure			4-870	1999 FRB 111

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Funding (Introduction)

The purpose of this Section is to discuss the types of funding ordinarily found in holding companies and to analyze their respective characteristics. It is not intended that this section include an analysis of the inter-relationships of these factors because that will be addressed in the various subsections of Section 4000 of the Manual.

The three major types of funding are short-term debt, long-term debt and equity. The ideal ''hypothetical'' holding company balance sheet would reflect sufficient equity to fund total bank and nonbank capital needs.

The complexity of the debt and/or equity financing will depend greatly upon the size and financial status of the holding company as well as the access to certain capital markets. The small holding company will be limited in the type and/or sophistication of financing instruments available for its use, and probably would look to local sources for its debt and equity needs. This would include sale of equity and debt instruments to owners of the holding company. The medium-sized holding company has access to public markets through investment bankers and occasionally may issue its own corporate notes in the commercial paper market. The large holding company has a wide range of choices depending upon its financial condition and the economic climate at the time of any offering. It also has the ability to place debt privately as an alternate to dealing with public markets. In summary, the type of financing needed by a holding company will vary with the size and nature of its banking and nonbanking operations. The following subsections address those issues.

A key principle underlying the Federal Reserve's supervision of bank holding companies is that such companies should be operated in a way that promotes the soundness of their subsidiary banks. Holding companies are expected to avoid funding strategies or practices that could undermine public confidence in the liquidity or stability of their banks. Consequently, bank holding companies should develop and maintain funding programs that are consistent with their lending and investment activities and that provide adequate liquidity to the parent company and its nonbank subsidiaries.

2080.05.1 FUNDING AND LIQUIDITY

A principal objective of a parent bank holding company's funding strategy should be to support capital investments in subsidiaries and long-term assets with capital and long-term sources of funds. Long-term or permanent financing not only reduces funding and liquidity risks, but also provides an organization with investors and lenders that have a long-run commitment to its viability. Long-term financing may take the form of term loans, long-term debt securities, convertible debentures, subordinated debt, and equity.

In general, liquidity can be measured by the ability of an organization to meet its maturing obligations, convert assets into cash with minimal loss, obtain cash from other sources, or roll over or issue new debt obligations. A major determinant of a bank holding company's liquidity position is the level of liquid assets available to support maturing liabilities. The use of short-term debt, including commercial paper, to fund long-term assets can result in unsafe and unsound banking conditions, especially if a bank holding company does not have alternative sources of liquidity or other reliable means to refinance or redeem its obligations. In addition, commercial paper proceeds should not be used to fund corporate dividends or pay current expenses. Funding mismatches can exacerbate an otherwise manageable period of financial stress or, in the extreme, undermine public confidence in an organization's viability. For this reason, bank holding companies, in managing their funding positions, should control liquidity risk by maintaining an adequate cushion of liquid assets to cover short-term liabilities. Holding companies should at all times have sufficient liquidity and funding flexibility to handle any runoff, whether anticipated or unforeseen, of commercial paper or other short-term obligations—without having an adverse impact on their subsidiary banks.

This objective can best be achieved by limiting the use of short-term debt to funding assets that can be readily converted to cash without undue loss. It should be emphasized, however, that the simple matching of the maturity of short-term debt with the stated or nominal maturity of assets does not, by itself, adequately ensure an organization's ability to retire its short-term obligations if the condition of the underlying assets precludes their timely sale or liquidation. In this regard, it is particularly important that parent company advances to subsidiaries be considered a reliable source of liquidity only to the extent that they fund assets of high quality that can readily be converted to cash. Consequently, effective procedures to monitor and ensure on an ongoing basis the quality and liquidity of the assets being funded by short-term debt are critical elements of a holding company's overall funding program.

Bank holding companies should establish and maintain reliable funding and contingency plans to meet ongoing liquidity needs and to address any unexpected funding mismatches that could develop over time. Such plans could include reduced reliance on short-term purchased funds, greater use of longer-term financing, appropriate internal limitations on parent company funding of long-term assets, and reliable alternate sources of liquidity. It is particularly important that bank holding companies have reliable plans or backup facilities to refinance or redeem their short-term debt obligations in the event assets being funded by these obligations cannot be liquidated in a timely manner when the debt must be repaid. In this connection, holding companies relying on backup lines of credit for contingency plan purposes should seek to arrange standby facilities that will be reliable during times of financial stress, rather than facilities that contain clauses which may relieve the lender of the obligation to fund the borrower in the event of a deterioration in the borrower's financial condition.

In developing and carrying out funding programs, bank holding companies should avoid overreliance or excessive dependence on any single short-term or potentially volatile source of funds, such as commercial paper, or any single maturity range. Prudent internal liquidity policies and practices should include specifying limits for, and monitoring the degree of reliance on, particular maturity ranges and types of short-term funding. Special attention should be given to the use of overnight money since a loss of confidence in the issuing organization could lead to an immediate funding problem. Bank holding companies issuing overnight liabilities should maintain on an ongoing basis a cushion of superior quality assets that can be immediately liquidated or converted to cash with minimal loss. The absence of such a cushion or a clear ability to redeem overnight liabilities when they become due should generally be viewed as an unsafe and unsound banking practice.

2080.05.2 ADDITIONAL SUPERVISORY CONSIDERATIONS

Bank holding companies and their nonbank affiliates should maintain sufficient liquidity and capital strength to provide assurance that outstanding debt obligations issued to finance the activities of these entities can be serviced and repaid without adversely affecting the condition of the affiliated bank(s). In this regard, bank holding companies should maintain strong capital positions to enable them to withstand potential losses that might be incurred in the sale of assets to retire holding company debt obligations. It is particularly important that a bank holding company not allow its liquidity and funding policies or practices to undermine its ability to act as a source of strength to its affiliated bank(s).

The principles and guidelines outlined above constitute prudent financial practices for bank holding companies and most businesses in general. Holding company boards of directors should periodically assure themselves that funding plans, policies and practices are prudent in light of their organizations' overall financial condition. Such plans and policies should be consistent with the principles outlined above, including the need for appropriate internal limits on the level and type of short-term debt outstanding and the need for realistic and reliable contingency plans to meet any unanticipated runoff of short-term liabilities without adversely affecting affiliated banks.

2080.05.3 EXAMINER'S APPLICATION OF PRINCIPLES IN EVALUATING LIQUIDITY AND IN FORMULATING CORRECTIVE ACTION PROGRAMS

Reserve Bank examiners should be guided by these principles in evaluating liquidity and in formulating corrective action programs for bank holding companies that are experiencing earnings weaknesses or asset-quality problems, or that are otherwise subject to unusual liquidity pressures. In particular, bank holding companies with less than satisfactory parent or consolidated supervisory ratings (that is, 3 or worse), or any other holding companies subject to potentially serious liquidity or funding pressures, should be asked to prepare a realistic and specific action plan for reducing or redeeming entirely their outstanding short-term obligations without directly or indirectly undermining the condition of their affiliated bank(s).[1] Such contingency plans should be reviewed and evaluated by Reserve Bank supervisory personnel during or subsequent to on-site inspections. Any deficiencies in the plan, if not addressed by management, should be brought to the attention of the organization's board of directors. If the liquidity or funding position of such a company appears likely to worsen significantly, or if the company's financial condition worsens to a sufficient degree, the company should be expected to implement on a timely basis its plan to curtail or eliminate its reliance on commercial paper or other volatile, short-term sources of funds. Any decisions or steps taken by Reserve Banks in this regard should be discussed and coordinated with Board staff.

Reference should also be made to other manual sections that address funding, cash flow, or liquidity (for example, 2010.1, 2080.0, 2080.1, 2080.2, 2080.4, 2080.5, 2080.6, 4010.0, 4010.1, 4010.2, 5010.27, and 5010.28).

1. It is important to note that there are securities registration requirements under the Securities Act of 1933 related to the issuance of commercial paper. A bank holding company should have procedures in place to ensure compliance with all applicable securities and SEC requirements. Refer to manual section 2080.1.

Commercial paper is a generic term that is generally used to describe short-term unsecured promissory notes issued by well-recognized and generally financially sound corporations. The largest commercial paper issuers are finance companies and bank holding companies which use the proceeds as a source of funds in lieu of fixed rate borrowing.

Generally accepted limitations on issuances and uses of commercial paper derive from Section 3(a)(3) of the Securities Act of 1933 (1933 Act). Section 3(a)(3) exempts from the registration requirements of the 1933 Act ''any note . . . which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions and which has a maturity at the time of issuance not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited. . . .'' The Securities and Exchange Commission (SEC) has rulemaking authority over the issuance of commercial paper.

The five criteria, as set forth in an SEC interpretation (SA Release #33–4412, September 20, 1961), that are deemed necessary to qualify securities for the commercial paper exemption are that the commercial paper must:

- Be of prime quality and negotiable;
- Be of a type not ordinarily purchased by the general public;
- Be issued to facilitate current operational business requirements;
- Be eligible for discounting by a Federal Reserve Bank;
- Have a maturity not exceeding nine months.

2080.1.1 MEETING THE SEC CRITERIA

The above criteria are discussed below.

2080.1.1.1 Nine-Month Maturity Standard

Although roll-over of commercial paper proceeds on maturity is common, the SEC has stated that obligations that are payable on demand or have provisions for automatic roll-over do not satisfy the nine-month maturity standard. However, the SEC staff has issued ''no action'' letters for commercial paper master note agreements which allow eligible investors to make daily purchases and withdrawals (subject to a minimum amount of $25,000) as long as the note and each investor's interest therein, does not exceed nine months. Such master note agreements may permit prepayment by the issuer, or upon demand of the investor, at any time.

2080.1.1.2 Prime Quality

Most commercial paper is rated by at least one of five nationally recognized statistical rating organizations. The SEC has not clearly articulated the line at which it will regard a specific rating of commercial paper as being ''not prime'' and, indeed, there is no requirement that a rating be obtained at all in order to qualify. SEC staff has issued a series of ''no-action'' letters to individual bank holding companies based on specific facts and circumstances even where it does not appear that a rating was obtained. However, where commercial paper is downgraded to below what is generally regarded as ''investment quality'' (ratings of less than medium grade—refer to the *Commercial Bank Examination Manual*, section 203.1), or a rating is withdrawn, BHCs may not be able to issue commercial paper based on the Section 3(a)(3) exemption, in the absence of a marked significant improvement in the issuer's financial condition.

2080.1.1.3 Current Transactions

There have been considerable interpretative problems arising out of the current transactions concept. The SEC staff has issued a partial laundry list of activities which would not be deemed suitable for investment of commercial paper proceeds, namely:

1. The discharge of existing indebtedness, unless such indebtedness is itself exempt under section 3(a)(3) of the 1933 Act;
2. The purchase or construction of a plant or the purchase of durable machinery or equipment;
3. The funding of commercial real estate development or financing;
4. The purchase of real estate mortgages or other securities;
5. The financing of mobile homes or home improvements; or

6. The purchase or establishment of a business enterprise.

The SEC has opined that commercial paper, which is used as bridge financing by a bank holding company to fund a permanent acquisition within the 270-day maturity period of the paper, will meet the current transactions criterion. The amount of a bank holding company's commercial paper cannot exceed the aggregate amount of ''current transactions'' of the bank holding company and its subsidiaries *on a consolidated basis*. For this purpose, ''current transactions'' include dividends, interest, taxes and short-term loan repayments. In summary, in most cases, the ''current transactions'' requirement will not be a significant limitation on issuances of commercial paper by bank holding companies.

In addition to meeting SEC requirements, a bank holding company must meet funding and liquidity criteria prescribed by the Board. For a detailed discussion on acceptable use of commercial paper in connection with a bank holding company overall funding strategies, see Sections 2080.05 and 2080.6.

2080.1.1.4 Sales to Institutional Investors

Commercial paper is generally marketed only to institutional investors (corporations, pension funds, insurance companies, etc.) although sales to individuals are not prohibited. It is clear, however, from the legislative history of the Section 3(a)(3) exemption that commercial paper was not to be marketed for sale to the general public. Currently, SEC staff will not issue a no-action letter if the minimum denomination of the commercial paper to be issued is less than $25,000. One of the underlying premises of the Section 3(a)(3) exemption is that purchasers of commercial paper have sufficient financial sophistication to make informed investment decisions without the benefit of the information provided by a registration statement. It is, therefore, generally recognized today that any individual purchaser of commercial paper should meet the ''accredited investor'' criteria of commercial paper set forth in SEC Regulation D (17 C.F.R 230.501(a)). To qualify as an ''accredited investor'', an individual can meet one of two tests—a net worth test or an income test. To qualify under the net worth test, an individual or an individual and his or her spouse must have a net worth at the time of purchase in excess of $1 million. The alternative test requires $200,000 in income for each of the last two years ($300,000 if the spouse's income is included) and a reasonable expectation of reaching the same income level in the current year.

For additional information on marketing of commercial paper, see the next subsection.

2080.1.2 MARKETING OF COMMERCIAL PAPER

The sale of bank holding company (or nonbank subsidiary) commercial paper by an affiliated bank to depositors or other investors raises a number of supervisory issues. Of particular concern is the possibility that individuals may purchase holding company paper with the misunderstanding that it is an insured deposit or obligation of the subsidiary bank. The probability of this occurring is increased when a bank subsidiary is actively engaged in the marketing of the paper of its holding company or nonbank affiliate, or when the holding company or nonbank affiliate has a name similar to the name of the commercial bank subsidiary.

It is a long-standing policy of the Federal Reserve (refer to letters SR 90–19 and SR–620) that debt obligations of a bank holding company or a nonbank affiliate should not be issued, marketed or sold in a way that conveys the misimpression or misunderstanding that such instruments are either: 1) federally-insured deposits, or 2) obligations of, or guaranteed by, an insured depository institution. The purchase of such holding company obligations by retail depositors of an affiliated depository institution can, in the event of default, result in losses to individuals who believed that they had acquired federally-insured or guaranteed instruments. In addition to the problems created for these individuals, such a situation could impair public confidence in the affiliated depository institution and lead to unexpected withdrawals or liquidity pressures.

Events surrounding the sale of uninsured debt obligations of holding companies to retail customers of affiliated depository institutions have focused attention on the potential for problems in this area. In view of these concerns, the Federal Reserve emphasizes that this policy applies to the sale of both long- and short-term debt obligations of a bank holding company and any nonbank affiliate, as well as to the sale of uninsured debt securities issued by a state member bank or its subsidiaries. Debt obligations covered by this supervisory policy include commercial paper and all other short-term and long-term debt securities, such as thrift notes and subordinated debentures.

Bank holding companies and nondepository affiliates that have issued or plan to issue uninsured obligations or debt securities should not market or sell these instruments in any public area of an insured depository institution where retail deposits are accepted, including any lobby area of the depository institution. Bank holding companies and any affiliates that are engaged in issuing debt obligations should establish appropriate policies and controls over the marketing and sale of the instruments. In particular, internal controls should be established to ensure that the promotion, sale, and subsequent customer relationship resulting from the sale of uninsured debt obligations is separated from the retail deposit-taking functions of affiliated depository institutions.

State member banks, including their subsidiaries, may also be engaged in issuing nondeposit debt securities (such as subordinated debt), and it is equally important to ensure that such securities are not marketed or sold in a manner that could give the purchaser the impression that the obligations are federally-insured deposits. Consequently, state member banks and their subsidiaries that have issued or plan to issue nondeposit debt securities should not market or sell these instruments in any public area of the bank where retail deposits are accepted, including any lobby area of the bank. Consistent with long-standing Federal Reserve policy, debt obligations of bank holding companies or their nonbank affiliates, including commercial paper and other short- or long-term debt securities, should prominently indicate that: 1) they are not obligations of an insured depository institution; and 2) they are not insured by the Federal Deposit Insurance Corporation. In cases where purchasers do not take physical possession of the obligation, the purchasers should be provided with a printed advice that conveys this information. Employees engaged in the sale of bank holding company debt obligations should be instructed to relate this information verbally to potential purchasers. In addition, with respect to the sale of holding company debt obligations, the instruments or related documentation should not display the name of the affiliated bank in such a way that could create confusion among potential purchasers about the identity of the obligor. State member banks involved in the sale of uninsured nondeposit debt securities of the bank should establish procedures to ensure that potential purchasers understand that the debt security is not federally-insured or guaranteed.

Federal Reserve examiners are responsible for monitoring compliance with this supervisory policy; and, as part of the examination of state member banks and bank holding companies, are expected to continue to review the polices and internal controls relating to the marketing and sale of debt obligations and securities. Examiners should determine whether the marketing and sale of uninsured nondeposit debt obligations are sufficiently separated and distinguished from retail banking operations, particularly the deposit-taking function of the insured depository affiliate.

In determining whether the activities are sufficiently separated, examiners should take into account: 1) whether the sale of uninsured debt obligations of a holding company affiliate or uninsured nondeposit debt securities of a state member bank is physically separated from the bank's retail-deposit taking function, including the general lobby area[1]; 2) whether advertisements that promote uninsured debt obligations of the holding company also promote insured deposits of the affiliated depository institution in a way that could lead to confusion; 3) whether similar names or logos between the insured depository institution and the issuing nonbank affiliate are used in a misleading way to promote securities of a nonbank affiliate without clearly identifying the obligor; 4) whether retail deposit-taking employees of the insured depository institution are engaged in the promotion or sale of uninsured debt securities of a nonbank affiliate; 5) whether information on the sale of uninsured debt obligations of a nonbank holding company affiliate is available in the retail banking area; and 6) whether retail deposit statements for bank customers also promote information on the sale of uninsured debt obligations of the bank holding company or a nonbank affiliate.

The Board's policy is that the manner in which commercial paper is sold should not lead bank customers or investors to construe commercial paper as an insured obligation or an instrument which may be higher in yield but equal in risk to insured bank deposits. All purchasers of commercial paper should clearly understand that such paper is an obligation of the parent company or nonbank subsidiary and not an obligation of the bank and that the quality

1. This policy is not intended to preclude the sale of holding company affiliate obligations from a bank's money market desk, provided that the money market function is separate from any public area where retail deposits are accepted, including any lobby area.

of the investment depends on the risks and operating characteristics associated with the overall holding company and its nonbanking activities.

2080.1.3 THRIFT NOTES AND SIMILAR DEBT INSTRUMENTS

In the event a bank holding company or nonbanking affiliate issues thrift notes or other debt obligations which do not fall within the generally accepted definition of commercial paper, examiners should be guided by the Board's 1978 position on the issuance of small denomination debt obligations by bank holding companies and their nonbanking affiliates. At that time, the Board was considering thrift notes issued by a nonbanking subsidiary of a bank holding company and concluded that such obligations should prominently indicate in bold type on their face that the obligations are not obligations of a bank and are not FDIC insured. The Board also stated that the obligations should not be sold on the premises of affiliated banks. Where there is substantial reliance on the sale of thrift notes to fund the operations of a bank holding company or nonbanking subsidiary, other than an industrial bank, a violation of the Glass–Steagall Act may be involved. Such cases should be discussed with Reserve Bank counsel.

2080.1.4 OTHER SHORT-TERM INDEBTEDNESS

A company's access to bank credit is almost universal, and most small to medium-sized companies will reflect this type of debt on their balance sheets. An important point to remember about bank debt is that maturities of the bank notes are usually short-term while the proceeds of the borrowings are often applied to long-term assets, that is, investment in the bank's capital and/or long-term debt accounts. The note may be subject to renewal on an annual basis, and the creditor may have the opportunity to call the note at renewal if the financial condition of the company has deteriorated. Rates of interest on short- term bank notes are usually pegged to the creditor's prime rate plus some fraction thereof. The principal is often repaid over a period of years as the notes are rolled over despite their short-term maturity.

2080.1.5 CURRENT PORTION OF LONG-TERM DEBT

This type of debt has many of the short-term characteristics of bank debt, with possibly one additional important feature. Such debt is usually tied to a written agreement between creditor and debtor, and encompasses certain minimum standards of performance to be adhered to by the company. The examiner must review the agreement to determine that the company is operating within the parameters of the covenants laid out in the agreement. Failure to abide by the covenants can trigger default provisions of the agreement and escalate the repayment of the total loan balance outstanding.

2080.1.6 INSPECTION OBJECTIVES

1. To determine the company's policy and actual practices with respect to the sale of uninsured debt obligations and securities issued by bank holding companies, nonbank affiliates or State member banks. More often than not, an informal policy evolves from practice. It then becomes important to interview senior officers in charge of this function to determine if they are adequately aware of the statutory and regulatory constraints with respect to appropriate usage of commercial paper.
2. To review the company's funding and liquidity strategy with a view to determining whether it has sufficient liquid assets to support maturing liabilities and whether there are any funding mismatches. (See Manual sections 2080.05, 4010.2.3, 4010.2.7, and 5010.24.1)
3. To determine compliance with the Federal Reserve System's supervisory policy with regard to the marketing of commercial paper, thrift notes or similar type debt instruments (refer to Board letter S 2427 dated June 27, 1980, and supervisory letters SR 90–19 and SR 620).
4. To identify potential weaknesses in corporate policy and practices.

2080.1.7 INSPECTION PROCEDURES

1. Review the bank holding company's procedures for authorizing the issuance of commercial paper and other uninsured debt obligations and securities of the holding company and/or its nonbank affiliates.
2. Review the board of directors' resolution authorizing the issuance of commercial paper and other uninsured debt obligations and securities.

3. Determine whether the company has sought a "no action" letter from the SEC. A "no action" letter indicates the SEC has reviewed the company's issuance of commercial paper and plans "no action" to require the registration of the commercial paper as "securities." Some companies rely on the opinion of their own counsel that their paper is not subject to SEC registration requirements. If the company does not have a "no action" letter there should be a legal opinion on file from the holding company's attorney regarding exemption from registration under section 5 of the 1933 Act.

4. Obtain a copy of the holding company's written policy on paper usage to compare with resolution and practice.

5. Review to determine the extent to which the commercial paper and other uninsured debt obligations are supported by back-up lines of credit provided by unaffiliated banks. These lines are established to cover any unexpected run-off of paper at maturity. Commitments for lines of credit should be in writing and have expiration dates. Commitment fees substantiate the enforceability of the commitment whereas compensating balances tend to indicate that the lending commitment is less formal. The examiner should determine whether material adverse change clauses exist in back-up line of credit agreements which may affect their reliability. Comment if it appears that those provisions might be utilized.

Compensating balance arrangements should be disclosed. A company may commit to a compensating balance, but if it relies on its bank subsidiary to provide the funds the bank should be compensated for utilization of its funds.

Reciprocal back-up lines may be established. This may eliminate the need for fees or compensating balances and may provide a certain comfort level for company management.

6. Obtain a listing of commercial paper and other uninsured debt obligation holders from management to the extent known. In the case of larger BHCs, there is a choice between issuing paper on a local level or placing it nationally through the auspices of an investment banking firm. In the latter case, there is likely to be no record of who purchases the paper because the paper is usually sold on a bearer basis. Holding companies looking for a wider market, national recognition, and higher ratings place their paper through an investment banking firm. However, it should be recognized that the market for commercial paper placed in this manner is more sophisticated and knowledgeable and therefore more sensitive to adverse developments than a local market. The smaller company can be content to sell its paper on a local level through its corporate headquarters, knowing its customer profile and limiting the amount to any one paperholder, thereby limiting its exposure to refinancing problems caused by large scale redemptions.

7. Review for potential weaknesses in corporate policy and practices. Any amounts in excess of 10 percent in the hands of one paperholder should be discussed with management and noted in the report. A large paperholder could refuse to purchase new paper at maturity (rollover) and place the company in a liquidity squeeze, requiring sell-off of assets or draw down of back-up lines.

Rollovers are prohibited under the 1933 Act. The instrument must have a definite date of maturity with no automatic provision for reinvestment of proceeds. Companies must abide by the 270-day provision and if the paperholder elects to reinvest the funds, a new instrument should be executed.

8. Request a copy of the commercial paper, thrift note or similar type instrument, and any printed advice to the purchasing customer for review. These documents should be checked for compliance with the standards set forth under the captions "Marketing of Commercial Paper" and "Thrift Notes and Similar Debt Instruments" in this section of the Manual.

9. If a bank sells the commercial paper and/or other uninsured debt obligations of its holding company or nonbanking affiliate, review the procedures to separate their sale from the retail operations of the bank.

This segregation should be reviewed as part of all holding company inspections. Examiner judgment must be relied upon, to a large extent, to determine whether the marketing activities of commercial bank subsidiaries for the bank holding company's commercial paper and other uninsured debt obligations are sufficiently separated and distinguished from retail banking operations, particularly the deposit- taking function. In making this determination, the examiner should consider whether:

a. The sale of uninsured debt obligations of a holding company affiliate or uninsured nondeposit debt securities of a state member bank is physically separated from the bank's retail-deposit taking function, including the general lobby area;

b. Advertisements that promote uninsured debt obligations of the holding company also promote insured deposits of the affiliated depository institution in a way that could lead to confusion;

c. Similar names or logos between the insured depository institution and the issuing nonbank affiliate are used in a misleading way to promote securities of a nonbank affiliate without clearly identifying the obligor;

d. Retail deposit-taking employees of the insured depository institution are engaged in the promotion or sale of uninsured debt securities of a nonbank affiliate;

e. Information on the sale of uninsured debt obligations of a nonbank holding company affiliate is available in the retail banking area; and

f. Retail deposit statements for bank customers also promote information on the sale of uninsured debt obligations of the bank holding company or a nonbank affiliate.

In those cases where the bank holding company or nonbanking affiliates issue thrift notes or similar type debt instruments, ascertain that these obligations are not being sold on the premises of affiliated banks.

10. The procedures in Nos. 8 and 9 address the manner in which bank holding companies (or nonbanking subsidiaries) market their commercial paper, thrift notes or similar type debt instruments; consequently, implementation will necessitate review of marketing procedures of all holding companies (or nonbanking subsidiaries), regardless of the type of charter or the identity of the primary supervisor of the subsidiary (affiliate) bank. Exceptions to the policies on the marketing of such paper should be noted on the ‘‘Commercial Paper and Lines of Credit’’ pages and discussed on the ‘‘Examiner’s Comments’’ page of the inspection report. The managements of all bank holding companies must be fully informed of the Federal Reserve’s policy with respect to the marketing of holding company debt obligations, as in SR Letter 90–19, and exceptions should be addressed in the supervisory follow-up process.

Long-term debt represents an alternative financing method to short-term debt and equity funds. Before choosing this type of funding the bank holding company will need to determine how the advantages and disadvantages of long-term debt apply to its financial position and funding needs. Interest on long-term debt is an expense item and therefore is tax deductible. The company issuing debt effectively pays approximately ''half-price'' (interest expense net of tax deduction) on debt while the company issuing equity pays the full dividend rate without a tax benefit. Counterbalancing the tax advantage is the fact that long-term debt must be serviced and retired to prevent default and cannot be used as an offset for losses.

The issuance of long-term debt will be relatively advantageous to the holding company whose price/earnings ratio is low and whose stock is selling significantly below book value. In this instance, the cost to the company of equity funding rises proportionately to the drop in the price of the stock since less funds are obtained for an equal number of shares, yet the dividend per share remains the same.

A major factor influencing a bank holding company's decision to issue long-term debt instead of equity is the dilution impact of new equity. Straight debt will not dilute ownership and is typically retired from cash flow, whereas new equity dilutes earnings per share (more so than the impact of the debt's interest expense on earnings).

Preferred stock can be retired through a sinking fund and is sometimes convertible to common shares. Convertible stock adds to the dilution effect when the conversion is exercised and prior to conversion, ''fully diluted'' earnings per share must be reported that assume full conversion. The bank holding company will consider both stockholder and market reaction to any dilution effects of long-term financing. The BHC may view debt financing as the best alternative if it feels that a diluted earnings per share would drive down the market price of its stock and contribute to stockholder discontent.

Inherent in any financing are intangible costs. While it is evident that on the surface debt financing is cheaper than equity financing, it would be hard to quantify the effects of potential missed interest payment or default associated with debt instruments. The bank holding company also will be concerned with its additional ''debt capacity'' if the present issuance of debt pushes the debt/equity ratio beyond acceptable limits.

Theoretically, ''straight debt'' is a direct secured or unsecured obligation requiring repayment at maturity and generally taking a senior position in the claim on assets. Principal is sometimes payable in a lump sum, often through the use of a sinking fund, while interest is paid at stated periods throughout the life of the note.

2080.2.1 CONVERTIBLE SUBORDINATED DEBENTURE

A convertible subordinated debenture is an unsecured debt that is subordinate to other debt and convertible to common stock at a certain date or price. The essential provision of this debt is that it may eventually be retired by equity and inherently has the potential for dilution. With this type of financing, the creditor typically has the right to convert the bond into a stated number of shares of common stock at some future time. Usually the conversion price is 10 to 15 percent above the market price of the stock. This encourages the bondholder to keep the bond until the market price meets or surpasses the conversion price. In many convertible debt agreements, the bank holding company issuing debt will have the option to call the issue when the conversion price equals the market price.

The bank holding company will issue a convertible subordinated debenture when its stock price is depressed. The convertibility provision is added as a ''sweetner'' to the issue and counteracts the negative aspect of its subordinated position. The subordinated nature of this issue will help a bank holding company with prior debt which includes covenants that dictate against additional senior debt.

2080.2.2 CONVERTIBLE PREFERRED DEBENTURE

This debt instrument is similar to straight convertible debt except it is convertible into preferred stock. This alternative is open to the bank holding company which needs to add a ''sweetner'' to this issue in order to market it, but does not want dilution of ''common'' ownership.

2080.2.3 NEGATIVE COVENANTS

The lender will be concerned with the borrower's debt structure when offering financing. If the borrower's debt/equity ratio is approaching an unacceptable level, the lender will try to assure that the bank holding company does not overextend itself. While the lender may demand the right to approve future equity issues, the lender is likely to be more willing to give such approval than to allow more debt because the equity issue adds to the capital base, and this base is a possible source of funds for the payment of debt.

Closely related to the restriction on further debt is the position of the lender in the liquidation of assets. The holder of a straight debt issue will usually demand to be senior to other debt holders. This characteristic is particularly suited to straight debt because straight debt is more vulnerable to default than convertible debt and doesn't have other sweetners such as a conversion right or a right to participate in distributions of earnings. The examiner will want to determine how the covenants affect future debt financing and if the effect is positive or negative.

The lender is likely to seek to insure that neither the structure nor policies of the bank holding company are altered without its approval during the life of the debt. The lender can insure this through other negative covenants attached to the debt. Some common covenants of this type include (1) limitations on capital expenditures and on the sale of assets, (2) restrictions on the BHC's redemption of its own stock, (3) restrictions on investments in general, (4) restrictions on dividend payment without prior approval, and (5) the imposition of loan to capital ratios, deposit to capital ratios and asset to capital ratios.

2080.2.4 INSPECTION OBJECTIVES

1. To determine the existence of and adherence to policies on long-term debt.
2. To review the use of long-term funds.
3. To determine the existence of debt covenants and compliance by the holding company.

2080.2.5 INSPECTION PROCEDURES

1. Review the parent-only balance sheet and income statement for debt and interest expense captions.
2. Review the consolidated balance sheet and income statement for debt and interest expense captions.
3. Review any written policies and procedures available as part of an overall capital plan. If no plan or policies exist, the examiner should encourage management to develop them, and in large BHCs, to put them in writing.
4. Determine that the bank holding company does not finance long-term assets with short-term debt, as this leaves the holding company vulnerable to rising interest rates and the possibility of a credit crunch. On the other hand, it may be beneficial for the holding company to finance short-term assets with long-term debt. This is particularly true during periods of rising interest rates because the bank holding company can get higher yields on loans financed by lower cost long-term debt, than it can with commercial paper that has to be turned over at generally increasing rates. In any event, the bank holding company will need to insure that it has ample capacity to finance additional long-term assets with long-term debt when the opportunity presents itself.
5. Review any sinking fund provisions usually found with straight debt and straight preferred issues if the issue is not going to be refinanced by further debt or by an equity issue. Since payments to the fund will directly drain cash reserves, it is imperative that the bank holding company have adequate annual cash flow to service both the interest and add to the sinking fund. The larger the debt, the more the lender will look for a sinking fund feature as a means of precluding a default when maturity occurs and refinancing is not available. When a sinking fund exists the examiner will need to analyze the parent's cash flow statement to see that payments do not produce an adverse cash drain.

The capacity of the holding company to serve as a source of financial strength to its bank subsidiaries is a major consideration of the Federal Reserve Board in supervising a bank holding company. The cornerstone of this financial strength is capital adequacy.

The financial structure of banking organizations allows for the use of substantial leverage. If capital is large in relation to debt, additional borrowing is relatively inexpensive. However, because of added risk to lenders, the cost of borrowing increases as new obligations are assumed. At some point, therefore, equity financing becomes less costly and may become the only alternative available for needed funds.

Basically, a holding company's financial structure can be viewed in two ways: the ''single entity'' approach, whereby the holding company is considered an integrated entity and financial strength is assessed on the basis of its consolidated totals, and the ''building block'' approach, wherein the holding company is seen as a collection of individual components. In the latter view, the company's financial strength is assessed primarily in terms of the financial structure of each component.

When applying the ''building block'' approach, the liability and capital structure of each subsidiary is compared to the norm of its particular industry. The use of the ''building block'' approach has some advantages:

1. Comparative statistics are usually available to measure the performance and strength of the individual subsidiaries.

2. It permits comparison of capitalization between holding companies engaged in differing activities.

3. It identifies the degree of leveraging within a single subsidiary of a bank holding company.

The parent should maintain a favorable balance of debt and equity so that it will be able to assist its subsidiaries when necessary through contributions of its own capital or through additional funds generated from debt or equity financing.

At times, however, sale of additional stock may not be a viable alternative for capital formation, even when a company can show a favorable debt/equity balance. Reluctance to enter into a new stock offering may stem from a desire to avoid further dilution of existing ownership interest or from an unfavorable market price of outstanding stock in relation to book value. In these instances, long-term quasi-capital funds may sometimes be obtained through other sources, such as convertible securities or subordinated debt.

2080.3.1 PREFERRED STOCK

Preferred stock is becoming a more acceptable alternative due to certain advantages. Through contracted covenants, it is senior to common stock because it usually has no voting voice in management as does common stock. Preferred stock usually carries a fixed dividend rate that is either cumulative or noncumulative. Cumulative preferred provides that unpaid dividends in prior years must be paid to preferred shareholders before common dividends can be paid. A noncumulative feature provides that dividends foregone during lean years are lost permanently. From the viewpoint of the bank holding company, a noncumulative preferred issue is more desirable, while investors would desire a cumulative feature.

Perpetual preferred stock does not have a stated maturity date and it may not be redeemed at the option of the holder. Advantages that preferred stock can offer the bank holding company are (1) avoidance of dilution of earnings per common share and (2) absence of voting rights. On the other hand, dividend payments, particularly cumulative dividends, are expensive since they are not a tax-deductible expense as is interest on debt. Cumulative dividends can be particularly draining on cash when they are declared after several years of suspended dividends and payment is then made in a lump sum.

Preferred stock is usually retired by refinancing with debt or through its own conversion feature. If the bank holding company feels that it can afford an equity issue in the future but not at present, it can issue a convertible preferred debenture to postpone the equity issue until a later date. On the other hand, if debt is the desired method of financing but the present debt/equity ratio is not acceptable, the bank holding company will issue preferred and refinance with debt at a more opportune time. However, the Board has expressed concern that in applications to form a BHC, preferred stock not be used as a debt substitute resulting in circumvention of its debt guidelines. On applications with preferred stock which has debt-like characteristics, such stock may be treated as debt in the financial analysis.

2080.3.2 INSPECTION OBJECTIVES

1. To determine the existence of and adherence to parent company policies on capital adequacy within the subsidiaries and for the consolidated organization.

2. To review the use of proceeds of equity capital financings.

3. To review any debt covenants that pertain to a minimum acceptable capital position.

2080.3.3 INSPECTION PROCEDURES

1. Review any existing BHC policies regarding capital adequacy or capital planning.

2. Request any plans regarding proposed capital issues.

Earnings retention provides the most immediate source of capital formation and growth. Earnings retained after dividend payout can often be sufficient to keep pace with asset growth, thereby preserving the balance or relationship between equity capital and total assets. Often referred to as ''internal funding,'' earnings retention should be carefully reviewed to assure that the BHC's capital base is keeping pace with asset growth.

Bank earnings retention should be reviewed carefully due to the dividend requirements often imposed on banks by their parent companies. Although a bank's board of directors must approve the declaration and payment of any bank dividend, often the bank's board is actually ratifying a decision determined at the parent level. The need for bank retention of earnings is particularly pronounced either during periods of expansion or periods of declining earnings or losses.

Parent company management may be under pressure from shareholders or ''the market'' to increase dividends or to maintain dividends at historic levels despite reversals in consolidated earnings trends. Examiners should be careful to point out to management that dividend pressures often serve to the detriment of the bank subsidiary(ies) which is often asked to supply the proceeds via a dividend to the parent company. As a regulator of banks (and bank holding companies), the Federal Reserve System is concerned with the preservation and maintenance of a sound banking system and in particular, soundly capitalized banks. Earnings retention contributes to capital growth and should be encouraged. For additional information on earnings retention and dividends see sections 2020.5.1, 4010.1, and 4020.1.

2080.4.1 PAYMENT OF DIVIDENDS BY BANK SUBSIDIARIES

Bank dividends can be determined to be excessive if they exceed the limitations imposed by either section 5199(b) or 5204 (also referred to as sections 56 and 60(b)) of the Revised Statutes and accordingly, should be reviewed with regard to those limitations. The Federal Reserve Board amended Regulation H on December 20, 1990, regarding the payment of dividends by state member banks [12 C.F.R. 208.19(a) and 208.19(b)]. These new regulations make the elements that are taken into account in determining a state member bank's dividend paying capacity more consistent with generally accepted accounting principles. Two different calculations are performed to measure the amount of dividends that may be paid, a Net Profits Test and an Undivided Profits Test.

2080.4.1.1 Net Profits Test

The approval of the Federal Reserve is required for dividends declared by a member bank that in any calendar year exceeds the net profits of the current year, combined with retained net profits for the two proceeding years (the ''Net Profits Test''). Under the regulation, net profits of a year will equal net income. A member bank is required to use these rules in calculating net profits beginning in 1991 and thereafter.

2080.4.1.2 Undivided Profits Test

The parent company's bank subsidiaries must receive prior approval of the Federal Reserve before paying dividends in amounts greater than undivided profits then on hand, after deducting any bad debts in excess of the allowance for loan and lease losses. Under the regulations effective January 25, 1991, undivided profits then on hand include undivided profits plus the amount of ''surplus surplus'' that meets certain conditions. ''Surplus surplus'' is defined as the amount of capital surplus in excess of the amount required under applicable state law, and the regulations provide that a bank may include surplus surplus in undivided profits then on hand only if the bank can demonstrate that surplus surplus is from earnings of prior periods (''earned surplus surplus''). Transfers from surplus surplus to undivided profits must receive prior approval of the Federal Reserve. Bad debts in excess of the allowance for loan and lease losses must be subtracted from undivided profits then on hand in calculating the amount available for dividends. Bad debts are defined as debts due and unpaid for a period of six months unless well secured and in the process of collection.[1]

1. Because for most banks bad debts are less than the allowance for loan and lease losses, this subtraction will not apply to most banks.

Holding companies have turned to employee pension plans and, to a lesser degree, stock option plans as ways to provide added capital for holding company operations. While there may be a number of reasons for implementing such programs, one of the by-products is the flow of working capital into the holding company. The program usually involves a pre-tax contribution by the holding company to an employee benefit plan (e.g., profit sharing plan) and the resulting purchase by such plan of common or preferred shares of the holding company's stock. The holding company benefits through the use of the funds for working capital, and the plan provides for retirement benefits for employees as shareholders in the company. Since ESOPs are administered under the Employees Retirement Income Security Act of 1974 (ERISA), the guidelines delineated in SR 85–21 should be followed in determining whether possible ERISA violations exist. Reference should also be made to Manual section 4010.1.1.

2080.5.1 STOCK OPTION PROGRAMS

Employee stock option programs generate a nominal percentage of a holding company's financing needs to reward key employees for service rendered via the reduced price of the company's stock. While such programs constitute one method of available funding for a holding company, they generally may not be expected to add any capital amounts beyond nominal levels.

2080.5.2 EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)

Employee Stock Ownership Plans (ESOP) are an alternative holding company funding tool. An ESOP is a tax-qualified employee benefit plan which is designed to be invested primarily in employer stock. The concept of an ESOP is to encourage the establishment of employee benefit programs which expand the employees' share in company stock ownership. Participation in an ESOP may also significantly enhance employee motivation. The essential differences between an ESOP and other qualified stock bonus plans are that an ESOP is permitted, in certain circumstances, to incur liabilities in the acquisition of employer securities, and that an employer may receive additional tax credits for amounts contributed to ESOPs. Under limited circumstances, lenders to ESOP's may also receive benefits that result in reduced borrowing costs to the ESOP. As long as ESOP meets the IRS requirements for a qualified employee plan, it may invest up to 100% of its assets in ‘‘qualifying’’ employer securities. It is exempt from some of the self-dealing limitations applicable to most employee benefit plans, as it is viewed as a means of providing stock ownership interests for employees rather than as strictly a retirement plan. Furthermore, an ESOP may purchase the stock either from the employer company or from shareholders. Therefore, in addition to use as a tool of corporate finance, an ESOP may serve as a ready purchaser for outstanding stock, without a corresponding loss of voting control.

ESOPs are in some ways similar to deferred profit sharing plans. ESOPs are authorized under the same section, namely, section 401 of the Internal Revenue Code. Employer contributions (within limits based on a percentage of eligible payroll) are allowable deductions from the employer's pre-tax income. Contributions are held in trust, and benefits when paid out upon an employee's retirement, death, or termination of service, must be paid in company stock. The distinguishing feature of an ESOP lies in the fact that the direct purpose of the plan is to invest employer contributions in the stock of the company.

2080.5.2.1 Accounting Guidelines for Leveraged ESOP Transactions

Newly issued or existing shares of BHC stock are sometimes sold to the ESOP and paid for with money borrowed from a third party; these types of ESOPs are commonly referred to as ‘‘leveraged ESOPs.’’ The borrowings are generally serviced with contributions by the employer, which are a tax deductible expense. The borrowing arrangement by the ESOP often includes a guarantee or commitment by the employer (the BHC or the subsidiary bank) to make future contributions to the ESOP sufficient to meet debt service requirements.

When this occurs, questions arise involving the appropriate accounting for the leveraged ESOP transaction. The Accounting Standards Executive Committee of the American Institute of CPAs has issued a Statement of Position (SOP) 72–3 which discusses ESOP borrowing situations. Since the Federal Reserve applies generally accepted accounting principles, banks and bank holding companies should follow SOP 76–3. The SOP statement covers cases where the employer either guarantees the ESOP loan or commits to make future ESOP contributions sufficient to service the debt. For such cases, the SOP indicates that the employer should credit a liability account for the amount of the ESOP debt and offset that entry by reducing shareholders' equity. The liability recorded by the employer should be reduced as the ESOP makes payments on the debt. This liability is recorded because the guarantee or commitment is in substance the employer's debt. When there is no guarantee, the ESOP is treated like any other shareholder.

In other words, where there is a leveraged ESOP which has purchased BHC stock, and there is a guarantee, commitment, or other arrangement which is in effect a guarantee relative to the debt service of the ESOP, for analytical purposes the amount of ESOP debt will be considered as parent debt and thus parent equity will be reduced accordingly. This will affect debt to equity ratios as well as consolidated capital ratios, where applicable.

2080.5.2.2 Fiduciary Standards under ERISA Pertaining to ESOPs

There are also general fiduciary standards under ERISA pertaining to ESOPs which have been delineated largely through court decisions rather than issuance of regulations. Although exempted from ERISA's asset diversification requirement, ESOP transactions are still required to meet fiduciary standards of prudence, and must be designed and administered for the ''exclusive benefit'' of plan employees. (ERISA § 404(a) and 29 CFR 2550.407d–6). Yet, as stated above, ESOPs may have distinct advantages which inure primarily to the sponsoring company, its management and large shareholders. Due to these potential or actual conflicts of interest, it is important that the sponsoring employer and any other fiduciaries of a plan undertake every effort to assure full consideration of the best interests of plan employees.

The safeguarding of the statutory ''exclusive'' interests of plan employees pursuant to ERISA is within the jurisdiction of the IRS and the Department of Labor. The bank regulatory agencies also have some responsibility in their review and examination activities where employee benefit plans such as ESOPs are involved. In this connection, a Uniform Interagency Referral Agreement mandated by statute, has been in effect since 1980 whereby certain possible violations of the provisions of ERISA are referred to the DOL by the Division of Banking Supervision and Regulation, pursuant to delegated authority. SR 81–697 (SA) contains the procedures for making referrals to the Department of Labor. Attached to the SR letter is an exhibit, *ERISA Referral Format,* which lists the information necessary when making referrals. Holding company examiners can expedite the ERISA referral process by including that information in their reports.

2080.5.3 STATUS OF ESOP'S UNDER THE BHC ACT

On August 6, 1985, the Board determined (1985 FRB 804) that an ESOP that controls more than 25 percent of the voting shares of a bank or bank holding company is a bank holding company. The Board determined that the underlying trust which held the shares of the bank holding company is a ''business trust'' as defined in the BHC Act and was thus not excluded from the definition of a ''company'' under the terms of the Act.

2080.5.4 INSPECTION CONSIDERATIONS

Examiners should review unfunded pension liabilities of the BHC to determine their potential impact on the organization. In addition, examiners should review the soundness of any borrowings used to fund ESOP purchases of BHC stock. ESOP borrowings from an affiliated bank used to purchase BHC shares may result in an apparent increase in BHC capital which in fact turns out to have been funded with subsidiary bank funds, a practice considered suitable for in-depth review by examination staff. Section 401 (of the Internal Revenue Code) plan holdings of BHC stock need to be evaluated under the ''content'' provisions of the BHC Act, change in Bank Control Act, and Regulation Y.

When an ESOP is subject to the Change in Bank Control Act, this fact should be brought to the attention of a BHC's management. Section 225.41 of Regulation Y specifies transactions—acquisitions—that would require providing the

Board with 60 days prior written notice before acquiring control of a bank holding company (or a state member bank), unless the transaction is exempt under section 225.42 of the Regulation. In addition to the above, a determination should be made as to whether the ESOP is a bank holding company. The examiner may also refer to the Financial Accounting Standards Board's Statement No. 87, ''Employers' Accounting for Pensions.''

A key principle underlying the Federal Reserve's supervision of bank holding companies is that such companies should be operated in a way that promotes the soundness of their subsidiary banks. Holding companies are expected to avoid funding strategies or practices that could undermine public confidence in the liquidity or stability of their banks. Consequently, bank holding companies should develop and maintain funding programs that are consistent with their lending and investment activities and that provide adequate liquidity to the parent company and its nonbank subsidiaries.

2080.6.1 FUNDING BY SWEEPING DEPOSIT ACCOUNTS

A principal objective of a bank holding company's funding strategy should be to maintain an adequate degree of liquidity at the parent company and its subsidiaries. Funding mismatches can exacerbate an otherwise manageable period of financial stress and, in the extreme, undermine public confidence in an organization's viability. In developing and carrying out funding programs, bank holding companies should give special attention to the use of overnight or extremely short-term liabilities since a loss of confidence in the issuing organization could lead to an immediate funding problem. Accordingly, bank holding companies relying on overnight or extremely short-term funding sources should maintain a level of superior quality assets, namely, assets that can be immediately liquidated or converted to cash with minimal loss, that is at least equal to the amount of those funding sources.

A potential source of funding mismatch arises from the use of what has been commonly referred to as deposit sweeps. This practice is based upon an agreement with a subsidiary bank's deposit customers (typically corporate accounts) which permits these customers to reinvest amounts in their deposit accounts above a designated level in overnight obligations of the parent bank holding company. These obligations include such instruments as commercial paper, program notes, and master notes.

In view of the extremely short-term maturity of most sweep arrangements, banking organizations should exercise great care when investing the proceeds. Appropriate uses of the proceeds of deposit sweep arrangements are limited to short-term bank obligations, short-term U.S. Government securities, or other highly liquid, readily marketable, investment grade assets that can be disposed of with minimal loss of principal.[1] Use of such proceeds to finance mismatched asset positions, such as those involving leases, loans, or loan participations, can lead to liquidity problems at the parent company and are not considered appropriate. The absence of a clear ability to redeem overnight or extremely short-term liabilities when they become due should generally be viewed as an unsafe and unsound banking activity.

Reserve Bank supervisory and examination personnel are to ensure that bank holding companies and their state member banks are in compliance with this section and related supervisory letters addressing the marketing of uninsured debt instruments, including master notes and other sweep arrangements (refer to Manual sections 2080.05 and 2080.1). Banking organizations not in compliance should take the necessary steps to achieve full compliance within a reasonable period of time. Reserve Banks should provide copies of the supervisory letter SR 90–31 to any bank holding company engaged in sweep arrangements with their subsidiary banks, or to any other organization if necessary to facilitate compliance.

1. Some banking organizations have interpreted language in a 1987 letter signed by the Secretary of the Board as condoning funding practices that may not be consistent with the principles set forth in this supervisory letter and prior Board rulings. The 1987 letter involved a limited set of facts and circumstances that pertained to a particular banking organization; it did not establish or revise Federal Reserve policies on the proper use of the proceeds of short-term funding sources. In any event, banking organizations should no longer rely on the 1987 letter to justify the manner in which they use the proceeds of sweep arrangements. Banking organizations employing sweep arrangements are expected to ensure that these arrangements conform with the policies contained in this section and in the Manual section 2080.05 on bank holding company funding.

The control provisions of the Bank Holding Company Act (the act) are found in section 2(a)(1) and (2) (see 12 U.S.C. 1841(a)) under the definition of a bank holding company. A bank holding company is defined as ‘‘any company which has control over any bank or over any company that is or becomes a bank holding company by virtue of the Act.’’

The term ‘‘company’’ means any corporation, partnership, business trust, association, or similar organization, or any other trust.[1] Any corporation in which the majority of the shares are owned by the United States or by any state is not considered a company.

A ‘‘company covered in 1970’’ means a company that became a bank holding company as a result of the enactment of the Bank Holding Company Act Amendments of 1970 and which would have been a bank holding company on June 30, 1968, if those amendments had been enacted on that date.

2090.0.1 CONCLUSIVE PRESUMPTIONS OF CONTROL

The conclusive presumptions of control are established in section 2(a)(2)(A) and (B) of the act when—

1. a company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 percent or more of any class of voting securities of a bank or company or
2. a company controls in any manner the election of a majority of the directors or trustees of the bank or company.

‘‘Acting through one or more other persons’’ could include—

1. acting through the executive officer of a company, or a relative or business associate of that officer;
2. financing the purchase of shares of a bank or company when—
   a. the amount of credit approximates the purchase price,
   b. there is no definite maturity on the credit extended,
   c. the credit is obtained at a favorable rate of interest, and
   d. the bank whose shares are held as collateral maintains an excessive balance with the lending company;
3. by a resolution of a company’s board of directors, guaranteeing an individual against any loss in relationship to his ownership in a bank or company when such ownership represents 25 percent or more of any voting class;
4. recognizing earnings from another company; or
5. participating in policy formation or daily operations of another company.

The ‘‘power to vote’’ includes the right to vote, to direct the voting of shares, or to immediately transfer shares to the name of the holder of such rights or the holder’s nominee, pursuant to any proxy, contract, or agreement. However, when stock is held as collateral for a loan under an agreement which enables the lender to transfer the stock into the name of the lender or its nominee without the power to vote, the right to have the shares transferred does not in itself constitute control. To constitute control, the power to vote must be perfected along with the transfer of the stock into the name of the lender or its nominee.

2090.0.2 DIRECT CONTROL

Direct control exists when a company (as defined in section 2(b) of the act) owns 25 percent or more of any one class of voting securities of a bank (as defined in section 2(c) of the act) or company. ‘‘Voting securities’’ includes potential as well as actual voting authority.

2090.0.3 INDIRECT CONTROL

Indirect ownership or control is defined in section 2(g) of the act in subsections 1 and 2 as follows:

‘‘(1) Shares owned or controlled by any subsidiary of a bank holding company shall be deemed to be indirectly owned or controlled by such bank holding company; and

‘‘(2) Shares held or controlled directly or indirectly by trustees for the benefit of (A) a company, (B) the shareholders or members of a company, or (C) the employees

1. Unless the terms of the trust require it to terminate within 25 years or not later than 21 years and 10 months after the death of individuals living on the effective date of the trust.

(whether exclusively or not) of a company, shall be deemed to be controlled by such company.''

To assist in the interpretation of the above subsections the following explanations are provided.

1. All shares owned by a subsidiary of a bank holding company are deemed to be controlled by the parent's ownership interest in the directly owned subsidiary.
2. Shares held in a trust for the benefit of a company are deemed to be controlled by such company regardless of whether the trustee or company votes the shares. A company is deemed to be the beneficial owner of shares which it does not vote if all other shareholders' rights are retained by such company (that is, dividends, or other rights).
3. Shares owned by a trustee for the benefit of a company's subsidiary (or the subsidiary's shareholders, members, or employees) are deemed to be controlled by both the subsidiary and its parent.
4. Shares held in a trust for the benefit of an individual ''stockholder, member, or employee'' are not deemed to be controlled by a company because such shares are held for the individual regardless of his or her relationship with the company. For a company to have control over the shares held for the benefit of a company's ''stockholders, members, or employees,'' the shares must be held as a class.
5. If a trust meets the definition of a company, it is possible for such a trust to be a bank holding company. In addition, it is possible for a bank through the administration of a trust(s)(which does not meet the definition of a company) to become a bank holding company (that is, a bank which has control over various trusts whose shares aggregate to 25 percent or more of a bank or bank holding company could be deemed a bank holding company; a bank which administers a trust that owns 25 percent or more of a bank or bank holding company (and such trust does not meet the definition of a company) could be a bank holding company.

In addition to the above determinants involving conclusive presumptions of control, the Board has determined that whenever the transferability of 25 percent or more of any class of voting securities of a company is restricted, in any manner, upon the transfer of 25 percent or more of any class of voting securities of another company, the holders of the two securities affected by the restriction constitute a company for the purposes of the act. This determination applies unless one of the issuers of such securities is a subsidiary of the other and is so identified in a Board order or in a registration statement or report accepted by the Board under the act.

In any administrative or judicial proceedings regarding conclusive presumptions of control, a company would not be considered to control a bank or company at any given time unless that company, at the time in question, directly or indirectly owned, controlled, or had power to vote 5 percent or more of any class of voting securities of the bank or company.

2090.0.4 REBUTTABLE PRESUMPTIONS OF CONTROL

A rebuttable presumption of control exists when the Board determines, after notice and opportunity for hearings, that a company directly or indirectly exercises a controlling influence over the management or policies of a bank or company (section 2(a)(2)(C) of the act). With regard to the above, there is a presumption that any company which directly or indirectly owns, controls, or has power to vote less than 5 percent of any class of voting securities of a given bank or company does not have control over that bank or company (section 2(a)(3) of the act). This 5 percent presumption does not prohibit the Board from determining that a company exercises a ''controlling influence'' when such company owns, controls, or has power to vote less than 5 percent of any class of voting securities of another company or bank. However, in overcoming the presumption, the Board bears the burden of proving that such a controlling influence exists.

2090.0.4.1 Regulation Y Determinants of Control

The Board has established the following rebuttable presumptions of control in section 225.31 of Regulation Y for use in proceedings:

1. Control of voting securities.
   a. *Securities convertible into voting securities.* A company that owns, controls, or holds securities that are immediately convertible, at the option of the holder or owner, into voting securities of a bank

or other company controls the voting securities.

b. *Option or restriction on voting securities.* A company that enters into an agreement or understanding under which the rights of a holder of voting securities of a bank or other company are restricted in any manner controls the securities. This presumption does not apply where the agreement or understanding—
   (1) is a mutual agreement among shareholders granting to each other a right of first refusal with respect to their shares;
   (2) is incident to a bona fide loan transaction; or
   (3) relates to restrictions on transferability and continues only for the time necessary to obtain approval from the appropriate federal supervisory authority with respect to acquisition by the company of the securities.

2. Control over company.
   a. *Management agreement.* A company that enters into any agreement or understanding with a bank or other company (other than an investment advisory agreement), such as a management contract, under which the first company or any of its subsidiaries directs or exercises significant influence over the general management or overall operations of the bank or other company controls the bank or other company.
   b. *Shares controlled by company and associated individuals.* A company that, together with its management officials or principal shareholders (including members of the immediate families of either (as defined in 12 C.F.R. 206.2(k)) owns, controls, or holds with power to vote 25 percent or more of the outstanding shares of any class of voting securities of a bank or other company, if the first company owns, controls, or holds with power to vote more than 5 percent of the outstanding shares of any class of voting securities of the bank or other company.
   c. *Common management officials.* A company that has one or more management officials in common with a bank or other company controls the bank or other company, if the first company owns, controls, or holds with power to vote more than 5 percent of the outstanding shares of any class of voting securities of the bank or other company, and no other person controls as much as 5 percent of the outstanding shares of any class of voting securities of the bank or other company.
   d. *Shares held as fiduciary.* The presumptions of control in paragraphs 225.31(d)(2)(ii) and (iii) of Regulation Y do not apply if the securities are held by the company in a fiduciary capacity without sole discretionary authority to exercise the voting rights.

2090.0.4.2 Other Presumptions of Control

In addition to the rebuttable presumptions, there are a number of other circumstances that are indicative of control and may call for further investigation to uncover facts that support a determination of control. Such circumstances include the following:

1. A company owns at least 10 percent of each of two banks or at least 5 percent of each of three or more banks.
2. A company owns 5 percent or more of a bank or bank holding company and has been instrumental in the hiring or firing of one or more persons; establishing policies or places for branches; establishing hours of business; deciding on rates, terms, or acceptance of loans or deposits; following uniform advertising practices or using a common telephone system; or any other respects directing the activities of management or establishing the policies of the bank or company.
3. A company lends to a borrower on more favorable terms than it would have for a borrower of comparable credit standing to enable the borrower to acquire voting shares of a bank or other company.

If the Board proposes to make a determination based on the above indicators of control, the Board bears the burden of providing evidence that such a control situation exists.

2090.0.5 PROCEDURES FOR DETERMINING CONTROL

The question of whether a control situation exists may arise from information coming to the Board's attention or from a company's seeking to obtain the Board's opinion regarding a specific situation. When this question arises, the Board has instructed each Reserve Bank to make every effort to resolve the matter with the company without resorting to the procedures outlined in this section. However, if the Reserve Bank is unsuccessful in resolving the matter, it is referred to the Board staff. If the Board staff feels the matter warrants Board consideration, it will recommend that the Board make a preliminary determination of control based on the available facts and so inform the company. (See section 225.31(a).) Following the preliminary determination of control, the company must, within 30 days (or longer as may be permitted by the Board), submit the information required by section 225.31(b).

If the company contests the Board's determination, it is entitled to a formal hearing at its request. (See section 225.31(c).)

Notwithstanding any other provision of the act, a company is not deemed to be a bank holding company by virtue of its control of—

1. ''. . . shares [held] in a fiduciary capacity, except as provided in paragraphs (2) and (3) of subsection (g)'' (section 2(a)(5)(A) of the act);
2. ''. . . shares acquired by it in connection with its underwriting of securities if such shares are held only for such period of time as will permit the sale thereof on a reasonable basis'' (section 2(a)(5)(B) of the act);
3. ''[a] company formed for the sole purpose of participating in a proxy solicitation if the voting rights of the shares acquired by such company are acquired in the ordinary course of such a solicitation'' (section 2(a)(5)(C) of the act);
4. ''. . . shares acquired in securing or collecting a debt previously contracted in good faith, until two years after the date of acquisition'' (section 2(a)(5)(D) of the act);

   (The Board is authorized upon application by a company to extend, from time to time for not more than one year at a time, the two-year period referred to herein for disposing of any shares acquired by a company in the regular course of securing or collecting a debt previously contracted in good faith, if, in the Board's judgment, such an extension would not be detrimental to the public interest, but no such extension shall in the aggregate exceed three years.)
5. ''. . . any State-chartered bank or trust company which
   (i) is wholly owned by thrift institutions or savings banks; and
   (ii) is restricted to accepting—
      (I) deposits from thrift institutions or savings banks;
      (II) deposits arising out of the corporate business of thrift insitutions or savings banks that own the bank or trust company; or
      (III) deposits of public moneys.'' (section 2(a)(5)(E) of the act); and
6. ''. . . a single . . . bank, if such . . . company is a trust company or mutual savings bank located in the same State as the bank and if . . . (i) such ownership or control existed on the date of enactment of the Bank Holding Company Act Amendments of 1970 and is specifically authorized by applicable State law, and (ii) the trust company or mutual savings bank does not after that date acquire an interest in any company that, together with any other interest it holds in that company, will exceed 5 percentum of any class of the voting shares of that company, except that this limitation shall not be applicable to investments of the trust company or mutual savings bank, direct and indirect, which are otherwise in accordance with the limitations applicable to national banks under section 5136 of the Revised Statutes (12 U.S.C. 24)'' (section 2(a)(5)(F) of the act).

2090.0.6 INSPECTION OBJECTIVES

1. To determine whether any change in control of a bank holding company has resulted in a company (as defined by section 2(b) of the act) becoming a bank holding company in violation of section 3(a)(1) of the act.
2. To ascertain whether an existing bank holding company has acquired either directly or indirectly additional banking assets in violation of section 3(a)(3) of the act.
3. To establish whether a company which has purchased its own stock is in compliance with section 225.4(b) of Regulation Y. (See section 2090.3.)

2090.0.7 INSPECTION PROCEDURES

1. Review the company's stock records and the company's investment portfolio.
2. If there are any subsidiaries that are indirectly owned or controlled as defined in section 2(g) of the act, determine if such shares are held in a trust and, if so, whether the trust agreement contains any provisions that could potentially expose the holding company or any of its subsidiaries to financial or other liabilities.

2090.0.8 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Regulation Y		225		
Direct control voting securities				1978 FRB 121
Indirect control as trustee			Ltr. 1/14/76 to W. Lloyd, Chicago Fed Ltr. 10/16/73 to W. Lloyd, Chicago Fed	
Acting through others				1970 FRB 350 1974 FRB 865 1972 FRB 717 1974 FRB 130 1974 FRB 131
Transfer of shares				1974 FRB 875
Rebuttable presumption of control				
• nonvoting stock				1972 FRB 487
• other indicators of control				136 *Fed. Reg.* 18945 (Sept. 24, 1971)
Procedures for determining control			S-2173 (Sept. 17, 1971) (at 4–191.1)	Patogonia vs. BOG 517 F. 2d 803 (9th Cir. 1975)
Nonvoting equity investments by BHCs		225.143		1982 FRB 413

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Section 2 (o) of the Bank Holding Company Act (the act) (as amended by section 2610 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996) exempts ‘‘qualified family partnerships’’ from the definition of ‘‘company’’ in the act.[1] Under this change to the act, a qualified family partnership would be able to own and control a bank holding company without the partnership becoming subject to the registration, source of strength, approval, reporting, or other requirements imposed on a bank holding company.

To qualify for the exemption, a qualified family partnership must have as partners only individuals who are related by blood, marriage, or adoption, or trusts for the primary benefit of those individuals. In addition, the partnership must—

- control any bank through a company that is itself a registered bank holding company subject to all of the provisions of the act;
- control only one registered bank holding company;
- not engage in any business activity except indirectly through ownership of other business entities (that is, the partnership must be an investment vehicle for the family and may not be an operating company);
- limit its investments to those permitted for a bank holding company under section 4 of the act; and
- not be obligated on any debt, either directly or as a guarantor.

Any partnership requesting qualification as a qualified family partnership must commit (1) to be subject to Federal Reserve Board examination to ensure compliance with the conditions for eligibility and (2) to be treated as a bank holding company for purposes of enforcement actions by the Board. In addition, while a qualified family partnership is exempt from the prior-approval requirements of section 3 of the act in connection with a bank acquisition, the partnership continues to be subject to the notice provisions of the Change in Bank Control Act.

As noted above, the primary benefits to becoming a qualified family partnership are (1) exemption from the capital requirements applicable to bank holding companies, (2) exemption from the reporting requirements applicable to a bank holding company, and (3) the freedom to make permissible nonbanking investments without prior Board approval. Because the qualified family partnership must use a single registered bank holding company to hold all of its bank investments, there continues to be a bank holding company subject to the requirements of the act in every case. This structure ensures that the cross-guarantee provisions of the Federal Deposit Insurance Act continue to apply to all banks controlled by a qualified family partnership.

1. Pub. L. 104-2089, section 2610; 110 Stat. 3009.

The Change in Bank Control Act of 1978 (CBC Act), title VI of the Financial Institutions Regulatory and Interest Rate Control Act of 1978, gives the federal bank supervisory agencies the authority to disapprove changes in control of insured depository institutions.[1] The Federal Reserve Board is the responsible federal banking agency for changes in control of bank holding companies and State member banks, and the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency are responsible for insured State nonmember and national banks, respectively.

The CBC Act requires any person (individual, partnership, corporation, trust, association, joint venture, pool, sole proprietorship, unincorporated organization) seeking to acquire control of any insured depository institution or bank holding company to provide 60 days' prior written notice to the appropriate federal banking agency. This requirement applies to all covered transactions that will be consummated after March 9, 1979. The act specifically exempts transactions that are subject to section 3 of the Bank Holding Company Act of 1956 or section 18 of the Federal Deposit Insurance Act, since these transactions are covered by existing regulatory approval procedures. Accordingly, changes in control due to acquisitions by bank holding companies and changes in control of insured depository institutions resulting from mergers, consolidations, or other similar transactions are not covered by the CBC Act.

The CBC Act describes the factors that the Federal Reserve and the other federal banking agencies are to consider in determining whether a transaction covered by the CBC Act should be disapproved. These factors include the financial condition, competence, experience, and integrity of the acquiring person (or persons acting in concert), the effect of the transaction on competition, the failure to provide all required information, and whether the proposed transaction would result in an adverse effect on the Bank Insurance Fund or the Savings Insurance Fund. The Federal Reserve Board's objectives in its administration of the CBC Act are to enhance and maintain public confidence in the banking system by preventing identifiable serious adverse effects resulting from anticompetitive combinations of interests, inadequate financial support, and unsuitable management in these institutions. The Board will review each notice to acquire control of a state member bank or bank holding company and will disapprove transactions that are likely to have serious harmful effects. It is the Board's intention to administer the CBC Act in a manner that will minimize delays and government regulation of private-sector transactions.

If the Board disapproves a change in control, the Board will notify the proposed acquiring party in writing within three days after its decision. The notice of disapproval will contain a statement of the basis for disapproval. The CBC Act provides that the acquiring party may request a hearing by the Board in the event of a disapproval and provides a procedure for further review by the courts.

Forms for filing notices of proposed transactions covered by the CBC Act are available from the Federal Reserve Banks. When a substantially complete notice is received by the Federal Reserve Bank, a letter of acknowledgement will be sent to the acquiring person indicating the date of receipt. The transaction may be completed 61 days or more after that date unless the acquiring person has been notified by the Board that the acquisition has been disapproved or that the 60-day period has been extended as provided for in subparagraph (j)(1) of the CBC Act. To avoid undue interference with normal business transactions, the Board may issue a notice of its intention not to disapprove a proposal, after consulting the relevant state banking authorities as the CBC Act requires.

2090.1.1 INFORMATION TO BE CONTAINED IN NOTICES

The CBC Act requires a ''person'' proposing to acquire control of a bank holding company or state member bank to file a notice with the Federal Reserve Board containing personal and biographical information, detailed financial information, details of the proposed acquisition, information on any structural or managerial changes contemplated for the institution, and other relevant information required by the Board.

1. The term ''insured depository institution'' includes any depository institution holding company and any *other* company which controls an insured depository institution. FIRREA substituted this term for banks in 1989. The CBC Act is found in 12 U.S.C. 1817(j)(1)–(18).

In order to be filed properly in accordance with the act, a notice must be substantially complete and responsive to every item specified in paragraph 6 of the CBC Act. When the acquiring party is an individual, or a group of individuals acting in concert, the requirement for five years' personal financial data is deleted in favor of a current statement of assets and liabilities, a brief income summary, and a statement of any material changes since the date thereof, but the Board reserves the right to require up to five years of financial data from any acquiring person. For complete details on the informational requirements of a change in control, see the System's ''Notice of Change in Control'' form.

2090.1.2 TRANSACTIONS REQUIRING SUBMISSION OF NOTICE

The CBC Act defines ''control'' as the power, directly or indirectly, to vote 25 percent or more of any class of voting securities, or to direct the management or policies of a bank holding company or insured depository institution. Therefore, any transaction, unless exempted by the CBC Act, that results in the acquiring party having voting control of 25 percent or more of any class of voting securities or that results in the power to direct the management or policies of such an institution would trigger the notice requirement. However, any person who on March 9, 1979, controls a bank holding company or state member bank shall not be required to file a notice to maintain or increase control positions in the same institution. In addition, the Board's regulations allow persons who on March 9, 1979, fall within a presumption described in the next paragraph to acquire additional shares of an institution without filing notice so long as they will not have voting control of 25 percent or more of the institution. In connection with transactions that would result in greater voting control, such persons may file the required notice or request that the Board make a determination that they already control the institution.

With respect to persons who have the power to vote less than 25 percent of an institution's shares, the Board has established the following rebuttable presumptions for purposes of the notice requirements under the CBC Act:

1. Where a transaction involving any class of voting securities of a bank holding company or state member bank would result in a person (or group of persons acting in concert) having voting control of 10 percent or more, and after the transaction the acquiring person would be the largest shareholder of that institution, the transaction results in control.

2. Where an institution has issued any class of securities subject to registration under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 781) (Regulation H banks) and a transaction would result in a person (or group of persons acting in concert) having voting control of 10 percent or more of any class of voting securities of that institution, the transaction results in control.

Other transactions resulting in a person's control of less than 25 percent of a class of voting shares of a bank holding company or state member bank would not result in control for purposes of the CBC Act. In addition, customary one-time proxy solicitations and the receipt of pro rata stock dividends are not subject to the CBC Act's notice requirements.

In some cases, corporations, partnerships, certain trusts, associations, and similar organizations that are not already bank holding companies may be uncertain whether to proceed under the CBC Act or under the Bank Holding Company Act with respect to a particular acquisition. These organizations should comply with the notice requirements of the CBC Act if they are not required to secure prior Board approval under the Bank Holding Company Act. However, some transactions, particularly foreclosures by institutional lenders, fiduciary acquisitions by banks, and increases of majority holdings by bank holding companies, described in sections 2(a)(5)(D) and 3(a)(A) and (B) of the Bank Holding Company Act, do not require the Board's prior approval, but they are considered subject to section 3 of the Bank Holding Company Act and, therefore, do not require notices under the CBC Act.

Persons contemplating an acquisition that would result in a change in control of a bank holding company or state member bank should request appropriate forms and instructions from the Federal Reserve Bank in whose district the affected institution is located. If there is any doubt whether a proposed transaction requires a notice, the acquiring person should consult the Federal Reserve Bank for guidance. The act places the burden of providing notice on the prospective acquiring person and substantial civil penalties can be imposed for willful violations.

2090.1.3 CONTROL TRANSACTIONS EXEMPT FROM PRIOR NOTICE REQUIREMENTS

The Board's regulations exempt the following transactions from the prior notice requirements of the Act:

1. A foreclosure of a debt previously contracted in good faith;
2. Testate or intestate succession; and
3. A bona fide gift.

Under these regulations, a person acquiring control in the situations described above is required to furnish certain information to the Federal Reserve Bank promptly after the transaction, and the affected institution must report promptly any changes or replacement of its chief executive officer or of any director, in accordance with paragraph 12 of the CBC Act.

Under these regulations, acquisitions of control of foreign bank holding companies are also exempt from the prior notice requirements of the Act, but this exemption does not extend to the reports and information required under paragraphs 9, 10, and 12 of the CBC Act.

2090.1.4 DISAPPROVAL OF CHANGES IN CONTROL

The CBC Act sets forth various factors to be considered in the evaluation of a proposal. The Board is required to review the competitive impact of the transaction, the financial condition of the acquiring person, and the competence, experience, and integrity of that person and the proposed management of the institution. In assessing the financial condition of the acquiring person, the Board will weigh any debt servicing requirements in light of the acquiring person's overall financial strength, the institution's earnings performance, asset condition, capital adequacy, future prospects, and the likelihood of an acquiring party making unreasonable demands on the resources of the institution.

2090.1.5 ADDITIONAL REPORTING REQUIREMENTS

As mentioned briefly above, paragraph 12 of the CBC Act requires that whenever a change in control of a bank holding company occurs, each insured depository institution is required to report promptly to the approporiate Federal banking agency any changes or replacement of its chief executive officer or of any director occurring in the next twelve-month period, including in its report a statement of the past and current business and professional affiliations of the new chief executive officer or directors.

Paragraph 9 of the CBC Act indicates that whenever any insured depository institution makes a loan secured by 25 percent or more of the outstanding voting stock of an insured depository institution (or bank holding company), the president or other chief executive officer of the lending bank shall promptly report such fact to the appropriate federal banking agency of the bank (or bank holding company) whose stock secures the loan. However, no report need be made where the borrower has been the owner of record of the stock for a period of one year or more or where the stock is that of a newly organized bank prior to its opening. Reports required by this paragraph shall contain information similar to the informational requirements of the Change in Control Notification form.

2090.1.6 STOCK REDEMPTIONS

A stock redemption by a BHC may result in an existing shareholder(s) then owning 25 percent or more of a class of voting securities which would require the filing of both a change in control and treasury stock notification. Furthermore, a stock redemption by a BHC may result in an existing shareholder(s) then owning between 10 percent and 25 percent of the outstanding shares and also being the largest shareholder thereby resulting in a rebuttable presumption of control. For additional information, see Manual section 2090.3 "Treasury Stock Redemptions."

2090.1.7 CORRECTIVE ACTION

Violations of the CBC Act are addressed through the same type of investigative and enforcement authority, and other formal corrective actions used in other administrative remedies (those specified in 12 U.S.C. 1818(b) through 1818(n)). The CBC Act also authorizes the assessment of civil money penalties for any violation of the CBC Act (see 12 U.S.C. 1817(j)(16)), and allows the Board to seek divestiture of a BHC or bank from any person or company who violates the CBC Act (12 U.S.C. 1817(j)(15)).

2090.1.8 INSPECTION OBJECTIVES

1. To determine that the BHC has complied with the prior notification requirements of the CBC Act and that changes in ownership between 10 percent and 25 percent have been reviewed for "rebuttable presumption" considerations.

2. To determine that the BHC has complied with the reporting requirements of paragraph 12 of the CBC Act regarding changes in its board of directors or its chief executive officer that occur within 12 months of a change in control.

3. To determine that the BHC has complied with the reporting requirements of paragraph 9 of the CBC Act regarding loans made directly by the BHC secured by 25 percent or more of the outstanding voting stock of an insured depository institution (or bank holding company).

2090.1.9 INSPECTION PROCEDURES

1. Review the BHC's stock certificate register or log to determine if any person (or group of persons acting in concert) has acquired 10 percent or more of any class of voting securities.

2. Review changes in control of between 10 percent and 25 percent of any class of voting securities to determine if the controlling party is the single largest shareholder.

3. When inspecting a BHC which was the subject of a change in control and a prior notification was filed, review the notification to determine that information submitted on management of the BHC is still valid. In cases where changes in directors or the chief executive officer occurred within 12 months of the change in control, determine if the BHC has reported such changes in compliance with paragraph 12 of the CBC Act.

4. When inspecting a BHC which has redeemed any of its own shares subsequent to March 9, 1979, thereby lowering the number of shares outstanding, determine whether the holdings of any individual shareholder has increased proportionally to greater than 10 percent, which might trigger the rebuttable presumption of control which in turn might have required prior notification of a change in control.

5. Review any loans made directly by the BHC that are secured by 25 percent or more of the outstanding shares of a bank (or bank holding company) and determine if the BHC has complied with the reporting requirements of paragraph 9 of the CBC Act.

2090.2.1 FORMATION OF A BANK HOLDING COMPANY AND CHANGES IN OWNERSHIP

The formation of a bank holding company and certain changes in the ownership of banks owned by a bank holding company come under the provisions of section 3 of the BHC Act. Section 3(a)(1) prohibits the formation of a bank holding company without prior Board approval. A company may receive approval pursuant to section 3(a)(1) to become either a one-bank holding company or a multibank holding company.

A primary reason for the formation of a one-bank holding company is to obtain income tax benefits.[1] These benefits include offsetting operating/capital losses of one corporation against the profits/capital gains of another.

Once a company becomes a bank holding company, either by the formation of a one-bank or multibank holding company, section 3(a)(3) of the act prohibits the direct or indirect acquisition of over 5 percent of any additional bank's or bank holding company's shares without prior Board approval. In addition to the above, section 3(a)(3) serves to prevent, without prior Board approval, an existing bank holding company from increasing its ownership in an existing subsidiary bank unless greater than 50 percent of the shares is already owned (section 3(a)(B)). A bank holding company which owns more than 50 percent of a bank's shares may buy and sell those shares freely without Board approval, provided the ownership never drops to 50 percent or less. If a bank holding company owns 50 percent or less of a bank's shares, prior Board approval is required before each additional acquisition of shares takes place until the ownership reaches more than 50 percent.

1. A corporation is entitled to a special deduction from gross income for dividends received from a taxable domestic corporation. There is (1) a 70 percent deduction for dividends received from a corporation that is less than 20 percent owned; (2) an 80 percent deduction for dividends received from a corporation that is 20 to less than 80 percent owned; (3) a 100 percent deduction for dividends received from members of the same affiliated group (i.e., a corporation that is 80 percent or more commonly owned); and (4) a 100 percent deduction for dividends received from small business investment corporations. There is also an overall limitation on dividends received. The recipient's aggregate amount is limited to 70 percent (80 percent for those corporations that are 20 to less than 80 percent owned) of taxable income. The manner in which the deduction is computed is also subject to further limitation.

2090.2.2 HISTORY OF APPLYING THE CAPITAL ADEQUACY GUIDELINES TO THE POLICY STATEMENT ON THE FORMATION OF SMALL BANK HOLDING COMPANIES

On March 28, 1980, the Board issued a policy statement with regard to the formations of small one-bank holding companies. The policy statement was included with the revision of Regulation Y (12 C.F.R. 225, appendix C) on January 5, 1984. Subsequent to this policy statement, capital adequacy standards were adopted for large multibank holding companies (on a consolidated basis[2]) in December 1981 (amended in June 1983, April 1985, and November 1986) that set minimum capital levels and capital zones relating to primary and total capital.[3] These were replaced in January 1989 (amended in October 1991) by the current minimum capital adequacy standards that use the risk-based capital and leverage capital measures.

Typically, a small bank holding company's capital position has not been evaluated on a consolidated basis. The evaluation of applications of small bank holding company formations for capital adequacy initially followed an 8 percent gross capital to total assets standard.[4] Subsequently, the 1981 guidelines established minimum 5.5 percent primary and 6.0 percent total capital ratios and the concept of capital zones above the minimum capital ratios. When analyzing bank capital for small bank holding company formations, December 1981's 7 percent (zone 1) total capital to assets leverage ratio (after adjusting for the addition of the allowance for loan and lease losses to the ratio's numerator and denominator) became the financial equivalent of 1980's 8 percent gross capital standard. For the bank, the change resulted in evaluating applications for capital adequacy based on a 7 percent total capital to total assets

2. Capital adequacy is evaluated on a bank-only basis for small bank holding companies.

3. Primary capital included common stockholders' equity, contingency and other capital reserves, the allowances for loan and lease losses, and the minority interest in the equity accounts of consolidated subsidiaries. It also included limited amounts of perpetual preferred stock, mandatory convertible securities, and perpetual debt.

4. The allowance for loan and lease losses was not added back to total assets. In other words, the ''total assets'' were net of the allowance for loan and lease losses, a contra asset.

ratio. Since most small banks did not have qualifying secondary capital, the practical effect of the change was that both the zone 1 primary and total capital ratios were at least 7 percent. In September 1990, a minimum tier 1 leverage ratio became effective. A tier 1 to total assets leverage ratio of 6 percent was applied as the financial equivalent of the former 7 percent total capital ratio.

Even though the components of the various capital ratios have changed over time, the capital standards used to evaluate capital positions of banks for small bank holding formations have not. The fundamental policy is still the same. In both instances, approximately the same percentage of small banks meets both ratios. It also should be noted that, if at any time, state or federal banking authorities or loan agreements require the banks of small bank holding company formations to satisfy higher capital standards, those standards will be used when evaluating capital adequacy.

Effective April 21, 1997, revisions to Regulation Y included revisions to the Board's one-bank holding company policy statement. The policy statement was revised to generalize its applicability beyond the formation of a bank holding company to include acquisitions by qualifying small bank holding companies. The policy statement incorporates previous informal policies that have evolved since the original publication of the statement. It also provides for streamlined processing of proposals that result in parent company debt-to-equity of less than 1.0 to 1 for small bank holding companies that are "well managed" and "well capitalized."

2090.2.3 SMALL BANK HOLDING COMPANY POLICY STATEMENT

In acting on applications filed under the act, the Board follows the principle that bank holding companies should serve as a source of strength for their subsidiary banks. When bank holding companies incur debt and rely on the earnings of their subsidiary banks as the means of repaying such debt, a question arises as to the probable effect on the financial condition of the holding company and its subsidiary bank or banks.

The Board believes that a high level of debt at the parent holding company level impairs the ability of a bank holding company to provide financial assistance to its subsidiary bank or banks, and, in some cases, the servicing requirements on such debt may be a significant drain on the bank's resources. For these reasons, the Board has not favored the use of acquisition debt in the formation of bank holding companies or in the acquisition of additional banks. Nevertheless, the Board has recognized that the transfer of ownership of small banks often requires the use of acquisition debt. The Board therefore has permitted the formation and expansion of small bank holding companies with debt levels that are higher than what would be permitted for larger bank holding companies. Approval of these applications has been given on the condition that the small bank holding companies demonstrate the ability to service the acquisition debt without straining the capital of their subsidiary banks and, further, that such companies restore their ability to serve as a source of strength for their subsidiary bank within a relatively short period of time.

In the interest of facilitating the transfer of ownership in banks without compromising bank safety and soundness, the Board has adopted the procedures and standards for the formation and expansion of small bank holding companies subject to the small bank holding company policy statement.

The policy focuses on the relationship between debt and equity at the parent holding company. The holding company has the option of improving the relationship of debt-to-equity by repaying the principal amount of its debt or through the retention of earnings, or both. Under these procedures, newly organized small one-bank holding companies are expected to reduce the relationship of their debt-to-equity over a reasonable period of time to a level that is comparable to that maintained by many large and multibank holding companies.

In general, this policy is intended to apply only to bank holding companies with pro forma consolidated assets of less than $150 million that (1) do *not* have significant leveraged nonbank activities and (2) do *not* have a significant amount of outstanding debt that is held by the general public. Although the policy statement applies to the formation of small bank holding companies, it also applies to existing bank holding companies that wish to acquire an additional bank or company and to transactions involving changes in control, stock redemptions, or other shareholder transactions. The criteria are described below.

In evaluating applications filed pursuant to section 3(a)(1) of the act, as amended, when the applicant intends to incur debt to finance the acquisition of a small bank, the Board will take into account a full range of financial and other information, including the recent trend and stability of earnings of the bank, prospective growth of the bank, asset quality, the ability of the applicant to meet debt-servicing requirements without placing an undue strain on the resources of the bank(s), and the record and competency of management. In addition, the Board will require applicants to meet the minimum requirements set forth below. As a general rule, failure to meet any of these requirements will result in denial of an application; however, the Board reserves the right to make exceptions if the circumstances warrant.

1. *Minimum down payment.* The amount of acquisition debt should not exceed 75 percent of the purchase price of the bank(s) or company to be acquired. When the owner(s) of the holding company incur debt to finance the purchase of the bank(s) or company, such debt will be considered acquisition debt even though it does not represent an obligation of the bank holding company, unless the owner(s) can demonstrate that such debt can be serviced without reliance on the resources of the bank(s) or bank holding company.
2. *Maintenance of adequate capital.* Each insured depository subsidiary of a small bank holding company is expected to be well capitalized. Any institution that is not well capitalized is expected to become well capitalized within a brief period of time.
3. *Reduction in parent company leverage.* Small bank holding companies are to reduce their parent company debt consistent with the requirement that all debt be retired within 25 years of being incurred. The Board expects these bank holding companies to reach a debt-to-equity ratio of .30 to 1 or less within 12 years after incurrence of the debt. The bank holding company must also comply with debt-servicing and other requirements imposed by its creditors.

   The term ''debt,'' as used in the ratio of debt to equity, means any borrowed funds (exclusive of short-term borrowings that arise out of current transactions, the proceeds of which are used for current transactions), and any securities issued by, or obligations of, the holding company that are the functional equivalent of borrowed funds. The term ''equity,'' as used in the ratio of debt to equity, means total stockholders' equity of the bank holding company as defined in accordance with generally accepted accounting principles.[5] In determining the total amount of stockholders' equity, the bank holding company should account for its investments in the common stock of subsidiaries by the equity method of accounting.

   Ordinarily, the Board does not view redeemable preferred stock as a substitute for common stock in a small bank holding company. Nevertheless, to a limited degree and under certain circumstances, the Board will consider redeemable preferred stock as equity in the capital accounts of the holding company if the following conditions are met: (1) the preferred stock is redeemable only at the option of the issuer, and (2) the debt-to-equity ratio of the holding company would be at or remain below 30 percent following the redemption or retirement of any preferred stock. Preferred stock that is convertible into common stock of the holding company may be treated as equity.
4. *Dividend restrictions.* The bank holding company is not expected to pay any corporate dividends on common stock until such time as its debt-to-equity ratio is at 1.0 to 1 or less and it otherwise meets the requirements in sections 225.14(c)(1)(ii), 225.14(c)(2), and 225.14(c)(7) of Regulation Y. However, some dividends may be permitted, provided all of the following conditions are met: the dividends are (1) reasonable in amount, (2) do not adversely affect the ability of the bank holding company to service its debt in an orderly manner, and (3) do not adversely affect the ability of the subsidiary banks to be well capitalized.[6] Also, it is expected that dividends will be eliminated if the holding company is (1) not reducing its debt consistent with the requirement that the debt-to-equity ratio be reduced to 30 percent within 12 years of consummation of the proposal or (2) not meeting the requirements of its loan agreement(s).

5. Goodwill is defined as the excess of cost of any acquired company over the sum of the fair market values assigned to identifiable assets acquired less the fair market values of the liabilities assumed, in accordance with generally accepted accounting principles.

6. For bank holding companies with consolidated assets under $150 million, ''well-capitalized'' means that the bank holding company maintains a total risk-based capital ratio of 10.0 percent or greater and a tier 1 risk-based capital ratio of 6.0 percent or greater, and it is not subject to any written agreement, order, capital directive, or prompt-corrective-action directive issued by the Board to meet and maintain a specific capital level for any capital measure.

2090.2.4 CAPITAL CONSIDERATIONS IN SMALL MULTIBANK AND CHAIN BANK HOLDING COMPANY APPLICATIONS

Multibank holding companies and chain banking organizations (whether or not the chain members are banks or bank holding companies) with less than $150 million in combined assets that meet certain conditions will not be consolidated or combined for capital adequacy purposes. Rather, such organizations will be analyzed in the context of the standards described in the Board's policy statement on small bank holding companies (appendix C of Regulation Y) discussed previously in this section. A bank holding company application that seeks to expand a small bank holding company with or without creating or expanding a chain controlling assets of less than $150 million would be evaluated on the basis of the policy statement in the same manner as if the proposed bank holding company was not part of a chain.

The above application would be evaluated on the basis of the financial and managerial condition of the entire organization. Although the policy statement would generally be applied, the focus of the analysis would be as much on the organization as an operating entity as on the instant proposal. For example, it would be expected that the condition of the applicant organization and that of its subsidiaries would be consistent with expansion, one aspect of which is that each banking subsidiary generally would be expected to maintain capital well above the minimum levels. The policy statement would generally govern the payment of dividends by the applicant organization and any prospective use of preferred stock. The bank to be acquired would be expected to maintain above-minimum capital ratios consistent with those contemplated by the Board's capital adequacy guidelines.

An acquisition debt retirement period would apply with respect to each proposal and the acquisition debt/purchase price ratio limitation of 75 percent would generally apply to the instant application. A specific parent only debt/equity limit would not be applied. However, it would be expected that the ratio would decline over time.

In addition, the financial and managerial condition of the members of any chain thereby formed or expanded (including compliance considerations and general consistency with the capital adequacy guidelines, giving consideration to the need to maintain capital positions well above the minimum ratios) would be evaluated. The chain would not have to meet a specific combined, parent only debt/equity standard. However, there would be a general presumption that the debt/equity level of the chain would tend to decline after the initial leveraged approval. Although individual bank holding companies might be leveraged up to 3 to 1, over time the combined leverage of the chain would tend to be less than this level through increases in the equity or reductions in the debt of the organization. Proposals by banking organizations whose combined banking assets exceed $150 million would be evaluated for capital adequacy on the basis of an analysis of the consolidated organization. (The term ''consolidated'' as used with the analysis of large chains would involve actually consolidating each parent bank holding company with its subsidiary (or subsidiaries), and then combining each such consolidated entity as well as any other bank in the chain). An analysis of the capital adequacy of each constituent entity in a large banking organization would also continue to be assessed to determine whether the holding company would serve as a source of strength to its subsidiary banks.

2090.2.5 INSPECTION OBJECTIVE

To determine compliance with all commitments made in the application/notification process.

2090.2.6 INSPECTION PROCEDURE

Review all commitments made by the company and its shareholders to determine compliance therewith.

2090.2.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Capital adequacy guidelines Regulation Y—appendixes A and D		225	4–797 4–798 4–855	
Small BHC policy statement—appendix C			4–856	1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

"Bootstrapping" is the term generally used to describe a treasury stock transaction in which a company incurs debt to purchase or redeem its own outstanding shares. Bootstrapping is often used to facilitate a change in control whereby a shareholder or shareholder group need only buy few or no shares in order to gain control. The repurchase or redemption is often made in accordance with a written agreement made between a former controlling shareholder(s) and the new controlling shareholder(s).

Section 225.4(b) of Regulation Y requires a bank holding company to file prior written notice with the Board before a purchase or redemption of any of its own equity securities if the gross consideration for the purchase or redemption, when aggregated with the net consideration paid by the company for all such purchases or redemptions during the preceding 12 months, is equal to 10 percent or more of the company's consolidated net worth. (Net consideration is the gross consideration paid by the company for all of its equity securities purchased or redeemed during the period minus the gross consideration received for all of its equity securities sold during the period other than as a part of a new issue.)

Each notice shall furnish the following information:

- The purpose of the transaction, a description of the securities to be purchased or redeemed, the total number of each class outstanding, the gross consideration to be paid, and the terms of any debt incurred in connection with the transaction.
- A description of all equity securities redeemed within the preceding 12 months, the net consideration paid, and the terms of any debt incurred in connection with those transactions.
- A current and pro forma consolidated balance sheet if the bank holding company has total assets of over $150 million, or a current and pro forma parent-company-only balance sheet if the bank holding company has total assets of $150 million or less.

2090.3.1 CHANGE IN CONTROL ACT CONSIDERATIONS

As indicated earlier, treasury stock redemptions are often intended to facilitate a change in control of a bank holding company. By redeeming the shares held by an existing shareholder(s), the remaining shareholder(s) increases his proportionate ownership. If a "person's" share ownership should rise above 25 percent or more of the remaining outstanding shares (subsequent to March 9, 1979), that person would then "control" the BHC. Under these circumstances, a change in control notification would have to be filed. If the treasury stock redemption is for an amount sufficient to trigger the requirement for a prior notification of redemption, then dual notifications are called for (change in control and redemption of treasury shares).

Similarly, prior notification is also required if a treasury stock redemption should result in a shareholder's holdings rising to between 10 percent and 25 percent of the remaining outstanding shares, and if (a) that shareholder is the firm's largest single shareholder immediately after the acquisition; or (b) the institution is registered under section 12 of the Securities Exchange Act of 1934 (i.e., corporations having assets exceeding $1 million, more than 500 shareholders, and securities that are publicly traded). For additional information on change in control notification requirements, see section 2090.1.

Additional notices under the CIBC Act do not have to be filed if regulatory clearance had already been received to acquire 10 percent or more of the voting shares of a bank holding company, and subsequent treasury stock redemptions resulted in ownership of between 10 and 25 percent of the shares of the bank holding company. Refer to section 225.41(a)(2) of Regulation Y.[1]

2090.3.2 INSPECTION OBJECTIVES

1. To determine that a BHC that has redeemed shares of its own stock has complied with section 225.4(b) of Regulation Y.

2. To determine that any new controlling shareholder of a BHC that has redeemed shares of its own stock has complied with section 225.41(a) of Regulation Y.

3. To determine if a treasury stock transaction has taken place for the purpose of depleting the original 25 percent equity investment in the purchase price.

1. Revised by the Board, effective November 9, 1990.

2090.3.3 INSPECTION PROCEDURES

1. Review the BHC's reconcilement of stockholders' equity to determine if shares have been redeemed.

2. If shares have been redeemed, review for compliance with treasury stock redemption approval and reporting requirements.

3. Determine whether the BHC is using, repeatedly, the less than 10 percent ownership exemption to avoid notice requirements, thus undermining the capital position of the banking organization, resulting in an unsafe and unsound practice.

4. Determine if the less than 10 percent ownership exemption is being used by the bank holding company when it does not satisfy the requirements of the Board's capital guidelines for redemptions.

The exemption should not be used by a bank holding company that does not meet the Board's capital guidelines for redemptions. Redemptions of permanent equity or other capital instruments before stated maturity could have a significant impact on an organization's overall capital structure. Use of the exemption could significantly reduce its capital. Consequently, an organization considering such a step should consult with the Federal Reserve before redeeming any equity (prior to maturity) if such redemption could have a material effect on the level or composition of the organization's capital base.

The exemption should not be used by a small one-bank holding company if it would increase its debt-to-equity ratios significantly above those relied on by the Board in approving its application to become a bank holding company.

5. If shares have been redeemed, determine if any shareholder's holdings have risen to 25 percent or more of the outstanding shares.

6. If shares have been redeemed, determine if any shareholder's holdings have risen to between 10 percent and 25 percent of the outstanding shares. Furthermore, determine whether the shareholder is then the largest shareholder or the institution has registered securities under section 12 of the Securities Exchange Act of 1934.

7. If a stock redemption occurred recently in a bank holding company, determine if the shareholders have maintained a 25 percent equity investment.

On July 8, 1982, the Board issued a policy statement setting forth its concerns and providing guidance with respect to investments by bank holding companies in nonvoting shares of other bank holding companies or banks (refer to F.R.R.S. 4–172.1, 1982 FRB 413, and 12 C.F.R. 225.143). The statement notes considerations the Board will take into account in determining whether such investments are consistent with the Bank Holding Company Act, and describes the general scope of arrangements to be avoided in these agreements. The Board's statement was occasioned by the fact that a number of bank holding companies have made substantial equity investments in banks or bank holding companies located across state lines, in expectation of statutory changes that might make interstate banking permissible. The following is the text of the Board's statement:

In recent months, a number of bank holding companies have made substantial equity investments in a bank or bank holding company (the ‘‘acquiree’’) located in states other than the home state of the investing company through acquisition of preferred stock or nonvoting common shares of the acquiree. Because of the evident interest in these types of investments and because they raise substantial questions under the Bank Holding Company Act (the ‘‘Act’’), the Board believes it is appropriate to provide guidance regarding the consistency of such arrangements with the Act.

This statement sets out the Board's concerns with these investments, the considerations the Board will take into account in determining whether the investments are consistent with the Act, and the general scope of arrangements to be avoided by bank holding companies. The Board recognizes that the complexity of legitimate business arrangements precludes rigid rules designed to cover all situations and that decisions regarding the existence or absence of control in any particular case must take into account the effect of the combination of provisions and covenants in the agreement as a whole and the particular facts and circumstances of each case. Nevertheless, the Board believes that the factors outlined in this statement provide a framework for guiding bank holding companies in complying with the requirements of the Act.

2090.4.1 STATUTORY AND REGULATORY PROVISIONS

Under section 3(a) of the Act, a bank holding company may not acquire direct or indirect ownership or control of more than 5 percent of the voting shares of a bank without the Board's prior approval (12 U.S.C. Para. 1842(a)(3)). In addition, this section of the Act provides that a bank holding company may not, without the Board's prior approval, acquire control of a bank: that is, in the words of the statute, ‘‘for any action to be taken that causes a bank to become a subsidiary of a bank holding company’’ (12 U.S.C. Para. 1842(a)(2)). Under the Act, a bank is a subsidiary of a bank holding company if:

1. The company directly or indirectly owns, controls, or holds with power to vote 25 percent or more of the voting shares of the bank;
2. The company controls in any manner the election of a majority of the board of directors of the bank; or
3. The Board determines, after notice and opportunity for hearing that the company has the power, directly or indirectly, to exercise a controlling influence over the management or policies of the bank (12 U.S.C. Para. 1841(d)).

In intrastate situations, the Board may approve bank holding company acquisitions of additional banking subsidiaries. However, where the acquiree is located outside the home state of the investing bank holding company, section 3(d) of the Act prevents the Board from approving any application that will permit a bank holding company to ‘‘acquire, directly or indirectly, any voting shares of, interest in, or all or substantially all of the assets of any additional bank’’ (12 U.S.C. 1842(d)(1)).

2090.4.2 REVIEW OF AGREEMENTS

In apparent expectation of statutory changes that might make interstate banking permissible, bank holding companies have sought to make substantial equity investments in other bank holding companies across state lines, but without obtaining more than 5 percent of the voting shares or control of the acquiree. These investments involve a combination of the following arrangements:

1. Options on, warrants for, or rights to convert nonvoting shares into substantial blocks of voting securities of the acquiree bank holding company or its subsidiary bank(s);
2. Merger or asset acquisition agreements

with the out-of-state bank or bank holding company that are to be consummated in the event interstate banking is permitted;

3. Provisions that limit or restrict major policies, operations or decisions of the acquiree; and
4. Provisions that make acquisitions of the acquiree or its subsidiary bank(s) by a third party either impossible or economically impracticable.

The various warrants, options, and rights are not exercisable by the investing bank holding company unless interstate banking is permitted, but may be transferred by the investor either immediately or after the passage of a period of time or upon the occurrence of certain events.

After a careful review of a number of these arrangements, the Board believes that investments in nonvoting stock, absent other arrangements, can be consistent with the Act. Some of the agreements reviewed appear consistent with the Act since they are limited to investments of relatively moderate size in nonvoting equity that may become voting equity only if interstate banking is authorized.

However, other agreements reviewed by the Board raise substantial problems of consistency with the control provisions of the Act because the investors, uncertain whether or when interstate banking may be authorized, have evidently sought to assure the soundness of their investments, prevent takeovers by others, and allow for sale of their options, warrants, or rights to a person of the investor's choice in the event a third party obtains control of the acquiree or the investor otherwise becomes dissatisfied with its investment. Since the Act precludes the investors from protecting their investments through ownership or use of voting shares or other exercise of control, the investors have substituted contractual agreements for rights normally achieved through voting shares.

For example, various covenants in certain of the agreements seek to assure the continuing soundness of the investment by substantially limiting the discretion of the acquiree's management over major policies and decisions, including restrictions on entering into new banking activities without the investor's approval and requirements for extensive consultations with the investor on financial matters. By their terms, these covenants suggest control by the investing company over the management and policies of the acquiree.

Similarly, certain of the agreements deprive the acquiree bank holding company, by covenant or because of an option, of the right to sell, transfer, or encumber a majority or all of the voting shares of its subsidiary bank(s) with the aim of maintaining the integrity of the investment and preventing takeovers by others. These long-term restrictions on voting shares fall within the presumption in the Board's Regulation Y that attributes control of shares to any company that enters into any agreement placing long-term restrictions on the rights of a holder of voting securities (12 C.F.R. Para. 225.31(d)(2).

Finally, investors wish to reserve the right to sell their options, warrants or rights to a person of their choice to prevent being locked into what may become an unwanted investment. The Board has taken the position that the ability to control the ultimate disposition of voting shares to a person of the investor's choice and to secure the economic benefits therefrom indicates control of the shares under the Act.[1] Moreover, the ability to transfer rights to large blocks of voting shares, even if nonvoting in the hands of the investing company, may result in such a substantial position of leverage over the management of the acquiree as to involve a structure that inevitably results in control prohibited by the Act.

2090.4.3 PROVISIONS THAT AVOID CONTROL

In the context of any particular agreement, provisions of the type described above may be acceptable if combined with other provisions that serve to preclude control. The Board believes that such agreements will not be consistent with the Act unless provisions are included that will preserve management's discretion over the policies and decisions of the acquiree and avoid control of voting shares.

As a first step towards avoiding control, covenants in any agreement should leave management free to conduct banking and permissible nonbanking activities. Another step to avoid control is the right of the acquiree to ''call'' the equity investment and options or warrants to assure that covenants that may become inhibiting can be avoided by the acquiree. This right makes such investments or agreements more like a loan in which the borrower has a right to escape covenants and avoid the lender's influence by prepaying the loan.

A measure to avoid problems of control aris-

1. See Board letter dated March 18, 1982, to C.A. Cavendes, Sociedad Financiera.

ing through the investor's control over the ultimate disposition of rights to substantial amounts of voting shares of the acquiree would be a provision granting the acquiree a right of first refusal before warrants, options or other rights may be sold and requiring a public and dispersed distribution of those rights if the right of first refusal is not exercised.

In this connection, the Board believes that agreements that involve rights to less than 25 percent of the voting shares, with a requirement for a dispersed public distribution in the event of sale, have a much greater prospect of achieving consistency with the Act than agreement involving a greater percentage. This guideline is drawn by analogy from the provision in the Act that ownership of 25 percent or more of the voting securities of a bank constitutes control of the bank.

The Board expects that one effect of this guideline would be to hold down the size of the nonvoting equity investment by the investing company relative to the acquiree's total equity, thus avoiding the potential for control because the investor holds a very large proportion of the acquiree's total equity. Observance of the 25 percent guideline will also make provisions in agreements providing for a right of first refusal or a public and widely dispersed offering of rights to the acquiree's shares more practical and realistic.

Finally, certain arrangements should clearly be avoided regardless of other provisions in the agreement that are designed to avoid control. These are:

1. Agreements that enable the investing bank holding company (or its designee) to direct in any manner the voting of more than 5 percent of the voting shares of the acquiree;
2. Agreements whereby the investing company has the right to direct the acquiree's use of the proceeds of an equity investment by the investing company to effect certain actions, such as the purchase and redemption of the acquiree's voting shares; and
3. The acquisition of more than 5 percent of the voting shares of the acquiree that ''simultaneously'' with their acquisition by the investing company become nonvoting shares, remain nonvoting shares while held by the investor, and revert to voting shares when transferred to a third party.

2090.4.4 REVIEW BY THE BOARD

This statement does not constitute the exclusive scope of the Board's concerns, nor are the considerations with respect to control outlined in this statement an exhaustive catalog of permissible or impermissible arrangements. The Board has instructed its staff to review agreements of the kind discussed in this statement and to bring to the Board's attention those that raise problems of consistency with the Act. In this regard, companies are requested to notify the Board of the terms of such proposed merger or asset acquisition agreements or nonvoting equity investments prior to their execution or consummation.

Pursuant to Section 3 of the Bank Holding Company Act, a bank holding company, directly or through its subsidiary banks, may not acquire more than 5 percent of the shares of an additional bank without the Board's prior approval. However, it is recognized that banks acting as trustee may acquire such shares without prior notice. Therefore, the Act requires a bank or banks which are subsidiaries of bank holding companies and acquire in excess of the 5 percent threshold limit, to file an application with the Board within 90 days after the shares exceeding the limit are acquired. The limit generally applies *only* to other bank shares over which the acquiring fiduciary exercises sole discretionary voting authority. Nevertheless, the Board has waived this application requirement under most circumstances in Section 225.12 of Regulation Y, unless—

1. the acquiring bank or other company has sole discretionary authority to vote the securities and retains the authority for more than two years; or
2. the acquisition is for the benefit of the acquiring bank or other company, or its shareholders, employees, or subsidiaries.

In determining whether the threshold limits have been reached, shares acquired prior to January 1, 1971 can ordinarily be excluded. On the other hand, shares of another bank held under the following circumstances should, in certain instances, be included in the 5 percent threshold, even though sole discretionary voting authority is not held:

1. Shares held by a trust which is a "company", as defined in Section 2(b) of the Bank Holding Company Act; and,
2. Shares held as trustee for the benefit of the acquiring bank or bank holding company, or its shareholders, employees or subsidiaries.

A bank holding company should have procedures for monitoring holdings of the stock of other banks and bank holding companies for compliance with the foregoing application requirements of the Act, for compliance with reporting requirements on form Y–6, and for compliance with certain similar reporting requirements under the federal securities laws. A general 5 percent threshold applies in all three situations, although differing requirements and exemptions apply.

Examiners specifically trained in trust examinations may need to conduct this portion of an inspection and, in appropriate circumstances, the examiner may need to consult with Federal Reserve Bank legal counsel. Trust examiners routinely review such matters in connection with individual trust examinations. The inspection objectives will be to determine whether the holdings of shares of other banks or bank holding companies, in a fiduciary capacity, are appropriately monitored to comply with section 3(a) of the Bank Holding Company Act with other reporting requirements for such holdings.

The spin-off or sale of property by a bank holding company may not sever the bank holding company's control relationship over such property for purposes of the Bank Holding Company Act. The factors which are normally considered in determining whether control has ceased include the presumptions of control listed in section 225.31(a) of Regulation Y and in sections 2(a)(2) and 2(g) of the Act, and certain ownership and voting rights.

Most of the irrebuttable and rebuttable presumptions of control were written to establish initially a control relationship between two companies. Only the provisions of section 2(g)(3) relate solely to a continued control relationship after an attempt has been made to end that control. However, all of the presumptions of control must be considered before presuming that a divestiture is effective. Irrebuttable control relationships are established, or continue to be recognized, when any of the conditions listed in section 225.2(e) of Regulation Y or sections 2(a)(2)(A), 2(a)(2)(B), 2(g)(1), or 2(g)(2) of the Act exist. Thus, a company is assumed to have irrebuttable control over a bank or another company without a Board determination if:

1. The company directly or indirectly owns, controls, or has power to vote 25 percent or more of the voting securities of the bank or other company;
2. The company controls in any manner the election of a majority of the directors or trustees of the bank or other company;
3. Trustees directly or indirectly hold or control shares of the bank or other company for the benefit of the company, the shareholders or members of the company, or the employees of the company.

Rebuttable presumptions of control are listed in section 225.31(d) of Regulation Y and in sections 2(a)(2)(C) and 2(g)(3) of the Act. These sections describe situations which are not as clearly defined as the irrebuttable presumptions. For example, a company which enters into a management contract that gives the company significant control over the operations or management of a bank or other company may be deemed to exercise a controlling influence over that bank or other company. Section 225.31(c) of Regulation Y and section 2(a)(2)(C) of the Act require a Board determination to establish that a company directly or indirectly exercises a controlling influence over the management or policies of a bank or other company. Thus, it is assumed that no control exists unless the Board determines that it does. Section 2(g)(3) of the Act, however, is ''automatic'' in the sense that an effective control relationship is assumed to continue without the need for a determination by the Board if certain conditions are met. This presumption is ''rebuttable'' because, at the request of the company, the Board later may determine that the control relationship in fact does not exist.

Section 2(g)(3) was added to the Act with the 1966 Amendments to provide the Board with an opportunity to consider the consequences of a transfer before it is deemed to be effective. It states that:

> ''shares transferred after January 1, 1966, by any bank holding company (or by any company which, but for such transfer, would be a bank holding company) directly or indirectly to any transferee that is indebted to the transferor, or has one or more officers, directors, trustees, or beneficiaries in common with or subject to control by the transferor, shall be deemed to be indirectly owned or controlled by the transferor unless the Board, after opportunity for hearing, determines that the transferor is not in fact capable of controlling the transferee.''

Section 2(g)(3) contains the factors most commonly cited as reasons for a control determination; i.e., the purchaser is indebted to the divesting company or has officers or directors in common with the divesting company. If the transferee is indebted to or has personnel in common with the transferor, an effective control relationship is assumed to continue at the date of the transfer without the need for an order or a determination by the Board. Control will continue to be presumed until either the condition causing the presumption is removed or the Board determines, that ''the transferor is not in fact capable of controlling the transferee.''

Although section 2(g)(3) refers to transfers of ''shares'' it is not limited to the disposition of corporate stock, but includes any transfer of a ''significant volume of assets.'' Thus, when the transfer constitutes the disposition of all or substantially all of the assets of a subsidiary or a separate activity of the company, it is deemed to represent a transfer of ''shares.'' General or limited partnership interests are included in this definition. A determination of whether the volume of assets transferred is ″significant'' will be made on an *ad hoc* basis. Included in the definition of ''shares'' are shares or other assets acquired in satisfaction of a debt previously contracted, or acquired as an incident to an essentially separate transaction.

The term ''transferor'' includes the bank holding company, its parent, and its subsidiaries. Likewise, ''transferee'' includes the parent and subsidiaries of any company to which assets are transferred. Thus, when the transferee, its parent, or its subsidiary is indebted to or has common personnel with the transferor, its parent, or its subsidiary, a presumption under section 2(g)(3) arises. For example, if a subsidiary of the transferee is indebted to the parent of the transferor, the presumption arises.

The term ''transferee'' has been interpreted also to include individuals. Thus, if property is transferred to an individual who holds a position with or is indebted to the transferor, its parent, or its subsidiaries, the presumption arises.

The indebtedness to which section 2(g)(3) refers may be debt incurred in connection with the transfer, or pre-existing debt. For instance, if a bank holding company transfers to an outside individual a subsidiary to which it had made a working capital loan, the presumption of control arises as a result of that debt. Although a presumption arises even when the debt was previously in existence, this factor may not be viewed as an indication of control in determinations pursuant to section 2(g)(3).

The statutory presumption of control in section 2(g)(3) will not apply in certain cases if the indebtedness of the transferee to the transferor or a subsidiary involves certain routine loans to companies (as defined in section 2(b) of the Act) in an aggregate amount not exceeding 10 percent of the total purchase price of the transferred asset; or certain personal loans to an individual such as a credit card balance, student loan or home mortgage loan. Such loans must have been made on normal terms in the ordinary course of business, and may not be secured by the transferred asset.

The phrase ''officers, directors, trustees, or beneficiaries'' has been interpreted to include policy-making employees or consultants, general partners in a partnership, or limited partners having a right to participate in management, and any person who performs (directly or through an agent, representative, or nominee) functions comparable to those normally associated with the foregoing offices or positions. The presumption is valid even if the position is held in an honorary or advisory capacity. The presumption is also valid even if the person involved does not hold the same type of position with the transferor as with the transferee or the transferred company. For example, if a bank holding company sells assets to a trust whose trustee is an officer of the holding company, the presumption is applicable.

When a divestiture takes place through the distribution of shares, quite often officers and directors will receive a portion of the shares. Because these individuals are considered to be transferees and because they are officers or directors of the transferor, a presumption of control under section 2(g)(3) results. However, the presumption will be of legal significance only when the shares subject to this presumption constitute more than 5 percent of the voting stock of a nonbanking company or 25 percent or more of the voting stock of a bank (5 percent if the transferor continues to be a bank holding company without reference to the shares transferred).

Finally, section 2(g)(3) provides that a Board determination will be made after opportunity for hearing. When the Board's General Counsel, acting under delegated authority, has determined that a control situation does continue to exist, the case will be referred to the Board for a decision and an opportunity for hearing will be made through publication of a notice in the *Federal Register.*

In addition to the review of the applicability of each of the conclusive and rebuttable presumptions of control, a review of certain ownership and voting rights will be made before a divestiture is considered effective. Generally, the Board has not regarded a divestiture of holdings of voting shares to less than 25 percent, but more than 5 percent, as effective though in most cases an acquisition of less than 25 percent of a company would not result in that company being regarded as a subsidiary. This policy pertains because the retention of such an economic interest in such a company could provide an incentive for the transferor to influence the management of the company. However, the reduction of ownership to less than 5 percent of the outstanding voting stock of a company usually is considered to be an effective divestiture. In addition, due to its continuing economic interest, a bank holding company cannot effectively divest of a company by converting its holdings of the company's voting shares to nonvoting shares or by agreeing not to vote the shares.

2090.6.1 INSPECTION OBJECTIVES

1. To determine whether or not the divesting company retained a significant voting or ownership interest in the divested property.
2. To determine whether section 2(g)(3) of the Act or any of the rebuttable presumptions of control listed in section 225.31(d) of Regulation Y raise a control issue with regard to the transferor and the transferee or the transferred property.
3. To determine whether section 2(g)(2) of the Act or any of the other irrebuttable presumptions of control listed in section 225.2(e) of Regulation Y raise a control issue with regard to the transferor and the transferee or the transferred property.

2090.6.2 INSPECTION PROCEDURES

The examiner should review the stock records of the transferor, the transferee, and the transferred entity, if possible. Management contracts, trust agreements, and any pertinent agreements among these parties also should be reviewed for any evidence of a control relationship. When following these procedures for a bank holding company which has divested or will divest of property, the examiner should be aware that the criteria for establishing a continuing control relationship are more stringent than those for establishing an initial control relationship. Thus, the examiner should review all ownership and voting rights rather than just those above 5 or 25 percent.

The examiner should review the records of the bank holding company, its parents, and its subsidiaries as well as the records of the company being divested and the company (and its parent and subsidiaries) acquiring the divested property for evidence of a continuing control relationship as described in section 2(g)(3) of the Act. If the transferee is an individual or if the records of the transferee are not available, the examiner should inquire whether any of the specific control relationships exist. Specifically, the examiner should determine whether the transferee, its parent, or its subsidiaries, are indebted to or have common personnel (officers, directors, trustees, beneficiaries, policy making employees, consultants, etc.) with the transferor, its parent, or its subsidiaries.

2090.6.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Presumptions of control	Sections 2(g)(1) and 2(g)(2) of the act	225.31(a) 225.139		
Statement of policy concerning divestitures		225.138		
Divestiture proceedings		225.32		
Rebuttable presumptions of control	Section 2(g)(3) of the act	225.31(d) 225.139		
Requirements placed on transferee and transferor to ensure a complete separation				Alfred I. duPont Testamentary Trust; September 21, 1977
Control is not terminated if a rebuttable presumption of control is applicable				Alfred I. duPont Testamentary Trust; October 3, 1977
Explanation of ‘‘transferor,’’ ‘‘transferee,’’ ‘‘shares,’’ and procedures		225.139(c)(1)		1978 FRB 211

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
"Transferee" includes individuals		225.139 (footnote 4)		Summit Home Insurance Company, Minneapolis, Minnesota; August 30, 1978 The Moody Foundation, Galveston, Texas; January 16, 1968
Presumption of control through common directors, officers, etc.		225.139		GATX Corporation, Chicago, Illinois; February 21, 1978
Reduction of ownership to less than 5 percent of a subsidiary is an effective divestiture				Financial Securities Corporation, Lake City, Tennessee; August 29, 1972
Individual may be a transferee; an insignificant debt relationship may exist		225.139		Mercantile National Corporation, Dallas, Texas; June 2, 1975
Control terminated although shares were pledged as collateral on a note representing part of purchase price				Equimark Corporation, Pittsburgh, Pennsylvania; February 4, 1977
Application to retain control pursuant to rebuttable presumption; approved, but company not authorized to acquire additional shares				First Bancorp, Inc., Dallas, Texas; February 22, 1977
Application to divest control pursuant to rebuttable presumption; approved				Commanche Land and Cattle Company, Commanche, Texas; January 15, 1980
Indebtedness of transferee to transferor		225.139(c)(4)		1980 FRB 237

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

2090.7.1 CEBA AND FIRREA PROVISIONS FOR NONBANK BANKS

The Competitive Equality Banking Act (CEBA), effective August 10, 1987, amended section 2(c) of the BHC Act by expanding the definition of ''bank'' to include all FDIC-insured depository institutions. The definition also includes any other institution that (1) accepts demand deposits or other deposits that the depositor may make payable to third parties (''demand deposits'') and (2) is engaged in the business of making commercial loans. The new definition covers institutions that were not previously covered by the BHC Act (''nonbank banks''). Thrift institutions that remain primarily residential mortgage lenders continue to be excepted from the definition of ''bank.''

CEBA amended section 4 of the BHC Act by adding a grandfather provision that permits a nonbanking company that on March 5, 1987, controlled an institution that became a bank under CEBA to retain the institution and not be treated as a bank holding company. A grandfathered company will lose its exemption, however, if it violates any of several prohibitions governing its activities. Among these prohibitions, a grandfathered company may not acquire control of an additional bank or a thrift institution or acquire more than 5 percent of the assets or shares of an additional bank or thrift.[1] In addition, no bank subsidiary of the grandfathered company may commence to accept demand deposits and engage in the business of making commercial loans. A bank subsidiary of the grandfathered company also may not permit an overdraft[2] (including an interday overdraft) or incur an overdraft on behalf of an affiliate[3] at a Federal Reserve Bank.[4]

If a grandfathered company no longer qualifies for an exemption, the company must divest control of all the banks it controls within 180 days after the date that the company receives notice from the Board that it no longer qualifies for the exemption. The exemption may be reinstated if, before the end of the 180-day notice period, the company (1) corrects the condition or ceases the activity that caused its exemption to end or submits a plan to the Board for approval to correct the condition or cease the activity within one year, and (2) implements procedures reasonably adapted to avoid a recurrence of the condition or activity.

The Board may examine and require reports of grandfathered companies and of the nonbank banks they control, but only to monitor or enforce compliance with the grandfather restrictions. The Board also may use civil enforcement powers, including cease-and-desist orders, to enforce compliance.

Grandfathered companies, their affiliates, and their nonbank banks also are subject to the anti-tying restrictions of the BHC Act and to the insider-lending restrictions of section 22(h) of the FRA and in Regulation O. Thus, for example, a nonbank bank may not condition a grant of credit on the purchase of a product or service from its grandfathered holding company, or vice versa, and it may not extend credit to insiders of the nonbank bank or its grandfathered holding company on preferential terms.

A bank holding company that controls a nonbank bank may retain it as long as the nonbank bank does not (1) engage in an activity[5] that

1. An exception to this prohibition is made for cases involving the acquisition of a failing thrift provided that (1) the thrift is acquired in an emergency acquisition and is either located in a state where the grandfathered company already controls a bank or has total assets of $500 million or more at the time of the acquisition; or (2) the thrift is acquired from the RTC, FDIC, or director of the OTS in an acquisition in which federal or state authorities find the institution to be in danger of default.

2. Section 225.52 of Regulation Y further defines the restrictions on overdrafts.

3. Section 225.52(b)(2)(ii) of Regulation Y provides that a nonbank bank (or industrial bank) incurs an overdraft on behalf of an affiliate when (1) the nonbank bank holds an account at a Federal Reserve bank for an affiliate from which third-party payments can be made, and (2) the posting of an affiliate's transactions to the nonbank bank's or industrial bank's account creates an overdraft or increases the amount of an existing overdraft in the account.

4. The overdraft prohibition does not apply if the overdraft (1) results from an inadvertent computer or accounting error that is beyond the control of both the bank and the affiliate; (2) is permitted or incurred on behalf of an affiliate that is monitored by, reports to, and is recognized as a primary dealer by the Federal Reserve Bank of New York and is fully secured, as required by the Board, by direct U.S. obligations, obligations fully guaranteed as to principal and interest by the United States, or securities or obligations eligible for settlement by the Federal Reserve book-entry system; or (3) is permitted or incurred by or on behalf of an affiliate in connection with an activity that is financial in nature or incidental to a financial activity and does not cause the bank to violate any provision of sections 23A or 23B of the Federal Reserve Act directly or indirectly or by virtue of section 18(j) of the Federal Deposit Insurance Act.

5. Previously, a nonbank bank could accept demand deposits *or* engage in the business of making commercial loans, but could not engage in both activities.

would have caused it to be a bank before the effective date of CEBA, or (2) increase the number of locations from which it does business after March 5, 1987. These limitations do not apply if (1) the nonbank bank is viewed as an additional bank subsidiary of the bank holding company, and (2) the BHC's acquisition of the nonbank bank would be permissible under the interstate banking provisions of the BHC Act.

2090.7.2 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Limitations on nonbank banks		225.52		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), effective August 9, 1990, provided [12 U.S.C. 1815 (e)] that any insured depository institution will be liable for any actual or reasonably anticipated loss incurred or to be incurred by the FDIC in connection with:

1. The default of a commonly controlled[1] depository institution; or
2. Any assistance provided by the FDIC to any commonly controlled insured depository institution.

2090.8.1 FIVE YEAR PROTECTION FROM LIABILITY (5-YEAR TRANSITION RULE)

Sister banks, for five years from the enactment of the law, are protected against losses due to the default of a thrift acquired before enactment. The law also grants a five- year protection to thrifts for loss due to the default of a bank acquired before the law's enactment.

2090.8.2 CROSS-GUARANTEE PROVISIONS

FIRREA contains cross-guarantee provisions. These provisions enable the FDIC to obtain reimbursement from insured depository institutions, in the event that the FDIC incurs a loss due to any assistance provided to, or a default of, a commonly controlled bank or thrift.

The FDIC will provide written notice when an insured depository institution is being held liable for losses sustained by the FDIC in connection with assistance to a commonly controlled bank or thrift. Upon receipt of the written notice from the FDIC, the insured depository institution is required to pay the amount specified. An insured depository institution is not liable for losses incurred by the FDIC, in connection with a commonly controlled institution, if the written notice is not received within two years from the date of the FDIC's loss.

The liability the insured depository institution has to the FDIC is senior to shareholders' claims and any obligation or liability owed to any affiliate of the depository institution.[2] Claims of the FDIC against the depository institution are subordinate to any deposit liabilities, secured obligations and obligations that are subordinated to depositors (i.e. subordinated debt).

The FDIC may grant an insured depository institution a waiver of the cross-guarantee provisions, if it determines that such an exemption is in the best interests of the either the Bank or Savings Association Insurance Funds. Limited partnerships and affiliates of limited partnerships (other than an insured depository institution, which is a majority owned subsidiary of such partnership) may also be exempted from the provisions, if the limited partnership or its affiliate has filed a registration statement with the Securities and Exchange Commission, on or before April 10, 1989. The registration statement must indicate that as of the date of the filing, the partnership intended to acquire one or more insured depository institutions. If an insured depository institution is granted an exemption from the cross-guarantee provisions, then the institution and all of its insured depository institution affiliates must comply with the restrictions of sections 23A and 23B of the Federal Reserve Act without regard to section 23A(d)(1) which provides for certain exemptions.

2090.8.3 EXCLUSION FOR INSTITUTIONS ACQUIRED IN DEBT COLLECTIONS

FIRREA provides an exclusion from the cross-guarantee provisions for an institution acquired in securing or collecting a debt previously contracted in good faith. However, during the entire exclusion period, the controlling bank and all of its insured depository institution affiliates must comply with sections 23A and 23B of the Federal Reserve Act (FRA),[3] for transactions with the insured depository institution involving acquisitions as a result of debts previously contracted in good faith.

1. Depository institutions are commonly controlled if:
   a. Such institutions are controlled by the same depository institution holding company (including any company, such as nonbank banks, that are required to file reports under [12 U.S.C. 1843(f)(6)]; or
   b. One depository institution is controlled by another depository institution.

2. Does not apply to any obligation to affiliates secured as of May 1, 1989.
3. Without regard to section 23A(d)(1) of the FRA.

Foreign Banking Organizations

Section 2100.0

The subsections following this introduction address the Board's supervisory authority over, and reporting requirements for foreign banking organizations. Supervisory policy statements issued by the Board or the Federal Financial Institutions Examination Council in conjunction with other federal financial institution regulatory agencies are also discussed. Foreign banks continue to expand their operations in the United States and are significant participants in the U.S. banking system. As of December 31, 1991, 313 foreign banks operated 529 state-licensed branches and agencies (of which 53 had FDIC insurance) and 84 branches and agencies licensed by the Office of the Comptroller of the Currency (of which 9 had FDIC insurance). Foreign banks also directly owned 11 Edge corporations and 13 commercial lending companies. In addition, foreign banks held an interest of at least 25 percent in 90 U.S. commercial banks. Together, these foreign banks controlled approximately 24 percent of U.S. banking assets.

The Federal Reserve has broad authority for the supervision and regulation of foreign banks that engage in banking in the United States through branches, agencies, and commercial lending companies. Foreign banks owning Edge corporations or U.S. banks are more directly subject to Federal Reserve supervision—in the former case as the Edge's chartering authority and in the latter as primary supervisor of bank holding companies. In all cases, the Board is primarily responsible for supervising the U.S. nonbanking operations of foreign banks with a U.S. banking presence.

Before the December 19, 1991 passage of the Federal Deposit Insurance Corporation Improvement Act, the Federal Reserve had residual authority to examine all branches, agencies, and commercial lending subsidiaries of foreign banks in the United States. The International Banking Act of 1978 instructed the Federal Reserve to use, to the extent possible, the examinations reports of other state and federal regulators. The FDICIA amended the International Banking Act and increased the Federal Reserve's authority with respect to these foreign bank operations, including representative offices, in the United States. The Federal Reserve may coordinate the examinations of foreign bank operations with other state and federal regulators. Branches and agencies are now required to be examined at least once during each twelve-month period in an on-site examination.

The FDICIA also authorized the Federal Reserve to terminate the operations of foreign banks in the United States under certain conditions. The legislation requires Federal Reserve approval to establish foreign bank branches, agencies, commercial lending subsidiaries, and representative offices in the United States.

2100.1.1 POLICY STATEMENT ON THE SUPERVISION AND REGULATION OF FOREIGN BANKING ORGANIZATIONS

On February 23, 1979, the Board issued a statement of policy on supervision and regulation of foreign banking organizations that control a U.S. subsidiary bank. The policies set forth in this statement continue to provide the framework within which the Board analyzes foreign bank acquisitions of U.S. banks. The Board has stated in a number of cases it has acted upon since 1984, that it views as ''a negative factor'' the failure of a foreign bank's stated capital ratio to meet the Board's capital adequacy guidelines. In addition to certain mitigating factors such as the existence of ''hidden reserves'' or a highly liquid funding position, the Board has relied upon assurances and commitments that the capital adequacy of the U.S. bank subsidiary will be maintained at a high level to offset this ''negative factor.'' Following are major excerpts from the policy statement.

The Board of Governors has a number of supervisory responsibilities over the operations of foreign banking organizations in the United States under the Bank Holding Company Act and under the International Banking Act of 1978. In order to inform the public and the banking industry, the Board issued this statement setting forth its policy toward regulating foreign bank holding companies in the United States.

Bank supervision in the United States has as a principal objective, the promotion of the safety and soundness of banking institutions as going concerns serving depository and credit needs of their communities and the economy as a whole. To this end, a number of standards have been established governing domestic entry into the banking business and ongoing supervision of banking operations of domestic banks and bank holding companies.

In urging legislation to provide for federal regulation of foreign banks in the United States, the Board endorsed the principle of national treatment, or nondiscrimination, as a basis for the rules governing the entry and subsequent operations of foreign banks in this country. The International Banking Act of 1978 generally incorporates that principle in its provisions.

The Board continues to believe that the principle of national treatment should be the guiding rule in administering the Bank Holding Company Act and the International Banking Act of 1978 as they affect foreign banks. Following this rule, the Board believes that in general, foreign banks seeking to establish banks or other banking operations in the United States should meet the same general standards of strength, experience and reputation as required for domestic organizers of banks and bank holding companies. The Board also believes that foreign banks should meet on a continuing basis these standards of safety and soundness if they are to be a source of strength to their U.S. banking operations.

At the same time, the Board is cognizant that foreign banks operate outside the United States in accordance with different banking practices and traditions and in different legal and social environments. The Board also recognizes that its supervisory responsibilities are for the safety and soundness of U.S. banking operations. Its supervisory concerns for the operations and activities of foreign banks outside the United States are, therefore, limited to their possible effects on the ability of those banks to support their operations inside the United States. As embodied in both the Bank Holding Company Act and the International Banking Act of 1978, it is the general policy of the Board not to extend U.S. bank supervisory standards extraterritorially to foreign bank holding companies. The Board will give due regard to these factors in applying the principle of national treatment.

The Board has jurisdiction over foreign entry in the case of foreign organizations seeking to acquire U.S. banks. Whenever a foreign bank applies to become a bank holding company, the Board will seek to assure itself of the foreign bank's ability to be a source of financial and managerial strength and support to the U.S. subsidiary bank. In reaching this judgment, the Board will analyze the financial condition of the foreign organization, evaluate the record and integrity of management, assess the role and standing of the bank in its home country, and request the views of the bank regulatory authorities in the home country. In connection with its financial analysis, the Board will require sufficient information to permit an assessment of the financial strength and operating performance of the foreign organization. Information will consist of reports prepared in accordance with local practices together with an explanation and reconciliation of major differences between local accounting standards and U.S. generally accepted accounting procedures including full information on earnings, capital, charge-offs, and reserves. The Board will also continue to work with bank supervisory authorities of other major countries to improve overall cooperation in international bank regulation.

Once a foreign bank holding company has been established, Board supervisory procedures will be primarily directed at promoting the safety and soundness of the subsidiary U.S. banks. Examinations carried out by the relevant federal and/or State supervisory authority will continue to be the primary instrument for this purpose. Special attention will be given to transactions and correspondence between the U.S. subsidiary bank and its foreign parent and to monitoring credits by the U.S. bank to parties that are also customers of the parent. In particular, federal bank supervisors will expect the U.S. bank to maintain sufficient information on all borrowers to permit both the U.S. bank and bank examiners to make an independent appraisal of the bank's credits. In addition to the examination process, the Board will require foreign bank holding companies to report semiannually on transactions between the U.S. subsidiary bank and its foreign parent.

The Board requires submission of sufficient financial information to enable it to assess the operations and general condition of the parent institution. In particular, full information on earnings, reserves and capital will be required along with an explanation of major material differences between U.S. and foreign accounting practices. In its use and handling of the information, the Board will take into account the fact that much of the information required may be confidential commercial information that is not generally disclosed and the parent's majority owned subsidiaries.

2100.1.2 INTERAGENCY POLICY STATEMENT ON THE SUPERVISION OF U.S. BRANCHES AND AGENCIES OF FOREIGN BANKS

A second policy statement was issued on July 20, 1979, through the Federal Financial Institutions Examination Council on the supervision of U.S. branches and agencies of foreign banks. Principal excerpts from this statement are as follows:

The International Banking Act of 1978 gives the three Federal bank regulatory agencies expanded supervisory authority and responsibility with respect to the operations of foreign banks' U.S. branches, agencies, and commercial lending companies.[1] It provides for the establishment of Federal branches and agencies by the Office of the Comptroller of the Currency and permits U.S. branches to apply for insurance coverage by the Federal Deposit Insurance Corporation. It also subjects these U.S. offices to many provisions of the Federal Reserve and Bank Holding Company Acts.

In order to insure adequate supervision of these offices within the present Federal-State regulatory framework, the IBA provides that the Comptroller, the FDIC, and the various State authorities will have primary examining authority over the offices within their jurisdictions. Additionally, the Act gives the Federal Reserve Board residual examining authority over all U.S. banking operations of foreign banks, similar to its existing authority over U.S. subsidiary banks of bank holding companies. This distribution of responsibilities calls for close coordination of the efforts of the relevant authorities. Accordingly, the Comptroller, the FDIC, and the Board, in coordination with the Federal Financial Institutions Examination Council (FFIEC), issued this joint statement to inform the public and the banking industry of their supervisory policy toward these U.S. offices.

The agencies' supervisory interests in the operations of U.S. branches and agencies of foreign banks are directed to the safety and soundness of those operations in serving the needs of borrowers and depositors and other creditors in the United States. For this reason, the regulatory agencies place primary emphasis on assessing the financial well-being of the U.S. offices. They are also concerned with adherence to U.S. law and regulation by these offices.

At the same time, the agencies recognize that, even more than in the case of U.S. bank subsidiaries of foreign banks, the strength of these branches and agencies devolves from their head offices and organizations outside the United States and that ultimate responsibility for branch and agency activities resides in head offices overseas. Consequently, the agencies will seek to assure themselves that the parent institutions are financially sound. To this end, they will collect information on the consolidated operations of the foreign banks and expand their contacts with senior managements of the banks.

1. The term ''commercial lending companies'' is intended to refer to investment companies organized under Article XII of the New York State Banking Law, and any similar corporations that may be organized under the laws of other States.

Additionally, United States authorities are working and will continue to work with bank supervisory authorities of other nations to improve both the coordinated exchange of banking information and the compatibility of international banking regulation.

The International Banking Act of 1978 mandates that the Federal regulatory agencies cooperate closely with State banking authorities in examining U.S. offices of foreign banks. In furtherance of this mandate, a uniform approach to examining these offices has been developed through the FFIEC in order to minimize dual examinations and to facilitate joint Federal-State examinations, when desirable. In exercising their responsibilities, the agencies will ensure that each U.S. office of a foreign bank is examined regularly by either State or Federal authorities.

2100.1.3 BOARD REPORTING REQUIREMENTS FOR FOREIGN PARENT INSTITUTIONS

To gain information on the consolidated bank, the Board has developed reporting requirements for the foreign parent institutions. These information requirements are the same as those for foreign bank holding companies, including disclosure of specific information on earnings, reserves, and capital, and an explanation for material differences between U.S. and foreign accounting practices. In use and handling of this information, the (Board) will take into account the fact that some of the information required may be confidential commercial information that is not generally disclosed.

2110.0.1 STATUTORY TOOLS FOR FORMAL SUPERVISORY ACTION

Statutory tools are available to the Federal Reserve's Board of Governors if formal supervisory action is warranted against a bank holding company or its bank or nonbank subsidiaries, or against certain individuals associated with either of them. The objective of formal actions is to correct practices that the regulators believe to be unlawful, unsafe, or unsound. The initial consideration and determination of whether formal action is required usually results from the inspection process. This section dicusses the following topics:

1. Board jurisdiction under the law
2. actions or practices that may trigger the statutory remedies
3. Board staff procedures
4. the elements of a corrective order
5. temporary orders
6. written agreements
7. suspensions and removals
8. enforcement of orders
9. civil money penalties
10. termination of certain nonbank subsidiary activities or ownership

2110.0.2 TYPES OF CORRECTIVE ACTIONS

Generally, under 12 U.S.C. 1818(b), the Board may use its cease-and-desist authority and other enforcement tools against (1) a bank holding company, (2) a nonbank subsidiary of a bank holding company, and (3) any institution-affiliated party. Institution-affiliated party includes any director, officer, employee, controlling shareholder (other than a bank holding company), agent, person who has filed or is required to file a change in control notice, consultant, joint venture partner, or other person who participates in the conduct of the affairs of a bank holding company or nonbank subsidiary, and any independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly participates in any violation of law or regulation, any breach of fiduciary duty, or any unsafe or unsound practice that causes or is likely to cause more than a minimal financial loss to, or a significant adverse effect on, the institution. The Board's enforcement authority also extends to foreign financial institutions and their branches and agencies doing business in the United States, their nonbank subsidiaries, Edge Act and agreement corporations, and institution-affiliated parties of those entities.

2110.0.2.1 Cease-and-Desist Orders

When Board staff, in conjunction with the appropriate Federal Reserve Bank, determine that a cease-and-desist action is necessary, the Board may issue a notice of charges and of hearing to the offending institution or person. The notice of charges will contain a statement describing the facts constituting the alleged violations or unsafe or unsound practices. The issuance of the notice of charges and of hearing starts a formal process that may include the convening of an administrative hearing to be conducted before an administrative law judge, who makes a recommended decision to the Board. At the conclusion of the hearing process and after consideration of the proceeding by the Board, the Board may issue a final cease-and-desist order. Institutions and individuals who are subject to cease-and-desist orders that were issued as a result of contested proceedings can appeal the Board's issuance of the order to federal courts of appeal.

To abbreviate the period of litigation, the offending party or institution is permitted an opportunity to consent to the issuance of a cease-and-desist order without the need for the notice and an administrative hearing. Board staff has the option of first drafting a proposed cease-and-desist order and presenting the matter to the offenders for their consent before submission of the case to the Board. Banks (and bank holding companies) or individuals are advised that they may have legal counsel present at all meetings with Board or Reserve Bank staff concerning formal corrective actions. If the parties voluntarily agree to settle the case by the issuance of a consent cease-and-desist order, the terms of the settlement will be presented to the Board for its ratification and formal issuance of the order, at which time the order will be final and binding.

Once it is issued by the Board, a cease-and-desist order may require the persons or entity subject to the order to (1) cease and desist from the practices or violations or (2) take affirmative action to correct the violations or practices. Affirmative actions might include returning the holding company to its original condition (as it was before the practice or violation), having an individual reimburse the company for unauthorized or improper payments received, or both. Affirmative actions may also include (1) restitution, reimbursement, indemnification, or guarantee against loss if the person or entity was unjustly enriched by the violation or practice, or if the violation or practice involved a reckless disregard for the law, applicable regulations, or a prior order; (2) restrictions on growth; (3) disposition of any loan or asset; (4) rescission of agreements or contracts; (5) employment of qualified officers or employees; and (6) any other action the Board determines to be appropriate. Under 12 U.S.C. 1818(b)(3), it is clear that the cease-and-desist authority in section 8(b) of the Federal Deposit Insurance Act also applies to BHCs and Edge and agreement corporations, as well as to all institution-affiliated parties associated with them.

2110.0.2.2 Temporary Cease-and-Desist Orders

The Board may issue a temporary (emergency) cease-and-desist order for a violation of law, rule, or regulation, or for the undertaking of an unsafe or unsound practice that is likely to cause the insolvency of a subsidiary bank or company, cause the significant dissipation of a subsidiary bank's or BHC's assets or earnings, weaken the condition of the subsidiary bank or company, or otherwise seriously prejudice the interests of depositors. The Board may also issue a temporary order if it determines that an institution's books and records are so incomplete or inaccurate that the institution's financial condition or the details or purpose of any transaction cannot be determined through the normal supervisory process. The temporary order may require the same corrections as an order issued either on consent or after the full administrative process. The advantage of the temporary order is that it is effective immediately upon service on the entity or individual. The temporary order remains in effect pending the completion of the administrative process, unless set aside or modified by a court. Within 10 days of the service of the temporary order, the subject may appeal to a U.S. district court for relief from the order.

2110.0.2.3 Written Agreements

When circumstances warrant a less severe form of formal supervisory action, a formal written agreement may be used. A written agreement may be with either the Board or with the Reserve Bank under delegated authority (12 C.F.R. 265.11(a)(15)). All written agreements must be approved by the Board's staff director of the Division of Banking Supervision and Regulation and by the general counsel. The provisions of a written agreement may relate to any of the problems found at the institution or involving institution-affiliated parties.

2110.0.2.4 Removal Authority

In addition to its cease-and-desist authority, the Board is authorized by 12 U.S.C. 1818(e) to suspend and remove current or former institution-affiliated parties of bank holding companies and their nonbank subsidiaries for certain violations and activities. The Board may also prohibit permanently their future involvement with insured depository institutions, BHCs, and nonbank subsidiaries. The Board is authorized to issue a written notice of its intention to remove from office or prohibit from further participation (or, under certain conditions, to suspend immediately) any institution-affiliated party of a BHC whenever it determines the following:

1. The institution-affiliated party has directly or indirectly—
   a. violated any law, regulation, cease-and-desist order, condition imposed in writing, or any written agreement;
   b. engaged in any unsafe or unsound practice; or
   c. breached a fiduciary duty; and
2. because of the violation, practice, or breach—
   a. the institution has suffered or will suffer financial loss or other damage;
   b. the interests of depositors have been or could be prejudiced; or
   c. the institution-affiliated party has received financial gain or other benefit from the violation or practice; and
3. such violation, practice, or breach—
   a. involves personal dishonesty; or
   b. demonstrates a willful or continuing disregard for the safety or soundness of the institution.

If an institution-affiliated party's actions warrant immediate attention, the Board is authorized to temporarily suspend the person pending the outcome of the complete administrative process. An institution-affiliated party currently associated with a BHC may also be suspended or removed for cause based on actions taken while formerly associated with a different insured depository institution, BHC, or other business institution. ''Other business institution'' is not specifically defined in the statute so that it may be interpreted to include any other business interests of the institution-affiliated party.

Under 12 U.S.C. 1818(g), the appropriate federal banking agency is authorized to suspend from office or prohibit from further participation any institution-affiliated party charged or indicted for the commission of a crime involving personal dishonesty or breach of trust that is punishable by imprisonment for a term exceeding one year under state or federal law, if the continued participation might threaten either the interests of depositors or public confidence in the bank. The suspension can remain in effect until the criminal action is disposed of or until the suspension is terminated by the agency.

The statute also authorizes the Board to initiate removal or prohibition actions against (1) any institution-affiliated party who has committed a violation of any provision of the Bank Secrecy Act that was not inadvertent or unintentional, (2) any officer or director of a bank who has knowledge that an institution-affiliated party has violated the money-laundering statutes and did not take appropriate action to stop or prevent the recurrence of such a violation, or (3) any officer or director of a bank who violates the prohibitions on management interlocks. These removal or prohibition actions do not require a finding of gain to the individual, loss to the institution, personal dishonesty, or willful or continuing disregard for the safety or soundness of the institution.

2110.0.2.5 Termination of Nonbank Activity

The Board is authorized by 12 U.S.C. 1844(e) to order a bank holding company to terminate certain activities of its nonbank subsidiary (other than a nonbank subsidiary of a bank) or to sell its shares of the nonbank subsidiary. When the Board has reasonable cause to believe that the bank holding company's continuation of any activity or ownership or control of any of its nonbank subsidiaries constitutes a serious risk to the financial safety, soundness, or stability of the holding company, and if the activity, ownership, or control is inconsistent with sound banking principles or inconsistent with the purposes of the Bank Holding Company Act or the Financial Institutions Supervisory Act of 1966, the Board may order the bank holding company to terminate the activity or sell control of the nonbank subsidiary.

2110.0.2.6 Violations of Final Orders and Written Agreements

When any of the various types of formal enforcement orders discussed above has been violated, including a temporary cease-and-desist order, the Board may apply to a U.S. district court for enforcement of the action, and the court may order and require compliance. Violations of final orders and written agreements may also give rise to the assessment of civil money penalties against the offending institution or its institution-affiliated parties, as the circumstances warrant. The amount of the civil money penalty is the same as that described in the civil money penalty section below. Any institution-affiliated party who violates a suspension or removal order is subject to a criminal fine of up to $1 million, imprisonment for up to five years, or both, as well as a civil money penalty assessment or federal court action.

2110.0.2.7 Civil Money Penalties

The Board may assess civil money penalties against any institution or institution-affiliated party for (1) any violation of law or regulation, (2) any violation of a final cease-and-desist, temporary cease-and-desist, suspension, removal, or prohibition order, or with respect to federally insured depository institutions, any failure to comply with a prompt-corrective-action directive,[1] (3) any violation of a condi-

1. Prompt-corrective-action directives may be enforced in the federal courts, and they may cause any bank, company, or institution-affiliated party that violates the directive to be subject to civil money penalties. The failure of a bank to implement a capital-restoration plan, or the failure of a company having control of a state member bank to fulfill a guarantee that the company has given in connection with a capital plan accepted by the Federal Reserve, could subject the bank or company or any of its institution-affiliated parties to a civil money penalty assessment. See section 4133.1 of the Federal Reserve's *Commercial Bank Examination Manual.*

tion imposed in writing by the Board in connection with the granting of an application or other request, and (4) any violation of a written agreement.

The Board can assess a fine of up to $5,000 per day for any of these violations. A fine of up to $25,000 per day can be assessed for any of these violations if the offender recklessly engages in an unsafe or unsound practice in conducting the affairs of the institution, or if an individual breaches his or her fiduciary duty, when such violation, practice, or breach is part of a pattern of misconduct, causes or is likely to cause more than a minimal loss, or results in pecuniary gain or other benefit for the offender. A civil money penalty of up to $1 million per day can be assessed for any of these violations if the offender knowingly committed the violation, knowingly engaged in the unsafe or unsound practice, or knowingly breached his or her fiduciary duty and, in so doing, knowingly or recklessly caused a substantial loss to the financial institution or received substantial pecuniary gain or other benefit. Civil money penalties may also be assessed for any violation of the Change in Bank Control Act and for violations of the anti-tying provisions of federal banking law, among other provisions (12 U.S.C. 1972).

The Board may also assess civil money penalties for the submission of any late, false, or misleading reports required by the Bank Holding Company Act and Regulation Y of the Board of Governors. If a financial institution maintains procedures that are reasonably adapted to avoid inadvertent errors and unintentionally fails to publish any report, submits any false or misleading report or information, or is minimally late with the report, it can be assessed a fine of up to $2,000 per day. The financial institution has the burden of proving that the error was inadvertent under these circumstances. If the error was not inadvertent, a penalty of up to $20,000 per day can be assessed for all false or misleading reports or information submitted to the Board. If the submission was done in a knowing manner or with reckless disregard for the law, a fine of up to $1 million or 1 percent of the institution's assets can be assessed for each day of the violation. Notwithstanding the above, violations of the Bank Holding Company Act (with the exception of late, false, or inaccurate report violations as described above) may be addressed by the assessment of civil money penalties of not more than $25,000 per day.

2110.0.2.8 Publication

Under 12 U.S.C. 1818(u), the Board is required to publish and make publicly available any final order issued with respect to an administrative enforcement proceeding it has initiated. If the Board determines that publication would seriously threaten the safety and soundness of the institution, it may delay publication for a reasonable time. The Board is also required to publish any written agreement or other written statement, a violation of which may be enforced by the Board, as well as publish any modifications to or terminations of orders or agreements.

2110.0.2.9 Public Hearings

All hearings on the record, including contested cease-and-desist, removal, and civil money penalty proceedings, are open to the public. Transcripts of all testimony and copies of all documents, which could include examination and inspection reports and supporting documents (except those filed under seal), are made available to the public. These documents could include examiner's workpapers, file memorandums, reports of examination and inspection, and correspondence between a problem institution or wrongdoer and the Federal Reserve Bank. Appropriate actions should always be taken to ensure that all written material prepared in connection with any supervisory matter be accurate and free of insupportable conclusions or opinions.

2110.0.2.10 Subpoena Power

Under 12 U.S.C. 1818(n), which is made applicable to BHCs by 12 U.S.C. 1818(b)(3) and 1844(f), the Board has the authority to issue subpoenas directly or through its delegated representatives, and it has the authority to administer oaths or take depositions in connection with an examination or inspection. An examiner may find it necessary to apply some of these enforcement powers to collect certain information from unwilling sources.

2110.0.2.11 Interagency Notification

Any federal banking regulatory agency that proposes to take formal enforcement action (such as a cease-and-desist order, civil money penalty, or removal) must notify the other federal financial institution regulatory agencies (including the Office of Thrift Supervision) that such action is being taken. The Board must take similar steps in connection with actions against bank holding companies, their nonbank subsidiaries, and all institution-affiliated parties. In the case of an informal enforcement action, such as memorandums of understanding, notification must be made when there is an affiliation or inter-institution relationship. Notifications are to be made to a designated contact person specified by each agency.

With respect to federal–state agency coordination, the Federal Reserve provides the appropriate state supervisory authority with notice of its intent to institute a formal corrective action against a bank holding company. Pursuant to 12 U.S.C. 1818(m), the federal regulatory agencies are required to provide the appropriate state supervisory authority with notice of their intent to institute a formal corrective action against a state-chartered bank. This requirement is made applicable to bank holding companies, their nonbank subsidiaries, and all institution-affiliated parties by 12 U.S.C. 1818(b)(3). (See SR-97-5.)

2110.0.3 GOLDEN PARACHUTE PAYMENTS AND INDEMNIFICATION PAYMENTS

The Crime Control Act authorizes the Federal Deposit Insurance Corporation (FDIC) to prohibit or limit, by order or regulation, any golden parachute payment or indemnification payment an insured depository institution or bank holding company makes to any institution-affiliated party of an insured depository institution. In general, an indemnification payment reimburses an insider for a specified liability or cost that the person incurred (for example, a bank might indemnify a director for the cost of legal fees or even, theoretically, penalties in connection with a Federal Reserve investigation or enforcement action). Golden parachute payments are severance payments or agreements to make severance payments that are paid or entered into at a time when the bank or holding company is in a troubled condition. These payments require the prior written approval of the institution's primary regulator and the FDIC. A golden parachute payment includes a glorified severance payment to a former insider that is paid under specified circumstances. Although both types of payments fall under the same statute, section 18(k) of the Federal Deposit Insurance Act (the FDI Act) (12 U.S.C. 1828(k)), the two types of payments are quite different and distinct. However, some of the restrictions on these payments are the same or similar. The FDIC's regulations generally prohibit insured depository institutions and their holding companies from making golden parachute payments except in certain circumstances.[2]

The FDIC's regulations define a golden parachute payment to mean any payment in the nature of compensation (or agreement to make such a payment) for the benefit of any current or former institution-affiliated party of an insured depository institution or its holding company that meets four criteria. First, the payment or agreement must be contingent on the termination of the institution-affiliated party's employment or association. Second, the payment or agreement is received on or after, or made in contemplation of, among other things, a determination that the institution or holding company is in a troubled condition under the regulations of the applicable banking agency.[3] Third, the payment or agreement must be payable to an institution-affiliated party when an insured depository institution has been assigned a CAMELS composite rating of 4 or 5 under the Uniform Financial Institutions Rating System or when its holding company is assigned a composite rating of 4 or 5 or unsatisfactory under the Federal Reserve Bank Holding Company Rating System. Fourth, the payment or agreement is payable to an institution-affiliated party when the insured depository institution is subject to a proceeding to terminate or suspend its deposit insurance by the FDIC. Several other factors are also considered in determining whether a payment is a golden parachute.

The definition of a golden parachute payment also covers a payment made by a bank holding company that is not in a troubled condition to an institution-affiliated party of an insured depository institution subsidiary that is in a troubled condition, if the other criteria in the definition are met. This circumstance may arise when a bank holding company, as part of an agreement to acquire a troubled bank or savings associa-

2. See the FDIC's golden parachute regulations in 12 C.F.R. 359.

3. See section 225.71 of Regulation Y (12 C.F.R. 225.71), which defines a ''troubled condition'' for a state member bank or bank holding company as an institution that (1) has a composite rating of 4 or 5; (2) is subject to a cease-and-desist order or formal written agreement that requires action to improve the institution's financial condition, unless otherwise informed in writing by the Federal Reserve; or (3) is informed in writing by the Federal Reserve that it is in a troubled condition.

tion, proposes to make payments to the troubled institution's institution-affiliated parties that are conditioned on their termination of employment.[4]

A state member bank or bank holding company may make or enter into an agreement to make a golden parachute payment only (1) if the Federal Reserve, with the written concurrence of the FDIC, determines that the payment or agreement is permissible; (2) as part of an agreement to hire competent management in certain conditions, with the consent of the Federal Reserve and the FDIC as to the amount and terms of the proposed payment; or (3) pursuant to an agreement to provide a reasonable severance not to exceed 12 months' salary in the event of an unassisted change in control of the depository institution, with the consent of the Federal Reserve. In determining the permissibility of the payment, the Federal Reserve may consider a variety of factors, including the individual's degree of managerial responsibilities and length of service, the reasonableness of the payment, and any other factors or circumstances that would indicate that the proposed payment would be contrary to the purposes of the statute or regulations.

A state member bank or bank holding company requesting approval to make a golden parachute payment or enter into an agreement to make such a payment should submit its request simultaneously to the appropriate FDIC regional office and Reserve Bank. The request must detail the proposed payments and demonstrate that the state member bank or bank holding company does not possess and is not aware of any evidence that there is reasonable basis to believe, at the time the payment is proposed to be made, (1) that the institution-affiliated party receiving such a payment has committed any fraud, breach of fiduciary duty, or insider abuse or has materially violated any applicable banking law or regulation that had or is likely to have a material adverse effect on the bank or company; (2) that the individual is substantially responsible for the institution's insolvency or troubled condition; and (3) that the individual has violated specified banking or criminal laws.

If a state member bank or bank holding company makes or enters into an agreement to make a golden parachute payment without prior regulatory approval when such approval is required, appropriate follow-up supervisory action should be taken. The follow-up could include an enforcement action requiring the offending institution-affiliated party to reimburse the institution for the amount of the prohibited payment. The appropriate Reserve Bank supervisory staff, and also the appropriate staff of the Board's Division of Banking Supervision and Regulation, should be notified and consulted on the golden parachute–related issues. (See SR-03-06.)

Bank holding companies or banks (including state member banks) may seek to indemnify their officers, directors, and employees from any judgments, fines, claims, or settlements, whether civil, criminal, or administrative. The bylaws of some bank holding companies or banks may have broadly worded indemnification provisions, or they may have entered into separate indemnification agreements that cover the ongoing activities of their own institution-affiliated parties. Such indemnification provisions may be inconsistent with federal banking law and regulations, as well as safe and sound banking practices.

Supervisory and examiner staff should be alert to the limitations and prohibitions on indemnification imposed by section 18(k) of the FDI Act[5] and the regulations issued thereunder by the FDIC. The purpose of the law and regulations is to safeguard the assets of financial institutions and to preserve the deterrent effects of administrative enforcement actions by ensuring that individuals subject to final enforcement actions bear the costs of any judgments, fines, and associated legal expenses.

A ''prohibited indemnification payment'' includes any payment (or agreement to make a payment) by a bank holding company or federally insured bank to an institution-affiliated party to pay or reimburse such person for any liability or legal expense in any federal banking agency administrative proceeding that results in a final order or settlement in which the institution-affiliated party is assessed a civil money penalty, is removed or prohibited from banking, or is required to cease an action or take any affirmative action, including making restitution, with respect to the bank holding company or bank.[6] In cases in which the institution-

4. The FDIC's regulations exclude from the definition of a golden parachute payment several types of payments, such as payments made pursuant to a qualified pension or retirement plan; a benefit plan or bona fide deferred compensation plan (which are further defined in the FDIC's regulations); or a severance plan that provides benefits to all eligible employees, does not exceed the base compensation paid over the preceding 12 months, and otherwise meets the regulatory definition of nondiscriminatory and other conditions in the FDIC's regulations.

5. See 12 U.S.C. 1828(k).

6. See 12 C.F.R. 359.

affiliated party prevails, the institution can make a payment if the board of directors determines that the payment is in the best interest of the institution and it does not have a material adverse effect on the institution's safety and soundness.

The law and the FDIC's regulations reinforce the Federal Reserve's long-standing policy that an institution-affiliated party who engages in misconduct *should not* be insulated from the consequences of his or her misconduct. From a safety-and-soundness perspective, a federally insured bank should not divert its assets to pay a fine or other final judgment issued against an institution-affiliated party for misconduct that presumably violates the bank's policy of compliance with applicable law, especially when the individual's misconduct has already harmed the bank.

The senior management of bank holding companies and federally insured banks should oversee the review of the banking organization's bylaws, as well as any outstanding indemnification agreements and insurance policies, to ensure that they conform with the requirements of federal law and regulations. If a bank holding company or state member bank fails to take appropriate action to bring its indemnification provisions into compliance with federal laws and regulations, appropriate follow-up supervisory action may be taken. As part of the supervisory process, which will include merger and acquisition applications, the Federal Reserve's supervisory and examiner staff will review identified agreements having indemnification-related issues for compliance with federal law and regulations. (See SR-02-17.)

The Crime Control Act does not specifically authorize the Board to prohibit these payments. Whenever the Board becomes aware of such payments by a bank holding company or a state member bank, however, it will refer these matters to the FDIC for action. Also, the Board may use its general cease-and-desist authority to prohibit such payments if they are deemed to be an unsafe or unsound practice.

2110.0.4 APPOINTMENT OF DIRECTORS AND SENIOR EXECUTIVE OFFICERS

Under section 32 of the Federal Deposit Insurance Act (12 U.S.C. 1831i) and subpart H of Regulation Y (12 C.F.R. 225.71 et seq.), any state member bank or bank holding company that is in a troubled condition or does not meet minimum capital standards must provide 30 days' written notice to the Board of Governors before appointing any new director or senior executive officer.[7] This requirement also applies to any change in the responsibilities of any current senior executive officer who is proposing to assume a different senior officer position. Subpart H of Regulation Y details the procedures for filing and the content of the notice. The Board may disapprove a notice if it finds that the competence, experience, character, or integrity of the proposed individual indicates that his or her service would not be in the best interest of the institution's depositors or the public. A disapproved individual or the institution that filed the notice may appeal the Federal Reserve's notice of disapproval under the procedures detailed in Regulation Y. The individual may not serve as a director or senior executive officer while the appeal is pending. If a state member bank or bank holding company that is in a troubled condition appoints a director or senior officer without the required 30 days' prior written notice, appropriate follow-up supervisory action should be taken.

7. Under extraordinary circumstances, the Board or Reserve Bank may permit an individual to serve as a director or senior executive officer before a notice is provided; however, this permission does not affect the Federal Reserve's authority to disapprove a notice within 30 days of its filing.

2120.0.1 INTRODUCTION

On January 17, 1978, the three federal bank supervisory agencies issued a joint policy statement to address their concern with regard to the potential for improper payments by banks and bank holding companies in violation of the Foreign Corrupt Practices Act and the Federal Election Campaign Act.

While not widespread, the federal bank supervisory agencies were concerned that such practices could reflect adversely on the banking system and constitute unsafe and unsound banking practices in addition to their possible illegality.

The potential devices for making political payments in violation of the law could include compensatory bonuses to employees, designated expense accounts, fees or salaries paid to officers, and preferential interest rate loans. In addition, political contributions could be made by providing equipment and services without charge to candidates for office. Refer to F.R.R.S. at 3–447.1 and 4–875.

2120.0.2 SUMMARY OF THE FEDERAL ELECTION CAMPAIGN ACT

The Federal Election Campaign Act (FECA), enacted in 1971, was designed to curb potential abuses in the area of federal election financing. In general, FECA regulates the making of campaign contributions and expenditures in connection with primary and general elections to federal offices. Since 1907, federal law has prohibited national banks from making contributions in connection with political elections. FECA does not specifically address the making of contributions and expenditures by banks or other corporations to advocate positions on issues that are the subjects of public referenda. As originally enacted, FECA required disclosure of contributions received or expenditures made; however, amendments to the law in 1974 and 1976 imposed additional limitations on contributions and expenditures as well. The 1974 amendments also established the Federal Election Commission (Commission) to administer FECA's provisions. The Commission is responsible for adopting rules to carry out FECA, for rendering advisory opinions, and for enforcing the Act. The Commission was reorganized as a result of the FECA Amendments of 1976, and it has issued regulations interpreting the statute (11 C.F.R.).

2120.0.3 BANKS AND THE FECA

National banks and other federally chartered corporations are specifically prohibited from making contributions or expenditures in connection with *any* election; other corporations, including banks and bank holding companies, may not make contributions or expenditures in connection with *federal* elections. However, corporations may establish and solicit contributions to ''separate segregated funds'' to be used for political purposes; these are discussed in greater detail below.

State member banks and bank holding companies may make contributions or expenditures that are consistent with state and local law in connection with state or local elections. Because many states have laws that prohibit or limit political contributions or expenditures by banks, familiarization with applicable state and local laws is a necessity. According to the joint policy statement of the three banking agencies, a political contribution must meet not only the requirement of legality but also the standards of safety and soundness. Thus, a contribution or expenditure, among other things, must be recorded properly on the bank's books, may not be excessive relative to the bank's size and condition, and may not involve self-dealing.

Banks may make loans to political candidates provided the loans satisfy the requirements set out below.

2120.0.4 CONTRIBUTIONS AND EXPENDITURES

The words ''contribution'' and ''expenditure'' are defined broadly by FECA and the Commission's regulations to include any loan, advance, deposit, purchase, payment, distribution, subscription or gift of money or anything of value which is made for the purpose of influencing the nomination or election of any person to federal office. The payment by a third party of compensation for personal services rendered without charge to a candidate or political committee is also treated as a contribution by FECA, although the term does *not* include the value of personal services provided by an individual without compensation on a volunteer basis.

Although loans are included in the definitions of contribution and expenditure under FECA, a specific exemption is provided for bank loans made in the ordinary course of business and in accordance with applicable banking laws and regulations. The Commission's regulations provide, further, that in order for extensions of credit to a candidate, political committee or other person in connection with a federal election to be treated as a loan and not a contribution, they must be on terms substantially similar to those made to non-political debtors and be similar in risk and amount. The regulations also provide that a debt may be forgiven only if the creditor has treated it in a commercially reasonable manner, including making efforts to collect the debt which are similar to the efforts it would make with a non-political debtor. In considering whether a particular transaction is a contribution or a loan, it is expected that a factor would be the extent to which the creditor may have departed from its customary credit risk analysis.

FECA and the implementing regulation permit certain limited payments to candidates or their political committees. For example, payment of compensation to a regular employee who is providing a candidate or political committee with legal or accounting services which are solely for the purpose of compliance with the provisions of the FECA is exempt from the definitions of contribution and expenditure. The Commission's regulations also permit occasional use of a corporation's facilities by its shareholders and employees for volunteer political activity; however, reimbursement to the corporation is required for the normal rental charge for anything more than occasional or incidental use.

2120.0.5 SEPARATE SEGREGATED FUNDS AND POLITICAL COMMITTEES

FECA allows the establishment and administration by corporations of "separate segregated funds" to be utilized for political purposes. While corporate monies may not be used to make political contributions or expenditures, corporations may bear the costs of establishing and administering these separate segregated funds, including payment of rent for office space, utilities, supplies and salaries. These costs need not be disclosed under FECA. Commission regulations also permit a corporation to exercise control over its separate segregated fund.

In practice, most corporate segregated funds are administered by a group of corporate personnel, which, if the fund receives any contributions or makes any expenditures during a calendar year, constitutes a "political committee," as defined by FECA. As such, it is required to file a statement of organization with the Commission, to keep detailed records of contributions and expenditures, and to file with the Commission reports identifying contributions in excess of $200 and candidates who are recipients of contributions from the fund.

Solicitation of contributions to corporate segregated funds by political committees must be accomplished within the precise limits established by FECA. All solicitations directed to corporate employees must satisfy the following requirements: (1) the contribution must be entirely voluntary; (2) the employee must be informed of the political purposes of the fund at the time of the solicitation; and (3) the employee must be informed of his right to refuse to contribute without reprisal. Beyond those basic requirements, FECA distinguishes between "executive and administrative" personnel and other employees. The former and their families may be solicited any number of times, while the latter and their families may only be solicited through a maximum of two written solicitations per year, and these solicitations must be addressed to the employees at their homes. Solicitations may also be directed to corporate stockholders and their families in the same manner as to executive and administrative personnel.

Although a corporation, or a corporation and its subsidiaries, may form several political committees, for purposes of determining the statutory limitations on contributions and expenditures, all committees established by a corporation and its subsidiaries are treated as one. Thus, the total amount which all political committees of a corporation and its subsidiaries may make to a single candidate is $5,000 in any federal election (provided that the committees are qualified multicandidate committees under FECA).

2120.0.6 INSPECTION OBJECTIVES

1. To determine if the company has made improper or illegal payments in violation of either of these statutes, and regardless of legality, and whether they constitute an unsafe and unsound banking practice.

2. To determine if controls have been established to prevent unproper payments in violation of these statutes.

2120.0.7 INSPECTION PROCEDURES

1. Determine whether the company and its nonbank subsidiaries have a policy prohibiting improper or illegal payments, bribes, kickbacks, or loans covered by either the Foreign Corrupt Practices Act or the Federal Election Campaign Act.

2. Determine how the policy, if any, has been communicated to officers, employees, or agents of the organization.

3. Review any investigation or study performed by, or on behalf of, the board of directors that evaluates policy or operations associated with the advancement of funds in possible violation of the statutes mentioned above. In addition, ascertain whether the organization has been investigated by any other government agency in connection with possible violations of the statutes and, if this is the case, review available materials associated with the investigation.

4. Review and analyze any internal or external audit program employed by the organization to determine whether the internal and external auditors have established appropriate routines to identify improper or illegal payments under the statutes. In connection with the evaluation of the adequacy of any audit program, the examiner should:

a. Determine whether the auditor is aware of the provisions of the Foreign Corrupt Practices Act and the Federal Election Campaign Act and whether audit programs are in place which check for compliance with these laws;

b. Review such programs and the results of any audits; and

c. Determine whether the program directs the auditor to be alert to unusual entries or charges which might indicate that improper or illegal payments have been made to persons or organizations covered by the statutes.

5. Analyze the general level of internal control to determine whether there is sufficient protection against improper or illegal payments being irregularly recorded on the organization's books.

6. Both the examiner and assistants should be alert in the course of their usual inspection procedures for any transactions, or the use of organization services or equipment, which might indicate a violation of the statutes. Examination personnel should pay particular attention to:

a. Commercial and other loans (including participations), which may have been made in connection with a political campaign, to assure that any such loans were made in the ordinary course of business in accordance with applicable laws.

b. Income and expense ledger accounts for unusual entries including unusual debit entries (reductions) in income accounts or unusual credit entries (reductions) in expense accounts, significant deviations from the normal amount of recurring entries, and significant entries from an unusual source, such as a journal entry.

Procedure 7, following here, should only be undertaken in cases in which the examiner believes that there is some sufficient evidence indicating that improper or illegal payments have occurred. Such evidence would justify the implementation of these additional procedures.

7. Verification of audit programs and internal controls.

a. Randomly select charged-off loan files and determine whether any charged-off loans were made to (i) foreign government officials or other persons or organizations covered by the Foreign Corrupt Practices Act, or (ii) persons or organizations covered under the Federal Election Campaign Act.

b. For those significant income and expense accounts on which verification procedures have not been performed: (i) prepare an analysis of the account for the period since the last examination, preferably by month, and note any unusual fluctuations for which explanations should be obtained, and (ii) obtain an explanation for significant fluctuations or any unusual items through discussions with organization personnel and review of supporting documents.

2120.0.8 APPARENT VIOLATIONS OF THE STATUTES

Where violations of law or unsafe and unsound banking practices result from improper payments, the Federal Reserve System should exercise its full legal authority, including cease-and-desist proceedings and referral to the appropriate law enforcement agency for further action, to ensure that such practices are terminated. In appropriate circumstances, the fact that such payments have been made may reflect so adversely on an organization's management as to be a relevant factor in connection with the consideration of applications submitted by the organization.

In addition, the Reserve Bank should forward any information on apparent violations of the Federal Election Campaign Act to the Federal

Election Commission. The Federal Election Commission is authorized to enforce FECA. The Commission may be prompted to investigate possible illegal payments by either a sworn statement submitted by an individual alleging a violation of the law, or on its own initiative based on information it has obtained in the course of carrying out its supervisory responsibilities. When the Commission determines that there is probable cause to believe a violation has occurred or is about to occur, it endeavors to enter into a conciliation agreement with the violator. If, however, it finds probable cause to believe that a willful violation has occurred or is about to occur, it may refer the matter directly to the Department of Justice for possible criminal prosecution, without having first attempted conciliation.

If informal means of conciliation fail, the Commission may begin civil proceedings to obtain relief. Should the Commission prevail, a maximum penalty of a fine equal to the greater of $10,000 or 200 percent of the amount of the illegal payment may be imposed. Knowing and willful violations involving over $1,000 may subject the violator to a fine, up to the greater of $25,000 or 300 percent of the illegal payment, and imprisonment for up to one year.

2120.0.9 ADVISORY OPINIONS

Any person, including a bank or a corporation, may request an advisory opinion concerning the application of FECA or of the Commission's regulations to a specific transaction or activity in which that person wishes to engage. The Commission must render such advisory opinion within 60 days from receipt of a complete request. Banks or bank employees wishing to engage in activity which may be regulated by FECA are encouraged to request advisory opinions from the Commission.

Techniques, practices, and tools for credit-risk management are evolving rapidly, as are the challenges that banking organizations face in their business-lending activities. For larger institutions, the number and geographic dispersion of their borrowers make it increasingly difficult for such institutions to manage their loan portfolios simply by remaining closely attuned to the performance of each borrower. As a result, one increasingly important component of the systems for controlling credit risk at larger institutions is the identification of gradations in credit risk among their business loans, and the assignment of internal credit-risk ratings to loans that correspond to these gradations.[1] The use of such an internal rating process is appropriate and necessary for sound risk management at large institutions. See SR-98-25.

Certain elements of internal rating systems are necessary to support sophisticated credit-risk management. Supervisors and examiners, both in their on-site inspections and other contacts with banking organizations, need to emphasize the importance of development and implementation of effective internal credit-rating systems and the critical role such systems should play in the credit-risk-management process at sound large institutions. See SR-98-18 with regard to lending standards for commercial loans.

Internal rating systems are currently being used at large institutions for a range of purposes. At one end of this range, they are primarily used to determine approval requirements and identify problem loans. At the other end, they are an integral element of credit-portfolio monitoring and management, capital allocation, the pricing of credit, profitability analysis, and the detailed analysis to support loan-loss reserving. Internal rating systems being used for these latter purposes should be significantly richer and more robust than systems used for the purposes such as approval requirements and identifying problem loans.

As with all material financial institutional activities, a sound risk-management process should adequately illuminate the risks being taken. It should also cause management to initiate and apply appropriate controls that will allow the institution to balance risks against returns. Furthermore, the process should provide information as to the institution's overall appetite for risk, giving due consideration to the uncertainties faced by lenders and the long-term viability of the institution. Accordingly, large banking organizations should have strong risk-rating systems which should take proper account of gradations in risk. They should also consider (1) the overall composition of portfolios in originating new loans, (2) assessing overall portfolio risks and concentrations, and (3) reporting on risk profiles to directors and management. Moreover, such rating systems should also play an important role in (1) establishing an appropriate level for the allowance for loan and lease losses, (2) conducting internal analyses of loan and relationship profitability, (3) assessing capital adequacy, and possibly (4) administering performance-based compensation.

Examiners should evaluate the adequacy of internal credit-risk-rating systems, including ongoing development efforts, when assessing both asset quality and the overall strength of risk management at large institutions. Recognizing that a strong risk-rating system is an important element of sound credit-risk management for such institutions, examiners should specifically evaluate the adequacy of internal risk-rating systems at large institutions as one factor in determining the strength of credit-risk management. In doing so, examiners should be cognizant that an internal risk-identification and -monitoring system should be consistent with the nature, size, and complexity of the banking organization's activities.

2122.0.1 APPLICATION TO LARGE BANK HOLDING COMPANIES

The guidance provided in this section should be applied to all "large" bank holding companies. For this purpose, examiners should treat an institution as being "large" if its lending activities are sufficient in scope and diversity such that informal processes that rely on keeping track of the condition of individual borrowers are inadequate to manage its loan portfolio. In this context, those institutions with significant involvement in relevant secondary-market credit activities, such as securitization of business loans or credit derivatives, should have more elaborate and formal approaches for managing

1. For information on current practices in risk rating among large banking organizations, see "Credit Risk Rating at Large U.S. Banks," *Federal Reserve Bulletin,* November 1998, pp. 897–921.

the risks associated with these activities.[2] Whether or not they are active in such secondary-market credit activities, however, larger and complex institutions typically would require a more structured and sophisticated set of arrangements for managing credit risk than smaller regional or community institutions. In performing their evaluation, examiners should also consider whether other elements of the risk-management process might compensate for any specific weaknesses attributable to an inadequate rating system.

In addition, examiners should review internal management information system reports to determine whether the portion of loans in lower-quality pass grades has grown significantly over time, and whether any such change might have negative implications for the adequacy of risk management or capital at the institution. Examiners should also consider whether a significant shift toward higher-risk pass grades, or an overall large proportion of loans in a higher-risk pass grade, should have negative implications for the institution's asset-quality rating, including the adequacy of the loan-loss reserve. To some extent, such reviews are already an informal part of the current inspection process. Examiners should also continue the long-standing practice of evaluating trends in categories associated with problem assets.

Examiners should discuss these issues, including plans to enhance existing credit-rating systems, with bank management and directors. Inspection comments on the adequacy of risk-rating systems and the credit quality of the pass portfolio should be incorporated within the inspection report, noting deficiencies where appropriate.

2122.0.2 SOUND PRACTICES IN FUNCTION AND DESIGN OF INTERNAL RATING SYSTEMS

A consistent and meaningful internal risk-rating system is a useful means of differentiating the degree of credit risk in loans and other sources of credit exposure. This consistency and meaning is rooted in the design of the risk-grading system itself. Although assigning such risk ratings—as with ratings issued by public rating agencies—necessarily involves subjective judgment and experience, a properly designed rating system will allow this judgment to be applied in a structured, more or less formal manner.

Credit-risk ratings are designed to reflect the quality of a loan or other credit exposure, and thus, explicitly or implicitly, the loss characteristics of that loan or exposure. Increasingly, large institutions link definitions to one or more measurable outcomes such as the probability of a borrower's default or expected loss (which couples the probability of default with some estimate of the amount of loss to be incurred in the event a default occurs). In addition, credit-risk ratings may reflect not only the likelihood or severity of loss but also the variability of loss over time, particularly as this relates to the effect of the business cycle. Linkage to these measurable outcomes gives greater clarity to risk-rating analysis and allows for more consistent evaluation of performance against relevant benchmarks. The degree of linkage varies among institutions, however.

Although the degree of formality may vary, most institutions distinguish the risks associated with the borrowing entity (essentially default risk) from the risks stemming from a particular transaction or structure (more oriented to loss in event of default). In documenting their credit-administration procedures, institutions should clearly identify whether risk ratings reflect the risk of the borrower or the risk of the specific transaction. In this regard, many large institutions currently assign both a borrower and facility rating, requiring explicit analysis of both the loan's obligor and how the structure and terms of the particular loan being evaluated (that is, collateral or guarantees) might strengthen or weaken the quality of the loan.

The rating scale chosen should meaningfully distinguish gradations of risk within the institution's portfolio so that there is clear linkage to loan quality (and/or loss characteristics), rather than just to levels of administrative attention.[3]

2. Secondary-market credit activities generally include loan syndications, loan sales and participations, credit derivatives, and asset securitizations, as well as the provision of credit enhancements and liquidity facilities to such transactions. Such activities are described further in section 2129.05 and in SR-97-21.

3. See the December 1993 Interagency Policy Statement on the Allowance for Loan and Lease Losses in section 2010.7. The policy does not apply to bank holding companies directly. As they supervise their respective FDIC-insured financial institution subsidiaries, bank holding companies are advised to apply this supervisory guidance. Internal risk-rating systems and/or supporting documentation should be sufficient to enable examiners to reconcile the totals for the various internal risk ratings under the institution's system to the federal banking agencies' categories for those loans graded below "pass" (that is, loans classified as special mention, substandard, doubtful, or loss).

To do so, the rating system should be designed to address the range of risks typically encountered in the underlying businesses involving the institution's loan portfolio. One reflection of this degree of meaning is that there should be a fairly wide distribution of portfolio outstandings or exposure across grades, unless the portfolio is genuinely homogeneous. Many current rating systems include grades intended solely to capture credits needing heightened administrative attention, such as so-called ''watch'' grades. Prompt and systematic tracking of credits in need of such attention is an essential element of managing credit risk. However, to the extent that loans in need of attention vary in the risk they pose, isolating them in a single grade may detract from that system's ability to indicate risk. One alternative is the use of separate or auxiliary indicators for those loans needing such administrative attention.

Institutions whose risk-rating systems are least effective in distinguishing risk use them primarily to identify loans that are classified for supervisory purposes or that bank management otherwise believes should be given increased attention (that is, ''watch'' loans). Such systems contribute little or nothing to evaluating the bulk of loans in the portfolio—that is, loans for which no specific difficulties are present or foreseen. In some cases these institutions might also establish one or two risk grades for loans having very little perceived risk, such as those collateralized by cash or liquid securities or those to ''blue-chip'' private firms. Although the foregoing gradations are well-defined in terms of the relative credit risk they represent, the consequence for these least effective systems is that the bulk of the loan portfolio falls into one or two remaining broad risk grades—representing ''pass'' loans that are neither extremely low risk nor current or emerging problem credits—even though such grades may encompass many different levels of underlying credit risk.

2122.0.3 SOUND PRACTICES IN ASSIGNING AND VALIDATING INTERNAL RISK RATINGS

Experience and judgment, as well as more objective elements, are critical both in making the credit decision and in assigning internal risk grades. Institutions should provide clear and explicit criteria for each risk grade in their credit policies, as well as other guidance to promote consistency in assigning and reviewing grades. Criteria should be specified, even when addressing subjective or qualitative considerations, that allow for consistent assignment of risk grades to similarly risky transactions. Such criteria should include guidance both on the factors that should be considered in assigning a grade and how these factors should be weighed in arriving at a final grade.

Such criteria can promote consistency in assessing the financial condition of the borrower and other objective indicators of the risk of the transaction. One vehicle for enhancing the degree of consistency and accuracy is the use of ''guidance'' or ''target'' financial ratios or other objective indicators of the borrower's financial performance as a point of comparison when assigning grades. Banking organizations may also provide explicit linkages between internal grades and credit ratings issued by external parties as a reference point, for example, senior public debt ratings issued by one or more major ratings agencies. The use of default probability models, bankruptcy scoring, or other analytical tools can also be useful as supporting analysis. However, the use of such techniques requires institutions to identify the probability of default that is ''typical'' of each grade. The borrower's primary industry may also be considered, both in terms of establishing the broad characteristics of borrowers in an industry (for example, degree of vulnerability to economic cycles or long-term favorable or unfavorable trends in the industry) and of a borrower's position within the industry.

In addition to quantitative indications and tools, credit policies and ratings definitions should also cite qualitative considerations that should affect ratings. These might include factors such as (1) the strength and experience of the borrower's management, (2) the quality of financial information provided, and (3) the access of the borrower to alternative sources of funding. Addressing qualitative considerations in a structured and consistent manner when assigning a risk rating can be difficult. It requires experience and business judgment. Nonetheless, adequate consideration of these factors is important to assessing the risk of a transaction appropriately. In this regard, institutions may choose to cite significant and specific points of comparison for qualitative factors in describing how such considerations can affect the rating (for example, whether a borrower's financial statements have been audited or merely compiled by its accountants, or whether collateral has been independently valued).

Although the rating process requires the exercise of good business judgment and does not lend itself to formulaic solutions, some formalization of the process can be helpful in promoting accuracy and consistency. For example, the use of a ‘‘risk-ratings analysis form’’ can be important (1) in providing a clear *structure* for identifying and addressing the relevant qualitative and quantitative elements to be considered in determining internal risk grades, and (2) for *documenting* how those grades were set by requiring analysis or discussion of key quantitative and qualitative elements of a transaction.

Risk ratings should be reviewed, if not assigned, by independent credit-risk management or loan-review personnel both at the inception of a transaction and periodically over the life of the loan.[4] Such independent reviewers should reflect a level of experience and business judgment that is comparable to that of the line staff responsible for assigning and reviewing initial risk grades. Among the elements of such independent review should be whether risk-rating changes (and particularly downgrades) have been timely and appropriate. Such independent reviews of individual ratings support the discipline of the rating assignments by allowing management to evaluate the performance of those individuals assigning and reviewing risk ratings. If an institution relies on outside consultants, auditors, or other third parties to perform all or part of this review role, such individuals should have a clear understanding of the institution’s ‘‘credit culture’’ and its risk-rating process, in addition to commensurate experience and competence in making credit judgments.

Finally, institutions should track performance of grades over time to gauge migration, consistency, and default/loss characteristics to allow for evaluation of how well risk grades are being assigned. Such tracking also allows for *ex post* analysis of the loss characteristics of loans in each risk grade.

Because ratings are typically applied to different types of loans—for example, to both commercial real estate and commercial loans—it is important that each grade retains the same meaning to the institution (in terms of overall risk) across the exposure types. Such comparability allows management to treat loans in high-risk grades as a potential concentration of credit risk and to manage them accordingly. It also allows management and supervisors to monitor the overall degree of risk, and changes in the risk makeup, of the portfolio. Such consistency further permits risk grades to become a reliable input into portfolio credit-risk models.[5]

2122.0.4 APPLICATION OF INTERNAL RISK RATINGS TO INTERNAL MANAGEMENT AND ANALYSIS

As noted earlier, robust internal credit-rating systems are an important element in several key areas of the risk-management process. Although nearly all large institutions currently use risk ratings, many of the institutions need to further develop these systems so that they provide accurate and consistent indications of risk and sufficient granularity—finer distinctions among risks, especially for riskier assets. Described below are approaches to risk management and analysis that are based on robust internal risk-rating systems and that are currently being used at some banking organizations. These techniques appear to be emerging as sound practices in the use of risk ratings.

2122.0.4.1 Limits and Approval Requirements

Many large institutions have different approval requirements and thresholds for different internal grades, allowing less scrutiny and greater latitude in decision making for loans with lesser risk.[6] While this appears reasonable, institutions should also consider whether the degree of eased approval requirements (or the degree to which limits are higher) is supported by the degree of reduced risk and uncertainty associated with these lower-risk loans. If not, lesser requirements may provide incentives to rate loans too favorably, particularly in the current benign economic environment, with resulting underassessment of transaction risks.

2122.0.4.2 Reporting to Management on Credit-Risk Profile of the Portfolio

As part of reports that analyze the overall credit risk in the institution’s portfolio, management

4. See section 2010.10 regarding internal loan review.

5. For a discussion of these models and the role played by internal credit-risk ratings, see the May 1998 Federal Reserve System report, ‘‘Credit Risk Models at Major U.S. Banking Institutions: Current State of the Art and Implications for Assessments of Capital Adequacy,’’ prepared by the Federal Reserve System Task Force on Internal Credit-Risk Models.

6. See section 2160.0 for more general guidance involving risk evaluation and control.

and directors should receive information on the profile of actual outstanding balances, exposures, or both by internal risk grade.[7] Such information can thus be one consideration among others, such as concentrations in particular industries or borrower types, in evaluating an institution's appetite for originating various types of new loans. Portfolio analysis may range from simple tallies of aggregates by risk grade to a formal model of portfolio behavior that incorporates diversification and other elements of the interaction among individual loan types. In this more complex analysis, gradations of risk reflect only one among many dimensions of portfolio risk, along with potential industry concentrations, exposure to an unfavorable turn in the business cycle, geographical concentrations, and other factors.

2122.0.4.3 Allowance for Loan and Lease Losses

The makeup of the loan portfolio and the loss characteristics of each grade—including individual pass grades—should be considered, along with other factors, in determining the adequacy of an institution's allowance for loan and lease losses.[8]

2122.0.4.4 Pricing and Profitability

In competitive marketplaces, it is properly the role of bankers rather than supervisors to judge the appropriateness of pricing, particularly with regard to any single transaction or group of transactions. One way that some institutions choose to discipline their overall pricing practices across their portfolio is by incorporating risk-rating-specific loss factors in the determination of the minimum profitability requirements (that is, ''hurdle rates''). Following this practice may render such institutions less likely to price loans well below the level indicated by the long-term risk of the transaction. Given that bank lending, particularly pricing, can be highly competitive, the application of appropriate disciplines to pricing, in conjunction with a clear and meaningful assessment of the risks inherent in each transaction and in the portfolio as a whole, can be important tools in avoiding competitive future excessive practices.

2122.0.4.5 Internal Allocation of Capital

Those institutions that choose to allocate capital may use their internal risk grades as important inputs in identifying appropriate internal capital allocations. Use of appropriately allocated capital in evaluating profitability offers many advantages, including the incentive to consider both risk and return in making lending decisions rather than merely rewarding loan volume and short-term fee revenue. Under appropriate circumstances—that is, where internal capital allocations are sufficiently consistent, rigorous, and well-documented—such allocations may also be considered as a source of input for supervisory evaluations of capital adequacy.[9]

2122.0.5 INSPECTION OBJECTIVES

1. To evaluate whether the internal risk-identification and -monitoring systems are consistent with—
   a. sound practices in the function and design of internal rating systems;
   b. sound practices in assigning and reviewing internal risk ratings; and
   c. the nature, size, and complexity of activities within the banking organization.
2. To determine whether the level and volume of lower-quality pass grades of loans have grown significantly over time and whether any such trends should—
   a. have adverse implications for determining the adequacy of risk management and capital, and
   b. materially alter the institution's asset-quality ratings and valuations, and the examiner's evaluation of the adequacy of the allowance for loan and lease losses.
3. To determine whether improvements are needed in the credit-risk-management process and to discuss them with the board of directors and senior management.
4. To document the extent to which the institution has adopted current and emerging sound

7. See section 2010.2 regarding a bank holding company's supervision of its subsidiaries and loan administration. See also the more general financial analysis sections 4020.2 and 4060.1 with regard to evaluating the asset quality of subsidiary financial institutions and evaluating the asset quality of the holding company on a consolidated basis.

8. See footnote 3. Section 2010.7 emphasizes the bank holding company's responsibility as it supervises its subsidiaries with respect to each entity maintaining an adequate allowance for loan and lease losses.

9. See sections 4060.3 and 4060.4 regarding the evaluation of capital adequacy of bank holding companies.

practices in the use of internal ratings information in internal risk management and analysis.

5. To incorporate the examiner's evaluation of sound credit-risk-rating practices into the assessment of management and capital adequacy.

2122.0.6 INSPECTION PROCEDURES

1. Determine whether the institution is considered ''large'' for purposes of applying this section's guidance and procedures.
2. Evaluate the adequacy of internal credit-risk-rating systems, including ongoing development efforts, when assessing the quality and overall strength of risk management. Give particular attention to the following practices:
   a. *Function and design of internal rating systems.*
      - Ascertain whether the rating scale meaningfully distinguishes gradations of risk within the institution's portfolio evidencing clear linkage to loan quality and/or loss characteristics.
        - — Determine if the design of the rating system has an adequate number of internal ratings to distinguish among levels of risks in its portfolio, and whether the grades used address the range of risks typically encountered in the underlying businesses of the institution.
        - — Determine whether loans or exposures are broadly distributed across the internal grades.
        - — Establish if there are ''watch grades'' that are intended to capture loans needing heightened administrative attention, or whether separate or auxiliary indicators are used for such loans.
      - Determine whether credit-risk-rating definitions are linked to one or more measurable outcomes (for example, the probability of a borrower's default or expected loss).
   b. *Sound practices in assigning internal risk ratings.*
      - Determine whether loan policies provide clear and explicit criteria for each risk grade as to the risk factors that are to be considered in assigning a grade with respect to—
        - — financial analysis, including whether reference financial ratios or other objective indicators are used to indicate the borrower's financial performance;
        - — explicit linkages between the internal grades assigned and credit ratings issued by external parties (for example, senior public debt ratings by major rating agencies);
        - — default probability models, bankruptcy scoring, or other analytical tools used;
        - — analysis of a borrower's primary industry, considering both the broad characteristics of borrowers within that industry and the borrower's position within that industry; and
        - — qualitative factors (for example, the quality of the financial information that is provided, the borrower's access to alternative sources of funding, whether the financial statements were audited or merely compiled, or whether collateral was independently valued).
      - Determine whether loan policies provide clear and explicit guidance as to how these risk factors should be weighed in arriving at a final grade.
      - Determine whether the ratings assignment is well documented, possibly including the use of a risk-rating form to provide formalization and standardization of the quantitative and qualitative criteria elements used in rating borrowers and/or transactions.
      - Establish whether risk ratings are independently reviewed at the inception of a loan and periodically over the life of a loan, and whether risk-rating changes have been timely and appropriate (particularly downgrades).
      - Ascertain whether the performance of rating grades is tracked over time to evaluate migration, consistency, and default/loss characteristics and trends.
   c. *Application of internal risk ratings to internal management and analysis.*
      - Determine whether loan-approval requirements for each grade appear to be supported by the degree of risk and uncertainty associated with the respective loans.
      - Review internal management information system reports and determine

whether such reporting is adequate for the institution.

- Ascertain if the risk-rating-specific loss factors are used to determine risk pricing, minimum profitability requirements, and capital adequacy needs, and document the institution's progress in this regard.

3. Determine whether other risk elements may compensate for any specific weaknesses attributable to an inadequate rating system.
4. Review internal management information system reports to determine whether the portion of loans in lower-quality pass grades has grown significantly over time, and whether any such change might have negative implications for the adequacy of risk management or capital at the institution.
5. Determine whether a significant shift toward higher-risk pass grades, or an overall large proportion of loans in a higher-risk pass grade, should have negative implications for the institution's asset-quality rating, including the adequacy of the loan-loss reserve.
6. Evaluate trends in risk-rating categories associated with problem assets.
7. Discuss the results of the evaluations with management, including whether there are any plans to enhance existing credit-rating systems.
8. Prepare written comments for the inspection report on the adequacy of risk-rating systems and the credit quality of the pass portfolio, noting any deficiencies.

Full-scope inspections under a risk-focused approach must be performed to fulfill the objectives of a full-scope inspection, adjusted depending on the circumstances of the banking organization being evaluated. At a minimum, full-scope inspections should include sufficient procedures to reach an informed judgment on the assigned ratings for the factors addressed by the BOPEC rating system. The business of banking is fundamentally predicated on taking risks, and the components of the supervisory rating system are strongly influenced by risk exposure. Consequently, the procedures of full-scope inspections focus to a large degree on assessing the types and extent of risks to which a bank holding company and its subsidiaries are exposed, evaluating the organization's methods of managing and controlling its risk exposures, and ascertaining whether management and directors fully understand and are actively monitoring the organization's exposure to those risks. Given the Federal Reserve's responsibility for ensuring compliance with banking laws and regulations, inspections also include an appropriate level of compliance testing. (See SR-96-14.)

2124.0.1 TRANSACTION TESTING

Historically, Federal Reserve examinations and inspections have placed significant reliance on transaction-testing procedures. For example, to evaluate the adequacy of the credit-administration process, assess the quality of loans, and ensure the adequacy of the allowance for loan and lease losses (ALLL), a high percentage of large loan amounts have traditionally been individually reviewed. Similarly, the assessment of the accuracy of regulatory reporting often has involved extensive review of reconciliations of a bank holding company's general ledger to the FR Y-9C report and other FR Y-series reports. Other similar procedures typically have been completed to ascertain compliance with applicable laws and regulations, to determine whether the banking and nonbank subsidiaries are following their internal policies and procedures and those of the bank holding company, and to evaluate the adequacy of internal control systems.

Transaction testing remains a reliable and essential inspection technique for assessing a banking organization's condition and verifying its adherence to internal policies, procedures, and controls. In a highly dynamic banking market, however, such testing is not sufficient for ensuring continued safe and sound operations. As evolving financial instruments and markets have enabled banking organizations to rapidly reposition their portfolio risk exposures, periodic assessments of the condition of banking organizations based on transaction testing alone cannot keep pace with the moment-to-moment changes occurring in financial risk profiles.

To ensure that banking organizations have in place the processes necessary to identify, measure, monitor, and control their risk exposures, inspections must focus more on evaluating the appropriateness of a very high degree of transaction testing. Under a risk-focused approach, the degree of transaction testing should be reduced when internal risk-management processes are determined to be adequate or risks are considered minimal. However, when an organization's risk-management processes or internal controls are considered inappropriate (such as when there is an inadequate segregation of duties or when on-site testing determines that such processes or controls are lacking), additional transaction testing sufficient to fully assess the degree of risk exposure in that function or activity must be performed. In addition, if an examiner believes that a banking organization's management is being less than candid, has provided false or misleading information, or has omitted material information, then substantial on-site transaction testing should be undertaken and appropriate follow-up actions should be initiated, including the requirement of additional audit work and appropriate enforcement actions.

In most cases, full-scope inspections are conducted on or around a single date. This is appropriate for the vast majority of banking organizations supervised by the Federal Reserve. However, as the largest banking organizations have undergone considerable geographic expansion and the range of their products has become more diversified, coordinating the efforts of the large number of examiners necessary to conduct inspections at a single point in time has become more difficult. To avoid causing undue burden on these banking organizations, full-scope inspections for many large companies are conducted over the course of a year, rather than over a span of weeks, in a series of targeted reviews focusing on one or two significant aspects of the bank holding company's operations. This approach to conducting full-scope inspections provides more continuous supervisory contact with the largest bank holding companies and can facilitate improved coordination of inspection efforts with other federal banking agencies. It also provides more flexibility in the allocation of examiner resources, which has been especially important as the complexity of banking markets and products has increased and has led to the development of cadres of examiners with specialized skills.

2124.0.2 RISK-FOCUSED INSPECTIONS

Developments in the business of banking have increased the range of banking activities, heightening demands on examiner resources and making the need for examiners to effectively focus their activities on areas of the greatest risk even more crucial. Improved in-office planning can result in more efficient and effective on-site inspections that are focused on risks particular to specific organizations of the bank holding company. Such improved planning minimizes supervisory burden and provides for the close coordination of the supervisory efforts of the Federal Reserve with those of the other state and federal banking agencies. Improved planning also allows information requests to be better tailored to the specific organizations.

2124.0.2.1 Risk Assessment

To focus procedures on the areas of greatest risk, a risk assessment should be performed before on-site supervisory activities. The risk-assessment process highlights both the strengths and vulnerabilities of a bank holding company and provides a foundation from which to determine the procedures to be conducted during an inspection. Risk assessments indentify the financial activities in which a banking organiation has chosen to engage, determine the types and quantities of risks to which these activities expose the organization, and consider the quality of management and control of these risks. At the conclusion of the risk-assessment process, a preliminary supervisory strategy can be formulated for the bank holding company and its subsidiaries and each of their major activities. Naturally, those activities that are most significant to the organization's risk profile or that have inadequate risk-management processes or rudimentary internal controls represent the highest risks and should undergo the most rigorous scrutiny and testing.

Identifying the significant activities of a bank holding company, including those conducted off-balance-sheet, should be the first step in the risk-assessment process. These activities may be identified through the review of prior bank examination and bank holding company inspection reports and workpapers, surveillance and monitoring reports generated by Board and Reserve Bank staffs, Uniform Bank Performance Reports and Bank Holding Company Performance Reports, regulatory reports (for example, bank call reports and the FR Y-9C and FFIEC 002 reports), and other relevant supervisory materials. Where appropriate, conduct reviews of strategic plans and budgets, internal management reports, board of directors information packages, correspondence and minutes of meetings between the bank holding company and the Reserve Bank, annual reports and quarterly SEC filings, press releases and published news stories, and stock analysts' reports. In addition, examiners should hold periodic discussions with management to gain insight into their latest strategies or plans for changes in activities or management processes.

Once significant activities have been identified, the types and quantities of risks to which these activities expose the bank holding company should be determined. This allows identification of the high-risk areas that should be emphasized in conducting inspections. The types of risk that may be encountered in banking activities individually or in various combinations include, but are not limited to, credit, market, liquidity, operational, legal, and reputational risks.[1] For example, lending activities are a primary source of credit and liquidity risks. They may also present considerable market risk (if the bank holding company or its subsidiaries are originating mortgage loans for later resale), interest-rate risk (if fixed-rate loans are being granted), or legal risk (if loans are poorly documented). Similarly, the asset/liability management function has traditionally been associated with exposures to interest-rate and liquidity risks. There are also operational risks associated with many of the transactions undertaken by this function, and with other market risks associated with the investments and hedging instruments commonly used by the asset/liability management function. The quantity of risks associated with a given activity may be indi-

1. Appendix A defines these primary risk types.

cated by the volume of assets and off-balance-sheet items that the activity represents or by the portion of revenue for which the activity accounts. Activities that are new to an organization or for which exposure is not readily quantified may also represent high risks that should be evaluated at inspections.

A number of analytical techniques may be used to estimate the quantity of risk exposure, depending on the activity or risk type being evaluated. For example, to assess the quantity of credit risk in loans and commitments, the level of past-due loans, internally classified or watch-list loans, nonperforming loans, and concentrations of credit exposure to particular industries or geographic regions should be considered (see section 2010.2). In addition, as part of the assessment of credit risk, the adequacy of the overall ALLL can be evaluated by considering trends in past-due, special-mention, and classified loans; historic charge-off levels; and the coverage of nonperforming loans by the ALLL. Analytical techniques for gauging the exposure of a bank holding company and its subsidiaries to interest-rate risk, as part of the evaluation of asset/liability management practices, can include a review of the historic performance of net interest margins, as well as the results of internal projections of future earnings performance or net economic value under a variety of plausible interest-rate scenarios. The measurement of the quantity of market risk arising from trading in cash and derivative instruments may take into account the historic volatility of trading revenues, the results of internal models calculating the level of capital and earnings at risk under various market scenarios, and the market value of contracts relative to their notional amounts.

Once the types and quantities of risk in each activity have been identified, a preliminary assessment of the banking organization's process to identify, measure, monitor, and control these risks should be completed. This evaluation should be based on findings from previous examination and inspection activities conducted by the Reserve Bank or other banking agencies, supplemented by the review of internal policies and procedures, management reports, and other documents that provide information on the extent and reliability of internal risk-management systems. Sound risk-management processes vary from one banking organization to another, but generally include four basic elements for each individual financial activity or function and for the organization in aggregate. These elements are (1) active board and senior management oversight; (2) adequate policies, procedures, and limits; (3) adequate risk-measurement, monitoring, and management information systems; and (4) comprehensive internal audits and controls. (See section 4070.1 and SR-95-51.)

The preliminary evaluation of the risk-management process for each activity or function also helps determine the extent of transaction testing that should be planned for each area. If the organization's risk-management process appears appropriate and reliable, then a limited amount of transaction testing may well suffice. If, on the other hand, the risk-management process appears inappropriate or inadequate to the types and quantities of risk in an activity or function, examiners should plan a much higher level of transaction testing. They should also plan to conduct the most testing in those areas that comprise the most significant portions of a bank holding company's activities and, thus, typically represent high potential sources of risk.

2124.0.2.2 Preparation of a Scope Memorandum

Once the inspection planning and risk-assessment processes are completed, a scope memorandum should be prepared. A scope memorandum provides a detailed summary of the supervisory strategy for a bank holding company and assigns specific responsibilities to inspection team members. A scope memorandum should be tailored to the size and complexity of the bank holding company that is subject to review, define the objectives of each inspection, and generally include—

- a summary of the results of the prior inspection;
- a summary of the strategy and significant activities of the banking organization, including its new products and activities;
- a description of the bank holding company's organization and management structure;
- a summary of performance since the prior inspection;
- a statement of the objectives of the current inspection;
- an overview of the activities and risks to be addressed by the inspection; and
- a description of the procedures that are to be performed at the inspection.

For large, complex organizations operating in a number of states or internationally, the planning and risk-assessment processes are necessarily more complicated. The traditional scope memorandum may have to be broadened into a more extensive set of planning documents to reflect the unique requirements of complex bank holding companies. Examples of these planning documents include annual consolidated analyses, periodic risk assessments, and supervisory plans.

2124.0.2.3 On-Site Procedures

The amount of review and transaction testing necessary to evaluate particular functions or activities of a bank holding company generally depend on the quality of the process the company uses to identify, measure, monitor, and control the risks of an activity. When the risk-management process is considered sound, further procedures are limited to a relatively small number of tests of the integrity of the management system. Once the integrity of the management system is verified through limited testing, conclusions on the extent of risks within the function or activity are drawn based on internal management assessments of those risks rather than on the results of more extensive transaction testing by examiners. On the other hand, if initial inquiries into the risk-management system—or efforts to verify the integrity of the system—raise material doubts as to the system's effectiveness, no significant reliance should be placed on the system. A more extensive series of tests should be undertaken to ensure that the banking organization's exposure to risk from a given function or activity can be accurately gauged and evaluated. More extensive transaction testing is also generally completed for activities that are much more significant to a bank holding company than for other areas, although the actual level of testing for these significant activities may be reduced commensurate with the quality of internal risk-management processes.

Consider, as an example, the risk exposure associated with commercial lending activities whereby examiners have traditionally reviewed a relatively high number and dollar volume of real estate–associated loans.[2] If, however, credit-administration practices are considered satisfactory, fewer loans may need be reviewed to verify that this is the case (that is, fewer loans than would be reviewed if deficiencies in credit-administration practices were suspected). This review may be achieved through a valid statistical sampling technique, when appropriate. It should be noted that if credit-administration practices are initially considered sound, but loans reviewed to verify this raise doubts about the accuracy of internal assessments or the compliance with internal policies and procedures, the number and volume of loans subject to review should generally be expanded. Examiners should thus review a sufficient number of loans to ensure that the level of risk is clearly understood, an accurate determination of the adequacy of the ALLL can be made, and the deficiencies in the credit risk-management process can be comprehensively detailed.

2. Guidance on the selection of loans for review is provided in SR-94-13, ''Loan Review Requirements for On-Site Examinations.''

2124.0.2.4 Evaluation of Audit Function as Part of Assessment of Internal Control Structure

A bank holding company's internal control structure is critical to its safe and sound functioning in general and to its risk-management system in particular. When properly structured, internal controls promote effective operations and reliable financial and regulatory reporting; safeguard assets; and help to ensure compliance with laws, regulations, and internal policies and procedures. In many banking organizations, internal controls are tested by an independent internal auditor who reports directly to the board of directors or its audit committee. However, in some smaller banking organizations whose size and complexity of operations do not warrant an internal audit department, reviews of internal controls may be conducted by other personnel independent of the area subject to review.

Because the audit function is an integral part of a bank holding company's assessment of its internal control system, examiners must include a review of the organization's control-assessment activities in every inspection. Such reviews help identify significant risks and facilitate a comprehensive evaluation of the organization's internal control structure and also provide information to determine the inspection procedures that should be completed in assessing internal controls for particular functions and activities and for the bank holding company overall. When conducting this review, examiners should evaluate the independence and competence of the personnel conducting control assessments and the effectiveness of the assessment program in covering the bank holding company's significant activities and risks. In addition, examiners should meet with the internal auditors or other personnel responsible for evaluating internal controls and review internal control risk assessments, work plans, reports, workpapers, and related communications with the audit committee or board of directors.

Depending on the size and complexity of the activities conducted by a bank holding company, the examiner should also consider conducting a similar review of the work performed by the company's external auditors. Such a review often provides added insight into key risk areas by detailing the nature and extent of the external auditors' testing of those areas.

2124.0.2.5 Evaluation of Overall Risk-Management Process

To highlight the importance of a banking organization's risk-management process, bank holding companies are assigned a risk-management rating on a five-point scale as a significant part of the evaluation of the management components of the BOPEC rating systems (see section 4070.1). In addition, U.S. branches and agencies of foreign banking organizations are assigned a similar rating under the ROCA rating system.[3] These risk-management ratings encompass evaluations of the quality of risk-management processes for all significant activities and all types of risks. As such, they should largely summarize conclusions on the adequacy of risk-management processes for each individual function or activity evaluated.

In assigning these risk-management ratings, it is important to consider the quality of the risk-management process for the bank holding company overall, as well as for each individual function. At smaller bank holding companies engaged in traditional banking and nonbanking activities, relatively basic risk-management processes established for each significant activity, such as lending or asset/liability management, may be adequate to allow senior management to effectively manage the organization's overall risk profile. On the other hand, at larger bank holding companies that are typically engaged in more complex and widely diversified activities, effective risk-management systems must evaluate various functional management processes in combination so that aggregate risk exposures can be identified and monitored by senior management. Management information reports should typically be generated for the overall organization, as well as for individual functional areas. Some aggregate or specific companywide limits may also be needed for the principal types of risks that are relevant to its activities.

A critical aspect of ensuring that a bank holding company's risk-management and control procedures remain adequate is the ongoing testing of the strength and integrity of these procedures and the extent to which they are understood and followed throughout the organization. When assigning a risk-management rating, examiners should assess the adequacy of the company's efforts to ensure that its procedures are being followed. The company's validation efforts must be conducted by those individuals who have proper levels of organizational independence and expertise, such as internal or external auditors, internal risk-management units, or managers or other professionals of the bank holding company who have no direct connection to the activities for which procedures are being assessed.

2124.0.2.6 Evaluation of Compliance with Laws and Regulations

Compliance with relevant laws and regulations should be assessed at every inspection. The steps taken to complete these assessments, however, will vary depending on the circumstances of the bank holding company being reviewed. When an organization has a history of satisfactory compliance with relevant laws and regulations or an effective compliance function, only a relatively limited degree of transaction testing need be conducted to assess compliance. For example, in evaluating compliance with the appraisal requirements of Regulation Y at a bank holding company with a formal compliance function, compliance may be ascertained by reviewing the scope and findings of internal and external audit activities, evaluating internal appraisal ordering and review processes, and sampling a selection of appraisals for compliance as part of the supervisory loan review process. On the other hand, at bank holding companies that have a less satisfactory compli-

3. U.S. branches and agencies of foreign banking organizations are assigned separate ROCA ratings for Risk management, Operational controls, Compliance, and Asset quality under guidance included in SR-95-22.

ance record or that lack a compliance function, more appraisals would naturally need to be tested to assess the overall compliance with the appraisal requirements of Regulation Y.

2124.0.2.7 Documentation of Supervisory Findings

The examiners' workpaper documentation of supervisory findings is necessary for Reserve Bank management to objectively verify the inspection work performed. Such documentation also provides a source of information on the condition and prospects of a bank holding company that is invaluable to the planning of future reviews. Most important, examiners' workpaper documentation provides support for the conclusions and recommendations detailed in the inspection report.

2124.0.2.8 Communication of Supervisory Findings

Effective and open communication between bank supervisory agencies and the board of directors and management of bank holding companies is essential to ensuring that the results of inspections are fully understood; the directorship and management are aware of any identified deficiencies; and, when necessary, they take appropriate corrective actions.

2124.0.3 INSPECTION OBJECTIVES

1. To ensure that the bank holding company has in place the processes necessary to identify, measure, monitor, and control its risk exposures for each of its activities or functions.
2. To improve inspection efficiencies by stressing increased in-office planning of inspections based on a risk- focused emphasis.
3. To identify and assess significant on- and off-balance-sheet activities and the greatest types and quantities of risk exposures and vulnerabilities to the bank holding company, tailoring the extent of transaction testing to the results of this review and other inspections' findings.
4. To review and assess the effectiveness and adequacy of documentation of the bank holding company's control and assessment activities and arrangements, including its internal control structure, and the qualifications of internal and external auditors and other independent personnel involved in the program.
5. To emphasize the preparation of a risk-focused scope memorandum, tailored to the size and complexity of the bank holding company under inspection.
6. To evaluate compliance with laws and regulations.
7. To adequately document and communicate inspection supervisory findings, recommendations, and conclusions.

2124.0.4 INSPECTION PROCEDURES

1. Identify the significant on- and off-balance-sheet activities of the bank holding company.
   a. Review prior inspection reports and workpapers, surveillance and monitoring reports generated by the Board and Reserve Bank staff, Uniform Bank Performance Reports and Bank Holding Company Performance Reports; regulatory reports (for example, bank call reports and FR Y-series and other FFIEC reports), and other relevant supervisory materials.
   b. Review strategic plans and budgets; internal management reports; board of directors information packages; correspondence and minutes, including minutes of meetings held between the bank holding company and the Reserve Bank; annual reports and quarterly SEC filings; press releases and published news stories; and stock analysts' reports.
2. Hold periodic discussions with management to gain insight into recently adopted strategies or plans to change activities or management processes.
3. Once the significant activities have been identified, determine and analyze the types (for example, credit, market, liquidity, operational, legal, and reputational) and quantities of risks to which those activities expose the bank holding company, placing greater inspection emphasis on the high-risk areas.
5. Develop an assessment of the processes that are used to identify, measure, monitor, and control the risks. Focus on the extent of board and senior management oversight; the adequacy of policies, procedures, limits, risk measurement, monitoring, and management information systems; and the existence of adequately documented internal audits and controls.
6. Prepare a scope memorandum tailored to the size and complexity of the bank holding company under inspection.
7. Conduct limited tests of the integrity of the risk-management system. Conduct more extensive transaction testing for those areas of a

bank holding company that are very significant in comparison to other areas, adjusting the level of transaction testing to the quality of internal risk-management processes. If initial inquiries or efforts to verify the system raise material doubts as to its effectiveness, place no reliance on the integrity of the bank holding company's risk-management system and conduct more extensive transaction testing.

8. Review the bank holding company's risk-assessment control activities, including an assessment of internal controls for particular functions and activities and for the bank holding company overall.

a. Evaluate the independence and competence of the personnel conducting control assessments and the effectiveness of the assessment program in covering the bank holding company's significant activities and risks.

b. Meet the independent external and internal auditors and other personnel responsible for evaluating internal controls and review the internal-control risk assessments, work plans, reports, workpapers, and related communications with the audit committee or board of directors.

9. Assess the adequacy of efforts to ensure that the current risk-management and control procedures are being followed.

10. Assess compliance with laws and regulations, adjusting the extent of transaction testing with the organization's history of satisfactory compliance.

11. Document all work performed and the supervisory findings. Include information on the condition and prospects of the bank holding company and its significant subsidiaries as well as the inspection's conclusions and recommendations.

2124.0.5 APPENDIX A—DEFINITIONS OF RISK TYPES EVALUATED AT INSPECTIONS

- *Credit risk* arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- *Market risk* is the risk to a bank holding company's condition resulting from adverse movements in market rates or prices, such as interest rates, foreign-exchange rates, or equity prices.
- *Liquidity risk* is the potential that a bank holding company will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as ''funding liquidity risk'') or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions (''market liquidity risk'').
- *Operational risk* arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.
- *Legal risk* arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a bank holding company.
- *Reputational risk* is the potential that negative publicity on a bank holding company's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions.

2124.01.1 INSPECTION APPROACH FOR RISK-FOCUSED SUPERVISION

The inspection approach for large, complex banking organizations (LCBOs) is a risk-focused process that relies on an understanding of the banking organization[1] (the institution), the performance of risk assessments, the development of a supervisory plan, and inspection procedures that are tailored to the risk profile. The process for a complex institution relies more heavily on a central point of contact (CPC), detailed risk assessments, and a supervisory plan before the on-site inspection. The risk-focused inspection also incorporates the U.S. operations of foreign banking organizations (FBOs), for which the Federal Reserve has overall supervisory authority. See SR-97-24, SR-99-15, and section 2124.04.

2124.01.1.1 Risk-Focused Supervisory Objectives

The Federal Reserve is committed to ensuring that the supervisory process for all banking organizations under its purview meets the following objectives:

1. *To provide flexible and responsive supervision.* The supervisory process is designed to be dynamic and forward looking so that it responds to technological advances, product innovation, and new risk-management systems and techniques, as well as to changes in the condition of an individual financial institution and developments in the market.
2. *To foster consistency, coordination, and communication among the appropriate supervisors.* Seamless supervision, which reduces regulatory burden and duplication, is promoted. The supervisory process uses examiner resources effectively by using the institution's internal and external risk-assessment and -monitoring systems; making appropriate use of joint and alternating examinations and inspections; and tailoring supervisory activities to an institution's condition, risk profile, and unique characteristics.
3. *To promote safety and soundness.* The supervisory process effectively evaluates the safety and soundness of banking organizations, including the assessment of risk-management systems, financial condition, and compliance with laws and regulations.
4. *To provide a comprehensive assessment of the institution.* The supervisory process integrates specialty areas (for example, information technology systems, trust, capital markets, and consumer compliance) and functional risk assessments and reviews, in cooperation with interested supervisors, into a comprehensive assessment of the institution.

2124.01.1.2 Key Elements of the Risk-Focused Framework

To meet the established objectives and respond to the characteristics of large institutions, the framework for risk-focused supervision of large, complex institutions contains the following key elements:

1. *Designation of a central point of contact.* Large institutions typically have operations in several jurisdictions, multiple charters, and diverse product lines. Consequently, the program requires that a CPC be designated for each institution to facilitate coordination and communication among the principal bank and other regulatory authorities (for example, securities, insurance, and other nonbanking supervisory entities). Further, the program requires that each CPC and LCBO be assigned a dedicated supervisory team and staff with specialized skills, knowledge, and experience tailored to the unique profile of a particular institution.
2. *Review of functional activities.* Large institutions are generally structured along business lines or functions, and some activities are managed on a centralized basis. As a result, a single type of risk may cross several legal entities. Therefore, the supervisory program incorporates assessments along functional lines to evaluate risk exposure and its impact on safety and soundness. These functional reviews will be integrated into the risk assessments for specific legal entities and

1. For this section, the term ''banking organization'' refers to bank holding companies and their domestic and foreign banking and nonbank subsidiaries. It is used synonomously with the term ''institutions.'' That term, however, has an even broader meaning since it may include other entities (for example, Edge Act corporations and foreign branches of state member banks). See subsection 2124.01.1.3.1

used to support the supervisory ratings for individual legal entities.[2]

3. *Focus on risk-management processes.* Large institutions generally have highly developed risk-management systems such as internal audit, loan review, and compliance. The supervisory program emphasizes each institution's responsibility to be the principal source for detecting and deterring abusive and unsound practices through adequate internal controls and operating procedures. The program incorporates an approach that focuses on and evaluates the institution's risk-management systems, processes, and core proficiencies for identifying, measuring, monitoring, and controlling key risks, including credit, market, and operational risks. Yet, the program retains transaction testing and supervisory rating systems such as CAMELS, BOPEC, and ROCA. This diagnostic perspective provides insight into how effectively an institution is managing its operations and how well it is positioned to meet future business challenges. The program places less emphasis on traditional ''point-in-time'' balance-sheet assessments.
4. *Tailoring of supervisory activities.* Large institutions are unique, but all possess the ability to quickly change their risk profiles. To deliver effective supervision, the program incorporates an approach that tailors supervisory activities to the risk profile of an institution. By concentrating on an institution's major risk areas, examiners can achieve a more relevant and penetrating understanding of the institution's condition.
5. *Review of internally and externally generated management information.* A review of internal management and board reports, internal and external audit reports, and publicly available information will further supplement existing supervisory processes. Banking organizations are also encouraged to continually review and enhance their public disclosures in order to promote transparency and to foster and support supervisory processes and effective market discipline.
6. *Emphasis on ongoing supervision.* Large institutions face a rapidly changing environment. The supervisory program thus emphasizes ongoing supervision, monitoring, and assessment through increased planning; no less than quarterly reassessment of the organization's profile; and continuous off-site monitoring. Ongoing supervision allows for timely adjustments to the supervisory strategy as conditions change within the institution, enhanced information sharing Systemwide and on an interagency basis, and the use of information technology platforms that foster more effective collaboration and communication.
7. *Effective communication with management.* An effective program of regular and meaningful contacts with management is necessary to maintain a current understanding of the institution's risk profile and risk-management processes without imposing undue burden, interfering with legitimate management prerogatives, or compromising the objectivity of the supervisory process.

2. When functions are located entirely in legal entities that are not primarily supervised by the Federal Reserve, the results of supervisory activities conducted by the primary regulator will be used to the extent possible to avoid duplication of activities.

2124.01.1.3 Banking Organizations Covered by the Framework

For purposes of the risk-focused supervision framework, LCBOs generally have a functional management structure, a broad array of products, operations that span multiple supervisory jurisdictions, and consolidated assets of $1 billion or more.[3] These institutions may be state member banks, bank holding companies (including their nonbank and foreign subsidiaries), and branches and agencies of FBOs. The complex-institution process may also be appropriate for some organizations with consolidated assets less than $1 billion.

LBCOs comprise larger institutions that have particularly complex operations and dynamic risk profiles. They demand a heightened level of planning, coordination, and innovative techniques to implement an effective supervisory program. These organizations typically have significant on- and off-balance-sheet risk exposures, offer a broad range of products and services at the domestic and international levels, are subject to multiple supervisors in the United States and abroad, and participate extensively in large-value payment and settlement systems.

An important aspect of the LCBO program is the assessment and evaluation of banking practices across a group of institutions with similar

3. Large institutions are defined differently in other regulatory guidance regarding regulatory reports and examination mandates.

business lines, characteristics, and risk profiles. This ‘‘portfolio’’ approach to supervision will (1) support and enhance timely judgments about individual institutions, including the identification of possible ‘‘outliers’’; (2) facilitate peer-group assessments; (3) provide an improved framework for discerning industry trends; (4) foster more consistent supervision of institutions with similar businesses and risk profiles; (5) contribute substantially to the maintenance of a highly informed and skilled supervisory staff; and (6) promote the development and sharing of the best supervisory practices within the Federal Reserve and the supervisory community more broadly.

2124.01.1.3.1 Foreign Institutions

U.S. supervisory authorities are host-country rather than home-country supervisors for most of the U.S. operations of FBOs; therefore, the supervisory focus and objectives are somewhat different for U.S. operations of FBOs and are addressed separately in the FBO supervision program. The desired result of a risk-focused examination process, however, should be the same. The framework encompasses the supervision and examination processes and procedures relevant to the U.S. operations of FBOs, to the extent that they are appropriate. Any significant remaining differences are incorporated in the FBO supervision program.

2124.01.1.3.2 Nonbank Subsidiaries of Domestic Institutions

Nonbank subsidiaries of large, complex domestic institutions are covered by the risk-focused supervision program. These include (1) nonbank subsidiaries of the parent bank holding company and those of the subsidiary state member banks; (2) the significant branch operations, primarily foreign branches, of state member banks; and (3) subsidiary foreign banks of the holding company. The level of supervisory activity to be conducted for nonbank subsidiaries and foreign branches and subsidiaries of domestic institutions should be based on their individual risk levels relative to the consolidated organization. The risk associated with significant nonbank subsidiaries or branches should be identified as part of the consolidated risk-assessment planning process, and the appropriate level of supervisory coverage (whether on-site or off-site) should be described in the supervisory plan for the organization. Risk-focused supervisory planning should incorporate the use of the workpaper, ‘‘Nonbank Subsidiary of a Bank Holding Company Risk-Assessment Questionnaire’’ (see appendix B). It should be used as a guide for (1) determining whether a nonbank subsidiary poses significant risk to the entire LCBO (parent bank holding company) and (2) determining whether an on-site supervisory inspection or examination of the entity is needed.[4] The supervisory plan for the organization should also include a review of the institution’s processes to ensure compliance with sections 23A and 23B of the Federal Reserve Act and various other regulations and guidelines that govern transactions between the bank and nonbank affiliates.

2124.01.1.3.3 Edge Act Corporations

Under section 25A, paragraph 17, of the Federal Reserve Act, Edge Act corporations are subject to examination once a year and at such other times as deemed necessary by the Federal Reserve. While Reserve Banks must fulfill this legal mandate, there is flexibility in determining the extent of examination coverage. The scope of Edge Act corporation examinations should be determined through the risk-assessment process. Additionally, separate reports of examination are not required for Edge Act corporations, provided that all relevant findings are included in the consolidated report of examination of the parent bank.[5] This reporting procedure also applies to other nonbank subsidiaries of the bank or bank holding company.

2124.01.1.3.4 Specialty Areas Covered by the Framework

The Federal Reserve regularly conducts examinations, inspections, or reviews of several spe-

4. When this workpaper is used, a separate risk assessment of each nonbank subsidiary of the LCBO (for domestic bank holding companies) is not required. The separate risk-assessment requirements of SR-93-19 are thus partially superseded for LCBOs. Nonbank subsidiary risk assessments should be reflected in the entire consolidated organization’s risk assessment.

5. A separate memorandum to the file should be prepared and retained that provides the date of examination of the Edge Act corporation, a summary of findings, the rating assigned, and a reference to the consolidated report of examination. This information should also be forwarded to Federal Reserve Board staff.

cialty areas. To achieve more efficient supervision and reduce the regulatory burden on institutions, steps have been taken to coordinate these reviews with the annual full-scope inspection of the consolidated organization. Under the risk-focused approach, the specialty areas should be included in the planning process in relation to the perceived level of risk to the consolidated organization or any state member bank subsidiary. Reviews of any specialty areas can be performed in conjunction with the annual full-scope inspection, or through targeted examinations or inspections, at any time during the supervisory cycle. The findings of all specialty reviews should be included in the inspection report for the consolidated organization.

2124.01.2 COORDINATION OF SUPERVISORY ACTIVITIES

Many large, complex institutions have interstate operations that expand with the continuation of mergers and acquisitions. In this environment, close cooperation with the other federal and state banking agencies is critical. To facilitate coordination between the Federal Reserve and other regulators, district Reserve Banks have been assigned roles and responsibilities that reflect their status as either the responsible Reserve Bank (RRB) with the CPC or the local Reserve Bank (LRB).

2124.01.2.1 Responsible Reserve Bank

The RRB facilitates the increased flexibility, planning, and coordination needed to effectively and efficiently supervise institutions with interstate operations. Considering the overriding objectives of seamless, risk-focused supervision, the RRB is responsible for designating the CPC and for ensuring that all aspects of the supervisory process are fully coordinated with LRBs and home-state supervisors.

To the extent possible, the RRB should rely on LRBs to provide the resources to conduct inspections/examinations of out-of-district subsidiaries of a parent organization, its state member bank subsidiaries, or the out-of-district offices of FBOs. Close coordination among the Reserve Banks and other appropriate regulators for each organization is critical to ensure a consistent, risk-focused approach to supervision. For further guidance, see sections 5000.0.7.5 or SR-93-48, section 5000.0.7.4 or SR-89-25, and SR-78-464.

2124.01.2.2 Local Reserve Banks

In general, LRBs are responsible for the direct supervision of institutions (including state member banks and bank holding companies) that are under Federal Reserve System supervision and are located in their district. The LRB provides the resources to the RRB to conduct the inspections of second-tier, domestic bank holding companies; nonbank subsidiaries; and branches and agencies of FBOs for top-tier holding companies located in the RRB's district. If the functional management of a banking organization is headquartered in its district, the LRB may also be called upon to conduct functional-business-line reviews. However, if a state member bank is owned by an out-of-district domestic holding company or if another Reserve Bank is responsible for the supervision of the overall U.S. operations of the FBO, the supervision of that entity should be coordinated by the RRB.

If the banking organization prefers to have supervisory contact with only one Reserve Bank, every effort should be made to centralize communication and coordination with the RRB for that organization. On the other hand, if the organization prefers more localized contact and communication, the coordination process can be adapted accordingly.

2124.01.2.3 Central Point of Contact

A CPC is critical to fulfilling the objectives of seamless, risk-focused supervision. The RRB should designate a CPC for each large, complex institution it supervises. Generally, all Federal Reserve System contacts, activities, and duties, as well as those with other supervisors, should be coordinated through this contact. The CPC should—

1. be knowledgeable, on an ongoing basis, about the institution's financial condition, management structure, strategic plan and direction, and overall operations;
2. remain up-to-date on the condition of the assigned institution and be knowledgeable regarding all supervisory activities, monitoring and surveillance information, applications issues, capital-markets activities, meetings with management, and enforcement issues, if applicable;

3. ensure that the objectives of seamless, risk-focused supervision are achieved for each institution and that the supervisory products (that is, an institutional overview, a risk matrix, a risk assessment, a supervisory plan, an inspection program, a scope memorandum, inspection modules, and an inspection report) are prepared in a timely manner;
4. ensure appropriate follow-up and tracking of supervisory concerns, corrective actions, or other matters which come to light through ongoing communications or surveillance; and
5. participate in the inspection/examination process, as needed, to (1) ensure consistency with the institution's supervisory plan and effective allocation of resources, including coordination of on-site efforts with specialty examination areas and other supervisors, as appropriate, and (2) to facilitate requests for information from the institution, wherever possible.

2124.01.2.4 Sharing of Information

To further promote seamless, risk-focused supervision, information related to a specific institution should be provided, as appropriate, to other interested supervisors. Sharing of these products with the institution, however, should be carefully evaluated on a case-by-case basis. The institutional overview, risk assessment, and supervisory plan may not be appropriate for release if they contain a hypothesis about an institution's risk rather than assessments verified through the inspection/examination process. On the other hand, it may be appropriate to share the inspection program with the institution in the interest of better coordination of activities.

2124.01.2.5 Coordination with Other Supervisors

Section 305 of the Riegle Community Development and Regulatory Improvement Act of 1994 directed the agencies to coordinate their examinations, to the extent possible, when they are jointly responsible for examination of various entities of a bank holding company.[6] To help achieve the desired degree of coordination, staffs of the agencies are expected, primarily at the regional level, to discuss examination plans and coordination issues. The institution involved is to be kept fully informed of the coordinated activities planned by the agencies, including a general timeframe in which each agency is expecting to conduct its examination activities.

2124.01.3 FUNCTIONAL APPROACH AND TARGETED INSPECTIONS

The framework for risk-focused supervision of large, complex institutions relies more heavily on a functional-business-line approach to supervising institutions, while effectively integrating the functional approach into the legal-entity assessment. Bank holding companies are increasingly being managed on a functional basis. Such functional management allows organizations to take advantage of the synergies among their components, to deliver better products to the market, and to provide higher returns to stockholders. Virtually all of the large bank holding companies operate as integrated units and are managed as such. For these companies, the risk-management systems are generally organized along business lines on a centralized basis. A key implication of this shift in management structure is that much of the information and insight gathered on inspections and examinations of individual legal entities can be fully understood only in the context of examination findings of other related legal entities or centralized functions. Developing that understanding means adapting some of the same functional-business-line approaches to supervision, including examination processes. Consequently, this risk-focused supervision framework incorporates risk assessments, that is, inspection and examination procedures that are organized by function.

The functional approach focuses principally on the key business activities (for example, lending, treasury, retail banking) rather than reviewing the legal entity and its balance sheet. This does not mean that the responsibility for a legal-entity assessment is ignored, nor should the Federal Reserve perform examinations of institutions for which other regulators have primary supervisory responsibility.[7] Rather, Fed-

6. In a December 1996 letter to the House Committee on Banking and Financial Services, the agencies outlined their cooperative efforts to meet the objectives of section 305.

7. With respect to U.S. banks owned by FBOs, it is particularly important to review the U.S. bank on a legal-entity basis and also the risk exposure to the U.S. bank from its parent foreign bank, as U.S. supervisory authorities do not supervise or regulate the parent bank.

eral Reserve examiners should integrate the findings of a functional review into the legal-entity assessment and coordinate closely with the primary regulator to gather sufficient information to form an assessment of the consolidated organization. Nonetheless, in some cases, effective supervision of the consolidated organization may require Federal Reserve examiners to perform process reviews and, possibly, transaction testing at all levels of the organization.

Functional-risk-focused supervision is to be achieved by the following actions:

1. Planning and conducting joint inspections and examinations with the primary regulator in areas of mutual interest, such as nondeposit investment products, interest-rate risk, liquidity, and mergers and acquisitions.
2. Leveraging off, or working from, the work performed by the primary regulator and the work performed by the institution's internal and external auditors by reviewing and using their workpapers and conclusions to avoid duplication of effort and to lessen the burden on the institution.
3. Reviewing inspection and examination reports and other communications to the institution that were issued by other supervisors.
4. Conducting a series of functional reviews or targeted inspections/examinations of business lines, relevant risk areas, or areas of significant supervisory concern during the supervisory cycle.[8] Functional reviews and targeted inspections/examinations are increasingly necessary to evaluate the relevant risk exposure of a large, complex institution and the effectiveness of related risk-management systems.

The relevant findings of functional reviews or targeted inspections and examinations should be handled as outlined below.

1. *Incorporated into the annual full-scope inspection.* In this context, a full-scope inspection involves the analysis of data sufficient to determine the safety and soundness of the institution and to assign supervisory ratings.

   The inspection/examination procedures required to arrive at those determinations do not necessarily have to be performed at the time of the annual inspection, but can be a product of the collective activities performed throughout the supervisory cycle. However, inspection procedures should contain follow-up on deficiencies noted in functional reviews or targeted inspections and examinations.
2. *Conveyed to the institution's management during a close-out or exit meeting with the relevant area's line management.* The need to communicate the findings to senior management or the board of directors is left to the judgment of Reserve Bank management based on the significance of the findings.
3. *Communicated in a formal written report to the institution's management or board of directors when significant weaknesses are detected or when the findings result in a downgrade of any rating component.* Otherwise, the vehicle for communicating the results is left to the judgment of the Reserve Bank's management and may either be a formal report or a supervisory letter.[9]

The functional approach to risk assessments and planning supervisory activities should include a review of the parent company and its significant nonbank subsidiaries. However, it is anticipated that the level of supervisory activities, on-site or off-site, will be appropriate to the risk profile of the parent company or its nonbank subsidiary in relation to the consolidated organization. Intercompany transactions should continue to be reviewed as part of the inspection procedures performed to ensure that they comply with laws and regulations and do not pose safety-and-soundness concerns.

2124.01.4 OVERVIEW OF THE PROCESS AND PRODUCTS

The risk-focused methodology for the supervi-

8. A supervisory cycle is the period of time from the close of one annual examination to the close of the following annual examination.

9. As discussed in SR-92-31, it is currently Federal Reserve System practice to update BOPEC ratings between inspections to keep them current and to ensure that they reflect the latest information on the institution's financial condition. For state member banks, current policy dictates that Reserve Banks refrain from revising CAMELS ratings based on off-site analysis in view of the emphasis being placed on the CAMELS ratings for implementing risk-based insurance assessments and other supervisory initiatives. In accordance with SR-96-26 (see section 5010.4), Reserve Banks should notify the institution's management whenever the rating is changed as a result of off-site analysis.

sion program for large, complex institutions reflects a continuous and dynamic process. As table 1 indicates, the methodology consists of six key steps, each of which uses certain written products to facilitate communication and coordination.

Table 1—Steps and Products Involved in the Risk-Focused Supervision Process

Steps	*Products**
1. Understanding the institution	1. Institutional overview
2. Assessing the institution's risk	2. Risk matrix 3. Risk assessment
3. Planning and scheduling supervisory activities	4. Supervisory plan 5. Inspection/examination program
4. Defining inspection activities	6. Scope memorandum 7. Entry letter
5. Performing inspection procedures	8. Functional-inspection modules
6. Reporting the findings	9. Inspection report(s)

* For examples of products 1 through 8, see the appendixes D through K of the Federal Reserve's handbook, "Framework for Risk-Focused Supervision of Large, Complex Institutions" referred to in SR-97-24. See also appendix B, the bank holding company nonbank subsidiary risk-assessment questionnaire, discussed in section 2124.01.1.3.2.

With the exception of the entry letter, the written products associated with steps one through four are designed to sharpen the supervisory focus on those business activities of an institution that pose the greatest risk, as well as to assess the adequacy of the institution's risk-management systems to identify, measure, monitor, and control risks. The products should be revised as new information is received from such sources as the current inspection, recent targeted inspections and examinations, and periodic reviews of regulatory reports.

The focus of the products should be on fully achieving a risk-focused, seamless, and coordinated supervisory process. The content and format of the products are flexible and should be adapted to correspond to the supervisory practices of the agencies involved and to the structure and complexity of the institution.

2124.01.5 UNDERSTANDING THE INSTITUTION

The starting point for risk-focused supervision is developing an understanding of the institution. This step is critical to tailoring the supervision program to meet the characteristics of the organization and to adjusting that program on an ongoing basis as circumstances change. It is also essential to clearly understand the Federal Reserve's supervisory role in relation to an institution and its affiliates. For example, the Federal Reserve's role pertaining to an FBO will vary depending on whether the Federal Reserve is the home- or host-country supervisor for the particular legal entity. Thus, planning and monitoring are key components.

Through increased emphasis on planning and monitoring, supervisory activities can focus on the significant risks to the institution and related supervisory concerns. Given the technological and market developments within the financial sector and the speed with which an institution's financial condition and risk profile can change, it is critical to keep abreast of events and changes in risk exposure and strategy. The CPC for each large, complex institution should continuously review certain information and prepare an institutional overview that will communicate the contact's understanding of that institution.

2124.01.5.1 Sources of Information

Information generated by the Federal Reserve, other supervisors, the institution, and public organizations may assist the CPC in forming and maintaining an ongoing understanding of the institution's risk profile and current condition. For example, the Federal Reserve maintains a significant amount of financial and structure information in various automated databases. In addition, prior inspection and examination reports are excellent sources of information regarding previously identified problems.

Each Reserve Bank has various surveillance reports that identify outliers when an institution is compared to its peer group. The Bank Holding Company Performance Report and Uniform Bank Performance Report may identify significant deviations in performance relative to the institutions' peer groups, currently and between the inspections and examinations of those institutions. For branches and agencies, state member banks, and domestic bank holding companies that are part of FBOs, the strength-of-support assessment (SOSA) rating and relevant credit assessments from major rating agencies provide information that needs to be considered in developing an appropriate supervisory strategy. For FBOs, the Federal Reserve has developed automated systems that provide information on foreign financial systems, foreign accounting standards, and the financial performance of FBOs with U.S. operations.

Leveraging off the work, knowledge, and conclusions of other supervisors is of key importance to understanding a large, complex organization. Ongoing contact and the exchange of information with other supervisors who have responsibilities for a given institution may provide insight into the institution that cannot be obtained from other sources. Additional information can be obtained from examination reports issued by other supervisors and their databases, for example, the OCC's Supervisory Monitoring System (SMS) and the FDIC's Bank Information Tracking System (BITS).

Using information generated by the institution's management information system improves the supervisory process. It provides an efficient way to reduce on-site time, identify emerging trends, and remain informed about the activities of the institution and financial markets. Information that may be periodically reviewed by the contact includes the size and composition of intraday balance sheets, internal risk-ratings of loans, internal limits and current risk measures regarding trading activities, and internal limits and measures covering the institution's interest-rate and market risk. Additionally, functional-organization charts reflecting the major lines of business across legal entities, changes to the organization's strategic plan, and information provided to the board of directors and management committees should be reviewed.

The CPC should also hold periodic discussions with the institution's management to cover, among other topics, credit-market conditions, new products, divestitures, mergers and acquisitions, and the results of any recently completed internal and external audits. When other agencies have supervisory responsibilities for the organization, joint meetings should be considered.

Publicly available information may provide additional insight into an institution's condition. This may be particularly valuable in assessing an organization's ability to raise capital. Public sources of information include SEC reports, press releases, and analyses by private rating agencies and securities dealers and underwriters.

2124.01.5.2 Preparation of the Institutional Overview

The institutional overview should provide an executive summary that communicates, in one concise document, information demonstrating an understanding of the institution's present condition and its current and prospective risk profiles. The overview should also highlight key issues and past supervisory findings. General types of information that may be valuable to present in the overview are listed below.[10]

1. a brief description of the organizational structure (with comments on the legal and business units) and changes through merger, acquisition, divestitures, consolidation, or charter conversion since the prior review
2. a summary of the organization's business strategies, key business lines, product mix, marketing emphasis, growth areas, acquisition or divestiture plans, and new products introduced since the prior review
3. key issues for the organization, either from external or internal factors (for example, difficulties in keeping pace with competition or poorly performing business lines)
4. an overview of management, commenting on the level of board oversight, leadership strengths or weaknesses, policy formulation, and the adequacy of management information systems (Comments should include anticipated changes in key management, unusual turnover in line management, and management-succession plans. Key executives and the extent of their participation in strategic planning, policy formulation, and risk management may also be described.)
5. a brief analysis of the consolidated financial condition and trends, including earnings, invested capital, and return on investment by business line
6. a description of the future prospects of the organization, expectations or strategic forecasts for key performance areas, and budget projections

10. This list is provided in the context of institutions for which the Federal Reserve is the home-country supervisor. In the case of an FBO, the analysis should begin with the SOSA rating and the Summary of Condition of its U.S. operations. See SR-95-22 and also sections 2124.0.2.5 and 2127.0.

7. descriptions of internal and external audit, including the nature of any special work performed by external auditors during the period under review
8. a summary of supervisory activity performed since the last review, including safety-and-soundness inspections, examinations, and targeted or specialty inspections/examinations; supervisory actions and the institution's degree of compliance; and applications approved or in process
9. considerations for conducting future inspections, including the institution's preference for the coordination of specialty inspections/examinations and combined inspection and examination reports, as well as logistical and timing considerations, including conversion activities, space planning, and management availability

2124.01.6 ASSESSING THE INSTITUTION'S RISKS

In order to focus supervisory activities on the areas of greatest risk to an institution, the CPC or designated staff personnel should perform a risk assessment. The risk assessment highlights both the strengths and vulnerabilities of an institution and provides a foundation for determining the supervisory activities to be conducted. Further, the assessment should apply to the entire spectrum of risks facing an institution, including the following risks:

1. *credit risk,* which arises from the potential that a borrower or counterparty will fail to perform on an obligation
2. *market risk,* which is the risk to an institution's financial condition resulting from adverse movements in market rates or prices, such as interest rates, foreign-exchange rates, or equity prices
3. *liquidity risk,* which is the potential that an institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as ''funding-liquidity risk'') or because it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions (referred to as ''market-liquidity risk'')
4. *operational risk,* which arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses
5. *legal risk,* which arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a banking organization
6. *reputational risk,* which is the potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions

An institution's business activities present various combinations and concentrations of the above risks depending on the nature and scope of the particular activity. When conducting the risk assessment, consideration must be given to the institution's overall risk environment, the reliability of its internal risk management, the adequacy of its information technology systems, and the risks associated with each of its significant business activities. The preparation of the risk matrix provides a structured approach to assessing an institution's risks and is the basis for preparing the narrative risk assessment. See section 4070.1 and SR-95-51 for additional guidance on the evaluation of an institution's risk management.

2124.01.6.1 Assessment of the Overall Risk Environment

The starting point in the risk-assessment process is an evaluation of the institution's risk tolerance and of management's perception of the organization's strengths and weaknesses. Such an evaluation should entail discussions with management and a review of supporting documents, strategic plans, and policy statements. Management, in general, is expected to have a clear understanding of the institution's markets; the general banking, business, and economic environment; and how these factors affect the institution (in other words, their effect on the institution's use of technology, products, and delivery channels).

The institution should have a clearly defined risk-management structure. This structure may be formal or informal, centralized or decentralized. However, the greater the risk assumed by the institution, the more sophisticated its risk-management system should be. Regardless of the approach, the types and levels of risk an institution is willing to accept should reflect the risk appetite determined by its board of directors.

2124.01.6.1.1 Internal-Risk-Management Evaluation

In assessing the overall risk environment, the CPC should make a preliminary evaluation of the institution's internal risk management. That includes an assessment of the adequacy of the institution's internal audit, loan-review, and compliance functions. External audits also provide important information regarding the risk profile and condition of the institution and may be used in the risk assessment. In completing this evaluation, Reserve Banks should consider holding meetings with the external auditor and senior management who are responsible for internal audit, loan review, and compliance, as well as with other key risk managers. As appropriate, the meetings should be held jointly with a representative from other supervisory agencies that have an interest in the institution.

In addition, the CPC or designated staff personnel should consider reviewing risk assessments developed by the internal audit department for significant lines of business, and then compare their results with the supervisory risk assessment. Further, the contact should consider evaluating management's ability to aggregate risks on a global basis. Examiners can use this preliminary evaluation to determine how much they can rely on the institution's internal risk management when developing their scope of inspection and examination activities.

2124.01.6.1.2 Adequacy of Information Technology Systems

Effective risk monitoring requires institutions to identify and measure all material risk exposures. Consequently, risk-monitoring activities must be supported by management information systems (MIS) that provide senior managers and directors with timely and reliable reports on the financial condition, operating performance, and risk exposure of the consolidated organization. Such systems must also provide managers engaged in the day-to-day management of the organization's activities with regular and sufficiently detailed reports for their areas of responsibility. Moreover, in most large, complex institutions, MIS not only provides reporting systems, but also supports a broad range of business decisions through sophisticated risk-management and decision tools, such as credit scoring and asset/liability models and automated trading systems. Accordingly, the institution's risk assessment must consider the adequacy of information technology systems.

Institutions need to determine which business unit or units are responsible for the development and operation of the information technology system. Traditionally, such systems were largely centered on mainframe computers. However, the development of increasingly powerful and inexpensive personal computers and sophisticated network communication capabilities has given institutions more timely access to a greater volume of information that supports a broader range of business decisions—moving some transaction processing out of the mainframe environment. Consequently, many large institutions are transferring responsibility for development and operation of the hardware (generally, a local area or wide area network) and the related operating systems and applications from a centralized, mainframe function to individual business units. Many of these institutions are also integrating the information technology audit function with the general internal-audit function.

Once it has been determined which business units are responsible for information technology, a fuller understanding of the risk profile of specific functions and of the consolidated organization can be gained through close coordination between information systems specialists and safety-and-soundness examiners. Since business managers must have MIS reports that are sufficient and appropriate for identifying risks, examiners must work with specialists to assess the adequacy of the information technology system and the extent to which it can be relied upon. Evaluating the integrity of the information contained in reports for business managers requires an understanding of the information flows and the control environment for the operation. Knowledge of the business application is essential to determine whether the information flows are complete, accurate, and appropriate in a particular MIS. In addition, such a determination requires an assessment of the extent to which the institution's internal audit function has procedures in place for reviewing and testing the effectiveness of the processes and internal controls related to information technology systems.

2124.01.6.2 Preparation of the Risk Matrix

A risk matrix is used to identify significant activities, the type and level of inherent risks in these activities, and the adequacy of risk management over these activities, as well as to determine composite-risk assessments for each of these activities and the overall institution. A risk matrix can be developed for the consolidated organization, for a separate affiliate, or along functional business lines. The matrix is a flexible tool that documents the process followed to assess the overall risk of an institution and is a basis for preparation of the narrative risk assessment.

2124.01.6.2.1 Identification of Significant Activities

Activities and their significance can be identified by reviewing information from the institution, the Reserve Bank, or other supervisors. Information generated by the institution may include the balance sheet, off-balance-sheet reports, the income statement, management accounting reports, or any other report that is prepared for the institution's board of directors and senior management to monitor performance. A detailed income statement is particularly informative because it reflects significant activities and their relative importance to the institution's revenue and net income. The income statement also yields information regarding the relationship between the return on individual assets and the inherent risk associated with these assets, providing an important indicator of the institution's overall risk appetite.

Off-site surveillance information is another source of information that can be used to identify new or expanding business activities. For example, substantial growth in the loan portfolio may indicate that the institution has introduced a new lending activity.

In addition to financial factors, information on strategic plans, new products, and possible management changes needs to be considered. The competitive climate in which the institution operates is very important and should be assessed in the identification of significant activities. Industry segmentation and the position the institution occupies within its markets should also be considered.

2124.01.6.2.2 Type and Level of Inherent Risk of Significant Activities

After the significant activities are identified, the type and level of risk inherent in those activities should be determined. Types of risk may be categorized according to section 4070.1.2 and SR-95-51, or by using categories defined either by the institution or other supervisory agencies. If the institution uses risk categories that differ from those defined by the supervisory agencies, the examiner should determine if all relevant types of risk are appropriately captured. If risks are appropriately captured by the institution, the examiner should use the categories identified by the institution.

Table 2 illustrates risk types as defined by the Federal Reserve and the OCC.[11] This table is designed to show the relationship between the respective agencies' risk categories.

Table 2—Types of Risk

Federal Reserve	*OCC*
Credit	Credit
Market	Price Interest rate Foreign exchange
Liquidity	Liquidity
Reputational	Reputation
Operational	Transaction
Legal	Compliance
	Strategic*

* Elements of strategic risk are reflected in each of the risk categories as defined by the Federal Reserve.

For the identified functions or activities, the inherent risk involved in that activity should be described as high, moderate, or low for each type of risk associated with it. For example, it may be determined that a portfolio of commercial loans in a particular institution has high credit risk, moderate market risk, moderate liquidity risk, low operational risk, low legal risk, and low reputational risk. The following definitions apply:

1. *High inherent risk* exists when (1) the activity is significant or positions are large in

11. The FDIC is considering its definition of risk types.

relation to the institution's resources or to its peer group, (2) there are a substantial number of transactions, or (3) the nature of the activity is inherently more complex than normal. Thus, the activity could potentially result in a significant and harmful loss to the organization.
2. *Moderate inherent risk* exists when (1) positions are average in relation to the institution's resources or to its peer group, (2) the volume of transactions is average, and (3) the activity is more typical or traditional. Thus, while the activity could potentially result in a loss to the organization, the loss could be absorbed by the organization in the normal course of business.
3. *Low inherent risk* exists when the volume, size, or nature of the activity is such that even if the internal controls have weaknesses, the risk of loss is remote or, if a loss were to occur, it would have little negative impact on the institution's overall financial condition.

It is important to remember that this assessment of risk is made without considering management processes and controls. Those factors are considered in evaluating the adequacy of the institution's risk-management systems.

2124.01.6.2.3 Risk-Management-Adequacy Assessment for Significant Activities

When assessing the adequacy of an institution's risk-management systems for identified functions or activities, the CPC or designated staff personnel should place primary consideration on findings related to the following key elements of a sound risk-management system:

1. active board and senior management oversight
2. adequate policies, procedures, and limits
3. adequate risk-management, -monitoring, and management information systems
4. comprehensive internal controls

Taking these key elements into account, the contact should assess the relative strength of the risk-management processes and controls for each identified function or activity. Relative strength should be characterized as strong, acceptable, or weak as defined below:

1. *Strong risk management* indicates that management effectively identifies and controls all major types of risk posed by the relevant activity or function. The board and management participate in managing risk and ensure that appropriate policies and limits exist, which the board understands, reviews, and approves. Policies and limits are supported by risk-monitoring procedures, reports, and management information systems that provide the necessary information and analyses to make timely and appropriate responses to changing conditions. Internal controls and audit procedures are appropriate to the size and activities of the institution. There are few exceptions to established policies and procedures, and none of these exceptions would likely lead to a significant loss to the organization.
2. *Acceptable risk management* indicates that the institution's risk-management systems, although largely effective, may be lacking to some modest degree. It reflects an ability to cope successfully with existing and foreseeable exposure that may arise in carrying out the institution's business plan. While the institution may have some minor risk-management weaknesses, these problems have been recognized and are being addressed. Overall, board and senior management oversight, policies and limits, risk-monitoring procedures, reports, and management information systems are considered effective in maintaining a safe and sound institution. Risks are generally being controlled in a manner that does not require more than normal supervisory attention.
3. *Weak risk management* indicates risk-management systems that are lacking in important ways and, therefore, are a cause for more than normal supervisory attention. The internal control system may be lacking in important respects, particularly as indicated by continued control exceptions or by the failure to adhere to written policies and procedures. The deficiencies associated in these systems could have adverse effects on the safety and soundness of the institution or could lead to a material misstatement of its financial statements if corrective actions are not taken.

The definitions above apply to the risk management of individual functions or activities. They parallel the definitions set forth in section

4070.1.2 (SR-95-51) that examiners are to use to rate an institution's overall risk management. However, unlike the overall risk-management rating, the assessment of the adequacy of risk-management systems incorporated into the risk matrix is to be used primarily for planning supervisory activities. In addition, because the risk matrix is prepared during the planning process, it generally would not be appropriate to make fine gradations in the strength of risk-management systems on a function-by-function basis. In particular, for purposes of rating an institution's overall risk management, section 4070.1.2 (SR-95-51) makes distinctions in degrees of weakness—fair, marginal, and unsatisfactory—that generally cannot be made appropriately on a function-by-function basis, as called for when preparing the risk matrix. After appropriate inspection and examination procedures are performed, the assessment of the institution's risk management that was prepared for the risk matrix may be a starting point for assigning an overall risk-management rating for the institution.

2124.01.6.2.4 Composite-Risk Assessment of Significant Activities

The composite risk for each significant activity is determined by balancing the overall level of inherent risk of the activity with the overall strength of risk-management systems for that activity. For example, commercial real estate loans usually will be determined to be inherently high risk. However, the probability and the magnitude of possible loss may be reduced by having very conservative underwriting standards, effective credit administration, strong internal loan review, and a good early warning system. Consequently, after accounting for these mitigating factors, the overall risk profile and level of supervisory concern associated with commercial real estate loans may be moderate. Table 3 provides guidance on assessing the composite risk of an activity by balancing the observed quantity and degree of risk with the perceived strength of related management processes and internal controls.

To facilitate consistency in the preparation of the risk matrix, general definitions of the composite level of risk for significant activities are provided below.

Table 3—Composite Risk for Significant Activities

Risk-Management Systems	*Inherent Risk of the Activity*		
	Low	*Moderate*	*High*
	Composite-Risk Assessment		
Weak	Low or Moderate	Moderate or High	High
Acceptable	Low	Moderate	High
Strong	Low	Low or Moderate	Moderate or High

1. A *high composite risk* generally would be assigned to an activity when the risk-management system does not significantly mitigate the high inherent risk of the activity. Thus, the activity could potentially result in a financial loss that would have a significant negative impact on the organization's overall condition—in some cases, even where the systems are considered strong. For an activity with moderate inherent risk, a risk-management system that has significant weaknesses could result in a high composite-risk assessment because management appears to have an insufficient understanding of the risk and an uncertain capacity to anticipate and respond to changing conditions.
2. A *moderate composite risk* generally would be assigned to an activity with moderate inherent risk where the risk-management systems appropriately mitigate the risk. For an activity with a low inherent risk, significant weaknesses in the risk-management system may result in a moderate composite-risk assessment. On the other hand, a strong risk-management system may reduce the risks of an inherently high-risk activity so that any potential financial loss from the activity would have only a moderate negative impact on the financial condition of the organization.
3. A *low composite risk* generally would be assigned to an activity that has low inherent risks. An activity with moderate inherent risk may be assessed a low composite risk where internal controls and risk-management systems are strong and effectively mitigate much of the risk.

2124.01.6.2.5 Overall-Composite-Risk Assessment

Once the examiner has assessed the composite risk of each identified significant activity or function, an overall-composite-risk assessment should be made for off-site analytical and planning purposes. This assessment is the final step in the development of the risk matrix; the evaluation of the overall composite risk is incorporated into the written risk assessment.

2124.01.6.2.6 Preparation of the Risk Assessment

A written risk assessment should be prepared to serve as an internal supervisory planning tool and to facilitate communication with other supervisors. A sample risk assessment is provided below. The goal is to develop a document that presents a comprehensive, risk-focused view of the institution, which delineates the areas of supervisory concern and is a platform for developing the supervisory plan.

The format and content of the written risk assessment are flexible and should be tailored to the individual institution. The risk assessment reflects the dynamics of the institution and, therefore, should consider the institution's evolving business strategies and be amended as significant changes in the risk profile occur. It should include input from other affected supervisors and specialty units to ensure that all significant risks of the institution are identified. The risk assessment should—

1. include an overall risk assessment of the organization;
2. describe the types of risks (credit, market, liquidity, reputational, operational, legal), their level (high, moderate, low), and the direction (increasing, stable, decreasing) of risks;
3. identify all major functions, business lines, activities, products, and legal entities from which significant risks emanate and the key issues that could affect the risk profile;
4. consider the relationship between the likelihood of an adverse event and the potential impact on an institution (for example, the likelihood of a computer system failure may be remote, but the financial impact could be significant); and
5. describe the institution's risk-management systems. Reviews and risk assessments performed by internal and external auditors should be discussed, as should the ability of the institution to take on and manage risk prospectively.

The CPC should attempt to identify and report the cause of unfavorable trends, as well as their symptoms. Also, it is very important that the risk assessment reflect a thorough, detailed analysis that supports the conclusions made about the institution's risk profile.

2124.01.7 PLANNING AND SCHEDULING SUPERVISORY ACTIVITIES

The supervisory plan represents a bridge between the institution's risk assessment, which identifies significant risks and supervisory concerns, and the supervisory activities to be conducted. In developing the supervisory plan and inspection and examination schedules, the CPC should minimize disruption to the institution and, whenever possible, avoid duplicative inspection and examination efforts and requests for information from other supervisors.[12]

The institution's organizational structure and complexity represent significant considerations in planning the specific supervisory activities to be conducted. Additionally, interstate banking and branching activities have implications for planning on-site and off-site reviews. The scope and location of on-site work for interstate banking operations will depend on the significance and risk profile of local operations, the location of the supervised entity's major functions, and the degree of its centralization. Consistent with the Federal Reserve practice of not examining each branch of an intrastate branching network, the bulk of safety-and-soundness examinations for branches of an interstate bank would likely be conducted at the head office or regional offices, supplemented by periodic reviews of branch operations and internal controls. The supervisory plan should reflect the need to coordinate these reviews of branch operations with other supervisors.

12. See section 5000.0.8.3 and SR-93-30 and its attachments for guidance on examination coordination of holding company inspections with subsidiary bank and thrift examinations, and SR-95-22 regarding coordination with other agencies as part of the FBO supervision program.

2124.01.7.1 Preparation of the Supervisory Plan

A comprehensive supervisory plan[13] should be developed annually and updated as appropriate for the consolidated organization. The plan should demonstrate the supervisory concerns identified through the risk-assessment process and how the deficiencies noted in the previous inspection or examination are being or will be addressed. To the extent that the institution's risk-management systems are adequate, the level of supervisory activity may be adjusted. The plan should generally address the following areas:

1. All supervisory activities to be conducted, the scope of those activities (full or targeted), the objectives of those activities (for example, review of specific business lines, products, support functions, legal entities), and specific concerns regarding those activities, if any. Consideration should be given to—
   a. prioritizing supervisory resources on areas of higher risk,
   b. pooling examiner resources to reduce burden and redundancies,
   c. maximizing the use of examiners located where the activity is being conducted,
   d. coordinating examinations of different disciplines,
   e. determining compliance with, or the potential for, supervisory action, and
   f. balancing mandated requirements with the objectives of the plan.
2. General logistical information (for example, timetable of supervisory activities, participants, and expected resource requirements).
3. The extent to which internal and external audit, internal loan review, compliance, and other risk-management systems will be tested and relied upon.

The planning horizon to be covered by the plan is generally 18 months for domestic institutions.[14] The overall supervisory objectives and basic framework need to be outlined by midyear to facilitate preliminary discussions with other supervisors and to coincide with planning for the Federal Reserve's scheduling conferences. The plan should be finalized by the end of the year, for execution in the following year.

2124.01.7.2 Preparation of the Inspection/Examination Program

The inspection/examination program should provide a comprehensive schedule of inspection/examination activities for the entire organization and aid in the coordination and communication of responsibilities for supervisory activities. An inspection/examination program provides a comprehensive listing of all inspection and examination activities to be conducted at an institution for the given planning horizon. To prepare a complete program and to reflect the current conditions and activities of an institution and the activities of other supervisors, the CPC needs to be the focal point for communications on a particular institution, including any communications with the Federal Reserve and the institution's management and other supervisors. The inspection/examination program should generally incorporate the following logistical elements:

1. a schedule of activities, the duration of time, and resource estimates for planned projects
2. an identification of the agencies conducting and participating in the supervisory activity (when conducted jointly with other agencies, indicate the lead agency and the agency responsible for a particular activity) and the resources committed by all participants to the area(s) under review
3. the planned product for communicating findings (indicate whether it will be a formal report or supervisory memorandum)
4. the need for special examiner skills and the extent of participation by specialty disciplines

2124.01.8 DEFINING INSPECTION/EXAMINATION ACTIVITIES

The scope memorandum is an integral product in the risk-focused methodology. The memorandum identifies the key objectives of the on-site inspection or examination. The focus of on-site inspection or examination activities, as identified in the scope memorandum, should be oriented to a top-down approach that includes a

13. The supervisory plan is a high-level plan of supervisory activities to be conducted in monitoring the consolidated organization. More detailed procedures for a specific on-site inspection are appropriately addressed in a scope memorandum, which is discussed in section 2124.01.8.

14. The examination plans and assessments of condition of U.S. operations that are used for FBO supervision use a 12-month period.

review of the organization's internal risk-management systems and an appropriate level of transaction testing. The risk-focused methodology provides flexibility in the amount of on-site transaction testing. Although the focus of the inspection/examination is on the institution's processes, an appropriate level of transaction testing and asset review will be necessary to verify the integrity of internal systems. If internal systems are considered reliable, then transaction testing should be targeted to a level sufficient to validate that the systems are effective and accurate. Conversely, if internal management systems are deemed unreliable or ineffective, then transaction testing must be adjusted to increase the amount of coverage. The entry letter identifies the information necessary for the successful execution of the on-site inspection and/or examination procedures.

2124.01.8.1 Scope Memorandum

After the areas to be reviewed have been identified in the supervisory plan, a scope memorandum should be prepared that documents specific objectives for the projected inspection or examination. This document is of key importance, as the scope will likely vary from year to year. Thus, it is necessary to identify the specific areas chosen for review and the extent of those reviews. The scope memorandum will help ensure that the supervisory plan for the institution is executed and will define and communicate those specific objectives to the inspection/examination staff.

The scope memorandum should be tailored to the size, complexity, and current rating of the institution subject to review. For large but less complex institutions, the scope memorandum may be combined with the supervisory plan or risk assessment. The scope memorandum should generally include—

1. a statement of the objectives;
2. an overview of the activities and risks to be evaluated;
3. the level of reliance on internal risk-management systems and internal or external audit findings;
4. a description of the procedures that are to be performed, indicating any sampling process to be used and the level of transaction testing, when appropriate;
5. identification of the procedures that are expected to be performed off-site; and
6. a description of how the findings of targeted reviews, if any, will be used on the current inspection/examination.

2124.01.8.2 Entry Letter

Standardized entry inspection and examination letters[15] have been developed that are closely aligned with the risk-focused approach for large, complex institutions. They are designed to reduce the institutions' paperwork burden. The entry letters include a core section of required information that is pertinent to all large institutions, regardless of size or complexity. In addition to the core requests, supplementary questionnaires should be used as needed for the specialized areas such as asset securitization/sales, information systems, private banking, securities clearance/lending, trading activities, and transfer risk. The cover letters must be used (they can be modified), as they provide specific guidance to the inspected or examined institution.

The entry letters direct management to provide written responses to questions and to provide copies of specific documents requested, but only if the requested information is new or has changed since the previous examination or inspection. Examiners should not request management to provide them with copies of the institution's regulatory reports that are available within each Federal Reserve Bank or from other bank regulatory agencies, such as regulatory inspection and examination reports and various financial information (for example, annual reports or call reports). These reports should be gathered from internal sources during the preexamination planning process. Also, entry letters should not request information that is regularly provided to designated CPCs. The examiner-in-charge should always review anticipated information and document needs with the CPC for the inspected or examined institution before the mailing of any entry letter.

The entry letters should be used as a starting point, or template, in preparing for an examination or inspection. They should be tailored during the planning process to fit the specific character and profile of the institution to be inspected or examined and the scope of the

15. Such entry letters should be used for a (1) combined bank holding company inspection and lead state member bank examination, (2) bank holding company inspection (see appendix B), and (3) state member bank examination.

activities to be performed. Thus, the effective use of entry letters is highly dependent on the planning and scoping of a risk-focused inspection or examination.

The entry letters request internal management information reports for each of the key inspection/examination areas. Internal management reports should be used in all instances. If they do not provide sufficient information to inspect or examine the institution, then it would appear that management is not adequately informed—this may well be the first inspection or examination finding. As specific items are selected for inclusion in the entry letter, the following guidelines for items should be considered:

1. *Reflect risk-focused supervision objectives and the inspection/examination scope.* Items that are not needed to support selected inspection/examination procedures should not be requested.
2. *Facilitate efficiency in the inspection/ examination process and lessen the burden on financial institutions.* Minimize the number of requested items and avoid, to the extent possible, duplicate requests for information already provided to other agencies.
3. *Limit, to the extent possible, requests for special management reports.*
4. *Eliminate items used for audit-type procedures.* Such procedures (for example, verifications) are generally performed only when there is a reason to suspect that significant problems exist.
5. *Distinguish information to be mailed to the examiner-in-charge for off-site inspection/ examination procedures from information to be held at the institution for on-site procedures.* Information that is not easily reproduced should be reviewed on-site (for example, policies, corporate minutes, audit workpapers).
6. *Allow management sufficient lead time to prepare the requested information.*

2124.01.9 PERFORMING INSPECTION OR EXAMINATION PROCEDURES

Inspection or examination procedures should be tailored to the characteristics of each institution, keeping in mind its size, complexity, and risk profile. The procedures should focus on developing appropriate documentation to adequately assess management's ability to identify, measure, monitor, and control risks. Procedures should be completed to the degree necessary to determine whether the institution's management understands and adequately controls the levels and types of risks that are assumed. In terms of transaction testing, the volume of transactions tested should be adjusted according to management's ability to accurately identify problem and potential problem transactions and to measure, monitor, and control the institution's risk exposure. Likewise, the level of transaction testing for compliance with laws, regulations, and supervisory policy statements should take into account the effectiveness of management systems to monitor, evaluate, and ensure compliance.

Most full-scope inspections/examinations are expected to include the examiners' evaluation of 10 functional areas during the supervisory cycle. There may be a need to identify and include additional functional areas. To evaluate these functional areas, examiners must perform procedures tailored to fit (1) the risk assessment prepared for the institution and (2) the scope memorandum. These functional areas represent the primary business activities and functions of large, complex institutions, as well as common sources of significant risk to them. Further, consistent with the risk-focused approach, examiners are expected to evaluate other areas that are significant sources of risk to an institution or that are central to the assignment of CAMELS, BOPEC, and ROCA ratings. The identified functional areas include the following:

1. loan-portfolio analysis (portfolio management, loan review, allowance for loan and lease losses)
2. Treasury activities (asset/liability management, interest-rate risk, parent company liquidity, funding, investments, deposits)
3. trading and capital-markets activities (foreign exchange, commodities, equities, and other interest-rate risk; credit risk; and liquidity risk)
4. audit and internal-control review
5. final assessment of supervisory ratings (CAMELS, BOPEC, ROCA, or other)
6. information systems
7. fiduciary activities
8. private banking
9. retail-banking activities (new products and delivery systems)
10. payments system risk (wire transfers, reserves, settlement)

2124.01.10 REPORTING THE FINDINGS

It is important for examiners to document their overall conclusions after performing the inspection/examination procedures. Conclusions, as they relate to the functional area under review, should clearly communicate the examiner's assessment of the internal risk-management system, the financial condition, and compliance with laws and regulations.

Inspection and examination activities should be coordinated with the respective state and other federal banking authorities, with joint examinations performed and joint inspection and examination reports completed wherever practicable. The inspection and examination activities should be planned over the supervisory cycle, culminating with an annual, full-scope inspection/examination of the organization. As part of the FBO supervision program, individual examination findings are integrated into an assessment of the FBO's entire U.S. operations.

The results of a targeted, subsidiary, or specialty inspection or examination are usually reported to the institution's management in a separate report or supervisory letter. Therefore, the report for the annual full-scope inspection of the consolidated parent organization should include a summary of the relevant results of any preceding supervisory activity. When targeted or specialty inspections or examinations of affiliates are conducted concurrently with the annual full-scope inspection of the consolidated parent organization, the findings from the targeted or specialty examinations should be incorporated into the parent's inspection report in lieu of separate reports, unless the institution's management requests separate reports. For organizations in which the lead bank is a state member bank, the annual full-scope examination report should be combined with the bank holding company inspection report, as appropriate. The bank holding company inspection report, or combined inspection/examination report, may also include other bank and nonbank subsidiary examinations, according to the organization's supervisory plan.

The contents of the report should clearly and concisely communicate to the institution's management or to the directorate any supervisory issues, problems, or concerns related to the institution, as well as disclose the assigned supervisory rating.[16] The report should also include appropriate comments regarding deficiencies noted in the institution's risk-management systems. Accordingly, the descriptions accompanying each component of the CAMELS rating system[17] should emphasize management's ability to identify, measure, monitor, and control risks. The rating assigned should reflect the adequacy of the institution's risk-management systems in light of the amount and types of risks that the institution has taken on.

16. See section 5010.4 and SR-96-26 for additional information.

17. See SR-96-38 for additional information on the revised CAMELS rating system.

2124.01.11 APPENDIX A—RISK-FOCUSED SUPERVISORY LETTERS WITH BHC SUPERVISION MANUAL SECTION NUMBERS

SR-Letter	*SR-Letter Title*	*BHCSM Section No.*
SR-00-15 (SUP)	Risk-Focused Supervision Policy for Small Shell BHCs	5000.0.4.5
SR-00-13 (SUP)	Framework for Financial Holding Company Supervision	3900.0
SR-99-37 (SUP)	Risk Management and Valuation of Retained Interests Arising from Securitization Activities	2128.06
SR-99-23 (SUP)	Recent Trends in Bank Lending Standards for Commercial Loans	2010.2.2 2010.10
SR-99-18 (SUP)	Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles	4060.7

SR-Letter	*SR-Letter Title*	*BHCSM Section No.*
SR-99-15 (SUP)	Risk-Focused Supervision of Large Complex Banking Organizations	2124.04
SR-99-6 (SUP)	Subprime Lending	2128.08
SR-99-3 (SUP)	Supervisory Guidance Regarding Counterparty Credit Risk Management	2126.3
SR-98-18 (SUP)	Lending Standards for Commercial Loans	2122.0
SR-98-12 (SUP)	FFIEC Policy Statement on Investment Securities and End-User Derivatives Activities	2126.1
SR-98-9 (SUP)	Assessment of Information Technology in the Risk-Focused Frameworks for the Supervision of Community Banks and Large Complex Banking Organizations	2124.1
SR-97-35 (SUP)	Interagency Guidance on the Internal-Audit Function and Its Outsourcing	2060.05
SR-97-24 (SUP)	Risk-Focused Framework for Supervision of Large Complex Institutions	2124.01
SR-97-21 (SUP)	Risk Management and Capital Adequacy of Exposures Arising from Secondary-Market Credit Activities	2129.05
SR-96-38 (SUP)	Uniform Financial Institution Rating System (CAMELS—adding the ‘‘S’’ for risk management)	4020.9 4070.0.4 4080.0
SR-96-33 (SUP)	State/Federal Protocol and Nationwide Supervisory Agreement	
SR-96-29 (SUP)	Supervisory Program for Risk-Based Inspection of Top 50 Bank Holding Companies	
SR-96-27 (SUP)	Guidance on Addressing Internal-Control Weaknesses in U.S. Branches and Agencies of Foreign Banking Organizations Through Special Audit Procedures	
SR-96-26 (SUP)	Provisions of Individual Components of the Rating System	5010.4
SR-96-17 (GEN)	Supervisory Guidance for Credit Derivatives	2129.0
SR-96-14 (SUP)	Risk-Focused Safety-and-Soundness Examination and Inspection	2124.0
SR-96-13 (SUP)	Joint Policy Statement on Interest-Rate Risk	2127.0
SR-96-10 (SPE)	Risk-Focused Fiduciary Examinations	
SR-95-51 (SUP)	Rating the Adequacy of Risk Management and Internal Controls at State Member Banks and Bank Holding Companies	4070.1
SR-95-17 (SUP)	Evaluating the Risk Management and Internal Controls of Securities and Derivative Contracts Used in Nontrading Activities	2126.0
SR-93-69 (FIS)	Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations	2125.0
SR-93-19 (FIS)	Supplemental Guidance for Inspection of Nonbank Subsidiaries of Bank Holding Companies	5000.0.4.4
SR-92-31 (FIS)	Administrative Procedures for Reporting Revised BOPEC Ratings	
SR-89-25 (FIS)	Multi-Tier Bank Holding Company Inspections	5000.0.7.5

2124.01.12 APPENDIX B—NONBANK SUBSIDIARY RISK-ASSESSMENT QUESTIONNAIRE

NONBANK SUBSIDIARY OF A BANK HOLDING COMPANY RISK-ASSESSMENT QUESTIONNAIRE

Name of subsidiary ________________________________

Name of bank holding company ________________________________

BHC Consolidated:
Tier 1 capital: $_____________ Total operating revenue*: $_____________

*Defined as the sum of total interest income and total non-interest income, before extraordinary items.

Subsidiary total assets: $________ Subsidiary total operating revenue: $________

Questions: *(Circle answer.)*

1. Are the subsidiary's total assets 10 percent or more of BHC consolidated tier 1 capital? Yes No
2. Is the subsidiary's total operating revenue 10 percent or more of BHC consolidated operating revenue? Yes No
3. Does the subsidiary issue debt to unaffiliated parties? Yes No
4. Does the subsidiary rely on affiliated banks for funding debt that is either greater than $10 million or 5 percent of BHC consolidated tier 1 capital? (See SR-93-19.) Yes No
5. Is the subsidiary involved in asset securitization? Yes No
6. Does the subsidiary generate assets and sell assets to affiliates? Yes No
7. Is the subsidiary a broker-dealer affiliate engaged in underwriting, dealing, or market making? Yes No
8. Does the subsidiary provide derivative instruments for sale or as a service to unaffiliated parties? Yes No
9. Has the subsidiary had a significant impact on the BHC's condition or performance? Yes No

If any question is answered yes, then this subsidiary should be considered for on-site review. If an on-site review is not being conducted, state the reason below.

Prepared by: ________________________________ Date: _____________

2124.01.13 APPENDIX C—FEDERAL RESERVE BANK COVER LETTER AND BHC INSPECTION QUESTIONNAIRE

Federal Reserve Bank
of San Francisco

Division of Banking Supervision and Regulation
San Francisco, California 94120

D.F. Roe
Senior Vice President
DEF BanCorp
Greentree Boulevard
Anytown, U.S.A. 11111

Dear Mr. Roe:

In order to facilitate an inspection of DEF BanCorp on a fully consolidated basis, you are requested to instruct the appropriate staff to provide the information described in this questionnaire. Unless indicated otherwise, information is requested as of the financial statement date December 31, 20X2. You are asked to provide written responses to questions and copies of specific documents requested in this questionnaire only if the requested information is new or has changed since the previous inspection, which was conducted as of December 31, 20X1 (indicate no change where applicable). For each area covered by this questionnaire, please provide the most recent reports used by management to identify, measure, monitor, and control risk in the respective areas. Please note that examiners may make additional requests during the inspection.

Single copies of all submissions in response to the requests will be satisfactory unless otherwise indicated and should be delivered to the examiner-in-charge or designee. Any requests for clarification or definition of terms should also be directed to the examiner-in-charge.

In order to expedite the inspection, each completed schedule and other requested information should be submitted as soon as prepared and should not be accumulated for submission as a package. Please respond to every item in the questionnaire, indicating N/A if a question is not applicable.

Most of the requested data will not be needed until the commencement of the inspection, which is March 15, 20X3. However, certain information may be needed earlier. Such information and the date due will be discussed with you.

____
Federal Reserve examiner-in-charge

____
Examiner’s telephone number

FEDERAL RESERVE BANK
BANK HOLDING COMPANY INSPECTION QUESTIONNAIRE

Please provide the following:

Structure

1. The most recent organization chart—
   (a) for the holding company and its subsidiaries by legal entity, showing percentage of ownership if less than 100 percent; and
   (b) of management by legal entity and functional business lines, if different, indicating lines of authority and allocation of duties for all key business lines and support areas of the organization.
2. List new activities that the bank holding company or nonbank subsidiaries have engaged in since the previous inspection, either on- or off-balance-sheet, and identify the group responsible for the management of these activities. How has management identified and evaluated risk in relation to these new activities? Provide copies of any management reports regarding these products/activities. Please provide a copy of the company's risk policy statement regarding new activities.
3. The following on each new subsidiary formed or acquired since the prior inspection and changes, where applicable, on existing subsidiaries.
   (a) name
   (b) location
   (c) date acquired or formed
   (d) percentage of ownership
   (e) nature of business or business purpose
   (f) list of branch locations by city and state
   (g) balance sheet and income statement
   (h) off-balance-sheet, asset securitization, and derivatives activities and description of such
   (i) list of principal officers
   (j) management contact person
4. Since (date), has there been any change in or transfer of functions or responsibilities between the corporation and its subsidiaries and between subsidiaries and/or their affiliates? If so, describe fully.
5. Since (date), have there been any sales or other transfers of any assets among the corporation and its subsidiary banks, affiliates of the banks, and/or other subsidiaries? If so, describe fully and include details on loan participations purchased and sold.
6. Since (date), have any subsidiaries been deactivated, sold, liquidated, transferred, or disposed of in some other way? If so, identify the subsidiary, the reason for disposition, and the effective date of disposition.
7. Has the corporation planned or entered into any new agreements, written or oral, to acquire any additional entities? If so, give pertinent details, including name, location, type of business, and purchase terms.

Corporate Planning and Policy Information

8. The latest financial projections or business plan(s) for revenues, expenses, assets, liabilities, capital, and contingent liabilities for the current and next fiscal years. Please include details on the assumptions used in the preparation of the projections.
9. A copy of the strategic business plan with updates or revisions, if any.
10. If new or amended since the prior inspection, copies of policies for the following:
    (a) the level of supervision exercised over subsidiaries
    (b) loans and investments of subsidiaries
    (c) loan participations by and between subsidiaries
    (d) dividends and fees from subsidiaries
    (e) dividends paid to stockholders
    (f) budgeting and tax planning for subsidiaries
    (g) insider transactions
    (h) funds, asset-liability, and interest-rate risk management at the parent company and subsidiaries
    (i) risk identification, evaluation, and control (for example, any credit risks, market risks, liquidity risks, reputational risks, operational risks, and legal risks)
    (j) internal loan-review and -grading system
    (k) internal audit
    (*l*) any authorized outstanding commitments to the Federal Reserve
    (m) description of any routine tie-in arrangements that are used in providing or contracting for services

Corporate Financial Information

11. For the consolidated company, provide consolidating balance sheet and income statement, including schedules of eliminating entries.
12. Full details on unaffiliated borrowings of the consolidated organization. For debt issued since the prior inspection, please provide the prospectus for public-debt offerings and a summary of terms for private-debt placements.
13. A copy of the most current periodic financial package prepared for senior management and/or directors.

Subsidiary Information

14. Consolidating and consolidated balance sheets, including off-balance-sheet items, and income statements for each nonbank first-tier subsidiary.
15. Details of all capital injections made to subsidiaries or returns of capital from subsidiaries (excluding normal operating dividends) since the prior inspection. Also provide details on any advance to a subsidiary which has been reclassified as equity.
16. If subsidiary banks have made any extensions of credit to the bank holding company and/or other affiliates, give details.

17. Describe any services performed by the parent for any subsidiaries or any company in which it has a 5 percent or greater interest.

Parent Company

18. Details on intercompany payments either (1) from the parent company to affiliates or subsidiaries or (2) from subsidiaries or affiliates to the parent company. Segregate into dividends, interest, management or service fees, expense payments, or other transfers made since the prior inspection. If a payment is governed by an intercompany agreement, please provide a copy of the agreement. If not, please provide the basis of the payment made.
19. Internally generated cash-flow statement and liquidity schedule for the latest quarter ending. Make available supporting documentation. Provide access to the workpapers supporting the preparation of the Cash-Flow Schedule (schedule PI-A) from the Y-9LP report
20. Full details on new parent company's investments in or advances to subsidiaries, and extensions of credit to and borrowings from subsidiaries (including unused lines of credit) since the previous inspection.
21. Full details on the terms of any third-party borrowing and credit lines made available since the previous inspection.
22. If any entities (parent company and/or subsidiaries) maintain compensating balances with third parties, indicate restrictions, if any.
23. A copy of the contingency funding plan. If such a plan does not exist, please provide a description of what actions would be taken to meet disruptions in the corporation's short-term liability market.
24. Details on security and other investments held by type; par; book and market values; number of shares owned; interest rates; maturity dates; and convertibility features, where applicable. Include a copy of all investment authorization policies and delegations of authority pertaining thereto.
25. For equity investments or any lending activity, please provide a listing with comments on any significant items that may not be fully collectible and any other relevant factors.
26. A copy of the capital funding plan or planned changes in equity funding, a financial analysis of any changes in equity (including any stock redemptions), and any internal financial analysis used to evaluate capital adequacy.
27. Since the previous inspection, if the corporation has purchased or sold securities or other assets under an agreement to resell or repurchase, give details.
28. If the corporation has, for its own account, any incomplete purchases or sales of securities pending, give details.
29. If the parent corporation and/or any nonbank subsidiaries have loans outstanding that are secured by stock or any obligations of the corporation or any of its subsidiaries, give details.
30. Since the prior inspection, if the corporation, either for its own account or for others, has guaranteed the payment of any loan or other debt obligation or guaranteed the performance of any other undertaking, provide details.

Corporate-Debt-Markets Activities

31. The following information on commercial paper:
    (a) direct placements outstanding

   (b) dealer placements outstanding
   (c) monthly maturity schedules showing breakdown for direct and dealer placements
   (d) a copy of a ‘‘no action’’ letter, if the SEC has issued one

32. Identify any subsidiary which sells commercial paper for its own use or for its parent.
33. If any commercial paper, stock, and/or convertible debt of the corporation or its subsidiaries is held by trust departments of subsidiary banks, provide details.
34. If there are any concentrations of commercial paper holdings in excess of 10 percent of the outstanding commercial paper by any individual or organization, provide details.

Corporate Tax Information

35. If the corporation files a consolidated tax return, on what basis does it determine the amount of taxes to be paid by subsidiaries? Provide a copy of the tax-sharing agreement with subsidiaries.
36. A schedule detailing the following information for (specify dates)—
    (a) payments (estimated or otherwise) made by the corporate-tax-paying entity to the taxing authorities and the dates of such payments; and
    (b) payments received by the tax-paying entity from other holding company subsidiaries (or the tax benefits paid to those subsidiaries) and transaction dates.
37. Provide details of any ongoing IRS audit.

Officers, Directors, and Shareholders

38. For senior officers of the corporation, indicate their title, responsibility, and position(s) held at subsidiary and/or other organizations.
39. List of directors of the corporation, including—
    (a) number of shares owned directly and/or indirectly, and
    (b) occupation or principal business affiliation.
40. A brief biography of each senior officer appointed and director elected since the prior inspection. Please include the person’s date of birth, business background, education, and affiliations with any outside organizations. For senior officers, indicate date of hire. For directors, indicate date of election to board.
41. List of board committees, their memberships, and frequency of meetings.
42. Make available board and committee minutes.
43. Details on fees paid to directors.
44. If the corporation has entered into any contracts or agreements to pay or provide additional sums or fringe benefits to any director, officer, or employee, provide cost and details.
45. Details on any stock option, incentive, bonus, or performance plans for officers and employees.
46. List of loans made by the parent company and/or nonbank subsidiaries to directors and executive officers (and their interests) of the parent company and/or subsidiaries. For the purpose of this request, a director’s or executive officer’s interest refers to a beneficial ownership, directly or indirectly, amounting to 25 percent or more and also to companies otherwise controlled by a director or officer.
47. List of investments of the parent and/or subsidiaries in stocks, bonds, or other obligations of

corporations in which directors and executive officers have a beneficial interest.

48. List of loans to any borrower that are secured by stocks, bonds, or other obligations of corporations in which directors and executive officers have a beneficial interest.
49. List of shareholders who own 5 percent or more of any class of voting stock and the percentage held.
50. List of loans made by the parent company and/or nonbank subsidiaries to shareholders who own 5 percent or more of the parent company's outstanding shares.

Asset Quality

51. A copy of the latest internal consolidated asset-quality tracking report with aggregate totals of internally criticized assets and off-balance-sheet items. Identify aggregate exposures by type, risk rating, and entity where the exposure is booked. Distinguish between direct and indirect extensions of credit.
52. Details on consolidated loans past due as to principal and/or interest, nonperforming loans and other real estate owned, and totals of such for each subsidiary.
53. A breakdown of the corporation's consolidated and major subsidiaries' loan-loss reserves (for example, the allowance for loan and lease losses), including portions earmarked for the commercial, consumer, and other segments, with a description of and supporting data for the methodology used in determining its adequacy.

Audit

(The following information should be requested only if the function resides within the parent company. If the function is performed at a nonmember lead bank subsidiary, then assess the audit function through discussions with the bank's primary regulator.)

54. A copy of the most recent engagement letters or equivalent information which describes the scope of external audit activities performed for the corporation and any of its nonbank subsidiaries. Make available a copy of the audit program.
55. An organization chart which shows the structure and staffing of the audit function.
56. The following information about the auditor and key assistants (if not provided at prior inspections):
    (a) present position and date assumed
    (b) date of employment
    (c) brief summary of education, experience at this institution, and prior work experience
57. Make available the audit timetable and audit program, workpapers, and procedures used in conducting audits of the parent company and all subsidiaries.

Miscellaneous

58. A summary schedule of fidelity bond and general liability insurance, listing all areas covered for loss/liability, and date of board approval.
59. Make available the corporation's latest pending litigation report describing any significant pending or potential litigation or investigations against the organization or any director, officer, or policy-making employee in their official capacity, with the following information:

(a) name(s) of plaintiff

(b) nature of claim and damages requested

(c) current status

(d) an opinion of the probable outcome, including an estimation of the organization's liability

The Federal Reserve's ongoing large, complex banking organization (LCBO) supervisory program is designed to recognize dramatic changes in the financial, technological, legal, and regulatory environment that necessitate a flexible supervisory framework. This includes the ongoing review and assessment of LCBO risk profiles and the continual adjustment of supervisory plans and programs for individual banking organizations (BOs). Environmental factors that have a significant impact on the nature of LCBO operations and the financial system include the following:

1. *Financial innovation and deregulation.* The range, volume, and complexity of traditional banking businesses have increased, and BOs have moved into nontraditional and potentially more complex financial activities and services, such as securitizations, securities underwriting and dealing, trading, derivatives, and other capital-markets activities.[1]
2. *Increasing competitive pressures.* The distinctions between financial products have blurred, and the competition in national and global markets between BOs, nonbank financial firms, and diversified financial-services conglomerates has intensified.
3. *Geographic expansion and globalization.* The continued expansion by BOs, both nationally and globally, and the integration of financial markets have increased the challenges associated with assessing and supervising the worldwide activities of U.S. BOs and the U.S. operations of foreign banking organizations.
4. *Revolution in information technology.* The dramatic changes in information and telecommunications technology have increased the speed, complexity, geographic scope, and volume of financial transactions, and have made possible new techniques for BOs to take on and manage risks.

These environmental factors have the potential for swift and dramatic changes in the risk profiles of LCBOs and can provide avenues for the more rapid transmission of financial shocks. Such developments in turn require supervisors to employ more continuous and risk-focused supervision processes. See SR-99-15, SR-97-24, and section 2124.01.

1. The term "banking organizations" refers to bank holding companies and their bank and nonbank subsidiaries.

2124.04.1 CONTINUED UNDERSTANDING OF AN LCBO AND ITS MAJOR RISKS

The process of maintaining a *current* understanding of an LCBO and its major risks relies heavily on gathering information from a wide variety of public and confidential sources, including supervisory reviews and evaluations and discussions with management and other supervisors. One of the primary objectives of this enhanced supervisory method is to generate a flow of meaningful information that continuously promotes a comprehensive understanding of the LCBO. This understanding should include its major business lines and strategies, the risks inherent in its business activities, and the quality and effectiveness of its risk-management systems. Maintaining an up-to-date understanding of an LCBO's risk profile reduces the time-consuming and burdensome discovery process associated with conducting on-site examinations. Similarly, this understanding can also facilitate timely and efficient processing of major regulatory applications, including acquisitions and mergers, and other requests from BOs. Publicly available information, internal management reports, discussions with management, regulatory reports, information from internal and external auditors, and information from other supervisors are examples of the sources that are used to develop and maintain a current understanding of the organization. It may be less burdensome for the BO if supervisors can access management reports electronically, so electronic access should be employed when and where feasible and appropriate.

It is important that the principal risk-focused supervisory tools and documents, including the overview, risk matrix, and risk assessment for the LCBO, remain current. Accordingly, the central point of contact (CPC) should regularly distill and incorporate significant new information into these documents *at least quarterly.* Factors such as emerging risks; new products; and significant changes in business strategy, management, condition, or ownership may warrant more frequent updates. In general, the more dynamic the LCBO's operations and risks, the more frequently the CPC should update the risk assessment, strategies, and plans.

2124.04.2 DESIGN AND EXECUTION OF A CURRENT SUPERVISORY PLAN

Effective risk-focused supervision requires the development and maintenance of a supervisory plan that is current and relevant to the organization's changing risk profile. In addition to addressing all key supervisory objectives, the supervisory plan should be individually tailored for each BO to reflect its particular organizational and operational structure, and, where appropriate, the activities of other principal or functional supervisors. The supervisory plan and attendant supervisory activities, including on-site examinations, inspections, and supervisory reviews, should be sufficiently robust to maintain an up-to-date and thorough understanding of the BO's operations and risks, as well as the quality of its risk-management systems.

Ongoing assessments of the LCBO's major risks (for example, credit, market, liquidity, operational, legal, and reputational risks) should be used to formulate, revise, and update the supervisory plan. The Federal Reserve's supervisory plan should endeavor to take into account (1) the nature and scope of major activities conducted by other regulators involved in the LCBO and (2) any actions necessary to address existing or emerging supervisory concerns, including follow-up on past supervisory issues. For BOs supervised by the Federal Reserve, a combination of full- and limited-scope examinations, inspections, targeted reviews, meetings with management, and analyses of public and supervisory information should be used to maintain an up-to-date risk assessment and to reduce unnecessary regulatory burden. The necessary level of transaction testing and the degree of reliance on sampling should be fully explained in the scope documents of the supervisory plan and should adequately address the types and level of risks in the organization's business lines. Instances in which efficiencies can be gained by relying on the work of other regulators, internal and external auditors, and the internal risk-management function should, where appropriate, be specified in the plan and incorporated in the supervisory program.

The CPC should review and revise the supervisory plan whenever necessary *(but in no case less frequently than quarterly)* to reflect any significant new information or emerging trends or risks. The supervisory plan and any revisions should be periodically discussed with representatives of the principal regulators of major affiliates to reconfirm agreement on the overall plan and to coordinate its implementation, when warranted.

2124.04.3 COMMUNICATION AND COORDINATION OF SUPERVISION IN DEVELOPING AND ADMINISTERING A SUPERVISORY PLAN

The communication process as described herein can serve as the basis for executing a comprehensive supervisory approach that capitalizes on the mandates and resources of the various supervisory authorities (for example, banking, securities, and insurance authorities), while minimizing possible duplication and burden on the BO. The objective is for supervisors to work cooperatively in developing supervisory plans and scope documents and, when possible and appropriate, to carry out important supervisory activities on a joint or coordinated basis. Coordination and communication among supervisors can reduce the burden on BOs and result in a more efficient deployment of supervisory resources.

An important element of the LCBO program is effective communication between the Federal Reserve and the BO's management throughout the supervision cycle. Communication with the LCBO can take various forms, including formal and informal meetings with management and the board of directors, and the issuance of periodic and annual supervisory reports, including examination/inspection reports, to the organization's management and board. The objective of these reports is to identify significant risks and summarize the Federal Reserve's view of the financial condition and effectiveness of the LCBO's risk-management processes.

As part of the LCBO program, the management of the BO should be encouraged to continue and, if warranted, strengthen communications with Reserve Bank management, CPCs, and the supervisory teams, particularly with respect to providing information to supervisors on a timely basis regarding material financial or operational issues or problems. BOs should also be encouraged to continuously review and enhance their public disclosures to promote transparency and foster effective market discipline. Also, if BOs promptly notify supervisors of emerging problems, they often can be resolved in a way that minimizes disruptions. Strong two-way communications and information flows between supervisors and the LCBO's senior management, including key business-line and risk managers, are essential to the success of the LCBO program. In carrying out this program, the Federal Reserve will continue to attach the highest priority to information security and to protecting the integrity of sensitive, confidential supervisory and examination/inspection information.

The LCBO supervisory framework also requires that results and findings of supervisory activities conducted throughout the supervisory cycle be continually evaluated and reflected in the Federal Reserve's current understanding and assessment of the organization's risk profile. Reports of examination/inspection or letters to the LCBO's management and board of directors should routinely be prepared when examinations, inspections, and targeted reviews are completed. If necessary, the organization's supervisory ratings should be revised in a timely manner based on those findings.[2] Management and composite supervisory ratings should be adjusted appropriately if material weaknesses in risk-management systems or controls exist, even if these weaknesses have not yet affected the organization's reported financial results.

At least annually, a comprehensive summary supervisory report should be prepared that supports the organization's assigned ratings and encompasses the results of the entire supervisory cycle. This report should convey the Federal Reserve's view of the condition of the LCBO and its key risk-management processes, communicate the composite supervisory rating(s), discuss each of the major business risks, summarize the supervisory activities conducted during the supervisory cycle and the resulting findings, and assess the effectiveness of any corrective actions taken by the LCBO. This report will satisfy supervisory and legal requirements for a full-scope examination/inspection. Reserve Bank management, as well as Board officials, when warranted, will meet with the LCBO's board of directors to present and discuss the contents of the report and the Federal Reserve's assessment of the condition of the BO.

2124.04.3.1 Information Sharing and Coordination with Supervisory Authorities and External and Internal Auditors

Information sharing and coordination within the Federal Reserve and with supervisors of major affiliates are critical elements of the LCBO program and are essential to successful supervision of LCBOs. Most LCBOs, regardless of their business lines and functional management structure, operate through a variety of legal entities that may be under the jurisdiction of different licensing and supervisory authorities in the United States and abroad.

To maximize efficiency and reduce regulatory burden, the risk-assessment and supervisory-planning processes should use and leverage off, or benefit from, the efforts of other principal supervisors to the extent possible, consistent with achieving the Federal Reserve's key supervisory objectives. The Reserve Bank responsible for the supervision of the LCBO should have regular contacts with supervisors of important affiliates of the organization to discuss and coordinate matters of common interest, to develop supervisory plans, and, when and where appropriate, to coordinate the scheduling and conduct of examinations, inspections, and targeted reviews. Consistent with the supervisory needs and responsibilities of the Federal Reserve and the other supervisors, information may be exchanged as permitted by law, and in accordance with applicable rules and policies of the Board. In addition, meetings should be held at reasonable intervals with internal and external auditors to review audit plans, evaluate significant audit findings and other control assessments, and foster opportunities to leverage off the auditors' work. Building on the work of auditors, when and where appropriate, can enhance supervisory efficiency and reduce the regulatory burden on the LCBO.

2124.04.3.2 Enhanced Use of Information Technology

The Federal Reserve's supervisory approach for LCBOs continues to use enhanced information technology. Timely and user-friendly access to a full range of internal and third-party information, and mechanisms to foster collaboration among Federal Reserve staff and other supervisors are essential to effective risk-focused supervision for LCBOs. Effective and timely information flows, facilitated by the use of enhanced information technology, can provide a way for supervisors to ‘‘harvest'' and share the core knowledge and experience gained through the conduct of supervisory activities and through ongoing contacts with BOs. Ready access to the

2. The supervisory ratings include the BOPEC, CAMELS, and an FBO's combined U.S. operations rating.

collective knowledge, insights, and current assessments of fellow supervisors, bank management, financial markets, and other relevant third parties can enhance the ability of supervisors to identify problems in a timely manner and formulate effective supervisory responses. To this end, the Federal Reserve System's information-sharing and information-technology strategies will continue to be aimed at broadening and strengthening the role of the CPCs, supervisory teams, and other System staff that are responsible for conducting and overseeing its supervisory programs, including the LCBO program.

2124.04.4 ORGANIZATION OF FEDERAL RESERVE SUPERVISORY TEAMS

A principal component of the supervisory framework is the assignment to each LCBO of a dedicated supervisory team, made up of individuals with specialized skills based on the organization's particular business lines and risk profile. This full-time, dedicated cadre will be supplemented, as necessary, by other specialized System staff, who will participate in examinations and targeted reviews.

In addition to designing and executing the supervisory strategy for an LCBO, the CPC has responsibility for managing the supervisory team. Important objectives in managing the supervision resources for a particular LCBO are to maximize institutional knowledge and minimize burden to the BO, while maintaining an objective, ongoing understanding of the BO's risk profile. The CPC serves as the Federal Reserve's primary day-to-day contact for a particular LCBO and has, together with other members of the Reserve Bank management team, primary responsibility for communicating with senior officials of the LCBO.

The supervisory team's major responsibilities are to maintain a high level of knowledge of the BO and to ensure that supervisory strategies and priorities are consistent with the identified risks and the LCBO's profile. The team should include supervisors with broad-based knowledge and experience in banking, as well as specialists whose technical skills and market knowledge bring depth and perspective to highly focused reviews of selected LCBO activities.

The Federal Reserve had adopted risk-focused supervision frameworks for community banks and large complex banking organizations, including foreign banking organizations. These frameworks incorporate a methodology to assess an organization's risks and business activities and to tailor supervisory activities to its risk profile. These frameworks aim to sharpen the focus of supervisory activities on areas that pose the greatest risk to the safety and soundness of banking organizations and on management processes to identify, measure, monitor, and control risks.[1]

The Federal Reserve recognizes that the use of information technology can greatly affect a banking organization's financial condition and operating performance.[2] With the increasing dependency of banking organizations on the use of information technology, the Federal Reserve expects an organization's management and board of directors to effectively manage the risks associated with information technology. Accordingly, examiners must consider the risks associated with information technology in their evaluations of an organization's significant business activities and assess the effectiveness of the risk-management process that the organization applies to information technology. See SR-98-09.

This section supplements further the guidance on the evaluation of banking organizations' risk-management processes. The primary objectives are to—

1. highlight the critical dependence of the financial services industry on information technology and its potential effect on safety and soundness,
2. reinforce the concept that the risk-focused supervisory process and related products (risk assessments, supervisory plans, and scope memoranda) for an organization must address the risks associated with its use of information technology,[3] and
3. provide a basic framework and a common vocabulary to evaluate the effectiveness of processes used to manage the risks associated with information technology.

2124.1.1 CHANGING ROLE OF INFORMATION TECHNOLOGY

As the automated processing of information has moved beyond centralized mainframe operations to encompass end-user computer and distributed processing systems, the use of information technology in general has expanded greatly. In the banking industry, information technology was once limited to automation of routine transactions and preparation of financial reports but is now used to automate all levels of a banking organization's operations and information processing. Some decision-making processes such as credit scoring and securities trading have been fully automated. New, complex financial products are possible largely because of valuation models that depend on technology. Moreover, technological advances in communications and connectivity have minimized geographic constraints within the industry.

While information technology enables banking organizations to carry out their activities more efficiently and effectively, information technology also can be a source of risk to the industry. The operational concerns associated with information processing, traditionally the domain of the "back office," have assumed critical importance during banking mergers and consolidations.

Banking organizations, recognizing the dependency of their operations and decision-making processes on information technology, have placed increased emphasis on the management of this important resource. In large banking organizations, the positions of the chief information officer and chief technology officer have become more visible in the top executive ranks of banking organizations. In addition, managers of activities that rely on end-user computing and distributed processing systems

1. The types of risk may be categorized according to those presented in the guidelines for rating risk management (that is, credit, market, liquidity, operational, legal, and reputational) or by categories defined by the institution or other supervisory agencies. If the institution uses risk categories that differ from those defined by the supervisory agencies, those categories may be used if all relevant types of risks are captured. See SR-95-51, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies."

2. Information technology refers to a business resource that is the combination of computers (hardware and software), telecommunications, and information.

3. The supervisory products are described in SR-97-24 for large complex institutions and SR-97-25 for community banks.

have been assigned more direct responsibility for the information technology used in conducting their business. As a result, the management of the risks associated with information technology must be evaluated for each significant business activity as well as for the overall organization.

Notwithstanding the move towards decentralized management of information technology, large centralized mainframe computer systems are still an integral part of the information technology on which many large banking organizations rely. This includes systems critical to the global payments system and to the transfer and custody of securities. Similarly, with the continued growth of outsourcing, many third-party information technology service centers also perform a vital role in the banking industry. Therefore, the review of the effectiveness and reliability of the critical mainframe systems and third-party processors will continue to be an important part of the Federal Reserve's supervisory activities.

2124.1.2 IMPLICATIONS FOR RISK-FOCUSED SUPERVISION

The risk-focused supervisory process is evolving and adapting to the changing role of information technology, with a greater emphasis being placed on an evaluation of information technology and an assessment of its effect on an organization's safety and soundness. Accordingly, examiners should explicitly consider information technology when developing their risk assessments and supervisory plans. It is expected that examiners will exercise appropriate judgment in determining the level of review, given the characteristics, size, and business activities of the organization. Moreover, to determine the scope of supervisory activities close coordination is needed between general safety-and-soundness examiners and information technology specialists during the risk assessment and planning, as well as during the on-site phase of the examination or inspection. In general, examiners should take the following actions:

1. Develop a broad understanding of the organization's approach, strategy, and structure with regard to information technology. This requires a determination of the role and importance of information technology to the organization and any unique characteristics or issues.
2. Incorporate an analysis of information technology systems into risk assessments, supervisory plans, and scope memoranda. The analysis should include identification of critical information technology systems, related management responsibility, and the major technology components.[4] An organization's information technology systems should be considered in relation to the size, activities, and complexity of the organization, as well as the degree of reliance on these systems.
3. Assess the organization's critical systems, that is, those that support its major business activities, and the degree of reliance those activities have on information technology systems. The level of review should be sufficient to determine that the systems are delivering the services necessary for the organization to conduct its business safely and soundly.
4. Determine whether the board of directors and senior management are adequately identifying, measuring, monitoring, and controlling the significant risks associated with information technology for the overall organization and its major business activities.

2124.1.3 FRAMEWORK FOR EVALUATING INFORMATION TECHNOLOGY

In order to provide a common terminology and consistent approach for evaluating the adequacy of an organization's information technology, five information technology elements are introduced and defined below. These elements may be used to evaluate the information technology processes at the functional business level or for the organization as a whole. They may also be applied to a variety of information technology management structures: centralized, decentralized, or outsourced.[5]

Although deficiencies in information technology appear to be most directly related to operational risk, information technology also can affect the other business risks (credit, market, liquidity, legal, and reputational) depending on

4. These components include mainframe, local area network, and personal computers, as well as software applications.

5. When banking organizations outsource operations, they delegate a certain level of responsibility and authority to an outside party (depending on the contractual arrangements). However, ultimate accountability remains with the banking organization.

the specific circumstances. Examiners should view the information technology elements in an integrated manner with the overall business risks of the organization or business activity; a deficiency in any one of the elements could have a substantive adverse effect on the organization's or activity's business risks. Moreover, the elements below do not replace or independently add to the business risks described in SR-95-51. Rather, these elements should be assessed in relation to all business risks.

The elements are to be used as a flexible tool to facilitate consideration and discussion of the risks associated with information technology. Where an organization uses different terminology to describe information technology elements, examiners may use that terminology provided the organization adequately addresses all elements. Regardless of the terminology employed, examiners should focus on those systems and issues that are considered critical to the organization.

The five information technology elements are described below:

1. *Management processes.* Management processes[6] encompass planning, investment, development, execution, and staffing of information technology from a corporate-wide and business-specific perspective. Management processes over information technology are effective when they are adequately and appropriately aligned with, and supportive of, the organization's mission and business objectives. Management processes include strategic planning, management and reporting hierarchy, management succession, and a regular independent review function. Examiners should determine if the information technology strategy for the business activity or organization is consistent with the organization's mission and business objectives and whether the information technology function has effective management processes to execute that strategy.
2. *Architecture.* Architecture[7] refers to the underlying design of an automated information system and its individual components. The underlying design encompasses both physical and logical architecture, including operating environments, as well as the organization of data. The individual components refer to network communications, hardware, and software, which includes operating systems, communications software, database management systems, programming languages, and desktop software. Effective architecture meets current and long-term organizational objectives, addresses capacity requirements to ensure that systems allow users to easily enter data at both normal and peak processing times, and provides satisfactory solutions to problems that arise when information is stored and processed in two or more systems that cannot be connected electronically. In assessing the adequacy of information technology architecture, examiners should consider the hardware's capability to run the software, the compatibility and integration with other systems and sources of data, the ability to upgrade to higher levels of performance and capacity, and the adequacy of controls.
3. *Integrity.* Integrity refers to the reliability, accuracy, and completeness of information delivered to the end-user. An information technology system has an effective level of integrity when the resulting information flows are accurate and complete. Insufficient integrity in an organization's systems could adversely affect day-to-day reliability, processing performance, input and output accuracy, and the ease of use of critical information. Examiners should review and consider whether the organization relies upon information system audits or independent application reviews to ensure the integrity of its systems. To assess the integrity of an organization's systems, examiners should review the reliability, accuracy, and completeness of information delivered.
4. *Security.* Security refers to the safety afforded to information assets and their data processing environments, using both physical and logical controls to achieve a level of protection commensurate with the value of the assets. Information technology has effective security when controls prevent unauthorized access; modification; destruction; or disclosure of information assets during their creation, transmission, processing, maintenance, or storage. Examiners should ensure that operating procedures and controls are commensurate with the potential for and risks associated with security breaches, which may be either physical or electronic, inadvertent or intentional, or internal or external.
5. *Availability.* Availability refers to the delivery of information to end-users. Information technology has effective availability when

6. Also referred to as ''organization'' or ''strategic.''
7. Sometimes referred to as ''infrastructure.''

information is consistently delivered on a timely basis in support of business and decision-making processes. In assessing the adequacy of availability, examiners should consider the capability of information technology to provide information from either primary or secondary sources to the end-users, as well as the ability of back-up systems, presented in contingency plans, to mitigate business disruption. Contingency plans should set out a process for an organization to restore or replace its information-processing resources, reconstruct its information assets, and resume its business activity from disruption caused by human error or intervention, natural disaster, or infrastructure failure (including the loss of utilities and communication lines and operational failure of hardware, software, and network communications).

Appendix A provides a table with examples of situations where deficiencies in information technology elements potentially have a negative effect on the business risks of an organization. The table also provides possible actions that an organization could take in these situations to mitigate its risks. The examples in this table are representative and should not be viewed as an exhaustive list of the risks associated with information technology.

2124.1.4 ALIGNING EXAMINER STAFFING WITH THE TECHNOLOGY ENVIRONMENT

While mainframe computer systems are still an integral part of the information technology for large organizations, information technology processes have become embedded in the various business activities of a banking organization—particularly with the increased use of local area network and personal computers. In contrast, many community and regional banks continue to rely on third-party information technology service centers. Given this variability of information technology environments, the level of technical expertise needed for a particular examination or inspection will vary and should be identified during its planning phase. For example, a specialist in information technology or the particular business activity may be the most appropriate person to review information technology integrity, while general safety-and-soundness examiners may be better suited to review management processes related to information technology. Development of the overall supervisory approach for an organization requires continuous collaboration between general safety-and-soundness examiners and information technology specialists. Accordingly, a discussion of information technology should be integrated into the supervisory process and products. That is, examiners should consider and comment on the risks associated with information technology when developing an understanding of an organization, assessing an organization's risks, and preparing a scope memorandum.

2124.1.5 INSPECTION OBJECTIVES

1. To assess the risks associated with information technology when developing the scope of supervisory plans and activities.
2. To consider the various risks associated with information technology along with the risk evaluation of the banking organization's business activities.
3. To assess the effectiveness of the risk-management process that the banking organization applies to information technology.
4. To view the banking organization's information technology elements in an integrated manner along with the overall business risks of the banking organization or its business activity, and ascertain if there are any deficiencies therein.

2124.1.6 INSPECTION PROCEDURES

1. Develop a broad understanding of the organization's approach, strategy, and structure with regard to information technology.
2. Incorporate an analysis of information technology systems into risk assessments, supervisory plans, and scope memoranda.
3. Assess the banking organization's critical systems and the degree of reliance those activities have on information technology systems.
4. Determine that the information systems are delivering the services necessary for the organization to conduct its business safely and soundly.
5. Determine if the board of directors or senior management has conducted an independent review, either by independent qualified staff or by an independent third-party consultant, of the current architecture, assessing the risks

associated with the institution's information technology. Did the review establish whether the organization's architecture had provided for—

a. current and long-term organizational objectives,
b. capacity requirements during normal and peak processing periods,
c. solutions when information is stored and processed in two or more separate systems,
d. the hardware's capability to run the software and its compatibility and integration with other systems and sources of data,
e. the ability to upgrade to higher levels of performance and capacity, and
f. the adequacy of controls.

6. Determine if the institution relies on information system audits or independent application reviews to determine whether information flows are accurate and complete.
7. Review, on a sample basis, the reliability, accuracy, and completeness of processed delivered information.
8. Determine whether the operating procedures and controls are commensurate with the potential for, and risks associated with, security breaches, which may be either physical or electronic, inadvertent or intentional, or internal or external.
9. Determine whether the board of directors and senior management are adequately identifying, measuring, monitoring, and controlling the significant risks associated with information technology for the overall banking organization and its major business activities.
10. After developing an understanding of the banking organization, assess and comment on the information technology risks and management in a scope memorandum.

2124.1.7 Appendix A—Examples of Information Technology Elements that Should Be Considered in Assessing Business Risks of Particular Situations

Situation	*IT elements to be considered*	*Potential effect on business risks*	*Risk mitigants*
A bank holding company expands very rapidly via acquisition into new product lines and geographic areas.	*Management processes.* Lack of clear, cohesive strategies could result in dependence on different systems that are incompatible and fragmented. *Integrity.* Unreliable information could be produced due to incompatible systems. *Availability.* Critical information may not be available to management when needed.	*Credit risk.* Exposure to less creditworthy borrowers may increase. *Liquidity risk.* Depositors may withdraw funds or close accounts due to unreliable account information. *Operational risk.* Controls may be inadequate to address the increase in manual interventions to correct incompatibility problems between affiliates' systems, leading to a greater potential for fraudulent transactions.	Develop a well-thought-out plan for integrating acquired systems, mapping data flows and sources, and ensuring reliability of systems.
A bank's consumer loan division inputs erroneous entries into the general-ledger system.	*Integrity.* Billing errors and unwarranted late-payment fees could occur due to the inaccurate loan information maintained by the system.	*Reputational risk.* Knowledge of errors could become widespread resulting in adverse public opinion. *Operational risk.* Increased expenditures may be required to resolve accounting operations problems. *Legal risk.* Litigation could arise because of errors in customer accounts due to processing deficiencies.	Improve policies and procedures related to input of accounting entries. Ensure internal audit considers system aspects of accounting operations.
Substantial turnover occurs in bank's wire-transfer department.	*Security.* Security procedures could be compromised due to inadequate training and lack of qualified personnel. *Integrity.* System may not be able to provide "real-time" funds availability.	*Operational risk.* Financial losses could occur due to fraud or incorrectly sent wire transfers. *Legal risk.* Litigation could arise as a result of errors in customer accounts and fraudulent wire transfers. *Reputational risk.* Knowledge of fraudulent or erroneous wire operations could result in adverse public opinion.	Increase and strengthen procedural and access controls for wire operations. Implement security measures such as passwords and firewalls. Develop and monitor appropriate audit trails. Provide for adequate training program and staffing levels.

The federal banking agencies jointly issued guidelines establishing standards for safeguarding customer information (the guidelines), which became effective July 1, 2001.[1] The guidelines implement sections 501 and 505 of the Gramm-Leach-Bliley Act (GLB Act) (15 U.S.C. 6801 and 6805). Bank holding companies and financial holding companies[2] must comply with these interagency guidelines (see appendix F of Regulation Y). The guidelines include standards for developing and implementing administrative, technical, and physical safeguards to protect the security, confidentiality, and integrity of customer information.

The guidelines apply to customer information maintained by or on behalf of state member banks, bank holding companies, and the nonbank subsidiaries *or affiliates* of each. The guidelines do not apply to brokers, dealers, investment companies, and investment advisers, or to persons providing insurance under the applicable state insurance authority of the state in which the person is domiciled.[3]

Under the guidelines, each bank holding company falling within the scope of the guidelines must implement a comprehensive, written information security program.[4] The board of directors, or an appropriate committee of the board, must oversee the bank holding company's development, implementation, and maintenance of the information security program, including assigning specific responsibility for its implementation and the review of reports received from management. The information security program should include administrative, technical, and physical safeguards appropriate to the size and complexity of the bank holding company and the nature and scope of its activities.

While all parts of the bank holding company are not required to implement a uniform information security program and set of policies, all elements of the information security program must be coordinated. A bank holding company must ensure that each of its subsidiaries is subject to a comprehensive information security program. It may fulfill this requirement either (1) by including a subsidiary within the scope of the bank's holding company's comprehensive information security program or (2) by having the subsidiary implement a separate comprehensive information security program in accordance with the guidelines and procedures of appendix F of Regulation Y.

The bank holding company's information security program must be designed to ensure the security and confidentiality of customer information,[5] protect against anticipated threats or hazards to the security or integrity of such information, and protect against unauthorized access to or use of customer information that could result in substantial harm or inconvenience to any customer.[6] Each bank holding company must identify reasonably foreseeable internal and external threats that could result in unauthorized disclosure, misuse, alteration, or destruction of customer information or customer information systems. An assessment must be made of the (1) likelihood and potential damage of these threats, taking into consideration the sensitivity of the customer information, and (2) sufficiency of policies, procedures, customer information systems, and other arrangements that are in place to control risks.

Appropriate policies, procedures, training, and testing must be implemented to manage and control identified risks. Management must also report at least annually to the board of directors or an appropriate committee of the board of directors. Management reports should describe the overall status of the information security program and the bank holding company's com-

1. See 66 *Fed. Reg.* 8616–8641 (February 1, 2001), and Regulation H, 12 CFR 208, appendix D-2; Regulation K, 12 CFR 211.9 and 211.24; and Regulation Y, 12 CFR 225, appendix F.

2. The discussion in this section applies equally to financial holding companies and bank holding companies.

3. The appropriate federal agency or state insurance authority regulates these entities under sections 501 and 505 of the GLB Act.

4. The guidelines apply only to customer information; as a result, a bank holding company that does not maintain any customer information is not subject to the guidelines. In addition, when customer information is maintained only in the banking subsidiaries or functionally regulated nonbank subsidiaries of the holding company, examiners generally may rely on the primary supervisor's assessment of the subsidiaries' information security programs, if applicable, to determine the holding company's compliance with the guidelines.

5. ''Customer information'' is defined to include any record containing a customer's nonpublic personal information, whether in paper, electronic, or other form, that is maintained by or on behalf of the bank holding company.

6. A ''customer'' is defined in the same manner as in Regulation P—a *consumer* who has established a continuing relationship with a bank holding company under which the bank holding company provides one or more financial products or services to the consumer to be used primarily for personal, family, or household purposes. The definition of customer does not include a business, nor does it include a consumer who has not established an ongoing relationship with the bank holding company.

pliance with the guidelines. The reports should discuss material matters related to the BHC's information security program, addressing issues such as risk assessment; risk-management and -control decisions; service-provider arrangements; results of testing; security breaches or violations and management's responses to them; and recommendations for changes in the information security program.

The guidelines outline specific information security measures that bank holding companies must consider in implementing an information security program. The bank holding company should adopt appropriate measures to manage and control identified risks, commensurate with the sensitivity of the information as well as the complexity and scope of its activities. The measures that the bank holding company must consider and may adopt include access controls, access restrictions, encryption of electronic customer information, dual-control procedures, segregation of duties, employee background checks, and other procedural controls, as well as monitoring systems and response programs. Training and testing are also critical components of an effective information security program. In addition, testing of the key controls, systems, and procedures is important. Tests should be conducted or reviewed by independent third parties or staff who are independent of those individuals who develop or maintain the security program.

The Federal Reserve recognizes that banking organizations are highly sensitive to the importance of safeguarding customer information and the need to maintain effective information security programs. Existing examination and inspection procedures and supervisory processes already address information security. As a result, most banking organizations may not need to implement any new controls and procedures.

Examiners should assess compliance with the guidelines during each safety-and-soundness inspection, which may include targeted reviews of information technology. Ongoing compliance with the guidelines should be monitored as needed during the risk-focused inspection process. Material instances of noncompliance should be noted in the inspection report.

Bank holding companies are required to oversee their service-provider arrangements in order to protect the security of customer information maintained or processed by their service providers. Appropriate due diligence must be used in selecting service providers, including reviewing the service provider's information security program or the measures the service provider uses to protect the bank holding company's customer information.[7] In addition, contracts entered into after March 5, 2001, must require that the service provider implement appropriate measures designed to meet the objectives of the guidelines. By July 1, 2003, all contracts are subject to this requirement.

When indicated by the bank holding company's risk assessment, the performance of service providers must be monitored to confirm that they have satisfied their obligations under the customer information security program. A bank holding company's methods for overseeing its service providers may differ depending on the type of services or service provider or on the level of risk to the customer information. For example, if a service provider is subject to regulations or a code of conduct that imposes a duty to protect customer information consistent with the objectives of the guidelines, the bank holding company may consider that duty in exercising its due diligence and oversight of the service provider.

2280.1 INSPECTION OBJECTIVE

1. To assess and review for compliance with the interagency guidelines establishing standards for safeguarding customer information.

2280.2 INSPECTION PROCEDURES

1. Referencing the "Safeguarding of Customer Information" portion of the internal control questionnaire in section 4060.3 of the System's *Commercial Bank Examination Manual*, assess the BHC's compliance with the interagency guidelines establishing standards for safeguarding customer information.
2. Conduct a review that is a sufficient basis for evaluating the BHC's overall information security program and its compliance with the interagency guidelines.

7. A "service provider" is deemed to be a person or entity that maintains, processes, or is otherwise permitted access to customer information through its direct provision of services directly to the bank holding company.

The review of risk management and internal controls is an essential element of the inspection or examination of trading activities. In view of the increasing importance of these activities to the overall risk profile and profitability of certain banking organizations,[2] this guidance highlights key considerations when inspecting or examining the risk management and internal controls of trading activities in both cash and derivative instruments.[3]

The principles set forth in this guidance apply to the risk management practices of bank holding companies, which should manage and control aggregate risk exposures on a consolidated basis while recognizing legal distinctions among subsidiaries. This guidance is specifically designed to target trading, market making, and customer accommodation activities in cash and derivative instruments at state member banks, branches and agencies of foreign banks, and Edge corporations. Many of the principles advanced can also be applied to banking organizations' use of derivatives as end-users. Examiners should assess management's application of this guidance to the holding company and to a banking organization's end-user derivative activities where appropriate, given the nature of the organization's activities and current accounting standards.

This examiner guidance is specifically provided for evaluating the following elements of an organization's risk management process for trading and derivatives activities:

- Board of directors and management oversight
- The measurement procedures, limit systems, and monitoring and review functions of the risk management process
- Internal controls and audit procedures

In assessing the adequacy of these elements at individual institutions, examiners should consider the nature and volume of a banking organization's activities and its overall approach toward managing the various types of risks involved. As with the inspection of other activities, examiner judgment plays a key role in assessing the adequacy and necessary sophistication of a banking organization's risk management system for cash and derivative instrument trading and hedging activities.

Many of the managerial practices and examiner procedures contained in this guidance are fundamental and are generally accepted as sound banking practices for both trading and nontrading activities. However, other elements may be subject to change, as both supervisory and bank operating standards evolve in response to new technologies, financial innovations, and developments in market and business practices.

2125.0.1 OVERSIGHT OF THE RISK MANAGEMENT PROCESS

As is standard practice for most banking activities, banking organizations should maintain written policies and procedures that clearly outline the organization's risk management guidance for trading and derivative activities. At a minimum these policies should identify the risk tolerances of the board of directors and should clearly delineate lines of authority and responsibility for managing the risk of these activities. Individuals throughout the trading and derivatives areas should be fully aware of all policies and procedures that relate to their specific duties.

The board of directors, senior-level management, and members of independent risk management functions are all important participants in the risk management process. Examiners should ensure that these participants are aware of their responsibilities and that they adequately perform their appropriate role in managing the risk of trading and derivative activities.

2125.0.1.1 Board of Directors' Approval of Risk Management Policies

The board of directors should approve all significant policies relating to the management of risks throughout the organization. These policies, which should include those related to trading activities, should be consistent with the organization's broader business strategies, capital adequacy, expertise, and overall willingness

1. The following is the text of SR-93-69, adapted for this manual. Section numbers have been added for reference.

2. The term ''banking organizations'' refers to institutions or entities that are directly supervised by the Board of Governors of the Federal Reserve System, such as state member banks and bank holding companies, including the nonbank subsidiaries of the holding company.

3. In general terms, derivative instruments are bilateral contracts or agreements whose value derives from the value of one or more underlying assets, interest rates, exchange rates, commodities, or financial or commodity indexes.

to take risk. Accordingly, the board should be informed regularly of risk exposure and should regularly reevaluate significant risk management policies and procedures with special emphasis placed on those defining the institution's risk tolerance regarding these activities. The board of directors should also conduct and encourage discussions between its members and senior management, as well as between senior management and others in the organization, regarding its risk management process and risk exposure.

2125.0.1.2 Senior Management's Risk Management Responsibilities

Senior management is responsible for ensuring that there are adequate policies and procedures for conducting trading operations on both a long-range and day-to-day basis. This responsibility includes ensuring that there are clear delineations of lines of responsibility for managing risk, adequate systems for measuring risk, appropriately structured limits on risk taking, effective internal controls, and a comprehensive risk-reporting process.

Senior management should regularly evaluate the procedures in place to manage risk to ensure that those procedures are appropriate and sound. Senior management should also foster and participate in active discussions with the board, with staff of risk management functions, and with traders regarding procedures for measuring and managing risk. Management must also ensure that trading and derivative activities are allocated sufficient resources and staff to manage and control risks.

2125.0.1.3 Independent Risk Management Functions

The process of measuring, monitoring, and controlling risk consistent with the established policies and procedures should be managed independently of individuals conducting trading activities, up through senior levels of the institution. An independent system for reporting exposures to both senior-level management and to the board of directors is an important element of this process.

Banking organizations should have highly qualified personnel throughout their trading and derivatives areas, including their risk management and internal control functions. The personnel staffing independent risk management functions should have a complete understanding of the risks associated with all traded on- and off-balance-sheet instruments. Accordingly, compensation policies for these individuals should be adequate to attract and retain personnel qualified to judge these risks. As a matter of general policy, compensation policies, especially in the risk management, control, and senior management functions, should be structured in a way that avoids the potential incentives for excessive risk taking that can occur if, for example, salaries are tied too closely to the profitability of trading or derivatives activities.

2125.0.2 THE RISK MANAGEMENT PROCESS

The primary components of a sound risk management process are a comprehensive risk measurement approach; a detailed structure of limits, guidelines, and other parameters used to govern risk taking; and a strong management information system for monitoring and reporting risks. These components are fundamental to both trading and nontrading activities alike. Moreover, the underlying risks associated with these activities, such as credit, market, liquidity, and operating risk, are not new to banking organizations, although their measurement and management can be somewhat more complex. Accordingly, the process of risk management for trading activities should be integrated into the organization's overall risk management system to the fullest extent possible using a conceptual framework common to its other activities. Such a common framework enables the organization to manage its consolidated risk exposure more effectively, especially since the various individual risks involved in trading activities can, at times, be interconnected and can often transcend specific markets.

As is the case with all risk-bearing activities, the risk exposures a banking organization assumes in its trading and derivatives activities should be fully supported by an adequate capital position. Banking organizations should ensure that their capital positions are sufficiently strong to support all trading and derivatives risks on a fully consolidated basis and that adequate capital is maintained in all affiliated entities engaged in these activities.

2125.0.2.1 Risk Measurement Systems

A banking organization's system for measuring the various risks of trading and derivatives activities should be both comprehensive and accurate. Risks should be measured and aggregated across trading and nontrading activities on an organizationwide basis to the fullest extent possible.

While examiners should not require the use of a single prescribed risk measurement approach for management purposes, they should evaluate the extent to which the organization's procedures enable management to assess exposures on a consolidated basis. Examiners should also evaluate whether the risk measures and the risk measurement process are sufficiently robust to accurately reflect the multiple types of risks facing the banking organization. Risk measurement standards should be understood by relevant personnel at all levels—from individual traders to the board of directors—and should provide a common framework for limiting and monitoring risk-taking activities.

The process of marking trading and derivatives positions to market is fundamental to measuring and reporting exposures accurately and on a timely basis. Banking organizations active in dealing in foreign exchange, derivatives, and other traded instruments should have the ability to monitor credit exposures, trading positions, and market movements at least daily. Some organizations should also have the capacity, or at least the goal, of monitoring their more actively traded products on a real-time basis.

Analyzing stress situations, including combinations of market events that could affect the banking organization, is also an important aspect of risk measurement. Sound risk measurement practices include identifying possible events or changes in market behavior that could have unfavorable effects on the organization and assessing its ability to withstand them. These analyses should consider not only the likelihood of adverse events, reflecting their probability, but also plausible "worst-case" scenarios. Ideally, such worst-case analysis should be conducted on an organizationwide basis by taking into account the effect of unusual price changes or the default of a large counterparty across both the derivatives and cash-trading portfolios and the loan and funding portfolios.

Such stress tests should not be limited to quantitative exercises that compute potential losses or gains. They should also include more qualitative analyses of the actions management might take under particular scenarios. Contingency plans outlining operating procedures and lines of communication, both formal and informal, are important products of such qualitative analyses.

2125.0.2.2 Limiting Risks

A sound system of integrated organizationwide limits and risk-taking guidelines is an essential component of the risk management process. Such a system should set boundaries for organizational risk-taking and should also ensure that positions that exceed certain predetermined levels receive prompt management attention, so that they can be either reduced or prudently addressed. The limit system should be consistent with the effectiveness of the organization's overall risk management process and with the adequacy of its capital position. An appropriate limit system should permit management to control exposures, to initiate discussion about opportunities and risks, and to monitor actual risk-taking against predetermined tolerances, as determined by the board of directors and senior management.

Global limits should be set for each major type of risk involved. These limits should be consistent with the banking organization's overall risk measurement approach and should be integrated to the fullest extent possible with organizationwide limits on those risks as they arise in all other activities of the firm. The limit system should provide the capability to allocate limits down to individual business units.

At times, especially when markets are volatile, traders may exceed their limits. While such exceptions may occur, they should be made known to senior management and approved only by authorized personnel. These positions should also prompt discussions between traders and management about the consolidated risk-taking activities of the firm or the trading unit. The seriousness of individual or continued limit exceptions depends in large part upon management's approach toward setting limits and on the actual size of individual and organizational limits relative to the organization's capacity to take risk. Banking organizations with relatively conservative limits may encounter more exceptions to those limits than do organizations where limits may be less restrictive. Ultimately, examiners should ensure that stated policies are enforced and that the level of exposure is managed prudently.

2125.0.2.3 Reporting

An accurate, informative, and timely management information system is essential to the prudent operation of a trading or derivatives activity. Accordingly, the examiner's assessment of the quality of the management information system is an important factor in the overall evaluation of the risk management process. Examiners should determine the extent to which the risk management function monitors and reports its measures of trading risks to appropriate levels of senior management and to the board of directors. Exposures and profit and loss statements should be reported at least daily to managers who supervise but do not, themselves, conduct trading activities. More frequent reports should be made as market conditions dictate. Reports to other levels of senior management and the board may occur less frequently, but examiners should determine whether the frequency of reporting provides these individuals with adequate information to judge the changing nature of the organization's risk profile.

Examiners should ensure that the management information systems translate the measured risk from a technical and quantitative format to one that can be easily read and understood by senior managers and directors, who may not have specialized and technical knowledge of trading activities and derivative products. Risk exposures arising from various products within the trading function should be reported to senior managers and directors using a common conceptual framework for measuring and limiting risks.

2125.0.2.4 Management Evaluation and Review of the Risk Management Process

Management should ensure that the various components of an organization's risk management process are regularly reviewed and evaluated. This review should take into account changes in the activities of the organization and in the market environment, since the changes may have created exposures that require additional management and examiner attention. Any material changes to the risk management system should also be reviewed.

The independent risk management functions should regularly assess the methodologies, models, and assumptions used to measure risk and to limit exposures. Proper documentation of these elements of the risk measurement system is essential for conducting meaningful reviews. The review of limit structures should compare limits to actual exposures and should also consider whether existing measures of exposure and limits are appropriate in view of the banking organization's past performance and current capital position.

The frequency and extent to which banking organizations should reevaluate their risk measurement methodologies and models depends, in part, on the specific risk exposures created by their trading activities, on the pace and nature of market changes, and on the pace of innovation with respect to measuring and managing risks. At a minimum, banking organizations with significant trading and derivative activities should review the underlying methodologies of their models at least annually—and more often as market conditions dictate—to ensure they are appropriate and consistent. Such internal evaluations may, in many cases, be supplemented by reviews by external auditors or other qualified outside parties, such as consultants who have expertise with highly technical models and risk management techniques. Assumptions should be evaluated on a continual basis.

Banking organizations should also have an effective process to evaluate and review the risks involved in products that are either new to the firm or new to the marketplace and of potential interest to the firm. In general, a banking organization should not trade a product until senior management and all relevant personnel (including those in risk management, internal control, legal, accounting, and auditing) understand the product and are able to integrate the product into the banking organization's risk measurement and control systems. Examiners should determine whether the banking organization has a formal process for reviewing new products and whether it introduces new products in a manner that adequately limits potential losses.

2125.0.2.5 Managing Specific Risks

The following discussions present examiner guidance for evaluating the specific components of a firm's risk management process in the context of each of the risks involved in trading cash and derivatives instruments.

2125.0.2.5.1 Credit Risk

Broadly defined, credit risk is the risk that a counterparty will fail to perform on an obligation to the banking organization. Banking organizations should evaluate both settlement and presettlement credit risk at the customer level across all traded derivative and nonderivative products. On settlement day, the exposure to counterparty default may equal the full value of any cash flows or securities the banking organization is to receive. Prior to settlement, credit risk is measured as the sum of the replacement cost of the position, plus an estimate of the banking organization's potential future exposure from the instrument as a result of market changes. Replacement cost should be determined using current market prices or generally accepted approaches for estimating the present value of future payments required under each contract, given current market conditions.

Potential credit-risk exposure is measured more subjectively than current exposure and is primarily a function of the time remaining to maturity and the expected volatility of the price, rate, or index underlying the contract. It is often assessed through simulation analysis and option-valuation models, but can also be addressed by using ''add-ons,'' such as those included in the risk-based capital standard. In either case, examiners should evaluate the reasonableness of the assumptions underlying the banking organization's risk measure and should also ensure that banking organizations that measure exposures using a portfolio approach do so in a prudent manner.

Master netting agreements and various credit enhancements, such as collateral or third-party guarantees, can be used by banking organizations to reduce their counterparty credit risk. In such cases, a banking organization's credit exposures should reflect these risk-reducing features only to the extent that the agreements and recourse provisions are legally enforceable in all relevant jurisdictions. This legal enforceability should extend to any insolvency proceedings of the counterparty. Banking organizations should be able to demonstrate that they have exercised due diligence in evaluating the enforceability of these contracts and that individual transactions have been executed in a manner that provides adequate protection.

Credit limits that consider both settlement and presettlement exposures should be established for all counterparties with whom the banking organization trades. As a matter of general policy, trading with a counterparty should not commence until a credit line has been approved. The structure of the credit-approval process may differ among organizations, reflecting the organizational and geographic structure of the organization and the specific needs of its trading activities. Nevertheless, in all cases, it is important that credit limits be determined by personnel who are independent of the trading function, that these personnel use standards that are consistent with those used for nontrading activities, and that counterparty credit lines are consistent with the organization's policies and consolidated exposures.

Examiners should consider the extent to which credit limits are exceeded and whether exceptions were resolved according to the banking organization's adopted policies and procedures. Examiners should also evaluate whether the organization's reports adequately provide traders and credit officers with relevant, accurate, and timely information about the credit exposures and approved credit lines.

Trading activities that involve cash instruments often involve short-term exposures that are eliminated at settlement. However, in the case of derivative products traded in over-the-counter markets, the exposure can often exist for a period similar to that commonly associated with a loan from a banking organization. Given this potentially longer-term exposure and the complexity associated with some derivative instruments, banking organizations should consider not only the overall financial strength of the counterparty and its ability to perform on its obligation, but should also consider the counterparty's ability to understand and manage the risks inherent in the derivative product.

2125.0.2.5.2 Market Risk

Market risk is the risk to a banking organization's financial condition resulting from adverse movements in market prices. Accurately measuring a banking organization's market risk requires timely information about the current market values of its assets, liabilities, and off-balance-sheet positions. Although there are many types of market risks that can affect a portfolio's value, they can generally be described as those involving forward risk and those involving options. Forward risks arise from factors such as changing interest rates and currency exchange rates, the liquidity of markets for specific commodities or financial instruments, and local or world political and economic events. Market risks related to options include these factors as well as evolving perceptions of the volatility of price changes, the passage of time, and the interactive effect of other market risks. All of these sources of potential market risk can affect the value of the organization and should be considered in the risk measurement process.

Market risk is increasingly measured by market participants using a value-at-risk approach, which measures the potential gain or loss in a position, portfolio, or organization that is associated with a price movement of a given probability over a specified time horizon. Banking organizations should revalue all trading portfolios and calculate their exposures at least daily. Although banking organizations may use risk measures other than value at risk, examiners should consider whether the measure used is sufficiently accurate and rigorous and whether it is adequately incorporated into the banking organization's risk management process.

Examiners should also ensure that the organization compares its estimated market-risk exposures with actual market-price behavior. In particular, the output of any market-risk models that require simulations or forecasts of future prices should be compared with actual prices. If the projected and actual results differ materially, the models should be modified, as appropriate.

Banking organizations should establish limits for market risk that relate to their risk measures and that are consistent with maximum exposures authorized by their senior management and board of directors. These limits should be allocated to business units and individual traders and be clearly understood by all relevant parties. Examiners should ensure that exceptions to limits are detected and adequately addressed by management. In practice, some limit systems may include additional elements such as stop-loss limits and trading guidelines that may play an important role in controlling risk at the trader and business-unit level; examiners should include them in their review of the limit system.

2125.0.2.5.3 Liquidity Risk

Banking organizations face two types of liquidity risk in their trading activities: those related to specific products or markets and those related to the general funding of the banking organization's trading activities. The former is the risk that a banking organization cannot easily unwind or offset a particular position at or near the previous market price because of inadequate market depth or because of disruptions in the marketplace. Funding-liquidity risk is the risk that the banking organization will be unable to meet its payment obligations on settlement dates. Since neither type of liquidity risk is unique to trading activities, management should evaluate these risks in the broader context of the organization's overall liquidity. When establishing limits, organizations should be aware of the size, depth, and liquidity of the particular market and establish trading guidelines accordingly. Management should also give consideration to the potential problems associated with replacing contracts that terminate early in volatile or illiquid markets.

In developing guidelines for controlling the liquidity risks in trading activities, banking organizations should consider the possibility that they could lose access to one or more markets, either because of concerns about the banking organization's own creditworthiness, the creditworthiness of a major counterparty, or because of generally stressful market conditions. At such times, the banking organization may have less flexibility in managing its market-, credit-, and liquidity-risk exposures. Banking organizations that make markets in over-the-counter derivatives or that dynamically hedge their positions require constant access to financial markets, and that need may increase in times of market stress. The banking organization's liquidity plan should reflect the organization's ability to turn to alternative markets, such as futures or cash markets, or to provide sufficient collateral or other credit enhancements in order to continue trading under a broad range of scenarios.

Examiners should ensure that banking organizations that participate in over-the-counter derivative markets adequately consider the potential liquidity risks associated with the early termination of derivative contracts. Many forms of standardized contracts for derivative transactions allow counterparties to request collateral or to terminate their contracts early if the banking organization experiences an adverse credit event or a deterioration in its financial condition. In addition, under conditions of market stress, customers may ask for the early termination of some contracts within the context of the dealer's market-making activities. In such situations, a banking organization that owes money on derivative transactions may be required to deliver collateral or settle a contract early and possibly at a time when the banking organization may face other funding and liquidity pressures. Early terminations may also open up additional, unintended, market positions. Management and directors should be aware of these potential liquidity risks and should address them in the banking organization's liquidity plan and in the broader context of the banking organization's liquidity management process. In their reviews, examiners should consider the extent to which such potential obligations could present liquidity risks to the banking organization.

2125.0.2.5.4 Operational Risk, Legal Risk, and Business Practices

Operating risk is the risk that deficiencies in information systems or internal controls will result in unexpected loss. Legal risk is the risk that contracts are not legally enforceable or documented correctly. Although operating and legal risks are difficult to quantify, they can often be evaluated by examining a series of plausible "worst-case" or "what-if" scenarios, such as a power loss, a doubling of transaction volume, a mistake found in the pricing software for collateral management, or an unenforceable contract. They can also be assessed through periodic reviews of procedures, documentation requirements, data processing systems, contingency plans, and other operating practices. Such reviews may help to reduce the likelihood of errors and breakdowns in controls, improve the control of risk and the effectiveness of the limit system, and prevent unsound marketing practices and the premature adoption of new products or lines of business. Considering the heavy reliance of trading activities on computerized systems, banking organizations should have plans that take into account potential problems with their normal processing procedures.

Banking organizations should also ensure that trades that are consummated orally are confirmed as soon as possible. Oral transactions conducted via telephone should be recorded on tape and subsequently supported by written documents. Examiners should ensure that the organization monitors the consistency between the terms of a transaction as they were orally agreed upon and the terms as they were subsequently confirmed.

Examiners should also consider the extent to which banking organizations evaluate and control operating risks through the use of internal audits, stress testing, contingency planning, and other managerial and analytical techniques. Banking organizations should also have approved policies that specify documentation requirements for trading activities and formal procedures for saving and safeguarding important documents that are consistent with legal requirements and internal policies. Relevant personnel should fully understand the requirements.

Legal risks should be limited and managed through policies developed by the organization's legal counsel (typically in consultation with officers in the risk management process) that have been approved by the banking organization's senior management and board of directors. At a minimum, there should be guidelines and processes in place to ensure the enforceability of counterparty agreements. Examiners should determine whether a banking organization is adequately evaluating the enforceability of its agreements before individual transactions are consummated. Banking organizations should also ensure that the counterparty has sufficient authority to enter into the transaction and that the terms of the agreement are legally sound. Banking organizations should further ascertain that their netting agreements are adequately documented, that they have been executed properly, and that they are enforceable in all relevant jurisdictions. Banking organizations should have knowledge of relevant tax laws and interpretations governing the use of these instruments. Knowledge of these laws is necessary not only for the banking organization's marketing activities, but also for its own use of derivative products.

Sound business practices provide that banking organizations take steps to ascertain the character and financial sophistication of counterparties. This includes efforts to ensure that the counterparties understand the nature of and the risks inherent in the agreed transactions. Where the counterparties are unsophisticated, either generally or with respect to a particular type of transaction, banking organizations should take additional steps to ensure that counterparties are made aware of the risks attendant in the specific type of transaction. While counterparties are ultimately responsible for the transactions into which they choose to enter, where a banking organization recommends specific transactions for an unsophisticated counterparty, the banking organization should ensure that it has adequate information regarding its counterparty on which to base its recommendation.

2125.0.3 INTERNAL CONTROLS AND AUDITS

A review of internal controls has long been central to the Federal Reserve's examination and inspection of trading and derivatives activities. Policies and related procedures for the operation of these activities should be an extension of the organization's overall structure of internal controls and should be fully integrated into routine work-flows. Properly structured, a system of internal controls should promote effective and efficient operations, reliable financial and regulatory reporting, and compliance with relevant laws, regulations, and banking organization policies. In determining whether internal controls meet those objectives, examiners should consider the overall control environment of the organization; the process for identifying, analyzing, and managing risk; the adequacy of management information systems; and adherence to control activities such as approvals, confirmations, and reconciliations.

Assessing the adequacy of internal controls involves a process of understanding, documenting, evaluating, and testing an organization's internal control system. This assessment should include product- or business-line reviews which, in turn, should start with an assessment of the line's organizational structure. Examiners should check for adequate separation of duties, especially between trading desk personnel and internal control and risk management functions, adequate oversight by a knowledgeable manager without day-to-day trading responsibilities, and the presence of separate reporting lines for risk management and internal control personnel on one side and for trading personnel on the other. Product-by-product reviews of management structure should supplement the overall assessment of the organizational structure of the trading and derivatives areas.

Examiners are expected to conduct in-depth reviews of the internal controls of key activities. For example, for transaction recording and processing, examiners should evaluate written policies and procedures for recording trades, assess the trading area's adherence to policy, and analyze the transaction processing cycle, including settlement, to ensure the integrity and accuracy of the banking organization's records and management reports. Examiners should review the revaluation process in order to assess the adequacy of written policies and procedures for revaluing positions and for creating any associated revaluation reserves. Examiners should review compliance with revaluation policies and procedures, the frequency of revaluation, and the independence and quality of the sources of revaluation prices, especially for instruments traded in illiquid markets. All significant internal controls associated with the management of market risk, such as position versus limit reports and limit overage approval policies and procedures, should also be reviewed. Examiners should also review the credit approval process to ensure that the risks of specific products are adequately captured and that credit approval procedures are followed for all transactions.

An important step in the process of reviewing internal controls is the examiner's appraisal of the frequency, scope, and findings of independent internal and external auditors and the ability of those auditors to review the banking organization's trading and derivatives activities. Internal auditors should audit and test the risk management process and internal controls on a periodic basis, with the frequency based on a careful risk assessment. The depth and frequency of internal audits should be increased if weaknesses and significant issues are discovered or if significant changes have been made to product lines, modeling methodologies, the risk oversight process, internal controls, or the overall risk profile of the organization.

In reviewing the risk management functions in particular, internal auditors should thoroughly evaluate the effectiveness of internal controls relevant to measuring, reporting, and limiting risks. Internal auditors should also evaluate compliance with risk limits and the reliability and timeliness of information reported to the banking organization's senior management and board of directors. Internal auditors are also expected to evaluate the independence and overall effectiveness of the banking organization's risk management functions.

The level of confidence that examiners place in the banking organization's audit programs, the nature of the audit findings, and management's response to those findings will influence the scope of the current examination of trading and derivatives activities. Even when the audit process and findings are satisfactory, examiners should document, evaluate, and test critical internal controls.

Similar to the focus of internal auditors, examiners should pay special attention to significant changes in product lines, risk measurement methodologies, limits, and internal controls that have occurred since the last examination. Meaningful changes in earnings from trading or derivatives activities, or in the size of positions or the value at risk associated with these activities, should also receive emphasis during the inspection or examination.

The following is the text of SR-95-17, adapted for this manual. Section numbers have been added for reference.

Section 2125.0, ‘‘Trading Activities of Banking Organizations (Risk Management and Internal Controls),’’ derived from SR-93-69, highlights the key elements of a sound risk-management process and emphasizes the importance of applying them to the trading and derivatives activities of banking institutions. It also provides examiners with guidance on evaluating the risk-management process and internal controls of trading activities. This section provides similar guidance on evaluating the risk-management practices used by banking institutions in acquiring and managing securities and off-balance-sheet (OBS) derivative contracts for ‘‘nontrading’’ purposes. Traditionally, these nontrading activities have been termed investment activities in the case of securities and end-user activities for OBS derivative contracts. Institutions should ensure that they employ sound risk-management practices consistently across these varying product categories regardless of legal characteristics or nomenclature.

2126.0.1 SCOPE OF NONTRADING ACTIVITIES AND GUIDANCE

This guidance specifically targets the risk-management practices of state member banks and Edge Act corporations engaged in banking. The basic principles also apply to bank holding companies, which should manage and control aggregate risk exposures on a consolidated basis, while recognizing legal distinctions and possible obstacles to cash movements among subsidiaries.[1] More generally, the principles advanced here set forth fundamental risk-management practices that are relevant to most portfolio-management endeavors. Institutions should review the applicability of these principles in providing trust and investment-management services.

For the purpose of this guidance, an institution’s nontrading activities involve the use of securities (both available-for-sale and held-to-maturity) and OBS derivative contracts to achieve earnings and risk-management objectives that involve longer time horizons than typically associated with trading activities. Nontrading activities involve the full array of cash securities, money market instruments, and OBS derivative contracts.[2] Cash securities include fixed- and floating-rate notes and bonds, structured notes, mortgage pass-through and other asset-backed securities, and mortgage-derivative products. OBS derivative contracts include swaps, futures, and options.

2126.0.2 OVERVIEW OF GUIDANCE

This guidance reiterates and supplements existing guidance and directives on the use of these instruments for nontrading purposes as provided in various supervisory letters and examination manuals.[3] It identifies basic factors that examiners should consider in evaluating the four key elements of a sound risk-management process:

1. active board and senior management oversight
2. adequate risk-management policies and limits
3. appropriate risk-measurement and -reporting systems
4. comprehensive internal controls

1. The basic principles set forth in this guidance should also be incorporated into the policies of U.S. branches and agencies of foreign banks with appropriate adaptations to reflect the facts that (1) those offices are an integral part of a foreign bank, which should be managing its risks on a consolidated basis and recognizing possible obstacles to cash movements among branches, and (2) the foreign bank is subject to overall supervision by its home authorities.

2. In general terms, derivatives are financial contracts whose value derives from the value of one or more underlying assets, interest rates, exchange rates, commodities, or financial or commodity indexes.

3. Existing policies and examiner guidance on various supervisory topics applicable to securities and off-balance-sheet instruments can be found in various chapters of the *Commercial Bank Examination Manual*, the *Bank Holding Company Supervision Manual*, the *Trust Activities Examination Manual*, the *Merchant and Investment Bank Examination Manual*, and the *Trading and Capital-Markets Activities Manual*, as well as in various supervision and regulation (SR) letters, including SR-90-16, ‘‘Implementation of Examination Guidelines for the Review of Asset Securitization Activities’’; SR-90-41, ‘‘Interest Rate Risk’’; SR-91-4, ‘‘Inspections of Investment Adviser Subsidiaries of Bank Holding Companies’’ (see section 3130.1); SR-98-12, announcement of the FFIEC *Statement on Investment Securities and End-User Derivatives Activities* (effective May 25, 1998); and SR-93-69, ‘‘Risk Management and Internal Controls for Trading Activities’’ (see section 2125.0). Examiners of U.S. branches and agencies of foreign banks should take the principles included in these guidelines into consideration in accordance with the procedures set forth in the *Examination Manual for Branches and Agencies of Foreign Banking Organizations*.

Section 2126.0.8 identifies important policy considerations related to specific risks and should receive special attention. It contains specific guidance for evaluating an institution's management of each of the risks involved in these activities, including credit, market, liquidity, operating, and legal risks.

In evaluating an institution's risk-management process, examiners should consider the nature and size of its holdings. Examiner judgment plays a key role in assessing the adequacy of an institution's risk-management process for securities and derivative contracts. Examiners should focus particular attention on evaluating an institution's understanding of the risks involved in the instruments it holds. Regardless of any responsibility, legal or otherwise, assumed by a dealer or counterparty regarding a transaction, the acquiring institution is ultimately responsible for understanding and managing the risks of the transactions into which it enters. *Failure of an institution to understand adequately the risks involved in its securities or derivative positions, either through the lack of internal expertise or inadequate outside advice, constitutes an unsafe and unsound banking practice.*

As with all risk-bearing activities, institutions should fully support the risk exposures of nontrading activities with adequate capital. Banking organizations should ensure that their capital positions are sufficiently strong to support all the risks associated with these activities on a fully consolidated basis and should maintain adequate capital in all affiliated entities engaged in these activities. In evaluating the adequacy of an institution's capital, examiners should consider any unrecognized net depreciation or appreciation in an institution's securities and derivative holdings.[4]

2126.0.3 BOARD OF DIRECTORS AND SENIOR MANAGEMENT OVERSIGHT

Active oversight by the institution's board of directors and relevant senior management is critical to a sound risk-management process. Examiners should ensure that these individuals are aware of their responsibilities and that they adequately perform their appropriate roles in overseeing and managing the risks associated with nontrading activities involving securities and derivative instruments.

2126.0.3.1 Board of Directors

The board of directors has the ultimate responsibility for the level of risk taken by the institution. Accordingly, the board should approve overall business strategies and significant policies that govern risk taking, including those involving securities and derivative contracts. In particular, policies identifying managerial oversight and articulating risk tolerances and exposure limits of these activities should be approved by the board of directors. The board should also actively monitor the performance and risk profile of the institution and its various securities and derivative portfolios. Directors should periodically review information that is sufficient in detail and timeliness to allow them to understand and assess the credit, market, and liquidity risks facing the institution as a whole and its securities and derivative positions in particular. Such reviews should be conducted at least quarterly and more frequently if the institution holds significant positions in complex instruments. In addition, the board should periodically reevaluate the institution's business strategies and significant risk-management policies and procedures, placing special emphasis on the institution's financial objectives and risk tolerances. The minutes of board meetings and accompanying reports and presentation materials should clearly demonstrate the board's fulfillment of these basic responsibilities. Section 2126.0.8 provides guidance on the types of objectives, risk tolerances, limits, and reports that directors should consider.

The board of directors should also conduct and encourage discussions between its members and senior management, as well as between senior management and others in the institution, regarding the institution's risk-management process and risk exposures. Although it is not essential for board members to have detailed technical knowledge of these activities, if they do not, it is incumbent upon them to ensure that they have adequate access to independent legal and professional advice regarding the institution's securities and derivative holdings and strategies. The familiarity, technical knowledge, and awareness of directors and senior management should be commensurate with the level and nature of an institution's securities and derivative positions.

4. For further guidance, see SR-93-72, ''Guidance on the Capital Treatment and Other Issues Relating to the Financial Accounting Standards Board Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities.''

2126.0.3.2 Senior Management

Senior management is responsible for ensuring that there are adequate policies and procedures for conducting nontrading securities and derivative activities on both a long-range and day-to-day basis. Management should maintain clear lines of authority and responsibility for acquiring instruments and managing risk, appropriate limits on risk taking, adequate systems for measuring risk, acceptable standards for valuing positions and measuring performance, effective internal controls, and a comprehensive risk-reporting and risk-management review process. In order to provide adequate oversight, management should fully understand the institution's risk profile, including that of its securities and derivative activities. Examiners should review the reports to senior management and evaluate whether they provide both good summary information and sufficient detail to enable management to assess the sensitivity of securities and derivative holdings to changes in credit quality, market prices and rates, liquidity conditions, and other important risk factors. As part of its oversight responsibilities, senior management should periodically review the organization's risk-management procedures to ensure that they remain appropriate and sound. Senior management also should encourage and participate in active discussions with members of the board and with risk-management staff regarding risk measurement, reporting, and management procedures.

Management should ensure that nontrading securities and derivative activities are conducted by competent staff with technical knowledge and experience consistent with the nature and scope of the institution's activities. There should be sufficient depth in staff resources to manage these activities if key personnel are not available. Management should also ensure that there are sufficient back-office and financial control resources to effectively manage and control risks.

2126.0.3.3 Independence in Managing Risks

To avoid possible conflicts of interest, the process of measuring, monitoring, and controlling risks should be managed as independently as practicable from those individuals who have the authority to initiate transactions. The nature and extent of this independence should be commensurate with the size and complexity of an institution's securities and derivative activities. Institutions with large and complex balance sheets, or with significant holdings of complex instruments, would be expected to have risk managers or risk-management functions fully independent of the individuals who have the authority to conduct transactions. Institutions with less complex holdings should ensure that there is some mechanism for independently reviewing both the level of risk exposures created by securities and derivative holdings and the adequacy of the process used in managing those exposures. Depending on the size and nature of the institution, such a mechanism may reside either in the management structure or in a board committee. Regardless of size and sophistication, institutions should ensure that back- office, settlement, and transaction-reconciliation responsibilities are conducted and managed by personnel who are independent of those initiating risk-taking positions.

2126.0.4 POLICIES AND PROCEDURES FOR ACQUIRING AND MANAGING SECURITIES AND DERIVATIVE INSTRUMENTS

Institutions should maintain written policies and procedures that clearly outline their approach for managing securities and derivative instruments. Such policies should be consistent with the organization's broader business strategies, capital adequacy, technical expertise, and general willingness to take risk. They should identify relevant objectives, constraints, and guidelines for both acquiring instruments and managing portfolios. In doing so, policies should establish a logical framework for limiting the various risks involved in an institution's securities and derivative holdings. Policies should clearly delineate lines of responsibility and authority over securities and derivative activities. They should also provide for the systematic review of products new to the firm. Examiners should evaluate the adequacy of an institution's risk-management policies and procedures in relation to its size, sophistication, and the scope of its activities.

2126.0.4.1 Specifying Objectives

Institutions can use securities and derivative instruments for several primary and complementary purposes.[5] Banking organizations should clearly articulate these objectives and identify the types of securities and derivative contracts to be used for achieving them. Objectives also should be identified at the appropriate portfolio and institutional levels. These objectives should guide the acquisition of individual instruments and should provide benchmarks for periodically evaluating the performance and effectiveness of an institution's holdings, strategies, and programs. Wherever multiple objectives are involved, management should identify the hierarchy of potentially conflicting objectives.

2126.0.4.2 Identifying Constraints, Guidelines, and Limits

An institution's policies should clearly articulate the organization's risk tolerance by identifying its willingness to take the credit, market, and liquidity risks involved in holding securities and derivative contracts. A statement of authorized instruments and activities is an important vehicle for communicating these risk tolerances. This statement should clearly identify permissible instruments or instrument types and the purposes or objectives for which the institution may use them. The statement also should identify permissible credit quality, market-risk sensitivity, and liquidity characteristics of the instruments and portfolios used in nontrading activities. For example, in the case of market risk, policies should address the permissible degree of price sensitivity and/or effective maturity volatility, taking into account an instrument's or portfolio's option and leverage characteristics. Specifications of permissible risk characteristics should be consistent with the institution's overall credit, market, and liquidity risk limits and constraints and should help delineate a clear set of institutional limits for use in acquiring specific instruments and managing portfolios. Such limits can be specified either as guidelines within the overall policies or in management operating procedures. Section 2126.0.8 provides further guidance on the types of constraints and limits an institution might use in managing the credit, market, and liquidity risk of securities and derivative contracts.

5. These purposes include, but are not limited to, generating earnings, creating funding opportunities, providing liquidity, hedging risk exposures, taking risk positions, modifying and managing risk profiles, managing tax liabilities, and meeting pledging requirements.

Limits should be set to guide acquisition and ongoing management decisions, control exposures, and initiate discussion within the organization about apparent opportunities and risks. Although procedures for establishing limits and for operating within them may vary among institutions, examiners should determine whether the organization enforces its policies and procedures through a clearly identified system of risk limits. Positions that exceed established limits should receive the prompt attention of appropriate management and should be resolved according to approved policies.

Limits should implement the overall risk tolerances and constraints articulated in general policy statements. Depending on the nature of an institution's holdings and its general sophistication, limits can be identified with individual business units, portfolios, instrument types, or specific instruments. The level of detail of risk limits should reflect the characteristics of the institution's holdings including the types of risk to which the institution is exposed. Regardless of their specific form or level of aggregation, limits should be consistent with the institution's overall approach to managing various types of risks. They should also be integrated to the fullest extent possible with institution-wide limits on the same risks as they arise in other activities of the firm. Section 2126.0.8 presents specific examiner considerations in evaluating the policies and limits used in managing each of the various types of risks involved in nontrading securities and derivative activities.

2126.0.4.3 New-Product Review

An institution's policies should also provide for effective review of products being considered that would be new to the firm. An institution should not acquire a meaningful position in a new instrument until senior management and all relevant personnel (including those in internal control, legal, accounting, and auditing functions) understand the product and can integrate it into the institution's risk-measurement and control systems. An institution's policies should define the terms "new product" and "meaningful position" consistent with its size, complexity, and sophistication. Institutions should not be hesitant to define an instrument as a new product. Small changes in payment formulas or other terms of relatively simple and standard products can greatly alter their risk profiles and justify the designation of an instrument as a new product. New-product reviews should analyze all of the relevant risks involved in an instrument and should assess the reasonableness of the product or activity in achieving specified objectives. New-product reviews also should include a description of the relevant accounting guidelines and identify the procedures for measuring, monitoring, and controlling the risks involved.

2126.0.4.4 Accounting

The accounting systems and procedures used for public and regulatory reporting purposes are critically important to enhancing the transparency of an institution's risk profile. Accordingly, an institution's policies should provide clear guidelines regarding the accounting for all securities and derivative holdings. This treatment should be consistent with specified objectives and with the institution's regulatory requirements. Institutions should ensure that they categorize each cash or derivative contract for accounting purposes consistent with appropriate accounting policies and requirements. Furthermore, the accounting for nontrading securities and OBS derivative contracts should reflect the economic substance of the transactions.[6] Where instruments are used for hedging purposes, the hedging rationale and performance criteria should be well documented. Management should reassess these classifications periodically to ensure that they remain appropriate.[7]

2126.0.5 RISK MEASUREMENT, MONITORING SYSTEMS, AND MANAGEMENT REVIEW

Clear procedures for measuring and monitoring risks are the foundation of a sound risk-management process. Examiners should ensure that an institution sufficiently integrates these functions into its ongoing management process and that relevant personnel recognize their role and understand the instruments held.

2126.0.5.1 Risk Measurement

An institution's system for measuring the credit, market, liquidity, and other risks involved in cash and derivative contracts should be as comprehensive and accurate as practicable. The degree of comprehensiveness should be commensurate with the nature of the institution's holdings and risk exposures. Exposures to each type of risk (that is, credit, market, liquidity) should be aggregated across securities and derivative contracts and integrated with similar exposures arising from lending and other business activities to obtain the institution's overall risk profile.

Examiners should evaluate whether the risk measures and the risk-measurement process are sufficiently robust to accurately reflect the different types of risks facing the institution. Institutions should establish clear risk-measurement standards for both the acquisition and ongoing management of securities and derivative positions. Risk-measurement standards should provide a common framework for limiting and monitoring risks and should be understood by relevant personnel at all levels of the institution—from individual managers to the board of directors.

2126.0.5.1.1 Acquisition Standards

Institutions conducting securities and derivative activities should have the capacity to evaluate the risks of instruments before acquisition. Before executing any transaction, an institution should evaluate the instrument to ensure that it meets the various objectives, risk tolerances, and guidelines identified by the institution's policies. Evaluations of the credit-, market-, and liquidity-risk exposures should be clearly and adequately documented for each acquisition. Such documentation should be appropriate for the nature and type of instrument. Relatively simple instruments would be expected to require less documentation than instruments with significant leverage or option characteristics.

Institutions with significant securities and derivative activities are expected to either conduct their own in-house preacquisition analyses or make use of specific third-party analyses that are independent of the seller or counterparty. Analyses provided by the originating dealer or counterparty should be used only when there is a clearly defined investment advisory relationship. Less active institutions with relatively uncomplicated holdings may use risk analyses provided by the dealer only to the extent that the analyses are derived using standard industry

6. Adjusted trading involves the sale of an instrument at a price above the prevailing market value and the simultaneous purchase and booking of an instrument at a price greater than its market value.

7. Reporting requirements for bank and bank holding company regulatory reports are set forth in the Reports of Condition and Income (call report) for banks and the FR Y-9C for bank holding companies.

calculators and market conventions. Such analyses must comprehensively depict the potential risks involved in the acquisition, and they should be accompanied by documentation that sufficiently demonstrates that the acquirer understands fully both the analyses and the nature of the institution's relationship with the provider of those analyses. Notwithstanding information and analyses obtained from outside sources, management is ultimately responsible for understanding the nature and risk profiles of the institution's securities and derivative holdings.

It is a prudent practice to obtain and compare price quotes and risk analyses from more than one dealer before acquisition. In doing so, institutions should ensure that they clearly understand the responsibilities of any outside parties that provide analyses and price quotes. With regard to analyses and price quotes provided by dealers, institutions should assume that each party deals at arm's length for its own account unless there is a written agreement stating the contrary. Institutions should exercise caution in situations in which dealers limit the institution's ability to show securities or derivative contract proposals to other dealers in order to receive comparative price quotes or risk analyses. As a general sound practice, unless the dealer or counterparty is also acting under a specific investment advisory relationship, an investor or end-user should not acquire an instrument or enter into a transaction if its fair value or the analyses required to assess its risk cannot be determined through a means that is independent of the originating dealer or counterparty.

2126.0.5.1.2 Portfolio-Management Standards

Institutions should periodically review the performance and effectiveness of instruments, portfolios, and institutional programs and strategies. This review should be conducted no less frequently than quarterly and should evaluate the extent to which the institution's securities and derivative holdings meet the various objectives, risk tolerances, and guidelines established by the institution's policies.[8] Institutions with large or highly complex holdings should conduct such reviews more frequently.

For internal measurement purposes, effective measurement of the credit, market, and liquidity risks of many securities and derivative contracts requires mark-to-market valuations.[9] Accordingly, the periodic revaluation of securities and derivative holdings is an integral part of an effective risk-measurement system. These periodic revaluations should be fully documented. Where available, actual market prices should be used. For less liquid or complex instruments, institutions with only limited holdings may use properly documented periodic prices and analyses provided by dealers or counterparties. More active institutions should conduct periodic revaluations and portfolio analyses using either their own in-house capabilities or outside party analytical systems that are independent of sellers or counterparties. Institutions should recognize that indicative price quotes and model revaluations may differ from the values at which transactions can be executed.

2126.0.5.1.3 Stress Testing

Analyzing the credit, market, and liquidity risk of individual instruments, portfolios, and the entire institution under a variety of unusual and stressful conditions is an important aspect of the risk-measurement process. Management should seek to identify the types of situations, or the combinations of credit and market events, that could produce substantial losses or liquidity problems. Since institutions typically manage nontrading securities and derivative contracts with consideration to the institution's consolidated exposures, management should review the effect of stress situations on an institution-wide basis. Stress tests should evaluate changes in market conditions, including alternatives in the underlying assumptions used to value instruments.

Stress tests should not be limited to quantitative exercises that compute potential losses or gains, but should also include qualitative analyses of the tools available to management to deal with various scenarios. Contingency plans outlining operating procedures and lines of communication, both formal and informal, are important products of such qualitative analyses.

8. For example, the performance of instruments and portfolios used to meet tax-advantaged earnings objectives should be evaluated to ensure that they meet the necessary credit rating, market sensitivity, and liquidity characteristics established for this objective.

9. The Reports of Condition and Income (call report) require quarterly reporting of the fair value of all securities holdings.

The appropriate extent and sophistication of an institution's stress testing depends heavily on the scope and nature of its securities and derivative holdings and on its ability to limit the effect of adverse events. Institutions holding securities or derivative contracts with complex credit-, market-, or liquidity-risk profiles should have an established regime of stress testing. Examiners should consider the circumstances at each institution when evaluating the adequacy or need for stress-testing procedures.

2126.0.5.2 Risk Reporting

An accurate, informative, and timely management information system is essential. Examiners should evaluate the adequacy of an institution's monitoring and reporting of the risks, returns, and overall performance of security and derivative activities to senior management and the board of directors. The frequency of reporting should provide the responsible individuals with adequate information to judge the changing nature of the institution's risk profile and to evaluate compliance with stated policy objectives and constraints.

Management reports should translate measured risks from technical and quantitative formats to those that can be easily read and understood by senior managers and directors, who may not have specialized and technical knowledge of all financial instruments used by the institution. Institutions should ensure that they use a common conceptual framework for measuring and limiting risks in reports to senior managers and directors. Such reports should include the periodic assessment of the performance of appropriate instruments or portfolios in meeting their stated objective(s) subject to the relevant constraints and risk tolerances.

2125.0.5.3 Management Evaluation and Review

Management should regularly review the institution's approach and process for managing risks. This includes regularly assessing the methodologies, models, and assumptions used to measure risks and to limit exposures. Proper documentation of the elements used in measuring risks is essential for conducting meaningful reviews. Limits should be compared to actual exposures. Such reviews should also consider whether existing measures of exposure and limits are appropriate in view of the institution's holdings, past performance, and current capital position.

The frequency of the reviews should reflect the nature of an institution's holdings and the pace of market innovations in measuring and managing risks. At a minimum, institutions with significant activities involving complex cash or derivative contracts should review the underlying methodologies of the models they use at least annually—and more often as market conditions dictate—to ensure that they are appropriate and consistent. Reviews by external auditors or other qualified outside parties, such as consultants with expertise in highly technical models and risk-management techniques, may often supplement these internal evaluations. Institutions depending on outside parties to provide various risk-measurement capabilities should ensure that the institution has personnel with the necessary expertise to identify and evaluate the important assumptions incorporated in the risk-measurement methodologies it uses.

2126.0.6 COMPREHENSIVE INTERNAL CONTROLS AND AUDIT PROCEDURES

An institution's risk-management process should be an extension of its overall structure of internal controls. Properly structured, a system of internal controls should promote effective and efficient operations, reliable financial and regulatory reporting, and compliance with relevant laws, regulations, and institutional policies. In determining whether internal controls meet those objectives, examiners should consider the general control environment of the organization; the process for identifying, analyzing, and managing risk; the adequacy of management information systems; and adherence to control activities such as approvals, confirmations, and reconciliations.

Assessing the adequacy of internal controls involves a process of understanding, documenting, evaluating, and testing an institution's internal control system. This assessment should include product reviews that start with an analysis of the organizational structure of securities and derivative activities. Duties should be separated between personnel initiating transactions and personnel overseeing back-office operations, internal controls, and the management of risk exposures.

Examiners should conduct in-depth reviews of the internal controls of all key activities involving securities and derivative contracts. For example, for transaction recording and processing, examiners should evaluate and assess adherence to the written policies and procedures for recording transactions. They should also analyze the transaction-processing cycle to ensure the integrity and accuracy of the institution's records and management reports. Examiners should review all significant internal controls associated with the management of the credit, market, liquidity, operational, and legal risks involved in securities and derivative holdings.

The examiner should appraise the frequency, scope, and findings of any independent internal and external auditors. This appraisal should include an evaluation of the ability of those auditors to review the institution's securities and derivative activities. Where applicable, internal auditors should audit and test the risk-management process and internal controls periodically. The depth and frequency of internal audits should increase if weaknesses and significant issues exist or if portfolio structures, modeling methodologies, or the overall risk profile of the institution has changed.

In reviewing the management of the risks of nontrading securities and derivative activities, internal auditors should thoroughly evaluate the effectiveness of internal controls used for measuring, reporting, and limiting risks. Internal auditors should also evaluate compliance with risk limits and the reliability and timeliness of information reported to the institution's senior management and board of directors. Internal auditors should also evaluate the independence and overall effectiveness of the institution's risk-management process. The level of confidence that examiners place in an institution's audit programs, the nature of the audit findings, and management's response to those findings will influence the scope of the current examination of securities and derivative activities.

Examiners should pay special attention to significant changes in the nature of instruments acquired, risk-measurement methodologies, limits, and internal controls that have occurred since the last examination. Significant changes in earnings from securities and derivative contracts, in the size of positions, or in the value at risk associated with these activities should also receive attention during the examination.

2126.0.7 SOUND RISK MANAGEMENT FOR MANAGING SECURITIES AND DERIVATIVE CONTRACTS—CONCLUSION

The foregoing discussion identified, in broad terms, the key elements of a sound risk-management system for acquiring and managing securities and derivative contracts. Section 2126.0.8 presents important guidance for evaluating specific risks—credit, market, liquidity, operating, and legal—that institutions encounter in conducting nontrading securities and derivative activities.

These guidelines, including those in section 2126.0.8, are intended to help examiners, and the management and boards of directors of institutions, evaluate the adequacy of the risk-management process as it applies to the use of securities and derivative contracts in a nontrading environment. However, the nature of these activities and the broad range of circumstances in which these instruments are used by banking organizations requires examiners to apply substantial judgment in their evaluation of management procedures. In the final analysis, *examiners must determine whether the institution's use of securities and derivatives represents a prudent activity in light of the purposes for which they are used, management's ability to evaluate and control risks, and the capital position of the institution.* They should also ensure that depository institutions adopt adequate policies related to securities and derivative transactions and that all levels of management provide sufficient oversight of the risk-management process.

2126.0.8 EVALUATING THE MANAGEMENT OF THE CREDIT, MARKET, LIQUIDITY, OPERATING, AND LEGAL RISKS OF NONTRADING SECURITIES AND DERIVATIVE ACTIVITIES

This section highlights specific considerations in evaluating the key elements of sound risk-management systems as they relate to the management of the various risks involved in an institution's use of securities and derivative contracts for nontrading activities. These risks include credit, market, liquidity, operating, and legal risks.

2126.0.8.1 Credit Risk

Broadly defined, credit risk is the risk that an issuer or counterparty will fail to perform on an obligation to the institution. The policies of an institution should recognize credit risk as a significant risk faced by the institution's securities and derivative activities. Accordingly, policies should identify credit-risk constraints, risk tolerances, and limits at the appropriate instrument, portfolio, and institutional level. In doing so, institutions should ensure that credit-risk constraints are clearly associated with specified objectives. For example, credit-risk constraints and guidelines should be defined for instruments used to meet pledging requirements, to generate tax-advantaged income, to hedge positions, and to generate temporary income or any other specifically defined objective.

As a matter of general policy, an institution should not acquire securities or derivative contracts until it has assessed the creditworthiness of the issuer or counterparty and determined that the risk exposure conforms with its policies. The credit risk arising from these positions should be incorporated into the overall credit-risk profile of the institution to the fullest extent possible. As a matter of policy, the board of directors and responsible senior management should be informed of the institution's total credit-risk exposures regularly, and no less frequently than quarterly.

In managing their credit risk, institutions also should consider settlement and presettlement credit risk. The selection of dealers, investment bankers, and brokers is particularly important in effectively managing these risks. An institution's policies should identify criteria for selecting these organizations and should list all approved firms. The approval process should include a review of each firm's financial statements and an evaluation of its ability to honor its commitments. An inquiry into the general reputation of the dealer is also appropriate. The board of directors, or a committee thereof, should set limits on the amounts and types of transactions authorized for each firm. They should also periodically review and reconfirm the list of authorized dealers, investment bankers, and brokers. See section 2190.0.5 for a discussion of SR-98-12 regarding the FFIEC *Statement on Investment Securities and End-User Derivatives Activities* (effective May 25, 1998).

An institution's credit policies should also include guidelines on the quality and quantity of each type of security that may be held. Policies should also provide credit-risk diversification and concentration limits. Such limits may define concentrations as those to a single or related issuer or counterparty, in a geographical area, or in obligations with similar characteristics.

Sound credit-risk management requires that credit limits be developed by personnel who are independent of the acquisition function. In authorizing issuer and counterparty credit lines, these personnel should use standards that are consistent with those used for other activities conducted within the institution, and with the organization's overall policies and consolidated exposures. In assessing the creditworthiness of other organizations, institutions should not rely solely on outside sources, such as standardized ratings provided by independent rating agencies, but should also perform their own analysis of a counterparty's or issuer's financial strength. In addition, examiners should review the credit-approval process to ensure that the credit risks of specific products are adequately identified and that credit-approval procedures are followed for all transactions.

For most cash instruments, credit exposure is measured as the current carrying value. In the case of many derivative contracts, especially those traded in OTC markets, credit exposure is measured as the replacement cost of the position, plus an estimate of the institution's potential future exposure to changes in the replacement value of that position in response to market-price changes. Replacement costs of derivative contracts should be determined using current market prices or generally accepted approaches for estimating the present value of future payments required under each contract, at current market rates.

The measurement of potential future credit-risk exposure for derivative contracts is more subjective than the measurement of current exposure and is primarily a function of the time remaining to maturity, the number of exchanges of principal, and the expected volatility of the price, rate, or index underlying the contract. Potential future exposure can be measured using an institution's own simulations or, more simply, through the use of "add-ons" such as those included in the Federal Reserve's risk-based capital guidelines. Regardless of method, examiners should evaluate the reasonableness of the assumptions underlying the institution's risk measure.

For derivative contracts and certain types of cash transactions, master agreements (including netting agreements) and various credit enhancements (such as collateral or third-party guarantees) can reduce settlement, issuer, and counterparty credit risk. In such cases, an institution's credit exposures should reflect these risk-reducing features only to the extent that the agreements and recourse provisions are legally enforceable in all relevant jurisdictions. This legal enforceability should extend to any insolvency proceedings of the counterparty. Institutions should be prepared to demonstrate sufficient due diligence in evaluating the enforceability of these contracts.

In reviewing credit exposures, examiners should consider the extent to which positions exceed credit limits and whether exceptions are resolved according to the institution's adopted policies and procedures. Examiners should also evaluate whether the institution's reports adequately provide all personnel involved in the acquisition and management of financial instruments with relevant, accurate, and timely information about the credit exposures and approved credit lines.

2126.0.8.2 Market Risk

Market risk is the exposure of an institution's financial condition to adverse movements in the market rates or prices of its holdings before such holdings can be liquidated or expeditiously offset. It is measured by assessing the effect of changing rates and/or prices on either the earnings or economic value of an individual instrument, a portfolio, or the entire institution. Although many banking institutions focus on carrying values and reported earnings when assessing market risk at the institutional level, other measures focusing on total returns and changes in economic or fair values better reflect the potential market-risk exposure of institutions, portfolios, and individual instruments. Changes in fair values and total returns directly measure the effect of market movements on the economic value of an institution's capital and provide significant insights as to their ultimate effects on the institution's long-term earnings. Institutions should manage and control their market risks using both an earnings and an economic-value approach and at least on an economic- or fair-value basis.

When evaluating capital adequacy, examiners should consider the effect of changes in market rates and prices on the economic value of the institution by evaluating any unrealized losses in an institution's securities or derivative positions. This evaluation should assess the ability of the institution to hold its positions and function as a going concern if recognition of unrealized losses would significantly affect the institution's capital ratios. Examiners also should consider the impact that liquidating positions with unrealized losses may have on the institution's prompt-corrective-action capital category.

Market-risk limits should be established for both the acquisition and ongoing management of an institution's securities and derivative holdings and, as appropriate, should address exposures for individual instruments, instrument types, and portfolios. These limits should be integrated fully with limits established for the entire institution. At the institutional level, the board of directors should approve market-risk exposure limits in terms of specific percentage changes in the economic value of capital and in the projected earnings of the institution under various market scenarios. Similar and complementary limits on the volatility of prices or fair value should be established at the appropriate instrument, product type, and portfolio levels based on the institution's willingness to accept market risk. Limits on the variability of effective maturities may also be desirable for certain types of instruments or portfolios.

The federal bank regulatory agencies have established price and effective maturity standards for mortgage-derivative products based on specified scenarios. Institutions should ensure that they meet these regulatory requirements and should employ similar techniques in controlling the exposures of other cash securities and to all derivative contracts—especially for instruments involving explicit or embedded options. The scenarios specified for assessing the market risk of these products should be sufficiently rigorous to capture all meaningful effects of any options. For example, in assessing interest-rate risk, scenarios such as 100, 200, and 300 basis point parallel shifts in yield curves should be considered as well as appropriate nonparallel shifts in structure to evaluate potential basis, volatility, and yield curve risks.

Accurately measuring an institution's market risk requires timely information about the current carrying and market values of its securities and derivative holdings. Accordingly, institutions should have market-risk-measurement systems commensurate with the size and nature of these holdings. Institutions with significant holdings of highly complex instruments should ensure that they have independent means to value their positions. Institutions employing internal models should have adequate procedures to validate the models and to periodically review all elements of the modeling process, including its assumptions and risk-measurement techniques. Institutions relying on third parties for market-risk-measurement systems and analyses should ensure that they fully understand the assumptions and techniques used.

Institutions should evaluate and report to their boards of directors the market-risk exposures of their securities and derivative positions on a regular basis and not less frequently than each quarter. These evaluations should assess trends in aggregate market-risk exposure and the performance of portfolios in terms of established objectives and risk constraints. They also should identify compliance with board-approved limits and identify any exceptions to established standards. Examiners should ensure that institutions have mechanisms to detect and adequately address exceptions to limits and guidelines. Examiners should also determine if management reports on market risk appropriately address potential exposures to basis risk, yield curve changes, and other factors pertinent to the institution's holdings. In this connection, examiners should assess an institution's compliance with broader guidance for managing interest-rate risk in a consolidated organization, including that detailed in the *Commercial Bank Examination Manual*.

Complex and illiquid instruments can often involve greater market risk than broadly traded, more liquid securities. Oftentimes, this higher potential market risk arising from illiquidity is not captured by standardized financial modeling techniques. Such risk is particularly acute for instruments that are highly leveraged or that are designed to benefit from specific, narrowly defined market shifts. If market prices or rates do not move as expected, the demand for such instruments can evaporate. Where examiners encounter such instruments, they should review the adequacy with which the institution has assessed its potential market risks. If the risks from these instruments are material, the institution should have a well-documented process of stress testing their value and liquidity assumptions under a variety of market scenarios.

2126.0.8.3 Liquidity Risk

Banks face two types of liquidity risk in their securities and derivative activities: those related to specific products or markets and those related to the general funding of the bank's activities. The former, market liquidity risk, is the risk that an institution cannot easily unwind or offset a particular position at or near the previous market price because of inadequate market depth or because of disruptions in the marketplace. Funding liquidity risk is the risk that the bank will be unable to meet its payment obligations on settlement dates. Since neither type of liquidity risk is unique to securities and derivative activities, management should evaluate these risks in the broader context of the institution's overall liquidity.

In specifying permissible securities and derivative instruments for accomplishing established objectives, institutions should ensure that they take into account the size, depth, and liquidity of the market for those instruments and the effect that such characteristics may have on achieving the objective. The market liquidity of certain types of instruments may make them entirely inappropriate for achieving certain objectives. Moreover, institutions should ensure that they consider the effects that market risk can have on the liquidity of different types of instruments. For example, some government-agency securities may have embedded options that make them highly illiquid during periods of market volatility and stress, despite their high credit rating. Accordingly, institutions should clearly articulate the market liquidity characteristics of instruments to be used in accomplishing institutional objectives.

The funding risk of an institution becomes a more important consideration when its unrealized losses are material and, therefore, should be a factor in evaluating capital adequacy. Institutions with weak liquidity positions are more likely to be forced to recognize these losses and to suffer declines in their accounting and regulatory capital. In extreme cases, these effects could force supervisors to take prompt corrective actions.

Examiners should assess whether the institution adequately considers the potential liquidity risks associated with the liquidation of securities or the early termination of derivative contracts. Many forms of standardized contracts for derivative transactions allow counterparties to request collateral or to terminate their contracts early if the institution experiences an adverse credit event or a deterioration in its financial condition. In addition, under situations of market stress, customers may ask for the early termination of some contracts within the context of the dealer's market-making activities. In such circumstances, an institution that owes money on derivative transactions may be required to deliver collateral or settle a contract early and possibly at a time when the institution may face other funding and liquidity pressures. Early terminations may also open additional, unintended market positions. Management and directors should be aware of these potential liquidity risks and should address them in the institution's liquidity plan and in the broader context of the institution's liquidity-management process. In their reviews, examiners should consider the extent to which such potential obligations could present liquidity risks to the institution.

2126.0.8.4 Operating Risk and Legal Risk

Operating risk is the risk that deficiencies in information systems or internal controls will result in unexpected loss. Some specific sources of operating risk that can result in unexpected losses include inadequate procedures, human error, system failure, or fraud. Inaccurately assessing or controlling operating risks is one of the more likely sources of problems facing institutions involved in securities and derivative activities.

Adequate internal controls are the first line of defense in controlling the operating risks involved in an institution's securities and derivatives activities. Of particular importance are internal controls that ensure the separation of duties and supervision of persons executing transactions from those responsible for processing contracts, confirming transactions, controlling various clearing accounts, approving the accounting methodology or entries, and performing revaluations.

Institutions should have approved policies that specify documentation requirements for transactions and formal procedures for saving and safeguarding important documents that are consistent with legal requirements and internal policies. Relevant personnel should fully understand the requirements. Examiners should also consider the extent to which institutions evaluate and control operating risks through the use of internal audits, stress testing, contingency planning, and other managerial and analytical techniques.

An institution's operating policies should establish appropriate procedures to obtain and maintain possession or control of instruments purchased. Institutions should also ensure that transactions consummated orally are confirmed as soon as possible. Banking organizations should, to the extent possible, seek diversification with regard to the firms used for safekeeping arrangements in order to avoid concentrations of assets or other types of risk.[10]

Legal risk is the risk that contracts are not legally enforceable or documented correctly. Legal risks should be limited and managed through policies developed by the institution's legal counsel. At a minimum, there should be guidelines and processes in place to ensure the enforceability of counterparty agreements. Examiners should determine whether an institution is adequately evaluating the enforceability of its agreements before individual transactions are consummated. Institutions should also ensure that the counterparty has sufficient authority to enter into the transaction and that the terms of the agreement are legally sound. Institutions should further ascertain that their netting agreements are adequately documented, that they have been executed properly, and that they are enforceable in all relevant jurisdictions. Institutions should have knowledge of relevant tax laws and interpretations governing the use of these instruments.

An institution's policies should also provide guidelines for conflicts of interest for employees who are directly involved in purchasing and selling securities for the institution from securities dealers. These guidelines should ensure that all directors, officers, and employees act in the best interest of the institution. The board of directors may wish to adopt policies prohibiting these employees from engaging in personal securities transactions with these same securities firms without specific prior board approval. The board of directors may also wish to adopt a policy applicable to directors, officers, and employees restricting or prohibiting the receipt of gifts, gratuities, or travel expenses from approved securities dealer firms and their personnel.

10. See SR-95-3 for further guidance on safekeeping.

On April 23, 1998, the Federal Financial Institutions Examination Council (FFIEC) issued a Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities that became effective on May 25, 1998. The statement was adopted by the Board of Governors and provides guidance on sound practices for managing the risks of investment activities. This statement replaced the 1992 Supervisory Policy Statement on Securities Activities, including the constraints on bank investments in ''high-risk'' mortgage investment products (the FFIEC ''high-risk test''). The guidance focuses on risk-management practices of state member banks and Edge corporations. The basic principles also apply to bank holding companies, which should manage and control risk exposures on a consolidated basis, recognizing the legal distinctions and potential obstacles to cash movements among subsidiaries. The statement's risk-management principles should also be incorporated into the policies of U.S. branches and agencies of foreign banks.[1]

The statement's principles set forth sound risk-management practices that are relevant to most portfolio-management endeavors. The statement places greater emphasis on a risk-focused approach to supervision. Instruments held for end-user reasons are considered, taking into consideration a variety of factors such as management's ability to manage and measure risk within the institution's holdings and the impact of those holdings on aggregate portfolio risk.

The statement focuses on managing the market, credit, liquidity, operational, and legal risks of investment and end-user activities. When managing the interest-rate-risk component of market risk, institutions are informed of the merits of developing internal policies that specify the type of pre-acquisition analysis (stress testing) that is consistent with the scope, sophistication, and complexity of their investment securities and end-user derivative holdings. Such analyses should be conducted for certain types of instruments, including those that have complex or potentially volatile risk profiles. Institutions are advised to periodically monitor the price sensitivity of their portfolios, ensuring that they meet the established limits of the board of directors. Institutions are further advised to fully assess the creditworthiness of their counterparties, including brokers and issuers. Institutions are to ensure that they take proper account of the liquidity of the instruments held. (See SR-98-12.)

The principles set forth within this interagency policy statement are derived generally from those set forth in SR-95-17. See section 2126.0 and the appropriate sections of the *Trading and Capital-Markets Activities Manual.* The policy statement, as written, follows. The section numbers have been added for reference.

1. Appropriate adaptations should be made to reflect the fact that (1) those offices are an integral part of a foreign bank that must also manage its consolidated risks and recognize possible obstacles to cash movement among branches; and (2) the foreign bank is subject to overall supervision by its home-country supervisory authority.

2126.1.1 SUPERVISORY POLICY STATEMENT ON INVESTMENT SECURITIES AND END-USER DERIVATIVES ACTIVITIES

2126.1.1.1 Purpose

This policy statement (statement) provides guidance to financial institutions (institutions) on sound practices for managing the risks of investment securities and end-user derivatives activities.[2] The FFIEC agencies—the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration—believe that effective management of the risks associated with securities and derivative instruments represents an essential component of safe and sound practices. This guidance describes the practices that a prudent manager normally would follow and is not intended to be a checklist. Management should establish practices and maintain documentation appropriate to the institution's individual circumstances, consistent with this statement.

2126.1.1.2 Scope

This guidance applies to all securities in *held-to-maturity* and *available-for-sale* accounts as defined in the Statement of Financial Accounting Standards No.115 (FAS 115), certificates of

2. The 1998 statement does not supersede any other requirements of the respective agencies' statutory rules, regulations, policies, or supervisory guidance.

deposit held for investment purposes, and end-user derivative contracts not held in trading accounts. This guidance covers all securities used for investment purposes, including money market instruments, fixed-rate and floating-rate notes and bonds, structured notes, mortgage pass-through and other asset-backed securities, and mortgage-derivative products. Similarly, this guidance covers all end-user derivative instruments used for nontrading purposes, such as swaps, futures, and options.[3] This statement applies to all federally insured commercial banks, savings banks, savings associations, and federally chartered credit unions.

As a matter of sound practice, institutions should have programs to manage the market, credit, liquidity, legal, operational, and other risks of investment securities and end-user derivatives activities (investment activities). While risk-management programs will differ among institutions, there are certain elements that are fundamental to all sound risk-management programs. These elements include board and senior management oversight and a comprehensive risk-management process that effectively identifies, measures, monitors, and controls risk. This statement describes sound principles and practices for managing and controlling the risks associated with investment activities.

Institutions should fully understand and effectively manage the risks inherent in their investment activities. *Failure to understand and adequately manage the risks in these areas constitutes an unsafe and unsound practice.*

2126.1.1.3 Board and Senior Management Oversight

Board of director and senior management oversight is an integral part of an effective risk-management program. The board of directors is responsible for approving major policies for conducting investment activities, including the establishment of risk limits. The board should ensure that management has the requisite skills to manage the risks associated with such activities. To properly discharge its oversight responsibilities, the board should review portfolio activity and risk levels, and require management to demonstrate compliance with approved risk limits. Boards should have an adequate understanding of investment activities. Boards that do not should obtain professional advice to enhance its understanding of investment-activity oversight, so as to enable it to meet its responsibilities under this statement.

Senior management is responsible for the daily management of an institution's investments. Management should establish and enforce policies and procedures for conducting investment activities. Senior management should have an understanding of the nature and level of various risks involved in the institution's investments and how such risks fit within the institution's overall business strategies. Management should ensure that the risk-management process is commensurate with the size, scope, and complexity of the institution's holdings. Management should also ensure that the responsibilities for managing investment activities are properly segregated to maintain operational integrity. Institutions with significant investment activities should ensure that back-office, settlement, and transaction-reconciliation responsibilities are conducted and managed by personnel who are independent of those initiating risk-taking positions.

2126.1.1.4 Risk-Management Process

An effective risk-management process for investment activities includes (1) policies, procedures, and limits; (2) the identification, measurement, and reporting of risk exposures; and (3) a system of internal controls.

2126.1.1.4.1 Policies, Procedures, and Limits

Investment policies, procedures, and limits provide the structure to effectively manage investment activities. Policies should be consistent with the organization's broader business strategies, capital adequacy, technical expertise, and risk tolerance. Policies should identify relevant investment objectives, constraints, and guidelines for the acquisition and ongoing management of securities and derivative instruments. Potential investment objectives include generating earnings; providing liquidity; hedging risk exposures; taking risk positions; modifying and managing risk profiles; managing tax liabilities; and meeting pledging requirements, if applicable. Policies should also identify the risk charac-

3. Natural-person federal credit unions are not permitted to purchase non-residential mortgage asset-backed securities and may participate in derivative programs only if authorized by the NCUA.

teristics of permissible investments and should delineate clear lines of responsibility and authority for investment activities.

An institution's management should understand the risks and cash-flow characteristics of its investments. This is particularly important for products that have unusual, leveraged, or highly variable cash flows. An institution should not acquire a material position in an instrument until senior management and all relevant personnel understand and can manage the risks associated with the product.

An institution's investment activities should be fully integrated into any institution-wide risk limits. In so doing, some institutions rely only on the institution-wide limits, while others may apply limits at the investment portfolio, subportfolio, or individual instrument level.

The board and senior management should review, at least annually, the appropriateness of its investment strategies, policies, procedures, and limits.

2126.1.1.4.2 Risk Identification, Measurement, and Reporting

Institutions should ensure that they identify and measure the risks associated with individual transactions prior to acquisition and periodically after purchase. This can be done at the institutional, portfolio, or individual-instrument level. Prudent management of investment activities entails examination of the risk profile of a particular investment in light of its impact on the risk profile of the institution. To the extent practicable, institutions should measure exposures to each type of risk, and these measurements should be aggregated and integrated with similar exposures arising from other business activities to obtain the institution's overall risk profile.

In measuring risks, institutions should conduct their own in-house pre-acquisition analyses, or to the extent possible, make use of specific third-party analyses that are independent of the seller or counterparty. Irrespective of any responsibility, legal or otherwise, assumed by a dealer, counterparty, or financial advisor regarding a transaction, the acquiring institution is ultimately responsible for the appropriate personnel understanding and managing the risks of the transaction.

Reports to the board of directors and senior management should summarize the risks related to the institution's investment activities and should address compliance with the investment policy's objectives, constraints, and legal requirements, including any exceptions to established policies, procedures, and limits. Reports to management should generally reflect more detail than reports to the board of the institution. Reporting should be frequent enough to provide timely and adequate information to judge the changing nature of the institution's risk profile and to evaluate compliance with stated policy objectives and constraints.

2126.1.1.4.3 Internal Controls

An institution's internal control structure is critical to the safe and sound functioning of the organization generally and the management of investment activities in particular. A system of internal controls promotes efficient operations; reliable financial and regulatory reporting; and compliance with relevant laws, regulations, and institutional policies. An effective system of internal controls includes enforcing official lines of authority, maintaining appropriate separation of duties, and conducting independent reviews of investment activities.

For institutions with significant investment activities, internal and external audits are integral to the implementation of a risk-management process to control risks in investment activities. An institution should conduct periodic independent reviews of its risk-management program to ensure its integrity, accuracy, and reasonableness. Items that should be reviewed include—

1. compliance with and the appropriateness of investment policies, procedures, and limits;
2. the appropriateness of the institution's risk-measurement system given the nature, scope, and complexity of its activities; and
3. the timeliness, integrity, and usefulness of reports to the board of directors and senior management.

The review should note exceptions to policies, procedures, and limits and suggest corrective actions. The findings of such reviews should be reported to the board and corrective actions taken on a timely basis.

The accounting systems and procedures used for public and regulatory reporting purposes are critically important to the evaluation of an organization's risk profile and the assessment of its financial condition and capital adequacy. Accordingly, an institution's policies should provide clear guidelines regarding the reporting treatment for all securities and derivatives holdings. This treatment should be consistent with the organization's business objectives, generally accepted accounting principles (GAAP), and regulatory reporting standards.

2126.1.1.5 Risks of Investment Activities

The following discussion identifies particular sound practices for managing the specific risks involved in investment activities. In addition to these sound practices, institutions should follow any specific guidance or requirements from their primary supervisor related to these activities.

2126.1.1.5.1 Market Risk

Market risk is the risk to an institution's financial condition resulting from adverse changes in the value of its holdings arising from movements in interest rates, foreign-exchange rates, equity prices, or commodity prices. An institution's exposure to market risk can be measured by assessing the effect of changing rates and prices on either the earnings or economic value of an individual instrument, a portfolio, or the entire institution. For most institutions, the most significant market risk of investment activities is interest-rate risk.

Investment activities may represent a significant component of an institution's overall interest-rate-risk profile. It is a sound practice for institutions to manage interest-rate risk on an institution-wide basis. This sound practice includes monitoring the price sensitivity of the institution's investment portfolio (changes in the investment portfolio's value over different interest-rate/yield curve scenarios). Consistent with agency guidance, institutions should specify institution-wide interest-rate-risk limits that appropriately account for these activities and the strength of the institution's capital position. These limits are generally established for economic value or earnings exposures. Institutions may find it useful to establish price-sensitivity limits on their investment portfolio or on individual securities. These sub-institution limits, if established, should also be consistent with agency guidance.

It is a sound practice for an institution's management to fully understand the market risks associated with investment securities and derivative instruments prior to acquisition and on an ongoing basis. Accordingly, institutions should have appropriate policies to ensure such understanding. In particular, institutions should have policies that specify the types of market-risk analyses that should be conducted for various types or classes of instruments, including that conducted prior to their acquisition (pre-purchase analysis) and on an ongoing basis. Policies should also specify any required documentation needed to verify the analysis.

It is expected that the substance and form of such analyses will vary with the type of instrument. Not all investment instruments may need to be subjected to a pre-purchase analysis. Relatively simple or standardized instruments, the risks of which are well known to the institution, would likely require no or significantly less analysis than would more volatile, complex instruments.[4]

For relatively more complex instruments, less familiar instruments, and potentially volatile instruments, institutions should fully address pre-purchase analyses in their policies. Price-sensitivity analysis is an effective way to perform the pre-purchase analysis of individual instruments. For example, a pre-purchase analysis should show the impact of an immediate parallel shift in the yield curve of plus and minus 100, 200, and 300 basis points. Where appropriate, such analysis should encompass a wider range of scenarios, including nonparallel changes in the yield curve. A comprehensive analysis may also take into account other relevant factors, such as changes in interest-rate volatility and changes in credit spreads.

When the incremental effect of an investment position is likely to have a significant effect on the risk profile of the institution, it is a sound practice to analyze the effect of such a position on the overall financial condition of the institution.

Accurately measuring an institution's market risk requires timely information about the current carrying and market values of its investments. Accordingly, institutions should have market-risk-measurement systems commensurate with the size and nature of these investments. Institutions with significant holdings of highly complex instruments should ensure that they have the means to value their positions. Institutions employing internal models should have adequate procedures to validate the models and to periodically review all elements of the modeling process, including its assumptions and

4. Federal credit unions must comply with the investment-monitoring requirements of 12 C.F.R. 703.90. See 62 FR 32989 (June 18, 1997).

risk-measurement techniques. Managements relying on third parties for market-risk-measurement systems and analyses should ensure that they fully understand the assumptions and techniques used.

Institutions should provide reports to their boards on the market-risk exposures of their investments on a regular basis. To do so, the institution may report the market-risk exposure of the whole institution. Alternatively, reports should contain evaluations that assess trends in aggregate market-risk exposure and the performance of portfolios in terms of established objectives and risk constraints. They also should identify compliance with board-approved limits and identify any exceptions to established standards. Institutions should have mechanisms to detect and adequately address exceptions to limits and guidelines. Management reports on market risk should appropriately address potential exposures to yield curve changes and other factors pertinent to the institution's holdings.

2126.1.1.5.2 Credit Risk

Broadly defined, credit risk is the risk that an issuer or counterparty will fail to perform on an obligation to the institution. For many financial institutions, credit risk in the investment portfolio may be low relative to other areas, such as lending. However, this risk, as with any other risk, should be effectively identified, measured, monitored, and controlled.

An institution should not acquire investments or enter into derivative contracts without assessing the creditworthiness of the issuer or counterparty. The credit risk arising from these positions should be incorporated into the overall credit-risk profile of the institution as comprehensively as practicable. Institutions are legally required to meet certain quality standards (i.e., investment grade) for security purchases. Many institutions maintain and update ratings reports from one of the major rating services. For non-rated securities, institutions should establish guidelines to ensure that the securities meet legal requirements and that the institution fully understands the risk involved. Institutions should establish limits on individual counterparty exposures. Policies should also provide credit-risk and concentration limits. Such limits may define concentrations relating to a single or related issuer or counterparty, a geographical area, or obligations with similar characteristics.

In managing credit risk, institutions should consider settlement and presettlement credit risk. These risks are the possibility that a counterparty will fail to honor its obligation at or before the time of settlement. The selection of dealers, investment bankers, and brokers is particularly important in effectively managing these risks. The approval process should include a review of each firm's financial statements and an evaluation of its ability to honor its commitments. An inquiry into the general reputation of the dealer is also appropriate. This includes review of information from state or federal securities regulators and industry self-regulatory organizations such as the National Association of Securities Dealers concerning any formal enforcement actions against the dealer, its affiliates, or associated personnel.

The board of directors is responsible for supervision and oversight of investment portfolio and end-user derivatives activities, including the approval and periodic review of policies that govern relationships with securities dealers.

Sound credit-risk management requires that credit limits be developed by personnel who are as independent as practicable of the acquisition function. In authorizing issuer and counterparty credit lines, these personnel should use standards that are consistent with those used for other activities conducted within the institution and with the organization's overall policies and consolidated exposures.

2126.1.1.5.3 Liquidity Risk

Liquidity risk is the risk that an institution cannot easily sell, unwind, or offset a particular position at a fair price because of inadequate market depth. In specifying permissible instruments for accomplishing established objectives, institutions should ensure that they take into account the liquidity of the market for those instruments and the effect that such characteristics have on achieving their objectives. The liquidity of certain types of instruments may make them inappropriate for certain objectives. Institutions should ensure that they consider the effects that market risk can have on the liquidity of different types of instruments under various scenarios. Accordingly, institutions should articulate clearly the liquidity characteristics of instruments to be used in accomplishing institutional objectives.

Complex and illiquid instruments can often involve greater risk than actively traded, more liquid securities. Oftentimes, this higher potential risk arising from illiquidity is not captured by standardized financial modeling techniques. Such risk is particularly acute for instruments that are highly leveraged or that are designed to benefit from specific, narrowly defined market shifts. If market prices or rates do not move as expected, the demand for such instruments can evaporate, decreasing the market value of the instrument below the modeled value.

2126.1.1.5.4 Operational (Transaction) Risk

Operational (transaction) risk is the risk that deficiencies in information systems or internal controls will result in unexpected loss. Sources of operating risk include inadequate procedures, human error, system failure, or fraud. Inaccurately assessing or controlling operating risks is one of the more likely sources of problems facing institutions involved in investment activities.

Effective internal controls are the first line of defense in controlling the operating risks involved in an institution's investment activities. Of particular importance are internal controls that ensure the separation of duties and supervision of persons executing transactions from those responsible for processing contracts, confirming transactions, controlling various clearing accounts, preparing or posting the accounting entries, approving the accounting methodology or entries, and performing revaluations.

Consistent with the operational support of other activities within the financial institution, securities operations should be as independent as practicable from business units. Adequate resources should be devoted, such that systems and capacity are commensurate with the size and complexity of the institution's investment activities. Effective risk management should also include, at least, the following:

1. *Valuation.* Procedures should ensure independent portfolio pricing. For thinly traded or illiquid securities, completely independent pricing may be difficult to obtain. In such cases, operational units may need to use prices provided by the portfolio manager. For unique instruments where the pricing isbeing provided by a single source (e.g., the dealer providing the instrument), the institution should review and understand the assumptions used to price the instrument.
2. *Personnel.* The increasingly complex nature of securities available in the marketplace makes it important that operational personnel have strong technical skills. This will enable them to better understand the complex financial structures of some investment instruments.
3. *Documentation.* Institutions should clearly define documentation requirements for securities transactions, saving and safeguarding important documents, as well as maintaining possession and control of instruments purchased.

An institution's policies should also provide guidelines for conflicts of interest for employees who are directly involved in purchasing and selling securities for the institution from securities dealers. These guidelines should ensure that all directors, officers, and employees act in the best interest of the institution. The board may wish to adopt policies prohibiting these employees from engaging in personal securities transactions with these same securities firms without specific prior board approval. The board may also wish to adopt a policy applicable to directors, officers, and employees restricting or prohibiting the receipt of gifts, gratuities, or travel expenses from approved securities dealer firms and their representatives.

2126.1.1.5.5 Legal Risk

Legal risk is the risk that contracts are not legally enforceable or documented correctly. Institutions should adequately evaluate the enforceability of its agreements before individual transactions are consummated. Institutions should also ensure that the counterparty has authority to enter into the transaction and that the terms of the agreement are legally enforceable. Institutions should further ascertain that netting agreements are adequately documented, executed properly, and are enforceable in all relevant jurisdictions. Institutions should have knowledge of relevant tax laws and interpretations governing the use of these instruments.

Bank holding companies should directly manage and control their aggregate risk exposures on a consolidated basis and, if appropriate, for individual subsidiaries, in view of the distinct legal existence of various subsidiaries and possible obstacles to moving cash, other assets, and contractual agreements among subsidiaries.[1] See SR-99-3.

2126.3.1 FUNDAMENTAL ELEMENTS OF COUNTERPARTY CREDIT RISK MANAGEMENT

When conducting bank holding company inspections and supervisory contacts, and when monitoring trading and derivatives activities, supervisors and examiners should fully evaluate the integrity of certain key elements of a banking organization's (BO) counterparty credit risk management process, such as the following:

1. The BO's assessment of counterparty creditworthiness, both initially and on an ongoing basis. A counterparty's creditworthiness can be evidenced by its capital strength, leverage, any on- and off-balance-sheet risk factors, and contingencies. Creditworthiness can also be evidenced by the counterparty's liquidity, operating results, reputation, and ability to understand and manage the risks inherent in its line of business, as well as the risks involved in the particular products and transactions that define a particular customer relationship.
2. The standards, methodologies, and techniques used in measuring counterparty-credit-risk exposures on an individual instrument, counterparty, and portfolio basis.
3. The use and management of credit enhancements to mitigate counterparty credit risks, including collateral arrangements and collateral-management systems, contractual downgrades or material-change triggers, and contractual ''option-to-terminate'' or close-out provisions.
4. The risk-limit and -monitoring systems that involve (1) setting meaningful limits on counterparty credit risk, (2) monitoring exposures against those limits, and (3) initiating meaningful risk assessments and risk-controlling actions in the event that exposures exceed limits.

The confluence of competitive pressures, pursuit of earnings, and overreliance on customer reputation can lead to substantive lapses in fundamental risk-management principles regarding counterparty risk assessment, exposure monitoring, and the management of credit-risk limits. Policies governing these activities may be unduly general so as to compromise their usefulness in managing the risks involved with particular types of counterparties. Practices may not conform to the stated policies or their intent. Situations may also exist where internal controls, including documentation and independent review, may be inadequate or lack rigor. For some larger BOs, regimes for measuring and monitoring counterparty-credit-risk exposure may be effective in more traditional areas of credit extension, but may need enhancements when used in trading and derivatives activities.

2126.3.2 TARGETING SUPERVISORY RESOURCES

When risk focusing their supervisory initiatives, examiners should continue to target those activities and areas with significant growth and above-normal profitability profiles—especially in trading and derivatives activities where the press of business and competitive pressures may invite a BO to offer new product lines before the approval of counterparties and the necessary risk-management infrastructure or procedures are fully in place. Supervisors and examiners should encourage a BO to adopt growth, profitability, and size criteria for their audit and independent risk-management functions to use in targeting their reviews.

2126.3.3 ASSESSMENT OF COUNTERPARTY CREDITWORTHINESS

Supervisors and examiners should increase their

1. These basic principles are also to be employed in the supervision of U.S. branches and agencies of foreign banks, with appropriate adaptations to reflect that (1) those offices are an integral part of a foreign bank that should be managing its risks on a consolidated basis and recognizing possible obstacles to cash movements among branches, and (2) the foreign bank is subject to overall supervision by its home-country authorities.

focus on the appropriateness, specificity, and rigor of the policies, procedures, and internal controls that a BO currently uses to assess the counterparty credit risks arising from its trading and derivatives activities. BOs should have extensive written policies covering their assessment of counterparty creditworthiness for both the initial due-diligence process (that is, before conducting business with a customer) and for ongoing monitoring. Examiners should focus particular attention on how such policies are structured and implemented. Broadly structured, general policies that apply to all types of counterparties may prove inadequate for directing staff in the proper review of the risks posed by particular types of counterparties. For example, although most policies call for the assessment and monitoring of the capital strength and leverage of customers, the assessment of hedge-fund counterparties should not rely exclusively on simple balance-sheet measures and traditional assessments of financial condition. This information may be insufficient for those counterparties whose off-balance-sheet positions are a source of significant leverage and whose risk profiles are narrowly based on concentrated business lines (such as with hedge funds and similar institutional investors). General policies calling for periodic counterparty credit reviews over significant intervals (such as annually) are another example of broad policies that may compromise the integrity of the assessment of individual counterparties or types of counterparties—a counterparty's risk profile can change significantly over much shorter time horizons.

Credit-risk-assessment policies should also properly define the types of analyses to be conducted for particular types of counterparties based on the nature of their risk profiles. Stress testing and scenario analysis may be needed, in addition to customizing fundamental analyses based on industry and business-line characteristics. Customized analyses are particularly important when a counterparty's creditworthiness may be adversely affected by short-term fluctuations in financial markets, especially when potential credit exposure to a counterparty increases at the same time the counterparty's credit quality deteriorates.

Examiners should continue to pay special attention to areas where banking organization practices may not conform to stated policies. Such supervisory efforts may be especially difficult when the BO's policies are not specificic enough for it to properly focus its counterparty risk assessments. Therefore, examiners must ensure that the banking organization's policies sufficiently address the risk profiles of particular types of counterparties and instruments. The policies should specify (1) the types of counterparties that may require special consideration; (2) the types and frequency of information to be obtained from such counterparties; (3) the types and frequency of analyses to be conducted, including the need for and type of any stress-testing analysis; and (4) how such information and analyses appropriately address the risk profile of the particular type of counterparty. This specificity in credit-assessment policies is particularly important when limited transparency may hinder market discipline on the risk-taking activities of counterparties—as may be the case with hedge funds.

Examiners should also place increasing emphasis on ensuring that a BO's existing practice conforms both with its stated objectives and the intent of its established policies. For example, some BOs may not obtain and evaluate all the information on the financial strength, condition, and liquidity of some types of counterparties that may be required by their own policies. In highly competitive and fast-moving transaction areas, organizations should be sufficiently rigorous in conducting the analyses specified in their policies, such as the review of a counterparty's ability to manage the risks of its business.

Necessary internal controls for ensuring that practices conform with stated policies include actively enforced documentation standards and periodic independent reviews by internal auditors or other risk-control units, particularly for business lines, products, and exposures to particular groups of counterparties and individual customers that exhibit significant growth or above-normal profitability. Using targeted inspections and reviews, examiners should evaluate the integrity of a BO's internal controls. Examiners should thus conduct their own transaction testing of such situations. This testing should include robust sampling of transactions with major counterparties in the targeted area, as well as sufficient stratification to ensure that practices involving smaller relationships also adhere to stated policies.

2126.3.4 CREDIT-RISK-EXPOSURE MEASUREMENT

Financial market turbulence emphasizes the important interrelationships between market movements and the credit-risk exposures involved in derivatives activities. Accordingly, supervisors and examiners should be alert to situations where a BO may need to be more diligent in conducting current computations of the loan equivalents and potential future exposures (PFE) that are used to measure, monitor, and control its derivatives counterparty credit exposure.

Most BOs fully recognize that the credit risk of derivatives positions includes both the current replacement cost of a contract as well as the contract's PFE. PFEs are generally calculated using statistical techniques to estimate the worst potential loss over a specified time horizon at some specified confidence interval (for example, 95 percent, 97.5 percent, and 99 percent), which is generally derived in some manner from historically observed market fluctuations. Together with the current replacement cost, such PFEs are used to convert derivatives contracts to ''loan equivalents'' for aggregating credit exposures across products and instruments.

The time horizon used to calculate PFEs can vary depending on the banking organization's risk tolerance, collateral protection, and ability to terminate its credit exposure. Some BOs may use a time horizon equal to the life of the respective instrument. While such a time horizon may be appropriate for unsecured positions, for collateralized exposures, the use of lifetime, worst-case-estimate PFEs may be ineffective to measure the true nature of counterparty risk exposure. While life-of-contract PFE measures provide an objective and conservative long-term exposure estimate, they bear little relationship to the actual credit exposures typically incurred in the case of collateralized relationships. In such cases, a banking organization's actual credit exposure is the PFE from the time a counterparty fails to meet a collateral call until the time the bank liquidates its collateral and closes out the derivative contract—a period which is typically much shorter than the contract's life. The lack of realism in conservative measurement can cause managers and traders to discount them and may result in inappropriate limits being set, thereby compromising the entire risk-management process.

More realistic measures of collateralized credit-risk exposures should also take into account the shorter time horizons over which action can be taken to mitigate losses in times of market stress. These measures should incorporate estimates of collateral-recovery rates given the potential market liquidity impacts of stress events on collateral values. Some BOs already do stress tests, calculating measures that assess the worst-case value of positions over a time horizon of one or two weeks—their estimate of a reasonable liquidation period in times of stress. They also perform scenario analyses of counterparty credit exposures. Stress testing and scenario analyses should evaluate the impact of large market moves on the credit exposure to individual counterparties, and they should assess the implications inherent in liquidating positions under such conditions. Analyses should consider the effects of market liquidity on the value of positions and any related collateral. The use of meaningful scenario analyses is particularly important since stress tests derived from simple applications of higher confidence intervals or longer time horizons to PFE, value-at-risk, and other measures may not adequately capture the market and exposure dynamics under turbulent market conditions, particularly as they relate to the interaction between market, credit, and liquidity risk.

The results of stress testing and scenario analyses should be incorporated into senior management reports. Such reports should provide sufficient information to ensure an adequate understanding of the nature of the exposure and the analyses conducted. Information should also be sufficient to trigger risk-controlling actions where necessary.

Other BOs are moving to build the capability of estimating portfolio-based PFEs by any one of several different time horizons or buckets, depending on the liquidity and breadth of the underlying instrument or risk factor. Based on management's opinion of the appropriate work-out timeframe, different time horizons can be used for different counterparties, transactions, or collateral types to more precisely define exposures. Supervisors and examiners should be alert to situations where collateralized exposures may be inaccurately estimated, and should encourage management at these BOs to enhance their exposure-measurement systems accordingly.

Supervisors should also be cognizant of the manner in which the credit exposures are aggregated for individual counterparties. Some BOs may take a purely transactional approach to aggregation and *not incorporate the netting of long and short derivatives contracts*, even when legally enforceable bilateral netting agreements are available. In such cases, *simple sum estimates of positive exposures may seriously overestimate true credit exposure*, and examiners should monitor and encourage a BO's movement toward more realistic measures of counterparty exposure. Other BOs may take a portfolio approach, in which information systems allow and incorporate netting (both within and across products, business lines, or risk factors) and portfolio correlation effects to construct more comprehensive counterparty exposure measures. In such cases, supervisors should ensure that a BO has adequate internal controls governing exposure estimation, including robust model-review processes and data-integrity checks.

When stratifying samples and selecting the counterparties and transactions to use for their targeted testing of practices and internal controls, supervisors and examiners should incorporate measures of potential future exposure regardless of the collateralization of current market-value exposures. As recent events have shown, meaningful counterparty credit risks that surface during periods of stress can go undetected when too much emphasis is placed on collateralization of current market values and only unsecured current market exposures are used for targeting transaction testing.

2126.3.5 CREDIT ENHANCEMENTS

BOs continue to rely increasingly on different types of credit enhancements to mitigate counterparty credit risks. These enhancements include the use of collateral arrangements, contractual downgrades or material-change triggers that enable the alteration of collateral or margining arrangements, or the activation of contractual ‘‘option to terminate’’ or closeout provisions.

CollateraIization of exposures has become an industry standard for many types of counterparties. Collateralization mitigates but does not eliminate credit risks. BOs therefore should ensure that overreliance on collateral does not compromise other elements of sound counterparty credit-risk management, such as the due-diligence process. Clear policies should govern the determination of loss thresholds and margining requirements for derivatives counterparties of BOs. Such policies should not be so broad that they compromise the risk-reducing nature of collateral agreements with specific types of counterparties. Policies governing collateral arrangements should specifically define those cases in which initial and variation margin is required, and they should explicitly identify situations in which the lack of transparency, business-line risk profiles, and other counterparty characteristics merit special treatment—as may be the case with some highly leveraged counterparties such as hedge funds. Where consistent with the risk profile of the counterparty and instruments involved, policies should specify when margining requirements based on estimates of potential future exposures might be warranted.

Adequate policies should also govern the use of material-change triggers and closeout provisions, which should take into account counterparty-specific situations and risk profiles. For example, closeout provisions based on annual events or material-change triggers based on long-term performance may prove ineffective for counterparties whose risk profiles can change rapidly. Also, such material-change triggers, closeout provisions, and related covenants should be designed to adequately protect against deterioration in a counterparty’s creditworthiness. They should ensure that a BO is made aware of adverse financial developments on a timely basis and should facilitate action as counterparty risk increases—well in advance of the time when termination of a relationship is appropriate.

Internal assessments of potential risk exposures sometimes dictate loss thresholds, margining requirements, and closeout provisions with some counterparties. Insufficient internal controls may unduly expose certain BOs to these as well as other types of trading and derivatives counterparties. When evaluating the management of collateral arrangements and other credit enhancements, examiners should not only assess the adequacy of a banking organization’s policies but should also determine whether internal controls are sufficient to ensure that practices comply with these policies. Examiners should identify the types of credit enhancements and contractual covenants that are being used when reviewing areas of counterparty risk management, and then determine whether the banking organization has sufficiently assessed the adequacy of these enhancements and covenants relative to the risk profile of the counterparty.

2126.3.6 CREDIT-RISK-EXPOSURE LIMIT-SETTING AND MONITORING SYSTEMS

Exposure-monitoring and limit systems are critical to the effective management of counterparty credit risk. Examiners should focus special attention on the policies, practices, and internal controls employed within such systems at large, complex BOs. An effective exposure-monitoring system consists of (1) establishing meaningful limits on the risk exposures a BO is willing to take, (2) independent, ongoing monitoring of exposures against such limits, and (3) adequate controls to ensure that meaningful risk-controlling action takes place when limits are exceeded. An effective exposure-monitoring and limit process depends on meaningful exposure-measurement methodologies, so supervisors should closely evaluate measurement methodologies, especially for the estimation of PFEs. Inaccurate measurement can easily compromise well-structured policies and procedures. Such situations can lead to limits driven primarily by customer demand and used only to define and monitor customer facilities, rather than limits that serve as strict levels defined by credit management and that initiate risk-controlling actions.

Supervisors and examiners should also assess the procedures used for controlling credit-risk exposures when they become large, when a counterparty's credit standing weakens, or when the market comes under stress. Management should demonstrate its clear ability to reduce large positions. Such actions can include ''capping'' current exposures, curtailing new business, assigning transactions to another counterparty (where feasible), and restructuring the transaction to limit potential exposure or make it less sensitive to market volatility. BOs can also use various credit-enhancement tools to manage exposures that have become unduly large or highly sensitive to market volatility.

2126.3.7 INSPECTION OBJECTIVES

1. To determine if sufficient resources are devoted and adequate attention is given to the management of the risks involved in growing, highly profitable, or potentially high-risk activities and product lines.
2. To ascertain if the banking organization's internal audit and independent risk-management functions adequately focus on growth, profitability, and risk criteria when targeting their reviews.
3. To determine if there is an appropriate balance among all elements of credit-risk management. This balance includes both qualitative and quantitative assessments of counterparty creditworthiness; measurement and evaluation of on- and off-balance sheet exposures, including potential future exposure; adequate stress testing; reliance on collateral and other credit enhancements; and the monitoring of exposures against meaningful limits.
4. To ascertain whether the banking organization employs policies that are sufficiently calibrated to the risk profiles of particular types of counterparties and instruments, which ensures adequate credit-risk assessment, exposure measurement, limit setting, and use of credit enhancements.
5. To ensure that the banking organization's actual business practices conform with their stated policies and the intent of these policies.
6. To establish if the banking organization is moving in a timely fashion to enhance its measurement of counterparty credit-risk exposures, including refining potential future exposure measures and establishing stress-testing methodologies to better incorporate the interaction of market and credit risks.
7. To accomplish the above inspection objectives by using sufficient, targeted transaction testing on those activities, business lines, and products experiencing significant growth, above-normal profitability, or large potential future exposures.

2126.3.8 INSPECTION PROCEDURES

1. Give increased focus to the adequacy, appropriateness, specificity, and rigor of the policies, procedures, and internal controls that a BO currently uses to assess the counterparty credit risks arising from its trading and derivatives activities.
   a. Determine if sufficient written policies cover the assessment of counterparty creditworthiness for the initial due-diligence process (that is, before conducting business with a customer) and for ongoing monitoring.
   b. Give particular attention to how such policies are structured, their adequacy, and how they are implemented.
2. Focus special attention on areas where a BO's practices may not conform to its stated policies.
   a. Determine if the banking organization's policies sufficiently address the risk profiles of its particular types of counterparties and instruments.
   b. Ascertain whether existing practices conform to the stated objectives and the intent of the organization's established policies.

3. Evaluate the banking organization's documentation standards.
4. Determine whether the internal reviews are adequately conducted for business lines, products, and exposures to particular groups of counterparties and individual customers that exhibit significant growth or above-normal profitability.
5. Evaluate the integrity of the internal controls that the banking organization uses to assess its own transaction testing during internal reviews.
6. Conduct independent targeted reviews of the internal controls.
   a. Use robust sampling when testing transactions of major counterparties within a targeted area.
   b. Employ sufficient stratification to ensure that practices involving smaller relationships also adhere to stated policies.
   c. Be alert to situations whereby the current computations of loan equivalents and potential exposures—that are used to measure, monitor, and control derivatives counterparty credit exposures—could be deliberately enhanced.
7. Determine if the banking organization needs to develop more meaningful measures of credit-risk exposures, such as using stress testing and scenario analyses, under volatile market conditions.

Interest-rate risk (IRR) is the exposure of a banking organization's financial condition to adverse movements in interest rates. Accepting this risk can be an important source of profitability and shareholder value. However, excessive levels of IRR can pose a significant threat to a bank's or bank holding company's earnings and capital base. Accordingly, effective risk management that maintains IRR at prudent levels is essential to the organization's safety and soundness.

Evaluating a bank holding company's exposure to changes in interest rates is an important element of any full-scope inspection and may be the sole topic for specialized or targeted inspections. This evaluation includes assessing both the adequacy of the management process used to control IRR and the organization's quantitative level of exposure. When assessing the IRR management process, examiners should ensure that appropriate policies, procedures, management information systems, and internal controls are in place to maintain IRR at prudent levels with consistency and continuity. Evaluating the quantitative level of IRR exposure requires examiners to assess the existing and potential future effects of changes in interest rates on a bank holding company's consolidated financial condition, including its capital adequacy; earnings; liquidity; and, where appropriate, asset quality. To ensure that these assessments are both effective and efficient, examiner resources must be appropriately targeted at those elements of an organization's IRR that pose the greatest threat to its financial condition. This targeting requires an inspection process built on a well-focused assessment of IRR exposure before the on-site engagement, a clearly defined inspection scope, and a comprehensive program for following up on inspection findings and ongoing monitoring.

The Board, together with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, adopted a Joint Agency Policy Statement on Interest-Rate Risk, effective June 26, 1996. (See SR-96-17.) It provides guidance to examiners and bankers on sound practices for managing interest-rate risk, which will form the basis for ongoing evaluation of the adequacy of interest-rate risk management at supervised institutions.

The policy statement outlines fundamental elements of sound management that have been identified in prior Federal Reserve guidance and discusses the importance of these elements in the context of managing interest-rate risk.[1] Specifically, the guidance emphasizes the need for active board and senior management oversight and a comprehensive risk-management process that effectively identifies, measures, and controls interest-rate risk.

Although the guidance targets interest-rate risk management at commercial banks and Edge Act corporations, the basic principles presented in the policy statement are to be applied to bank holding companies. Bank holding companies should manage and control aggregate risk exposure on a consolidated basis by recognizing legal distinctions and possible obstacles to cash movements among subsidiaries. The assessment of interest-rate risk management made by examiners in accordance with the 1996 Joint Policy Statement will be incorporated into a bank holding company's overall risk-management rating. Bank holding company examiners should refer to section 4090.1 of the *Commercial Bank Examination Manual* for more detailed inspection guidance on the joint policy statement on interest-rate risk.

1. Guidance to examiners identifying fundamental elements of sound risk management includes SR-96-14 (see section 2124.0), ''Risk-Focused Examinations and Inspections''; SR-96-13, ''Joint Policy Statement on Interest-Rate Risk''; SR-96-10, ''Risk-Focused Fiduciary Examinations''; SR-95-51 (see section 4070.1), ''Rating the Adequacy of Risk-Management Processes and Internal Controls at State Member Banks and Bank Holding Companies''; SR-95-22, ''Enhanced Framework for Supervising the U.S. Operations of Foreign Banking Organizations''; SR-95-17 (see section 2126.0), ''Evaluating the Risk Management and Internal Controls of Securities and Derivatives Contracts Used in Nontrading Activities''; and SR-93-69 (see section 2125.0), ''Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations.''

This section discusses supervisory policy with regard to structured notes and their increased use by banking organizations. Examiners should be mindful of these instruments, whether they are used in the banking organization's trading, investment, or trust activities. Some of these instruments can expose investors to significant losses as interest rates, foreign-exchange rates, and other market indices change. Consequently, during examinations or inspections, examiners need to ensure that banks and bank holding companies that hold structured notes do so according to their own investment policies and procedures and with a full understanding of the risks and price sensitivity of these instruments under a broad range of market conditions.

Structured notes, many of which are issued by U.S. government agencies, government-sponsored entities, and other organizations with high credit ratings, are debt securities whose cash flows are dependent on one or more indices in ways that create risk characteristics of forwards or options. They tend to have medium-term maturities and reflect a wide variety of cash-flow characteristics that can be tailored to the needs of individual investors.

As such, these notes may offer certain advantages over other financial instruments used to manage market risk. In particular, they may reduce counterparty credit risk, offer operating efficiencies and lower transaction costs, require fewer transactions, and more specifically address an institution's risk exposures. Risk to principal is typically small. Accordingly, when structured notes are analyzed and managed properly, they can be acceptable investments and trading products for banks.

However, structured notes can also have characteristics that cause them to be inappropriate holdings for many banking organizations, including depository institutions. They can have substantial price sensitivity; they can be complex and difficult to evaluate; and they may also reflect high amounts of leverage relative to fixed-income instruments with comparable face values. Their customized features and embedded options may also make them difficult to price and can reduce their liquidity. Consequently, banking organizations considering the purchase of structured notes should determine whether these factors are compatible with their investment horizons and with their overall portfolio strategies.

There are a wide variety of structured notes, with names such as single- or multi-index floaters, inverse floaters, index-amortizing notes, step-up bonds, and range bonds. These simple, though sometimes cryptic, labels can belie the potential complexity of these notes and their possibly volatile and unpredictable cash flows, which can involve both principal and interest payments. Some notes employ "trigger levels" at which cash flows can change significantly, or caps or floors, which can also substantially affect their price behavior.

The critical factor for examiners to consider is the ability of management to understand the risks inherent in these instruments and to satisfactorily manage the market risks of their institution. Therefore, examiners should evaluate the appropriateness of these securities institution by institution, with a knowledge of management's expertise in evaluating such instruments, the quality of the relevant information systems, and the nature of its overall exposure to market risk. This evaluation may include a review of the stress-test capabilities. Failure of management to adequately understand the dimensions of the risks in these and similar financial products can constitute an unsafe and unsound practice for banking organizations.

When making investment decisions, some banking organizations may focus only on the low credit risk and favorable yields of structured notes and either overlook or underestimate their market and liquidity risks. Consequently, where these notes are material, examiners should discuss their role in the organization's risk-management process and assess management's recognition of their potential volatility.

The risks inherent in such complex instruments and relevant risk-management standards have been addressed in a variety of previously issued supervisory guidance, including SR-letters and supervisory manuals. This guidance includes SR-90-16, standards for investing in asset-backed securities (see section 2128.02); SR-93-69 (see section 2125.0) and SR-95-17 (see section 2126.0), examination guidance for reviewing trading and nontrading activities (SR-95-17 deals with securities and derivative contracts used in nontrading activities); and the *Trading and Capital-Markets Activities Manual.* Although these documents may not specifically cite structured notes, they all help to highlight the following important supervisory and risk-management practices that are relevant to these instruments:

1. the importance of policies, approved by the board of directors, that address the goals and objectives expected to be achieved with such products and that set limits on the amount of funds that may be committed to them
2. the need for management to fully understand the risks these instruments can present, including their potentially reduced liquidity in secondary markets and the price volatility that any embedded options, leveraging, or other characteristics can create
3. the need for adequate information systems and internal controls for managing the risks under changing market conditions
4. the importance of clear lines of authority for making investment decisions and for evaluating and managing the institution's securities activities that involve such instruments

For additional information, see SR-97-21 and SR-91-4. See also sections 3010.3 and 4040.1 of the *Trading and Capital-Markets Activities Manual* for more detailed guidance.

Banking organizations have long been involved with asset-backed securities (ABS), both as investors in such securities and as major participants in the securitization process. In recent years, banking organizations have stepped up their involvement by increasing their participation in the long-established market for securities backed by residential mortgage loans and by expanding their securitizing activities to other types of assets, including credit card receivables, automobile loans, boat loans, commercial real estate loans, student loans, nonperforming loans, and lease receivables.

While the objectives of securitization may vary from one depository institution to another, there are essentially five benefits that can be derived from securitization transactions. First, the sale of assets may reduce regulatory costs. The removal of an asset from an institution's books reduces capital requirements and reserve requirements on deposits funding the asset. Second, securitization provides originators with an additional source of funding and liquidity. The process of securitization is basically taking an illiquid asset and converting it into a security with greater marketability. Securitized issues often carry a higher credit rating than that which the banking organization itself could normally obtain and, consequently, may provide a cheaper form of funding. Third, securitization may be used to reduce interest-rate risk by improving the banking organization's asset-liability mix. This is especially true if the banking organization has a large investment in fixed-rate, low-yield assets. Fourth, by removing assets, the banking organization enhances its return on equity and assets. Finally, the ability to sell these securities worldwide diversifies the banking organization's funding base, thereby reducing dependence on local economies.

It is appropriate for banking organizations to engage in securitization activities and to invest in ABS, if they do so prudently. Nonetheless, these activities can significantly affect their overall risk exposure. It is therefore of great importance, particularly given the growth and expansion of such activities, for examiners to be fully informed about the fundamentals of the securitization process, various risks that securitization and investing in ABS can create for banking organizations, and procedures that should be followed in examining banks and inspecting bank holding companies to effectively assess their exposure to risk and their management of that exposure.

To provide examiners with the information and guidance they need on asset securitization, the following guidance was developed for System use. The mechanics of securitization and related accounting issues are discussed, and inspection guidelines, objectives, and procedures are provided.[1]

2128.02.1 OVERVIEW OF ASSET SECURITIZATION

Over the past decade, the number of banks and bank holding companies (hereafter referred to as banking organizations) that have issued securities backed by their assets and that have acquired asset-backed securities as investments has increased markedly. The reason for this increase is that securitization activities can yield significant financial and operational benefits for banking organizations.

In its simplest form, asset securitization involves the selling of assets. The process first segregates generally illiquid assets into pools and transforms them into capital-market instruments. The payment of principal and interest on these instruments depends on the cash flows from the assets in the pool that underlies the new securities. The new securities may have denominations, cash flows, and other features that differ from the pooled assets, which make them more attractive to investors.

The federal government encouraged the securitization of residential mortgages. In 1970, the Government National Mortgage Association (Ginnie Mae or GNMA) created the first publicly traded mortgage-backed security. Soon, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), both government-sponsored agencies, also developed mortgage-backed securities. The guarantees that these government or government-sponsored entities provide, which assure investors of the payment of principal and interest, have greatly facilitated the securitization of mortgage assets.

1. The Federal Reserve System has developed the following three-volume set that contains educational material on the process of asset securitization and provides examination guidelines (see SR-90-16):
- An Introduction to Asset Securitization
- Accounting Issues Relating to Asset Securitization
- Examination Guidelines for Asset Securitization

2128.02.2 SECURITIZATION PROCESS

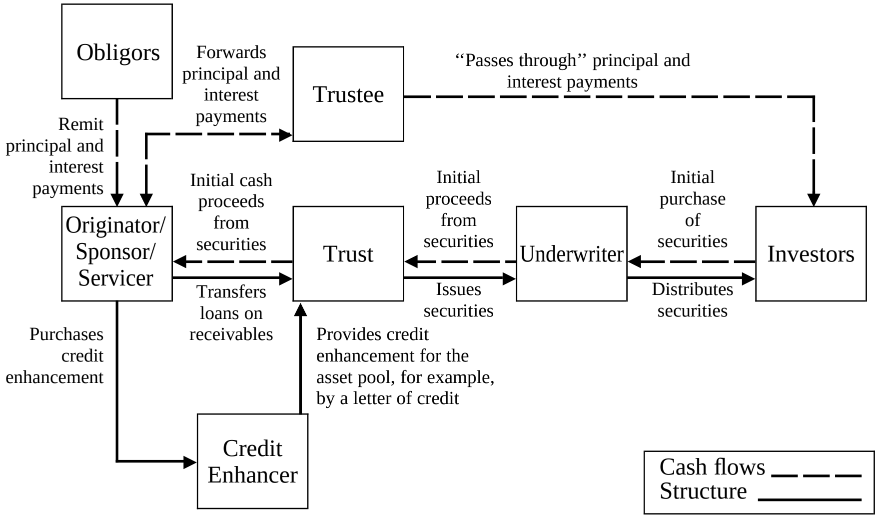
The asset-securitization process, as depicted in figure 1, begins with the segregation of loans or leases into pools that are relatively homogeneous with respect to credit, maturity, and interest-rate risks. These pools of assets are then transferred to a trust or other entity known as an issuer because it issues the securities or ownership interests that are acquired by investors. These asset-backed securities may take the form of debt, certificates of beneficial ownership, or other instruments. The issuer is typically protected from bankruptcy by various structural and legal arrangements. A sponsor that provides the assets to be securitized owns or otherwise establishes the issuer.

Traditional lending activities are generally funded by deposits or other liabilities, and both the assets and related liabilities are reflected on the balance sheet. Deposit liabilities must generally increase to fund additional loans. In contrast, the securitization process generally does not increase on-balance-sheet liabilities in proportion to the volume of loans or other assets securitized. As discussed more fully below, when banking organizations securitize their assets and these transactions are treated as sales under Statement of Financial Accounting Standards No. 140 (FAS 140), both the assets and the related asset-backed securities (i.e., liabilities) are removed from the balance sheet. The cash proceeds from the securitization transactions are generally used to originate or acquire additional loans or other assets for securitization, and the process is repeated. Thus, for the same volume of loan originations, securitization results in lower assets and liabilities, compared with traditional lending activities.

Each issue of asset-backed securities has a servicer responsible for collecting interest and principal payments on the loans or leases in the underlying pool of assets and for transmitting these funds to investors (or a trustee representing them). A trustee monitors the activities of servicers to ensure that they properly fulfill their role.

An investment banking firm or other organization generally serves as an underwriter for asset-backed securities. In addition, for asset-backed issues that are publicly offered, a credit rating agency will analyze the policies and operations of the originator and servicer, as well as the structure, underlying pool of assets, expected cash flows, and other attributes of such securities. Before assigning a rating to the issue, the rating agency will also assess the extent of loss protection provided to investors by the credit enhancements associated with the issue.

Figure 1
Pass-through, asset-backed securities: structure and cash flows



The structure of an asset-backed security and the terms of the investors' interest in the collateral can vary widely, depending on the type of collateral, the desires of investors, and the use of credit enhancements. Securitizations typically carve up the risk of credit losses from the underlying assets and distribute it to different parties. The "first-dollar," or most subordinate, loss position is first to absorb losses, and the most senior investor position is last to absorb losses; there may also be one or more loss positions in between ("second-dollar" loss positions). Each loss position functions as a credit enhancement for the more senior positions in the structure. In other words, when ABS reallocate the risks in the underlying collateral (particularly credit risk), the risks are moved into security tranches that match the desires of investors. For example, senior-subordinated security structures give holders of senior tranches greater credit-risk protection—albeit at lower yields—than holders of subordinated tranches. Under this structure, at least two classes of asset-backed securities, a senior and a junior or subordinated class, are issued in connection with the same pool of collateral. The senior class is structured so that it has a priority claim on the cash flows from the underlying pool of assets. The subordinated class must absorb credit losses on the collateral before losses can be charged to the senior portion. Because the senior class has this priority claim, cash flows from the underlying pool of assets must first satisfy the requirements of the senior class. Only after these requirements have been met will the cash flows be directed to service the subordinated class.

2128.02.3 CREDIT ENHANCEMENT

A guarantor may also be involved to see that investors receive principal and interest payments on a timely basis, even if the servicer does not collect these payments from the obligors. Many issues of mortgage-backed securities are either directly guaranteed by GNMA, a government agency backed by the full faith and credit of the U.S. government, or are guaranteed by Fannie Mae or Freddie Mac, which are government-sponsored agencies that are perceived by the credit markets to have the implicit support of the federal government. Privately issued mortgage-backed securities and other types of asset-backed securities generally depend on some form of credit enhancement provided by the originator or third party to insulate the investor from some or all of any credit losses. Usually, credit enhancement is provided for several multiples of the historical losses experienced on the particular asset backing the security.

One form of credit enhancement is the recourse provision, or guarantee, that requires the originator to cover any losses up to an amount contractually agreed upon. Some asset-backed securities, such as those backed by credit card receivables, typically use a "spread account," which is actually an escrow account. The funds in this account are derived from a portion of the spread between the interest earned on the assets in the underlying pool and the lower interest paid on securities issued by the trust. The amounts that accumulate in the account are used to cover credit losses in the underlying asset pool up to several multiples of historical losses on the particular asset collateralizing the securities.

Overcollateralization, another form of credit enhancement covering a predetermined amount of potential credit losses, occurs when the value of the underlying assets exceeds the face value of the securities. Other forms of credit enhancement include standby letters of credit, collateral or pool insurance, or surety bonds from third parties. The sponsor of the asset securitization may provide a portion of the total credit enhancement internally, as part of the securitization structure, through the use of excess spread accounts, overcollateralization, retained subordinated interests, or other similar on-balance-sheet assets. When these or other on-balance-sheet internal enhancements are provided, the enhancements are "residual interests" and are a form of recourse.[2] Residual interests (or residuals) represent claims on any cash flow after all obligations to investors and any related expenses have been met. Such excess cash flows may arise as a result of overcollateralization or from reinvestment income. Residuals can be retained by sponsors or purchased by investors in the form of securities.

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, it assumes some portion of the assets' credit risk. All forms of third-party enhancements, that is, all arrangements in which a banking organization assumes credit risk from third-party assets

2. Under the Federal Reserve's capital adequacy guidelines, purchased credit-enhancing interest-only strips are also considered "residual interests."

or other claims that it has not transferred, are referred to as ''direct-credit substitutes.'' The economic substance of a banking organization's credit risk from providing a direct-credit substitute can be identical to its credit risk from retaining recourse on assets it has transferred. Many asset securitizations use a combination of recourse and third-party enhancements to protect investors from credit risk. When third-party enhancements are not provided, the selling banking organization ordinarily retains virtually all of the credit risk on the assets transferred.

2128.02.4 STRUCTURE OF ASSET-BACKED SECURITIES

Asset securitization involves different kinds of capital-market instruments. These instruments may be structured as ''pass-throughs'' or ''pay-throughs.'' Under a pass-through structure, the cash flows from the underlying pool of assets are passed through to investors on a pro rata basis. This type of security is typically a single-class instrument such as a GNMA pass-through. The pay-through structure, with multiple classes, combines the cash flows from the underlying pool of assets and reallocates them to two or more issues of securities that have different cash-flow characteristics and maturities. An example is the collateralized mortgage obligation (CMO), which has a series of bond classes, each with its own specified coupon and stated maturity. In most cases, the assets that make up the CMO collateral pools are pass-through securities. Scheduled principal payments, and any prepayments, from the underlying collateral go first to the earliest maturing class of bonds. This first class of bonds must be retired before the principal cash flows are used to retire the later bond classes. The development of the pay-through structure resulted from the desire to broaden the marketability of these securities to investors who were interested in maturities other than those generally associated with pass-through securities.

Multiple-class asset-backed securities may also be issued as derivative instruments such as ''stripped'' securities. Investors in each class of a stripped security will receive a different portion of the principal and interest cash flows from the underlying pool of assets. In their purest form, stripped securities may be issued as *interest-only (IO) strips*, for which the investor receives 100 percent of the interest from the underlying pool of assets, and as *principal-only (PO) strips*, for which the investor receives all of the principal.

In addition to these securities, other types of financial instruments may arise as a result of asset securitization. One such instrument is loan-servicing rights that are created when organizations purchase the right to act as servicers for pools of loans. The cost of these purchased servicing rights may be recorded as an intangible asset when certain criteria are met. Another financial instrument, excess-servicing-fee receivables, generally arise when the present value of any additional cash flows from the underlying assets that a servicer expects to receive exceeds standard normal servicing fees.

2128.02.5 SUPERVISORY CONSIDERATIONS REGARDING ASSET SECURITIZATION

Although banking organizations clearly benefit from engaging in securitization activities and investing in asset-backed securities, these activities, if not conducted prudently, can increase a banking organization's overall risk profile. For the most part, the risks that banking organizations encounter in the securitization process are identical to those that they face in traditional lending transactions. These involve credit risk, concentration risk, and interest-rate risk—including prepayment risk, operational risk, liquidity risk, and funding risk. However, since the securitization process separates the traditional lending function into several limited roles such as originator, servicer, credit enhancer, trustee, and investor, the types of risks that a banking organization will encounter will differ depending on the role it assumes.

Investors who invest in asset-backed securities, like investors who invest directly in the underlying assets, will be exposed to credit risk, that is, the risk that obligors will default on principal and interest payments. Investors are also subject to the risk that the various parties in the securitization structure, for example, the servicer or trustee, will be unable to fulfill their contractual obligations. Moreover, investors may be susceptible to concentrations of risks across various asset-backed security issues through overexposure to an organization performing various roles in the securitization process or as a result of geographic concentrations within the pool of assets providing the cash flows for an individual issue. Also, because the secondary markets for certain asset-backed securities are thin, investors may encounter greater-than-anticipated difficulties when seeking to sell their securities. Furthermore, certain derivative instruments, such as stripped asset-backed securities and residuals, may be extremely sensitive to interest rates and exhibit a high degree of price volatility. Therefore, these instruments may dramatically affect the risk exposure of investors unless they are used in a properly structured hedging strategy.

Banking organizations that issue asset-backed securities may be subject to pressures to sell only their best assets, thus reducing the quality of their own loan portfolios. On the other hand, some banking organizations may feel pressures to relax their credit standards because they can sell assets with higher risk than they would normally want to retain for their own portfolios.

Banking organizations that service securitization issues must ensure that their policies, operations, and systems will not permit breakdowns that may lead to defaults. Issuers and servicers may face pressures to provide ‘‘moral recourse’’ by repurchasing securities backed by loans or leases that they have originated and that have deteriorated and have become nonperforming. Funding risk may also be a problem for issuers when market aberrations do not permit the issuance of asset-backed securities that are in the securitization pipeline.

Asset-securitization transactions are frequently structured to obtain certain accounting treatments, which, in turn, affect reported measures of profitability and capital adequacy. In transferring assets into a pool to serve as collateral for asset-backed securities, a key question is whether the transfer should be treated as a sale of the assets or as a collateralized borrowing, that is, as a financing transaction secured by assets. Sales treatment results in the removal of the assets from the banking organization’s balance sheet, thus reducing total assets relative to earnings and capital, and thereby producing higher performance and capital ratios. Treatment of these transactions as financings, however, means that the assets in the pool remain on the balance sheet and are subject to capital requirements and the related liabilities to reserve requirements.[3]

3. Note, however, that the Federal Reserve’s Regulation D defines what constitutes a reservable liability of a depository institution. Thus, although a given transaction may qualify as an asset sale for call report purposes, it nevertheless could result in a reservable liability under Regulation D.

2128.02.6 POLICY STATEMENT ON INVESTMENT SECURITIES AND END-USER DERIVATIVES ACTIVITIES

On April 23, 1998, the FFIEC issued a Statement on Investment Securities and End-User Derivatives Activities, effective May 25, 1998. The statement was adopted by the Board of Governors and the other federal financial institutions regulatory agencies. It provides guidance on sound practices for managing the risks of investment activities, focusing on sound risk-management practices that should be used by state member banks and Edge corporations. The basic principles also apply to bank holding companies, which should manage and control risk exposures on a consolidated basis, giving recognition to the legal distinctions and potential obstacles to cash movements among subsidiaries.

The statement’s principles set forth risk-management practices that are relevant to most portfolio-management endeavors. The statement places greater emphasis on a risk-focused approach to supervision. Instruments held for end-user reasons are considered, taking into consideration a variety of factors such as management’s ability to manage and measure risk within the institution’s holdings and the impact of those holdings on aggregate portfolio risk. (See section 2126.1 and SR-98-12.[4])

2128.02.6.1 Mortgage-Derivative Products

Mortgage-derivative products include instruments such as collateralized mortgage obligations (CMOs), real estate mortgage investment conduits (REMICs), stripped mortgage-backed securities, and CMO and REMIC residuals. Supervisory concerns about these instruments arise from their extreme sensitivity to interest rates and the resulting price volatility. This price volatility is caused in part by the uncertain cash flows that result from changes in the prepayment rates of the underlying mortgages. A banking organization that purchases such high-risk mortgage-derivative securities needs to understand and effectively manage the associated

4. The supervisory policy statement on Investment Securities and End-User Derivatives Activities is in the *Federal Reserve Regulatory Service* at 3–1562.

risks. The levels of activity in such products should reasonably be related to the banking organization's capital, capacity to absorb losses, and level of in-house management sophistication and expertise. Appropriate managerial and financial controls need to be in place, and the banking organization must analyze, monitor, and prudently adjust its holdings of high-risk mortgage securities in an environment of changing price and maturity expectations.

Before a banking organization takes a position in any high-risk mortgage security, management should conduct an analysis to ensure that the position will reduce the institution's overall interest-rate risk. It should also consider the liquidity and price volatility of these products before their purchase.

CMOs and REMICs were developed in response to investors' concerns about the uncertainty of cash flows associated with the prepayment option of the underlying mortgagor. These securities can be collateralized directly by mortgages, but more often they are collateralized by mortgage-backed securities issued or guaranteed by GNMA, Fannie Mae, or Freddie Mac and held in trust for investors. The cash flow from the underlying mortgages is segmented and paid in accordance with a predetermined priority to investors holding various tranches. By allocating the principal and interest cash flows from the underlying collateral among the separate CMO tranches, different classes of bonds are created, each with its own stated maturity, estimated average life, coupon rate, and prepayment characteristics. It is essential to understand the coupon rates of the underlying mortgages of the CMO or REMIC in order to assess the prepayment sensitivity of the CMO tranches.

Stripped mortgage-backed securities consist of two classes of securities, with each class receiving a different portion of the monthly interest and principal cash flows from the underlying mortgage-backed securities (MBS). A stripped mortgage-backed security, in its purest form, is converted into an interest-only (IO) strip, in which the investor receives all of the interest cash flows and none of the principal. An investor owning a principal-only (PO) strip receives all of the principal cash flows and none of the interest. IOs and POs have highly volatile price characteristics based, in part, on the prepayment variability of the underlying mortgages. Generally, POs increase in value when interest rates decline, in part because prepayments shorten the maturity of mortgages. In contrast, IOs and residuals tend to increase in value when interest rates rise because prepayments decline, maturities lengthen, and more interest is collected on the underlying mortgages.

When purchasing an IO, PO, or residual, without offsetting hedges, the investor may be speculating on future interest-rate movements and how these movements will affect the prepayment of the underlying collateral. Furthermore, stripped mortgage-backed securities that do not have a government agency's or a government-sponsored agency's guarantee of principal and interest have an added element of credit risk. The policy statement discusses the appropriateness of these instruments for depository institutions and the prudential measures that a depository institution should take to protect itself from undue risk when investing in them.

Residuals represent claims on any cash flows from a CMO issue or other asset-backed security remaining after the payments to the holders of the other classes have been made and after trust-administration expenses are met. The economic value of a residual is a function of the present value of the anticipated cash flows.

2128.02.7 RISK-BASED CAPITAL PROVISIONS AFFECTING ASSET SECURITIZATION

The risk-based capital framework has three main features that will affect the asset-securitization activities of banking organizations. First, the framework assigns risk weights to loans, asset-backed securities, and other assets related to securitization. Second, bank holding companies that transfer assets with recourse to the seller as part of the securitization process are required to hold capital against their off-balance-sheet credit exposures. Third, banking organizations that provide credit enhancement to asset-securitization issues through standby letters of credit or by other means will have to hold capital against the related off-balance-sheet credit exposure.

2128.02.7.1 Assigning Risk Weights

The risk weights assigned to an asset-backed security depend on the issuer and whether the assets that make up the collateral pool are mortgage-related assets. Asset-backed securities issued by a trust or a single-purpose corporation and backed by nonmortgage assets are to be assigned a risk weight of 100 percent.

Securities guaranteed by U.S. government agencies and those issued by U.S. government–sponsored agencies are assigned risk weights of 0 and 20 percent, respectively, because of the low degree of credit risk. Accordingly, mortgage pass-through securities guaranteed by GNMA are placed in the risk category of 0 percent. In addition, securities such as participation certificates and CMOs issued by Fannie Mae or Freddie Mac are assigned a 20 percent risk weight.

However, several types of securities issued by Fannie Mae and Freddie Mac are excluded from the lower risk weight and slotted in the 100 percent risk category. Residual interests (for example, CMO residuals) and subordinated classes of pass-through securities or CMOs that absorb more than their pro rata share of loss are assigned to the 100 percent risk-weight category. Furthermore, all stripped mortgage-backed securities, including IOs, POs, and similar instruments, are assigned to the 100 percent risk-weight category because of their extreme price volatility and market risk.

A privately issued, mortgage-backed security that meets the criteria listed below is considered as a direct or indirect holding of the underlying mortgage-related assets and is assigned to the same risk category as those assets (for example, U.S. government agency securities, U.S. government–sponsored agency securities, FHA- and VA-guaranteed mortgages, and conventional mortgages). However, under no circumstances will a privately issued mortgage-backed security be assigned to the 0 percent risk category. Therefore, private issues that are backed by GNMA securities will be assigned to the 20 percent risk category as opposed to the 0 percent category appropriate to the underlying GNMA securities. The criteria that a privately issued mortgage-backed security must meet to be assigned the same risk weight as the underlying assets are as follows:

1. The underlying assets are held by an independent trustee, and the trustee has a first-priority, perfected security interest in the underlying assets on behalf of the holders of the security.
2. The holder of the security has an undivided pro rata ownership interest in the underlying mortgage assets, or the trust or single-purpose entity (or conduit) that issues the security has no liabilities unrelated to the issued securities.
3. The cash flow from the underlying assets of the security in all cases fully meets the cash-flow requirements of the security without undue reliance on any reinvestment income.
4. No material reinvestment risk is associated with any funds awaiting distribution to the holders of the security.

Those privately issued mortgage-backed securities that do not meet the above criteria are to be assigned to the 100 percent risk category.

If the underlying pool of mortgage-related assets is composed of more than one type of asset, then the entire class of mortgage-backed securities is assigned to the category appropriate to the highest risk-weighted asset in the asset pool. For example, if the security is backed by a pool consisting of U.S. government–sponsored agency securities (for example, Freddie Mac participation certificates) that qualify for a 20 percent risk weight and conventional mortgage loans that qualify for the 50 percent risk category, then it would receive the 50 percent risk weight.

As previously mentioned, bank holding companies report their activities in accordance with generally accepted accounting principles (GAAP), which permits asset-securitization transactions to be treated as sales when certain criteria are met, even when there is recourse to the seller. With the advent of risk-based capital, bank holding companies are required to hold capital against the off-balance-sheet credit exposure arising from the contingent liability associated with the recourse provisions. This exposure is considered a direct-credit substitute that would be converted at 100 percent to an on-balance-sheet credit-equivalent amount for appropriate risk weighting.

The risk-based capital treatment for asset securitizations, as discussed in detail in section 4060.3, uses, in general, a multilevel, ratings-based approach (effective January 1, 2002) to assess the capital requirements on recourse obligations, residual interests (except credit-enhancing I/O strips), direct-credit substitutes, and senior and subordinated securities in asset securitizations, based on their relative exposure to credit risk. Credit ratings from rating agencies are used to measure relative exposure to credit risk and to determine the associated risk-based capital requirement. The Federal Reserve is relying on these credit ratings to make determinations of credit quality for the regulatory treatment for loss positions that represent different gradations of risk, the same as investors and other market participants. Residual interests, however, are subject to (1) a dollar-for-dollar capital charge and (2) a 25 percent of tier 1 capital concentration limit on a subset of residual interests, credit-enhancing I/O strips.

2128.02.7.2 Recourse Obligations

For regulatory purposes, recourse is generally defined as an arrangement in which a banking organization retains the risk of credit loss in connection with an asset transfer, if the risk of credit loss exceeds a pro rata share of its claim on the assets. In addition to broad contractual language that may require the seller to support a securitization, recourse can arise from retained interests, retained subordinated security interests, the funding of cash-collateral accounts, or other forms of credit enhancements that place a bank holding company's earnings and capital at risk. These enhancements should generally be aggregated to determine the extent of a bank holding company's support of securitized assets. Although an asset securitization qualifies for sales treatment under GAAP, the underlying assets may still be subject to regulatory risk-based capital requirements. Assets sold with recourse should generally be risk-weighted as if they had not been sold.

2128.02.7.2.1 Residuals

For residuals, the risk-based capital treatment is harmonized with the broader capital treatment for recourse and direct-credit substitutes. The capital treatment matches the use of the ratings to the relative risk of loss in asset securitizations. Highly rated investment-grade positions in securitizations receive a favorable (less than 100 percent) risk weight. Below-investment-grade or unrated positions in securitizations receive a less favorable risk weight (generally greater than a 100 percent risk weight). Therefore, if the external rating provided to such a residual interest is investment grade or no more than one category below investment grade, that residual interest is afforded more favorable capital treatment than the dollar-for-dollar capital requirement otherwise required for residuals.

2128.02.7.2.2 Credit-Equivalent Amounts and Risk Weights of Recourse Obligations and Direct-Credit Substitutes

The credit-equivalent amount for a recourse obligation or direct-credit substitute is the full amount of the credit-enhanced assets for which the bank holding company directly or indirectly retains or assumes credit risk, multiplied by a 100 percent conversion factor. A bank holding company that extends a partial direct-credit substitute, for example, a financial standby letter of credit that absorbs the first 10 percent of loss on a transaction, must maintain capital against the full amount of the assets being supported.

To determine the bank holding company's risk-weighted assets for an off-balance-sheet recourse obligation, a third-party direct-credit substitute, or a letter of credit, the credit-equivalent amount is assigned to the risk category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral. For a direct-credit substitute that is an on-balance-sheet asset, for example, a purchased subordinated security, a bank holding company must calculate risk-weighted assets using the amount of the direct-credit substitute and the full amount of the assets it supports, that is, all the more senior positions in the structure. This treatment is subject to the low-level-exposure rule discussed below.

If a bank holding company has no claim on a transferred asset, then the retention of any risk of credit loss is recourse. A recourse obligation typically arises when a bank holding company transfers assets and retains an explicit obligation to repurchase the assets or absorb losses—because of a default on the payment of principal or interest or because of any other deficiency in the performance of the underlying obligor or some other party. Recourse may also exist implicitly if a bank holding company provides credit enhancement beyond any contractual obligation to support assets it has sold. The following are examples of recourse arrangements:

1. credit-enhancing representations and warranties made on the transferred assets
2. loan-servicing assets retained under an agreement that requires the bank holding company to be responsible for credit losses associated with the loans being serviced (mortgage-servicer cash advances that meet the conditions of section III.B.3.a.viii. of the capital adequacy guidelines (12 CFR 225, appendix A) are not recourse arrangements
3. retained subordinated interests that absorb more than their pro rata share of losses from

the underlying assets
4. assets sold under an agreement to repurchase, if the assets are not already included on the balance sheet
5. loan strips sold without contractual recourse when the maturity of the transferred loan is shorter than the maturity of the commitment under which the loan is drawn
6. credit derivatives issued that absorb more than the bank holding company's pro rata share of losses from the transferred assets
7. clean-up calls that, at inception, are greater than 10 percent of the balance of the original pool of transferred loans (Clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the bank holding company are not recourse arrangements.)

2128.02.7.2.3 Low-Level-Recourse Treatment

Securitization transactions involving recourse may be eligible for ''low-level-recourse'' treatment. A bank holding company that contractually limits its maximum off-balance-sheet recourse obligation or direct-credit substitute (except credit-enhancing I/O strips) to an amount less than the effective risk-based capital requirement for the enhanced assets is required to hold risk-based capital equal to the maximum contractual exposure,[5] less any recourse liability established in accordance with GAAP. The low-level-recourse capital treatment thus applies to transactions accounted for as sales under GAAP. The low-level-exposure rule provides that the dollar amount of risk-based capital required for assets transferred with recourse should not exceed the maximum dollar amount for which a bank holding company is contractually liable, less any recourse liability account established in accordance with GAAP. The limitation does not apply when the bank holding company provides credit enhancement beyond any contractual obligation to support assets it has sold. The low-level capital treatment applies to low-level-recourse transactions involving all types of assets, including commercial loans and residential mortgages.

Low-level-recourse transactions can arise when a bank holding company sells or securitizes assets and uses contractual cash flows, such as spread accounts and I/O strips receivables, as a credit enhancement for the sold or securitized assets. A spread account is an escrow account that a bank holding company typically establishes to absorb losses on receivables it has sold in a securitization, thereby providing credit enhancement to investors in the securities backed by the receivables, for example, credit card receivables. As defined in paragraph 14 of FAS 140, an I/O strip receivable is the contractual right to receive some or all of the interest due on a bond, a mortgage loan, or other interest-bearing financial assets. I/O strips are to be measured at fair value with gains or losses recognized either in earnings (if classified as trading) or a separate component of shareholders' equity (if classified as available-for-sale).

Paragraph 14 of FAS 140 states that I/O strips, retained interests in securitizations, loans, other receivables, or other financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment (except for instruments that are within the scope of Statement of Financial Accounting Standards No. 133 (FAS 133), ''Accounting for Derivative Instruments and Hedging Activities'') shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement of Financial Accounting Standards No. 115 (FAS 115), ''Accounting for Certain Investments in Debt and Equity Securities.'' Retained interests that lack objectively verifiable support or that fail to meet the supervisory standards (discussed previously in this section) will be classified as loss and disallowed as assets of the bank holding company for regulatory capital purposes.

2128.02.7.2.4 Standby Letters of Credit

Bank holding companies that issue standby letters of credit as credit enhancements for ABS issues must hold capital against these contingent liabilities under the risk-based capital guidelines. According to the guidelines, financial standby letters of credit are direct-credit substitutes. A direct-credit substitute is an arrangement in which a bank holding company assumes, in form or substance, credit risk associated with an on- or off-balance-sheet credit exposure that it did not previously own (a third-party asset), and the risk assumed by the bank holding company exceeds the pro rata share of its interest in the third-party asset. If the

5. For example, the effective risk-based capital requirement generally would be 4 percent for residential mortgages and 8 percent for commercial loans.

bank holding company has no claim on the third-party asset, then its assumption of *any* credit risk with respect to the third-party asset is a direct-credit substitute. Direct-credit substitutes are converted in their entirety to credit-equivalent amounts. The credit-equivalent amounts are then risk-weighted according to their credit rating, like other direct-credit substitutes, and the risk weight for the corresponding credit rating.

2128.02.8 CONCENTRATION LIMITS IMPOSED ON RESIDUAL INTERESTS

The creation of a residual interest (the debit) typically results in an offsetting ‘‘gain on sale’’ (the credit), and thus the generation of an asset. Banking organizations that securitize high-yielding assets with long durations may create a residual-interest asset value that exceeds the risk-based capital charge that would be in place if it had not sold the assets. Serious problems can arise for those banking organizations that distribute earnings too generously, only to be faced later with a downward valuation and charge-off of part or all of the residual interests.

Under the Federal Reserve’s capital adequacy guidelines, there is a dollar-for-dollar capital charge on residual interests and a concentration limit on a subset of residual interests, credit-enhancing I/O strips. These strips include any on-balance-sheet assets that represent a contractual right to receive some or all of the interest due on transferred assets, after taking into account trustee and other administrative expenses, interest payments to investors, servicing fees, reimbursements to investors for losses attributable to beneficial interests they hold, and reinvestment income and ancillary revenues (for example, late fees) on the transferred assets. Credit-enhancing I/O strips expose the bank holding company to more than its pro rata share of credit risk and are limited to 25 percent of tier 1 capital, whether they are retained or purchased. Any amount of credit-enhancing I/O strips that exceeds the 25 percent limit will be deducted from tier 1 capital and assets. An example of the concentration calculation required for bank holding companies that hold credit-enhancing I/O strips is described below.

A bank holding company has purchased and retained on its balance sheet credit-enhancing I/O strips with a face amount of $100, and it has tier 1 capital of $320 (before any disallowed servicing assets, disallowed purchased credit-card relationships, disallowed credit-enhancing I/O strips, disallowed deferred tax assets, and amounts of nonfinancial equity investments required to be deducted). To determine the amount of credit-enhancing I/O strips that fall within the concentration limit, the bank holding company would multiply the tier 1 capital of $320 by 25 percent, which is $80. The amount of credit-enhancing I/O strips that exceeds the concentration limit, in this case $20, is deducted from tier 1 capital for risk-based and leverage capital calculations and from assets. Credit-enhancing I/O strips that are not deducted from tier 1 capital (that is, the remaining $80 in the above example), along with all other residual interests not subject to the concentration limit, are subject to a dollar-for-dollar capital requirement. Banks are not required to hold capital for more than 100 percent of the amount of the residual interest. Credit-enhancing I/O strips are not aggregated with any servicing assets or purchased credit-card relationships for purposes of calculating the 25 percent concentration limit.

Continuing the above illustration for credit-enhancing I/O strips, once a bank holding company deducts the $20 in disallowed credit-enhancing I/O strips, it must hold $80 in total capital for the $80 that represents the credit-enhancing I/O strips not deducted from tier 1 capital. The $20 deducted from tier 1 capital, plus the $80 in total risk-based capital required under the dollar-for-dollar treatment, equals $100, the face amount of the credit-enhancing I/O strips. Bank holding companies may apply a net-of-tax approach to any credit-enhancing I/O strips that have been deducted from tier 1 capital, as well as to the remaining residual interests subject to the dollar-for-dollar treatment. A bank holding company is permitted, but not required, to net the deferred tax liabilities recorded on its balance sheet, if any, that are associated with the residual interests. This netting of the deferred tax liabilities may result in a bank holding company’s holding less than 100 percent capital against residual interests.

Normally, a sponsor will eventually receive any excess cash flow remaining from securitizations after investor interests have been met. As previously stated, residual interests are vulnerable to sudden and sizeable write-downs that can hinder a bank holding company’s access to the capital markets; damage its reputation in the marketplace; and, in some cases, threaten its solvency. A bank holding company’s board of directors and management are expected to develop and implement policies that limit the amount of residual interests that may be carried as a percentage of total equity capital, based on the results of their valuation and modeling processes. Well-constructed internal limits also lessen the incentives for its personnel to engage in activities designed to generate near-term “paper profits” that may be at the expense of the bank holding company’s long-term financial position and reputation.

2128.02.9 INSPECTION OBJECTIVES

1. To determine that securitization activities are integrated into the overall strategic objectives of the organization.
2. To determine that sources of credit risk are understood, properly analyzed, and managed, without excessive reliance on credit ratings by outside agencies.
3. To determine that credit, operational, and other risks are recognized and addressed through appropriate policies, procedures, management reports, and other controls.
4. To determine that liquidity and market risks are recognized and that the organization is not excessively dependent on securitization as a substitute for funding or as a source of income.
5. To determine that steps have been taken to minimize the potential for conflicts of interest from securitization.
6. To determine that possible sources of structural failure in securitization transactions are recognized and that the organization has adopted measures to minimize the impact of such failures if they occur.
7. To determine that the organization is aware of the legal risks and uncertainty regarding various aspects of securitization.
8. To determine that concentrations of exposure in the underlying asset pools, in the asset-backed securities portfolio, or in the structural elements of securitization transactions are avoided.
9. To determine that all sources of risk are evaluated at the inception of each securitization activity and are monitored on an ongoing basis.

2128.02.10 INSPECTION PROCEDURES

1. Review the parent company’s policies and procedures to ensure that its banking and nonbanking subsidiaries follow prudent standards of credit assessment and approval for all securitization exposure. Procedures should include thorough and independent credit assessment of each loan or pool for which the banking organization has assumed credit risk, followed by periodic credit reviews to monitor performance throughout the life of the exposure. If a banking organization invests in asset-backed securities, determine whether there is sole reliance on conclusions of external rating services when evaluating the securities.
2. Determine that rigorous credit standards are applied regardless of the role the organization plays in the securitization process, for example, servicer, credit enhancer, or investor.
3. Determine that major policies and procedures, including internal credit-review and -approval procedures and in-house exposure limits, are reviewed periodically and approved by the bank holding company’s board of directors.
4. Determine that the banking organization uses effective risk-management measures and that those measures are commensurate with the nature and volume of its securitization activities. Verify that the banking organization effectively manages the operational risk associated with credit-enhancing representations and warranties as part of its overall risk-management strategy.
5. If the banking organization uses computer software to apply the ratings-based approach to its unrated direct-credit substitutes in asset-backed commercial paper programs, determine that the software produces credit assessments that credibly and reliably correspond with the ratings of traded positions by the rating agencies.
6. Determine whether adequate procedures for evaluating the organization’s internal-control procedures and the financial strength of the other institutions involved in the securitization process are in place.
7. Obtain the documentation outlining the remedies available to provide credit enhancement in the event of a default. Both originators and purchasers of securitized assets should have prospectuses on the issue. (Obtaining a copy of the prospectus can be an invaluable source of information on credit enhancement, default provisions, subordination agreements, etc.)
8. Ensure that, regardless of the role a banking

organization plays in securitization, the documentation for an asset-backed security clearly specifies the limitations of the banking organization's legal responsibility to assume losses.

9. Verify whether the banking organization, acting as originator, packager, or underwriter, has written policies addressing the repurchase of assets and other reimbursement to investors in the event that a defaulted package results in losses exceeding any contractual credit enhancement. The repurchase of defaulted assets or pools in contradiction of the underlying agreement in effect sets a standard by which a banking organization could be found legally liable for all "sold" assets. Review and report any situations in which the organization has repurchased or otherwise reimbursed investors for poor-quality assets.
10. Classify adverse credit risk associated with the securitization of assets when analyzing the adequacy of an organization's capital or reserve levels.
11. Aggregate securitization exposures with all loans, extensions of credit, debt and equity securities, legally binding financial guarantees and commitments, and with any other investments involving the same obligor, when determining compliance with internal credit-exposure limits.
12. Review securitized assets for industrial or geographic concentrations. Excessive exposures to an industry or region among the underlying assets should be noted in the review of the loan portfolio.
13. Ensure that, in addition to policies limiting direct-credit exposure, a banking organization has developed exposure limits with respect to particular originators, credit enhancers, trustees, and servicers.
14. Review the policies of the banking organization engaged in underwriting with regard to situations in which it cannot sell underwritten asset-backed securities. Credit review, funding capabilities, and approval limits should allow the banking organization to purchase and hold unsold securities. All potential credit exposure should be within legal lending limits.
15. Ensure that internal systems and controls adequately track the performance and condition of internal exposures and adequately monitor the organization's compliance with internal procedures and limits. In addition, adequate audit trails and internal audit coverage should be provided.
16. Determine that management information systems provide—
    a. a listing of all securitizations in which the organization is involved;
    b. a listing of industry and geographic concentration;
    c. information on total exposure to specific originators, servicers, credit enhancers, trustees, or underwriters;
    d. information regarding portfolio aging and performance relative to expectations; and
    e. periodic and timely information to senior management and directors on the organization's involvement in and credit exposure arising from securitization.
17. Ensure that internal auditors examine all facets of securitization regularly.
18. Review policies and procedures for compliance with applicable state lending limits and federal law, such as section 5136 of the Revised Code. These requirements must be analyzed to determine whether a particular asset-backed security issue is considered a single investment or a loan to each of the creditors underlying the pool. Collateralized mortgage obligations may be exempt from this limitation if they are issued or guaranteed by an agency or instrumentality of the U.S. government.
19. Determine whether the underwriting of asset-backed securities of affiliates is—
    a. rated by an unaffiliated, nationally recognized statistical rating organization or
    b. issued or guaranteed by Fannie Mae, Freddie Mac, or GNMA, or represents interests in such obligations.
20. If the parent organization or any of its banking and nonbanking subsidiaries invest in high-risk mortgage-derivative securities, determine whether management effectively manages the associated risks commensurate with the level of activity.
    a. Determine whether the level of activity is reasonably related to the level of capital, the organization's ability to absorb losses, and the level of in-house management sophistication and expertise.
    b. Ascertain whether the appropriate managerial and financial controls are required to be in place, and whether the parent organization analyzes, monitors, and prudently adjusts holdings of such high-risk securities when an environment of changing price and maturity expectations exists. In that regard, determine to

what extent the organization considers the liquidity and price volatility of the high-risk mortgage-derivative products before their acquistion.

2128.03.1 INTRODUCTION TO CREDIT- SUPPORTED AND ASSET-BACKED COMMERCIAL PAPER

The issuance of commercial paper provides an alternative to bank borrowing for large corporations (nonfinancial and financial) and municipalities. Generally, commercial paper issuers are those with high credit ratings. In recent years, however, some corporations with lower credit ratings have been able to issue commercial paper by obtaining credit enhancements (credit support from a firm with a high credit rating[1]) or other high-quality asset collateral (asset-backed commercial paper) to allow them to enter the market as issuers. An example of credit-supported commercial paper is one supported by a letter of credit (LOC), the terms of which specify that the bank issuing the LOC guarantees that the bank will pay off the commercial paper if the issuer fails to pay off the commercial paper upon maturity.[2] A credit enhancement could also consist of a surety bond from an insurance company.

2128.03.2 COMMERCIAL BANK INVOLVEMENT IN CREDIT-ENHANCED AND ASSET-BACKED COMMERCIAL PAPER

A number of commercial banks have become involved in credit-enhanced and asset-backed commercial paper programs. These securitization programs enable banks to help arrange short-term financing support for their customers without having to extend credit directly. This provides borrowers with an alternative source of funding and allows banks to earn fee income for managing the programs. Fees are earned for providing credit and liquidity enhancements to these programs.

It is important to emphasize that involvement in such programs can have potentially significant implications for the organizations' credit and liquidity risk exposure. Therefore, examiners need to be fully informed on the fundamentals of these programs, on the risks associated with these programs, and on the examination and inspection procedures for banking organizations engaged in this activity.

1. Such paper is usually called ''credit-supported commercial paper.''
2. Usually referred to as ''LOC paper.''

Asset-backed commercial paper programs have been in existence since the early 1980s and have grown substantially over the last few years. These programs use a special-purpose entity (SPE) to acquire receivables generally originated either by corporations or sometimes by the advising bank itself.[3] The SPEs, which are owned by third parties,[4] fund their acquisitions of receivables by issuing commercial paper that is to be repaid from the cash flow of the receivables.

Bank involvement in an asset-backed commercial paper program can range from advising the program to advising and providing all of the required credit and liquidity enhancements in support of the SPE's commercial paper. Typically, the advising bank, or an affiliate, performs a review to determine if the receivables of potential program participants (that is, corporate sellers) are eligible for purchase by the SPE. The scope of the review is similar to that used in structuring credit card or automobile-loan-backed transactions.

Once the bank (or its affiliate) determines that a receivables portfolio has an acceptable credit-risk profile, it approves the purchase of the portfolio at a discounted price by the SPE. The bank or its affiliate may also act as the operating agent for the SPE. This entails structuring the sale of receivable pools to the SPE and then overseeing the performance of the pools on an ongoing basis.

The SPE pays for the receivables by issuing commercial paper in an amount equal to the discounted price paid for the receivables. The difference between the face value of the receivables and the discounted price paid provides, as discussed below, the first level of credit protection for the commercial paper. The individual companies selling their receivables traditionally act as the servicer for receivables sold to an SPE; that is, they are responsible for collecting principal and interest payments from the obli-

3. To date, the type of receivables that have been included in such programs are trade receivables, installment sales contracts, financing leases, and noncancelable portions of operating leases and credit card receivables.
4. Employees of an investment banking firm or some other third party generally own the equity of the SPE. The advising bank can specifically avoid owning the stock if it does not want to raise the issue of whether it must consolidate the SPE for accounting purposes.

gors and passing these funds on to the SPE on a periodic basis. The SPE then distributes the proceeds to the holders of the commercial paper.

Asset-backed commercial paper programs typically have several levels of credit enhancement cushioning the commercial paper purchaser from potential loss. As noted above, the first level of loss protection is provided by the difference between the face value of the receivables purchased and the discounted price paid for them, known as a ‘‘holdback’’ or ‘‘overcollateralization.’’ In some cases, the terms of the sale also give the SPE recourse back to the seller if there are defaults on the receivables. The amount of overcollateralization and recourse varies from pool to pool and depends, in part, upon the quality of the receivables in the pool and the desired credit rating for the paper to be issued. Usually, the level of credit protection provided by overcollateralization is specified in terms of some multiple of historical loss experience for similar assets.

In addition to overcollateralization and recourse, secondary credit enhancements are also customarily provided. Secondary credit enhancements include letters of credit, surety bonds, or other backup facilities that obligate a third party to purchase pools of receivables from the SPE at a specified price. In addition to credit enhancements, the programs generally have liquidity enhancements to ensure that the SPE can meet maturing paper obligations.

The rating agencies typically require an SPE’s commercial paper to have secondary enhancements aggregating 100 percent of the amount outstanding in order to receive the highest credit rating. These enhancements are generally structured in one of two ways. In the first, a commercial bank enters into a single agreement under which it is unconditionally obligated to provide funding for all or any portion of maturing commercial paper that an SPE cannot pay from other sources. The obligation to fund may be triggered by credit losses, a liquidity shortfall, or both. In the second, two separate agreements that jointly cover 100 percent of an SPE’s outstanding commercial paper are established.

The first, typically an irrevocable letter of credit, is primarily intended to absorb credit losses that exceed the first tier of credit enhancement for the commercial paper. The second arrangement is a ‘‘liquidity’’ facility that may or may not provide credit support. This second structure will often have a letter of credit equalling 10 to 15 percent of outstandings, with the liquidity facility covering the remaining 85 to 90 percent.

2128.03.3 RISK-BASED CAPITAL TREATMENT FOR CREDIT-SUPPORTED AND ASSET-BACKED COMMERCIAL PAPER PROGRAMS

Generally, a single funding agreement that has no escape clause, such as a material-adverse-change clause that requires a bank to unconditionally provide funding to repay maturing commercial paper when the need arises because of either credit or liquidity problems should be treated as a direct credit substitute, or guarantee. The risk-based capital guidelines specify that the full amount of such obligations are to be converted to an on-balance-sheet credit-equivalent amount using a 100 percent conversion factor. No part of these arrangements should be considered commitments (either short-term or long-term) for risk-based capital purposes and assigned the conversion factor of a commitment. In the case of enhancements provided by separate facilities, a 100 percent conversion factor should be assigned to a letter of credit or any other form of credit guarantee provided by the bank. The accompanying liquidity facility, on the other hand, should be treated as a commitment and assigned a 50 percent conversion factor if over one year in maturity and a zero percent conversion factor if one year or less in maturity. One of the characteristics of liquidity facilities is that such arrangements generally have some reasonable asset-quality test that must be met before funds are extended to the SPE, to ensure that the bank is not providing credit protection.

2128.03.4 BOARD OF DIRECTORS’ POLICIES PERTAINING TO CREDIT-ENHANCED OR ASSET-BACKED COMMERCIAL PAPER

A banking organization (that is, a bank or bank holding company) participating in an asset-backed commercial paper program should ensure that such participation is clearly and logically integrated into its overall strategic objectives. Furthermore, the management should ensure that the risks associated with the various roles that the institution may play in such programs are fully understood and that safeguards are in place to manage these risks properly.

Appropriate policies, procedures, and controls should be established by a banking organization before it participates in asset-backed commercial paper programs. Significant policies and procedures should be approved and reviewed periodically by the organization's board of directors. These policies and procedures should ensure that the organization follows prudent standards of credit assessment and approval regardless of the role an institution plays in an asset-backed commercial paper program. Such policies and procedures would be applicable to all pools of receivables to be purchased by the SPE as well as the extension of any credit enhancements and liquidity facilities. Procedures should include an initial, thorough credit assessment of each pool for which it had assumed credit risk, followed by periodic credit reviews to monitor performance throughout the life of the exposure. Furthermore, the policies and procedures should outline the credit-approval process and establish ''in-house'' exposure limits, on a consolidated basis, with respect to particular industries or organizations, that is, companies from which the SPE purchased the receivables as well as the receivable obligors themselves. Controls should include well-developed management information systems and monitoring procedures.

Institutions should analyze the receivables pools underlying the commercial paper as well as the structure of the arrangement. This analysis should include a review of—

1. the characteristics, credit quality, and expected performance of the underlying receivables;
2. the banking organization's ability to meet its obligations under the securitization arrangement; and
3. the ability of the other participants in the arrangement to meet their obligations.

Banking organizations providing credit enhancements and liquidity facilities should conduct a careful analysis of their funding capabilities to ensure that they will be able to meet their obligations under all foreseeable circumstances. The analysis should include a determination of the impact that fulfillment of these obligations would have on their interest-rate risk exposure, asset quality, liquidity position, and capital adequacy.

Examiners should review carefully the asset-backed commercial paper facilities provided by banking organizations to ensure that they are applying, for risk-based capital purposes, the proper conversion factors to their obligations supporting asset-backed commercial paper programs. In addition, examiners should determine whether the previously discussed policies are operative and that institutions are adequately managing their risk exposure. A discussion of the size, effectiveness, and risks associated with these programs should be included in the confidential section of the examination or inspection report if not appropriate for the open section. See SR-92-11.

2128.03.5 INSPECTION OBJECTIVES

1. To determine whether the banking organization (that is, a bank or bank holding company) participating in an asset-backed commercial paper program has included such participation in its overall strategic objectives.
2. To determine whether management fully understands the risks associated with the involvement in such credit enhancement and asset-backed commercial paper programs and whether appropriate safeguards are in place to properly manage those risks.
3. To ascertain that the appropriate policies, procedures, and controls have been established by the banking organization before participating in asset-backed commercial paper programs.
4. To verify whether existing managerial and internal controls include well-developed management information systems and monitoring procedures.
5. To determine whether the banking organization has conducted a careful analysis of its funding capabilities to ensure that it will be able to meet its obligations under all foreseeable circumstances.

2128.03.6 INSPECTION PROCEDURES

1. Review the board of directors or executive committee minutes and establish whether the significant policies and procedures for credit-enhanced or asset-backed commercial paper have been approved and reviewed periodically by the organization's board of directors.
   a. Determine whether the policies are operative and that institutions are adequately managing their risk exposure.
   b. Determine whether the policies and procedures are applicable to all pools of receivables to be purchased by the SPE as well

as to the extension of any credit enhancements and liquidity facilities.

2. Determine if the organization follows prudent standards of credit assessment and approval.
   a. Ascertain whether the procedures include an initial, thorough credit assessment of each pool for which it had assumed credit risk, followed by periodic credit reviews to monitor performance throughout the life of the exposure.
   b. Determine if the policies and procedures outline the credit-approval process and establish ''in-house'' exposure limits, on a consolidated basis, with respect to particular industries or organizations, that is, companies from which the SPE purchased the receivables as well as the receivable obligors themselves.
   c. Determine whether the organization analyzes the receivables pools underlying the commercial paper as well as the structure of the arrangement. Does the analysis include a review of—
      - the characteristics, credit quality, and expected performance of the underlying receivables;
      - the ability of the banking organization to meet its obligations under the securitization arrangement; and
      - the ability of the other participants in the arrangement to meet their obligations?
3. Review the organization's funding obligations and commitments, and determine whether there is sufficient liquidity to satisfy those funding requirements. Include a determination of the impact that fulfillment of these obligations would have on their interest-rate risk exposure, asset quality, liquidity position, and capital adequacy.
4. Review carefully the asset-backed commercial paper facilities to ensure that they are applying, for risk-based capital purposes, the proper conversion factors to their obligations supporting asset-backed commercial paper programs.
5. Include in the inspection report a discussion of the size, effectiveness, and risks associated with these programs (include in the confidential section of the inspection report if not appropriate for the open section).

Implicit recourse arises when a bank holding company[1] provides credit support to one of more of its securitizations beyond its contractual obligation. Implicit recourse, like contractual recourse, exposes a bank holding company to the risk of loss arising from deterioration in the credit quality of the underlying assets of the securitization. Implicit recourse is of supervisory concern because it demonstrates that the securitizing bank holding company is reassuming risk associated with the securitized assets—risk that the bank holding company initially transferred to the marketplace. For risk-based capital purposes, bank holding companies deemed to be providing implicit recourse are generally required to hold capital against the entire outstanding amount of assets sold, as though the assets remained on the bank holding company's books.

Banking organizations have typically provided implicit recourse in situations where the originating banking organization perceived that the failure to provide this support, even though not contractually required, would damage its future access to the asset-backed securities market. An originating bank holding company can provide implicit recourse in a variety of ways. The ultimate determination as to whether implicit recourse exists depends on the facts. The following actions point to a finding of implicit recourse:

1. selling assets to a securitization trust or other special-purpose entity (SPE) at a discount from the price specified in the securitization documents, which is typically par value
2. purchasing assets from a trust or other SPE at an amount greater than fair value
3. exchanging performing assets for nonperforming assets in a trust or other SPE
4. funding credit enhancements[2] beyond contractual requirements

By providing implicit recourse, a bank holding company signals to the market that it still holds the risks inherent in the securitized assets, and, in effect, the risks have not been transferred. Accordingly, examiners must be attentive to bank holding companies that provide implicit support, given the risk these actions pose to a bank holding company's financial condition. Increased attention should be given to situations where a bank holding company is more likely to provide implicit support.

Particular attention should be paid to revolving securitizations, such as those used for credit card lines and home equity lines of credit, in which receivables generated by the lines are sold into the securitizations. These securitizations typically provide that, when certain performance criteria hit specified thresholds, no new receivables can be sold into the securitization, and the principal on the bonds issued will begin to pay out. These early-amortization events are intended to protect investors from further deterioration in the underlying asset pool. Once an early-amortization event has occurred, the bank holding company could have difficulties using securitization as a continuing source of funding and, at the same time, have to fund the new receivables generated by the lines of credit on its balance sheet. Thus, bank holding companies have an incentive to avoid early amortization by providing implicit support to the securitization.

Examiners should be alert for securitizations that are approaching early-amortization triggers, such as a decrease in the excess spread[3] below a certain threshold or an increase in delinquencies beyond a certain rate. Providing implicit recourse can pose a degree of risk to a bank holding company's financial condition and to the integrity of its regulatory and public financial statements and reports. Examiners should review securitization documents (for example, pooling and servicing agreements) to ensure that the selling institution limits any post-sale support to that specified in the terms and conditions in the securitization documents. Examiners should also review a sample of receivables transferred between the seller and the trust to ensure that these transfers were conducted in accordance with the contractual terms of the securitization, particularly in cases where the overall credit quality of the securitized loans or receivables has deteriorated. While bank holding companies are not prohibited from provid-

1. The reference to implicit-recourse activities of bank holding companies is intended to include all of a bank holding company's domestic and foreign subsidiaries supervised by the Federal Reserve, as well as its federally insured depository institutions and other entities that are subject to this interpretation and guidance of the Federal Financial Institutions Examination Council (FFIEC).

2. Credit enhancements include retained subordinated interests, asset-purchase obligations, overcollateralization, cash-collateral accounts, spread accounts, and interest-only strips.

3. Excess spread generally is defined as finance-charge collections minus certificate interest, servicing fees, and charge-offs allocated to the series.

ing implicit recourse, such support will generally result in higher capital requirements.

Examiners should recommend that prompt supervisory action be taken when implicit recourse is identified. To determine the appropriate action, examiners need to understand the bank holding company's reasons for providing support and the extent of the impact of this support on the bank holding company's earnings and capital. As with contractual recourse, actions involving noncontractual post-sale credit enhancement generally result in the requirement that the bank holding company hold risk-based capital against the entire outstanding amount of the securitized assets. The Federal Reserve may require the bank holding company to bring all assets in existing securitizations back on the balance sheet for risk-based capital purposes, as well as require the bank holding company to increase its minimum capital ratios. The Federal Reserve may prevent a bank holding company from removing assets from its risk-weighted asset base on future transactions until the bank holding company demonstrates its intent and ability to transfer risk to the marketplace. The Federal Reserve may consider other actions to ensure that the risks associated with implicit recourse are adequately reflected in the capital ratios. For example, supervisors may require the bank holding company to deduct residual interests from tier 1 capital as well as hold risk-based capital on the underlying assets. (See SR-02-15.)

The following examples illustrate post-sale actions that banking organizations may take with respect to assets they have securitized. These examples are intended to provide guidance on whether these actions would be considered implicit recourse for risk-based capital and other supervisory purposes. A key factor in each scenario and analysis is the potential risk of loss a bank holding company's earnings and capital may be exposed to as a result of its actions.

Account Removal: Example 1a

Facts. A bank holding company originates and services credit card receivables throughout the country. The bank holding company decides to divest those credit card accounts of customers who reside in specific geographic areas where the bank holding company lacks a significant market presence. To achieve the maximum sales price, the sale must include both the credit card relationships and the receivables. Because many of the credit card receivables are securitized through a master-trust structure, the bank holding company needs to remove the receivables from the trust. The affected receivables are not experiencing any unusual performance problems. In that respect, the charge-off and delinquency ratios for the receivables to be removed from the trust are substantially similar to those for the trust as a whole.

The bank holding company enters into a contract to sell the specified credit card accounts before the receivables are removed from the trust. The terms of the transaction are arm's length, wherein the bank holding company will sell the receivables at market value. The bank holding company separately agrees to purchase the receivables from the trust at this same price. Therefore, no loss is incurred as a result of removing the receivables from the trust. The bank holding company will remove from the trust only those receivables that are due from customers located in the geographic areas where the bank holding company lacks a significant market presence, and it will remove all such receivables from the trust.

Analysis. The removal of the above-described receivables from the trust does not constitute implicit recourse for regulatory capital purposes. Supporting factors for this conclusion include the following:

1. The bank holding company's earnings and capital are not exposed to actual or potential risk of loss as a result of removing the receivables from the trust.
2. There is no indication that the receivables are removed from the trust because of performance concerns.
3. The bank holding company is removing the receivables from the trust for a legitimate business purpose other than to systematically improve the quality of the trust's assets. The legitimate business purpose is evidenced by the bank holding company's prearranged, arm's-length sale agreement that facilitates exiting the business in identified geographic locations.

Examiners should review the terms and conditions of the transaction to ensure that the market value of the receivables is documented and well supported before concluding that this transaction does not represent implicit recourse. Examiners should also ensure that the selling bank holding company has not provided the purchaser with any guarantees or credit enhancements on the sold receivables.

Account Removal: Example 1b

Facts. After the establishment of a master trust for a pool of credit card receivables, the receivables in the trust begin to experience adverse performance. A combination of lower-than-expected yields and higher-than-anticipated charge-offs on the pool causes spreads to compress significantly (although not to zero). The bank holding company's internally generated forecasts indicate that spreads will likely become negative in the near future. Management takes action to support the trust by purchasing the low-quality (delinquent) receivables from the trust at par, although their market value is less than par. The receivables purchased from the trust represent approximately one-third of the trust's total receivables. This action improves the overall performance of the trust and avoids a potential early-amortization event.

Analysis. The purchase of low-quality receivables from a trust at par constitutes implicit recourse for regulatory capital purposes. The purchase of low-quality receivables at an above-market price exposes the bank holding company's earnings and capital to potential future losses from assets that had previously been sold. Accordingly, the bank holding company is required to hold risk-based capital for the remaining assets in the trust as if they were retained on the balance sheet, as well as hold capital for the assets that were repurchased.

Additions of Future Assets or Receivables: Example 2a

Facts. Months after the issuance of credit card asset-backed securities, charge-offs and delinquencies on the underlying pool of receivables rise dramatically. A rating agency places the securities on watch for a potential rating downgrade. The securitization documents require the bank holding company to transfer new receivables to the securitization trust at par value. However, to maintain the rating on the securities, the bank holding company begins to sell replacement receivables into the trust at a discount from par value.

Analysis. The sale of receivables to the trust at a discount constitutes implicit recourse for regulatory capital purposes. The sale of assets at a discount from the price specified in the securitization documents, par value in this example, exposes the bank holding company's earnings and capital to future losses. The bank holding company must hold regulatory capital against the outstanding assets in the trust.

Additions of Future Assets or Receivables: Example 2b

Facts. A bank holding company established a credit card master trust. The receivables from the accounts placed in the trust were, on average, of lesser quality than the receivables from certain affinity accounts retained on the bank holding company's balance sheet. Under the criteria for selecting the receivables to be transferred to the master trust, the bank holding company was prevented from including the better-performing affinity accounts in the initial pool of accounts because the affinity-relationship contract was expiring. The bank holding company and the affinity client subsequently revised the terms of their contract, enabling the affinity accounts to meet the selection criteria and be included in future securitization transactions. Later, rising charge-offs within the pool of receivables held by the trust caused spread compression in the trust. To improve the performance of the assets in the trust, the bank holding company begins to include the better-performing and now-eligible receivables from the affinity accounts among the receivables sold to the trust. This action improves the trust's performance, including its spread levels and charge-off ratios. However, the replacement assets were sold at par in accordance with the terms of the trust agreement, so no current or future charge to the bank holding company's earnings or capital will result from these asset sales. As another result of this action, the performance of the trust's assets closely tracks the credit card receivables that remain on the bank holding company's balance sheet.

Analysis. The actions described above do not constitute implicit recourse for regulatory capital purposes. The bank holding company did not incur any additional risk to earnings or capital after the affinity accounts met the selection criteria for replacement assets and after the associated receivables were among the receivables sold to the trust. The replacement assets were sold at par in accordance with the terms of the trust agreement, so no future charge to earnings or capital will result from these asset sales. The sale of replacement assets into a master-trust structure is part of normal trust management.

In this example, the credit card receivables that remain on the bank holding company's balance sheet closely track the performance of the trust's assets. Nevertheless, examiners should ascertain whether a securitizing bank holding company sells disproportionately higher-quality assets into securitizations while retaining comparatively lower-quality assets on its books. If a bank holding company engages in this practice, examiners should consider its effect on the bank holding company's capital adequacy.

Additions of Future Assets or Receivables: Example 2c

Facts. A bank holding company establishes a credit card master trust composed of receivables from accounts that were generally of lower quality than the receivables retained on the bank holding company's balance sheet. The difference in the two portfolios is primarily due to logistical and operational problems that prevent the bank holding company from including certain better-quality affinity accounts in the initial pool from which accounts were selected for securitization. Rising charge-offs and other factors later result in margin compression on the assets in the master trust, which causes some concern in the market regarding the stability of the outstanding asset-backed securities. A rating agency places several tranches of the securities on its watch list for a potential rating downgrade. In response to the margin compression, as part of the bank holding company's contractual obligations, spread accounts are increased for all classes by trapping excess spread in conformance with the terms and conditions of the securitization documents. To stabilize the quality of the receivables in the master trust, as well as to preclude a downgrade, the bank holding company takes several actions beyond its contractual obligations:

1. Affinity accounts are added to the pool of receivables eligible for inclusion in the trust. This change results in improved overall trust performance. However, these receivables are sold to the trust at par value, consistent with the terms of the securitization documents, so no current or future charge to the bank holding company's earnings or capital will result from these asset sales.
2. The charge-off policy for cardholders that have filed for bankruptcy is changed from criteria that were more conservative than industry standards, the applicable Federal Reserve classification policy for bank holding companies, and the FFIEC Uniform Retail Credit Classification and Account Management Policy to criteria that conform to industry standards, the Federal Reserve's standards, and the FFIEC's policy.
3. Charged-off receivables held by the trust are sold to a third party. The funds generated by this sale, effectively accelerating the recovery on these receivables, improve the trust's spread performance.

Analysis. The actions described above do not constitute implicit recourse for regulatory capital purposes. None of the noncontractual actions result in a loss or expose the bank holding company's earnings or capital to the risk of loss. Because of the margin compression, the bank holding company is obligated to increase the spread accounts in conformance with the terms and conditions of the securitization documents. To the extent this results in an increase in the value of the subordinated spread accounts (residual interests) on the bank holding company's balance sheet, the bank holding company will need to hold additional capital on a dollar-for-dollar basis for the additional credit risk it retains. In contrast, if the bank holding company increased the spread accounts beyond its contractual obligation under the securitization documents, this action would be considered a form of implicit recourse. None of the other actions the bank holding company took would affect its earnings or capital:

1. Like other additions to credit card trusts, the additions of receivables from the new affinity accounts were made at par value, in accordance with the securitization documents. Therefore, the additions of receivables from the new affinity accounts would not affect the bank holding company's earnings or capital.
2. The trust's policy on the timing of charge-offs on accounts of cardholders who have filed for bankruptcy was changed to meet the less stringent standards of the industry and those required under the Federal Reserve's policy in order to improve trust performance, at least temporarily. Nonetheless, this would not affect the bank holding company's earnings or capital.
3. In accordance with the securitization documents, proceeds from recoveries on charged-off accounts are the property of the trust. These and other proceeds would continue to

be paid out in accordance with the pooling and servicing agreement. No impact on the bank holding company's earnings or capital would result.

Modification of Loan-Repayment Terms: Example 3

Facts. In performing the role of servicer for its securitization, a bank holding company is authorized under its pooling and servicing agreement to modify loan-repayment terms when it appears that this action will improve the likelihood of repayment on the loan. These actions are part of the bank holding company's process of working with customers who are delinquent or otherwise experiencing temporary financial difficulties. All of the modifications are consistent with the bank holding company's internal loan policy. However, in modifying the loan terms, the contractual maturity of some loans may be extended beyond the final maturity date of the most junior class of securities sold to investors. When this occurs, the bank holding company repurchases these loans from the securitization trust at par.

Analysis. The combination of the loan-term modification for securitized assets and the subsequent repurchase constitutes implicit recourse for regulatory capital purposes. While the modification of loan terms is permitted under the pooling and servicing agreement, the repurchase of modified loans with extended maturities at par exposes the bank holding company's earnings and capital to potential risk of loss.

Servicer's Payment of Deficiency Balances: Example 4

Facts. A wholly owned subsidiary of a bank holding company originates and services a portfolio of home equity loans. After liquidation of the collateral for a defaulted loan, the subsidiary makes the trust whole in terms of principal and interest if the proceeds from the collateral are not sufficient. However, there is no contractual commitment that requires the subsidiary to support the pool in this manner. The payments made to the trust to cover deficient balances on the defaulted loans are not recoverable under the terms of the pooling and servicing agreement.

Analysis. The subsidiary's action constitutes implicit recourse to the bank holding company for regulatory capital purposes. This action is considered implicit recourse because it adversely affects the bank holding company's earnings and capital since the bank holding company absorbs losses on the loans resulting from the actions taken by its subsidiary. Further, no mechanism exists to provide for and ensure that the subsidiary will be reimbursed for the payments made to the trust. In addition, examiners will consider any servicer advance a credit enhancement if the servicer is not entitled to full reimbursement[4] or if the reimbursement is subordinate to other claims.

Reimbursement of Credit Enhancer's Actual Losses: Example 5

Facts. A bank holding company sponsoring a securitization arranges for an unrelated third party to provide a first-loss credit enhancement, such as a financial standby letter of credit, that will cover losses up to the first 10 percent of the securitized assets. The bank holding company agrees to pay a fixed amount as an annual premium for this credit enhancement. The third party initially covers actual losses that occur in the underlying asset pool in accordance with its contractual commitment under the letter of credit. Later, the bank holding company agrees not only to pay the credit enhancer the annual premium on the credit enhancement, but also to reimburse the credit enhancer for the losses it absorbed during the preceding year. This reimbursement for actual losses was not originally provided for in the contractual arrangement between the bank holding company and the credit-enhancement provider.

Analysis. The bank holding company's subsequent reimbursement of the credit-enhancement provider's losses constitutes implicit recourse because the bank holding company's reimbursement of losses went beyond its contractual obligations. Furthermore, the Federal Reserve would consider any requirement contained in the original credit-enhancement contract that obligates the bank holding company to reimburse the credit-enhancement provider for its losses to be a recourse arrangement.

4. A servicer advance will also be considered a form of credit enhancement if, for any one loan, nonreimbursable advances are not contractually limited to an insignificant amount of that loan's outstanding principal.

2128.04.1 INSPECTION OBJECTIVES

1. To identify asset-securitization transactions in which the bank holding company has provided implicit recourse.
2. To ascertain whether implicit recourse provided to asset-securitization transactions may be detrimental to the bank holding company's earnings performance, capital adequacy, and financial condition.
3. To initiate quick supervisory action, which may include increased minimum-capital requirements, when implicit recourse is identified.

2128.04.2 INSPECTION PROCEDURES

1. Be attentive to situations in which the bank holding company may have provided implicit support to an asset-securitization transaction.
2. Be alert for securitizations that are approaching early-amortization triggers, such as a decrease in the excess spread below a certain threshold or an increase in delinquencies beyond a certain rate.
3. Review securitization documents to ensure that the selling institution limits any post-sale support to that specified in the terms and conditions in the securitization documents.
4. Review a sample of receivables transferred between the seller and the trust to ensure that the transfers were conducted in accordance with the contractual terms of the securitization, particularly in cases where the overall credit quality of the securitized loans or receivables has deteriorated.
5. Review the terms and conditions of the securitization transactions reviewed to ensure that the market value of the receivables is documented and well supported.
6. Ascertain that the selling bank holding company has not provided a purchaser with any guarantees or credit enhancements on the sold receivables.
7. Ascertain whether a securitizing bank holding company sells disproportionately higher-quality assets into securitizations while retaining comparatively lower-quality assets on its books. Evaluate the effect of this practice on the bank holding company's earnings and capital adequacy.
8. Provide appropriate written documentation and recommend that prompt supervisory action be taken when implicit recourse is identified.

A bank holding company's board of directors and senior management are responsible for initiating policies and procedures, and for monitoring processes and internal controls, that will provide reasonable assurance that the bank holding company's contracts and commitments do not include detrimental covenants that affect its safety and soundness. When examiners review a bank holding company's securitization contracts and related documentation, they should be alert to any covenants that use adverse supervisory actions or the breach of supervisory thresholds as triggers for early-amortization events or the transfer of servicing. Examples of such supervisory actions can include a downgrade in the banking organization's BOPEC or CAMELS rating, an enforcement action, or a downgrade in a depository institution's prompt-corrective-action capital category. The inclusion of supervisory-linked covenants in securitization documents is considered to be an "unsafe and unsound banking practice" that undermines the objective of supervisory actions and thresholds. An early amortization or transfer of servicing triggered by such events can create or exacerbate liquidity and earnings problems for a bank holding company that may lead to further deterioration in its financial condition.

Covenants that contain triggers tied, directly or indirectly, to supervisory actions or thresholds can also result in the early amortization of a securitization at a time when the sponsoring organization's ability to access other funding sources is limited. If an early-amortization event occurs, investors may lose confidence in the stability of the sponsoring organization's asset-backed securities, thus limiting its ability to raise new funds through securitization. At the same time, the organization must fund new receivables on the balance sheet, potentially resulting in liquidity problems. Moreover, the existence of a supervisory-linked trigger potentially could inhibit supervisors from taking action intended to address problems at a troubled organization because the action could trigger an event that worsens its condition or causes its failure.

The Federal Reserve is concerned that covenants related to supervisory actions may obligate a bank holding company's management to disclose confidential information, such as BOPEC or CAMELS ratings. Disclosure of such information by a banking organization's directors, officers, employees, attorneys, or independent auditors, without explicit authorization by its primary regulator, violates supervisory information disclosure rules and policies and may result in follow-up supervisory action.

Because of the supervisory concerns about covenants that are linked to supervisory actions, a federal bank interagency advisory was issued on May 23, 2002. (See SR-02-14.) The advisory emphasizes that a banking organization's management and board of directors should ensure that covenants related to supervisory actions or thresholds are not included in securitization documents. Covenants that provide for the early termination of the transaction or compel the transfer of servicing due, directly or indirectly, to the occurrence of a supervisory action or event will be criticized, under appropriate circumstances, as an unsafe and unsound banking practice. The Federal Reserve (and other supervisors) may also take other supervisory actions, such as requiring additional capital or denying capital relief for risk-based capital calculations, regardless of the treatment under generally accepted accounting principles (GAAP).

Examiners should consider the potential impact of such covenants in existing transactions when evaluating both the overall condition of the bank holding company and the specific component ratings of capital, liquidity, and management. Early-amortization triggers will specifically be considered in the context of the bank holding company's overall liquidity position and contingency funding plan. For organizations with limited access to other funding sources or a significant reliance upon securitization, the existence of these triggers presents a greater degree of supervisory concern. Any bank holding company that uses securitization as a funding source should have a viable contingency funding plan in the event it can no longer access the securitization market. Examiners should encourage bank holding company management to amend, modify, or remove covenants linked to supervisory actions from existing transactions. Any impediments a bank holding company may have to taking such actions should be documented and discussed with the appropriate supervisory staff of its responsible Reserve Bank.

2128.05.1 INSPECTION OBJECTIVES

1. During the review of securitization activities and contracts, to be alert to securitization

documents containing covenants that have triggers tied, directly or indirectly, to supervisory actions or thresholds.

2. To criticize, as an unsafe and unsound banking practice, under appropriate circumstances, the inclusion of covenants in a securitization-transaction document that provide for the early termination of the transaction or that compel the transfer of servicing due, directly or indirectly, to the occurrence of a supervisory action or event.
3. To determine if the bank holding company has a viable contingency funding plan that it can use in the event that it can no longer access the securitization market.

2128.05.2 INSPECTION PROCEDURES

1. Review a sample of the bank holding company's securitization contracts and related documentation.
2. Evaluate the overall condition of the bank holding company, as well as the specific component ratings of capital, liquidity, and management.
3. If the bank holding company uses securitization as a funding source, determine its overall liquidity position and whether it has an adequate and viable contingency funding plan, which can be used if it can no longer access the securitization market.
4. Determine the potential impact of any early-amortization triggers or transfer of servicing within the asset-securitization contracts (any covenants that use adverse supervisory actions or the crossing of supervisory thresholds as triggers for early-amortization events or the transfer of servicing).
5. Encourage bank holding company management to amend, modify, or remove from existing transactions any securitization covenants linked to supervisory actions.
6. Report to and consult with Reserve Bank supervisory staff on any impediments the directors and senior management of the bank holding company have to amending, modifying, or removing any such detrimental securitization convenants.

Securitization activities present unique and sometimes complex risks that require the attention of senior management and the board of directors. Retained interests from securitization activities, including interest-only strips receivable, arise when a banking organization (BO) keeps an interest in the assets sold to a securitization vehicle that, in turn, issues bonds to investors.[1]

The methods and models BOs use to value retained interests and the difficulties in managing exposure to these volatile assets can raise supervisory concerns. Under generally accepted accounting principles (GAAP), a BO recognizes an immediate gain (or loss) on the sale of assets by recording its retained interest at fair value. The valuation of the retained interest is based on the present value of future cash flows in excess of the amounts needed to service the bonds and cover credit losses and other fees of the securitization vehicle.[2]

Determinations of fair value should be based on reasonable, conservative assumptions about factors such as discount rates, projected credit losses, and prepayment rates. Bank supervisors expect retained interests to be supported by verifiable documentation of fair value in accordance with GAAP. In the absence of such support, the retained interests should not be carried as assets on a BO's books, but should be charged off. Other supervisory concerns include failure to recognize and hold sufficient capital against recourse obligations generated by securitizations, and the absence of an adequate independent audit function.

The supervisory guidance focuses on and incorporates important fundamental concepts of risk-management and risk-focused supervision: active oversight by senior management and the board of directors, the use of effective policies and limits, accurate and independent procedures to measure and assess risk, and the maintenance of strong internal controls.[3] The guidance stresses sound risk-management, modeling, valuation, and disclosure practices for asset securitization; complements previous supervisory guidance issued on this subject; and supplements existing policy statements and examination-inspection procedures.[4] Emphasis is placed on the expectation that a BO's securitization-related retained interest must be supported by documentation of the interest's fair value, using reasonable, conservative valuation assumptions that can be objectively verified. Retained interests that lack such objectively verifiable support or that fail to meet these supervisory standards will be classified as loss and disallowed for inclusion as assets of the BO for regulatory capital purposes. See SR-99-37 and the more complete text of its referenced interagency guidance on the risk mangement and valuation of retained interests arising from asset securitization activities.

Examiners will review a BO's valuation of retained interests and the concentration of these assets relative to capital. Consistent with existing supervisory authority, BOs may be required, on a case-by-case basis, to hold additional capital commensurate with their risk exposures.[5] An excessive dependence on securitizations for day-to-day core funding can present significant liquidity problems during times of market turbulence or if there are difficulties specific to the BO.

2128.06.1 ASSET SECURITIZATION

Asset securitization typically involves the transfer of on-balance-sheet assets to a third party or trust. In turn, the third party or trust issues certificates or notes to investors. The cash flow from the transferred assets supports repayment of the certificates or notes. BOs use asset securi-

1. The term ''banking organization'' (BO) refers to any federally supervised banking organization. This includes federally insured, federally chartered financial institutions that are supervised by a federal bank or savings association supervisory authority, as well as bank holding companies and their nonbank subsidiaries.

2. See Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard No. 125 (FAS 125), ''Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.''

3. See SR-96-14, ''Risk-Focused Safety-and-Soundness Examinations and Inspections'' (section 2124.0 of this manual), and SR-95-51, ''Rating the Adequacy of Risk-Management Processes and Internal Controls at State Member Banks and Bank Holding Companies'' (section 4070.1 of this manual).

4. See SR-97-21, ''Risk Management and Capital Adequacy of Exposures Arising from Secondary-Market Credit Activities''; SR-96-40, ''Interim Guidance for Purposes of Applying FAS 125 for Regulatory Reporting in 1997 and for the Treatment of Servicing Assets for Regulatory Capital''; and SR-96-30, ''Risk-Based Capital Treatment for Spread Accounts That Provide Credit Enhancement for Securitized Receivables.''

5. For instance, a BO has high concentrations of retained interests relative to its capital or is otherwise at risk from impairment of these assets.

tization to access alternative funding sources, manage concentrations, improve financial-performance ratios, and more efficiently meet customer needs. Assets typically securitized include credit card receivables, automobile receivable paper, commercial and residential first mortgages, commercial loans, home equity loans, and student loans.

Senior management and directors must have the requisite knowledge of the effect of securitization on the BO's risk profile and must be fully aware of the accounting, legal, and risk-based capital nuances of this activity. BOs must fully and accurately distinguish and measure the risks that are transferred versus those retained, and must adequately manage the retained portion. It is essential that BOs engaging in securitization activities have appropriate front- and back-office staffing, internal and external accounting and legal support, audit or independent review coverage, information systems capacity, and oversight mechanisms to execute, record, and administer these transactions correctly.

Appropriate valuation and modeling methodologies must be used. They must be able to determine the initial and ongoing value of retained interests. Accounting rules provide a method to recognize an immediate gain (or loss) on the sale through booking a "retained interest." The carrying value, however, of that interest must be fully documented, based on reasonable assumptions, and regularly analyzed for any subsequent impairment in value. The best evidence of fair value is a quoted market price in an active market. When quoted market prices are not available, accounting rules allow fair value to be estimated. This estimate must be based on the "best information available in the circumstances."[6] An estimate of fair value must be supported by reasonable and current assumptions. If a best estimate of fair value is not practicable, the asset is to be recorded at zero in financial and regulatory reports.

Unforeseen market events that affect the discount rate or performance of receivables supporting a retained interest can swiftly and dramatically alter its value. Without appropriate internal controls and independent oversight, a BO that securitizes assets may inappropriately generate "paper profits" or mask actual losses through flawed loss assumptions, inaccurate prepayment rates, and inappropriate discount rates. Liberal and unsubstantiated assumptions can result in material inaccuracies in financial statements; substantial write-downs of retained interests; and, if retained interests represent an excessive concentration of the sponsoring BO's capital, the BO's demise. BO managers and directors need to ensure the following:

1. Independent risk-management processes are in place to monitor securitization-pool performance on an aggregate and individual transaction level. An effective risk-management function includes appropriate information systems to monitor securitization activities.
2. Conservative valuation assumptions and modeling methodologies are used to establish, evaluate, and adjust the carrying value of retained interests on a regular and timely basis.
3. Audit or internal review staffs periodically review data integrity, model algorithms, key underlying assumptions, and the appropriateness of the valuation and modeling process for the securitized assets the BO retains. The findings of such reviews should be reported directly to the board or an appropriate board committee.
4. Accurate and timely risk-based capital calculations are maintained, including recognition and reporting of any recourse obligation resulting from securitization activity.
5. Internal limits are in place to govern the maximum amount of retained interests as a percentage of total equity capital.
6. A realistic liquidity plan is in place for the BO in case of market disruptions.

2128.06.2 INDEPENDENT RISK-MANAGEMENT FUNCTION

BOs engaged in securitizations should have an independent risk-management function commensurate with the complexity and volume of their securitizations and their overall risk exposures. The risk-management function should ensure that securitization policies and operating procedures, including clearly articulated risk limits, are in place and appropriate for the BO's circumstances. A sound asset securitization policy should include or address, at a minimum—

1. a writtten and consistently applied accounting methodology;
2. regulatory reporting requirements;
3. valuation methods, including FAS 125 residual value assumptions, and procedures

6. See FAS 125, at para. 43.

to formally approve changes to those assumptions;
4. a management reporting process; and
5. exposure limits and requirements for both aggregate and individual transaction monitoring.

It is essential that the risk-management function monitor origination, collection, and default-management practices. This includes regular evaluations of the quality of underwriting, soundness of the appraisal process, effectiveness of collections activities, ability of the default-management staff to resolve severely delinquent loans in a timely and efficient manner, and the appropriateness of loss-recognition practices. Because the securitization of assets can result in the current recognition of *anticipated income*, the risk-management function should pay particular attention to the types, volumes, and risks of assets being originated, transferred, and serviced. Senior management and the risk-management staff must be alert to any pressures on line managers to originate abnormally large volumes or higher-risk assets to sustain ongoing income needs. Such pressures can lead to a compromise of credit-underwriting standards. This may accelerate credit losses in future periods, impair the value of retained interests, and potentially lead to funding problems.

The risk-management function should also ensure that appropriate management information systems (MIS) exist to monitor securitization activities. Reporting and documentation methods must support the initial valuation of retained interests and ongoing impairment analyses of these assets. Pool-performance information will help well-managed BOs ensure, on a qualitative basis, that a sufficient amount of economic capital is being held to cover the various risks inherent in securitization transactions. The absence of quality MIS will hinder management's ability to monitor specific pool performance and securitization activities.

At a minimum, MIS reports should address the following:

1. *Securitization summaries for each transaction.* The summary should include relevant transaction terms such as collateral type, facility amount, maturity, credit-enhancement and subordination features, financial covenants (termination events and spread-account capture ''triggers''), right of repurchase, and counterparty exposures. Management should ensure that the summaries for each transaction are distributed to all personnel associated with securitization activities.
2. *Performance reports by portfolio and specific product type.* Performance factors include gross portfolio yield, default rates and loss severity, delinquencies, prepayments or payments, and excess spread amounts. The reports should reflect the performance of assets, both on an individual-pool basis and total managed assets. These reports should segregate specific products and different marketing campaigns.
3. *Vintage analysis for each pool using monthly data.* Vintage analysis will help management understand historical performance trends and their implications for future default rates, prepayments, and delinquencies, and therefore retained interest values. Management can use these reports to compare historical performance trends with underwriting standards, including the use of a validated credit-scoring model, to ensure loan pricing is consistent with risk levels. Vintage analysis also helps in the comparison of deal performance at periodic intervals and validates retained-interest valuation assumptions.
4. *Static-pool cash-collection analysis.* A static-pool cash-collection analysis involves reviewing monthly cash receipts relative to the principal balance of the pool to determine the cash yield on the portfolio, comparing the cash yield to the accrual yield, and tracking monthly changes. Management should compare monthly the timing and amount of cash flows received from the trust with those projected as part of the FAS 125 retained-interest valuation analysis. Some master-trust structures allow excess cash flow to be shared between series or pools. For revolving-asset trusts with this master-trust structure, management should perform a cash-collection analysis for each master-trust structure. These analyses are essential in assessing the actual performance of the portfolio in terms of default and prepayment rates. If cash receipts are less than those assumed in the original valuation of the retained interest, this analysis will provide management and the board with an early warning of possible problems with collections or extension practices, and impairment of the retained interest.
5. *Sensitivity analysis.* A sensitivity analysis measures the effect of changes in default rates, prepayment or payment rates, and dis-

count rates to assist management in establishing and validating the carrying value of the retained interest. Stress tests should be performed at least quarterly. Analyses should consider potential adverse trends and determine ''best,'' ''probable,'' and ''worst case'' scenarios for each event. Other factors that need to be considered are the impact of increased defaults on collections staffing, the timing of cash flows, spread-account capture triggers, overcollateralization triggers, and early-amortization triggers. An increase in defaults can result in higher than expected costs and a delay in cash flows, thus decreasing the value of the retained interests. Management should periodically quantify and document the potential impact to both earnings and capital, and report the results to the board of directors. Management should incorporate this analysis into their overall interest-rate risk measurement system.[7] Examiners will review the BO-conducted analysis and the volatility associated with retained interests when assessing the Sensitivity to Market Risk component rating (the ''S'' in the CAMELS rating system for banks or the ''M'' for the BHC rating system[8]).

6. *Statement of covenant compliance.* Ongoing compliance with deal-performance triggers as defined by the pooling and servicing agreements should be affirmed at least monthly. Performance triggers include early amortization, spread capture, changes to overcollateralization requirements, and events that would result in servicer removal.

2128.06.3 VALUATION AND MODELING PROCESSES

The method and key assumptions used to value the retained interests and servicing assets or liabilities must be reasonable and fully documented. The key assumptions in all valuation analyses include prepayment or payment rates, default rates, loss-severity factors, and discount rates. BOs are expected to take a logical and conservative approach when developing securitization assumptions and capitalizing future income flows. It is important that management quantifies the assumptions at least quarterly on a pool-by-pool basis and maintains supporting documentation for all changes to the assumptions as part of the valuation. Policies should define the acceptable reasons for changing assumptions and require appropriate management approval.

An exception to this pool-by-pool valuation analysis may be applied to revolving-asset trusts if the master-trust structure allows excess cash flows to be shared between series. In a master trust, each certificate of each series represents an undivided interest in all of the receivables in the trust. Therefore, valuations are appropriate at the master-trust level.

To determine the value of the retained interest at inception, and make appropriate adjustments going forward, the BO must implement a reasonable modeling process to comply with FAS 125. Management is expected to employ reasonable and conservative valuation assumptions and projections, and to maintain verifiable objective documentation of the fair value of the retained interest. Senior management is responsible for ensuring that the valuation model accurately reflects the cash flows according to the terms of the securitization's structure. For example, the model should account for any cash collateral or overcollateralization triggers, trust fees, and insurance payments if appropriate. The board and management are accountable for the model builders' possessing the necessary expertise and technical proficiency to perform the modeling process. Senior management should ensure that internal controls are in place to provide for the ongoing integrity of MIS associated with securitization activities.

As part of the modeling process, the risk-management function should ensure that periodic validations are performed to reduce vulnerability to model risk. Validation of the model includes testing the internal logic, ensuring empirical support for the model assumptions, and back-testing the models using actual cash flows on a pool-by-pool basis. The validation process should be documented to support conclusions. Senior management should ensure the validation process is independent from line management and from the modeling process. The audit scope should include procedures to ensure that the modeling process and validation mechanisms are both appropriate for the BO's circumstances and executed consistent with its asset securitization policy.

7. The Joint Agency Policy Statement on Interest-Rate Risk (see SR-96-13 and section 2127.0) advises institutions with a high level of exposure to interest-rate risk relative to capital that they will be directed to take corrective action.

8. See sections 4070.0 and 4070.1.

2128.06.4 USE OF OUTSIDE PARTIES

Third parties are often engaged to provide professional guidance and support regarding a BO's securitization activities, transactions, and valuing of retained interests. The use of outside resources does not relieve directors of their oversight responsibility, or relieve senior management of its responsibilities to provide supervision, monitoring, and oversight of securitization activities, particularly the management of the risks associated with retained interests. Management is expected to have the experience, knowledge, and abilities to discharge its duties and understand the nature and extent of the risks retained interests present, and to have the policies and procedures necessary to implement an effective risk-management system to control such risks. Management must have a full understanding of the valuation techniques employed, including the basis and reasonableness of underlying assumptions and projections.

2128.06.5 INTERNAL CONTROLS

Effective internal controls are essential to a BO's management of the risks associated with securitization. When properly designed and consistently enforced, a sound system of internal controls will help management safeguard the BO's resources; ensure that financial information and reports are reliable; and comply with contractual obligations, including securitization covenants. It will also reduce the possibility of significant errors and irregularities, and assist in their timely detection. Internal controls typically (1) limit authorities; (2) safeguard access to and use of records; (3) separate and rotate duties; and (4) ensure both regular and unscheduled reviews, including testing.

Operational and managerial standards have been established for internal control and information systems.[9] A system of internal controls should be maintained that is appropriate to the BO's size and the nature, scope, and risk of its activities.[10]

2128.06.6 AUDIT FUNCTION OR INTERNAL REVIEW

A BO's board of directors is responsible for ensuring that its audit staff or independent review function is competent regarding securitization activities. The audit function should perform periodic reviews of securitization activities, including transaction testing and verification, and report all findings to the board or appropriate board committee. The audit function also may be useful to senior management in identifying and measuring risk related to securitization activities. Principal audit targets should include compliance with securitization policies, operating and accounting procedures (FAS 125), deal covenants, and the accuracy of MIS and regulatory reports. The audit function also should confirm that the BO's regulatory reporting process is designed and managed to facilitate timely and accurate report filing. Furthermore, when a third party services loans, the auditors should perform an independent verification of the existence of the loans to ensure that balances reconcile to internal records.

2128.06.7 REGULATORY REPORTING OF RETAINED INTERESTS

The securitization and subsequent removal of assets from a BO's balance sheet requires additional reporting as part of the regulatoryreporting process. Common regulatory reporting errors stemming from securitization activities may include—

1. failure to include off-balance-sheet assets subject to recourse treatment when calculating risk-based capital ratios;
2. failure to recognize retained interests and retained subordinate security interests as a form of credit enhancement;
3. failure to report loans sold with recourse in the appropriate section of the regulatory report; and
4. overvaluing retained interests.

A BO's directors and senior management are responsible for the accuracy of its regulatory

9. See the safety-and-soundness standards for national banks at 12 CFR 30 (OCC), and for savings associations at 12 CFR 570 (OTS).

10. BOs that are subject to the requirements of FDIC regulation 12 CFR 363 should include an assessment of the effectiveness of internal controls over their asset securitization activities as part of management's report on the overall effectiveness of the system of internal controls over financial reporting. This assessment implicitly includes the internal controls over financial information that is included in regulatory reports.

reports. Because of the complexities associated with securitization accounting and risk-based capital treatment, attention should be directed to ensuring that personnel who prepare these reports maintain current knowledge of reporting rules and associated interpretations. This often will require ongoing support by qualified accounting and legal personnel.

2128.06.8 MARKET DISCIPLINE AND DISCLOSURES

Transparency through public disclosure is crucial to effective market discipline and can reinforce supervisory efforts to promote high standards in risk management. Timely and adequate information on the BO's asset securitization activities should be disclosed. The information in the disclosures should be comprehensive; however, the amount of disclosure that is appropriate will depend on the volume of securitizations and complexity of the BO. Well-informed investors, depositors, creditors, and other counterparties can provide a BO with strong incentives for maintaining sound risk-management systems and internal controls. Adequate disclosure allows market participants to better understand the BO's financial condition and apply market discipline, creating incentives to reduce inappropriate risk taking or inadequate risk-management practices. Examples of sound disclosures include—

1. accounting policies for measuring retained interests, including a discussion of the impact of key assumptions on the recorded value;
2. the process and methodology used to adjust the value of retained interests for changes in key assumptions;
3. risk characteristics, both quantitative and qualitative, of the underlying securitized assets;
4. the role of retained interests as credit enhancements to special-purpose entities and other securitization vehicles, including a discussion of techniques used for measuring credit risk; and
5. sensitivity analyses or stress testing conducted by the BO, showing the effect of changes in key assumptions on the fair value of retained interests.

2128.06.9 RISK-BASED CAPITAL FOR RECOURSE AND LOW-LEVEL-RECOURSE TRANSACTIONS

For regulatory purposes, recourse is generally defined as an arrangement in which an institution retains the risk of credit loss in connection with an asset transfer, if the risk of credit loss exceeds a pro rata share of its claim on the assets.[11] In addition to broad contractual language that may require the seller to support a securitization, recourse can arise from retained interests, retained subordinated security interests, the funding of cash-collateral accounts, or other forms of credit enhancements that place a BO's earnings and capital at risk. These enhancements should generally be *aggregated* to determine the extent of a BO's support of securitized assets. Although an asset securitization qualifies for sales treatment under GAAP, the underlying assets may still be subject to regulatory risk-based capital requirements. Assets sold with recourse should generally be risk-weighted as if they had not been sold.

Securitization transactions involving recourse may be eligible for "low-level-recourse" treatment.[12] Risk-based capital standards provide that the dollar amount of risk-based capital required for assets transferred with recourse should not exceed the maximum dollar amount for which a BO is contractually liable. The low-level-recourse treatment applies to transactions accounted for as sales under GAAP in which a BO contractually limits its recourse exposure to less than the full risk-based capital requirements for the assets transferred. Under the low-level-recourse principle, the BO holds capital on approximately a dollar-for-dollar basis up to the amount of the aggregate credit enhancements.

If a BO does not contractually limit the maximum amount of its recourse obligation, or if the amount of credit enhancement is greater than the risk-based capital requirement that would exist if the assets were not sold, the low-level-recourse treatment does not apply. Instead, the

11. See the risk-based capital treatment for sales with recourse at 12 CFR 3, appendix A, section (3)(b)(1)(iii) (OCC), and 12 CFR 567.6(a)(2)(i)(c) (OTS). For a further explanation of recourse, see the glossary of the call report instructions, "Sales of Assets for Risk-Based Capital Purposes."

12. See 60 *Fed. Reg.* 17986, April 10, 1995 (OCC); 60 *Fed. Reg.* 8177, February 13, 1995 (FRB); and 60 *Fed. Reg.* 15858, March 28,1995 (FDIC). The OTS low-level-recourse rule is found at 12 CFR 567.6(a)(2)(i)(c).

BO must hold risk-based capital against the securitized assets as if those assets had not been sold. Retained interests that lack objectively verifiable support or that fail to meet the supervisory standards set forth in this section will be classified as loss and disallowed as assets of the BO for regulatory capital purposes.

2128.06.10 CONCENTRATION LIMITS IMPOSED ON RETAINED INTERESTS

The creation of a retained interest (the debit) typically also results in an offsetting ''gain on sale'' (the credit), and thus generation of an asset. BOs that securitize high-yielding assets with long durations may create a retained-interest asset value that exceeds the risk-based capital charge that would be in place if it had not sold the assets (under the existing risk-based capital guidelines, capital is not required for the amount over 8 percent of the securitized assets). Serious problems can arise for those BOs that distribute contrived earnings only later to be faced with a downward valuation and charge-off of part or all of the retained interests.

As an example, a BO could sell $100 in subprime home equity loans and book a retained interest of $20 using liberal ''gain on sale'' assumptions. Under the current capital rules, the BO is required to hold approximately $8 in capital. This $8 is the current capital requirement if the loans were never removed from the balance sheet (8 percent of $100 = $8). However, the institution is still exposed to substantially all the credit risk, plus the additional risk to earnings and capital from the volatility of the retained interest. If the value of the retained interest decreases to $10 due to inaccurate assumptions or changes in market conditions, the $8 in capital is insufficient to cover the entire loss.

Normally, the sponsor will eventually receive any excess cash flow remaining from securitizations after investor interests have been met. However, recent experience has shown that retained interests are vulnerable to sudden and sizeable write-downs that can hinder a BO's access to the capital markets; damage its reputation in the marketplace; and, in some cases, threaten its solvency. A BO's board of directors and management is expected to develop and implement policies that limit the amount of retained interests that may be carried as a percentage of total equity capital, based on the results of their valuation and modeling processes. Well-constructed internal limits also lessen the incentives for a BO's personnel to engage in activities designed to generate near-term ''paper profits'' that may be at the expense of its long-term financial position and reputation.

2128.06.11 INSPECTION OBJECTIVES

1. To determine whether the BO's retained interests from asset securitization are properly documented, valued, and accounted for.
2. To verify that the amount of those retained interests not supported by adequate documentation has been charged off and that the involved assets are not used for risk-based calculation purposes.
3. To ascertain the existence of sound risk modeling, management information systems (MIS), and disclosure practices for asset securitization.
4. To obtain assurances that the board of directors and management oversee sound policies and internal controls concerning the recording and valuation of retained interests derived from asset securitization activities.
5. To determine if liquidity problems may arise as the result of an overdependence on asset securitization activities for day-to-day core funding.
6. To determine that sufficient capital is held commensurate with the risk exposures arising from recourse obligations generated by asset securitizations.
7. To determine whether there is an independent audit function that is capable of evaluating retained interests involving asset securitization activities.

2128.06.12 INSPECTION PROCEDURES

1. Determine the existence of independent risk-management processes and MIS, and whether they are being used to monitor securitization-pool performance on an aggregate and individual transaction level.
2. Review the MIS reports and determine whether the reports provide—
   a. securitization summaries for each transaction;
   b. performance reports by portfolio and specific product type;
   c. vintage analysis for each pool using monthly data;

   d. static-pool cash-collection analysis;
   e. sensitivity analysis; and
   f. a statement of covenant compliance.
3. Review the BO's valuation assumptions and modeling methodologies, and determine if they are conservative and being used to establish, evaluate, and adjust the carrying value of retained interests on a regular and timely basis.
4. Determine if audit or internal review staffs periodically review data integrity, model algorithms, key underlying assumptions, and the appropriateness of the valuation and modeling process for the securitized assets that the BO retains.
5. Review the risk-based capital calculations, and determine if they include recognition and reporting of any recourse obligation resulting from securitization activities.
6. Ascertain that internal limits govern the amount of retained interests held as a percentage of total equity capital.
7. Establish that an adequate liquidity contingency plan is in place and that it will be used in the event of market disruptions. Determine further whether liquidity problems may arise as the result of an overdependence on asset securitization activities for day-to-day core funding.
8. Determine whether consistent, conservative accounting practices are in place that satisfy the reporting requirements of regulatory supervisors, GAAP reporting requirements, and valuation assumptions and methods. Ascertain that adequate disclosures of asset securitization activities are made commensurate with the volume of securitizations and the complexities of the BO.
9. Establish that risk-exposure limits and requirements exist and are adhered to on an aggregate and individual transaction basis.

Subprime lending presents unique and significantly greater risk to banking organizations (BOs) associated with the activity,[1] raising issues about how well they are prepared to manage and control those risks. Subprime-lending institutions need strong risk-management practices and internal controls, as well as board-approved policies and procedures that appropriately identify, measure, monitor, and control all associated risks. BOs considering or engaging in this type of lending should recognize the additional risks inherent in this activity and determine if these risks are acceptable and controllable, given their organization's financial condition, asset size, level of capital support, and staff size.

In response to concerns about subprime lending, the statement Interagency Guidance on Subprime Lending was issued on March 1, 1999.[2] The statement's objective is to increase awareness among examiners and financial institutions of some of the pitfalls and hazards of this type of lending. (See SR-99-06.) Additional interagency examination guidance was issued on January 31, 2001, to further strengthen the supervision of certain institutions, primarily those institutions having subprime-lending programs with an aggregate credit exposure equaling or exceeding 25 percent of their tier 1 capital.[3] (See SR-01-04.) The aggregate credit exposure includes principal outstanding and committed, accrued and unpaid interest, and any retained residual interests[4] relating to securitized subprime loans. The Federal Reserve may also apply the additional guidelines to certain smaller subprime portfolios, such as those experiencing rapid growth or adverse performance trends, those administered by inexperienced management, and those with inadequate or weak controls. The subprime-lending policy statements are directed primarily to insured depository institutions and their subsidiaries. As such, the guidance applies to bank holding companies with regard to their oversight and supervision of insured depository institutions. Bank holding companies should also consider the statements' guidance as they supervise the lending activities of their nonbanking subsidiaries. Bank holding company examiners should consider this guidance in conjunction with the loan-administration and lending-standards inspection guidance in section 2010.2 and with the guidance for asset securitization in section 2128.02. The interagency subprime-lending policy statements are described below.

1. The term ''banking organizations'' refers to bank holding companies and their banking and nonbanking subsidiaries.
2. The statement was adopted and issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.
3. The March 1999 and January 2001 subprime-lending interagency guidance is consolidated within this section. To focus on the supervisory guidance that applies primarily to institutions having subprime-lending programs equaling or exceeding 25 percent of tier 1 capital, see the January 2001 release specifically. The March 1999 interagency supervisory guidance applies to all institutions that engage in subprime lending.
4. Residual interests are on-balance-sheet assets that represent interests (including beneficial interests) in transferred financial assets retained by a seller (or transferor) after a securitization or other transfer of financial assets. They are structured to absorb more than a pro rata share of credit loss related to the transferred assets through subordination provisions or other credit-enhancement techniques.

2128.08.1 INTERAGENCY GUIDANCE ON SUBPRIME LENDING

Insured depository institutions traditionally avoided lending to customers with poor credit histories because of the higher risk of default and resulting loan losses. However, some lenders[5] extend their risk-selection standards to attract lower-credit-quality accounts. Moreover, previous turmoil in the equity and asset-backed securities markets has caused some nonbank subprime specialists to exit the market, which created increased opportunities for financial institutions to enter, or expand their participation in, the subprime-lending business

The term ''subprime lending'' is defined for this statement as extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers.[6] Subprime borrowers represent a broad spectrum of debtors, ranging from those who have repayment problems because of an adverse event, such as job loss or medical emergency, to those who persistently mismanage their finances and debt obligations. Subprime borrowers typically have weakened credit histories that include payment delinquencies and possibly more severe problems, such as charge-offs, judgments, and bankruptcies. They

5. The terms ''lenders,'' ''financial institutions,'' and ''institutions'' refer to insured depository institutions and their subsidiaries.
6. For purposes of this statement, loans to customers who are not subprime borrowers are referred to as ''prime.''

may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories. Generally, subprime borrowers will display a range of one or more credit-risk characteristics, such as—

1. two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;
2. judgment, foreclosure, repossession, or charge-off in the prior 24 months;
3. bankruptcy in the last five years;
4. relatively high default probability as evidenced by, for example, a credit bureau risk score (FICO) of 660 or below (depending on the product or collateral), or by other bureau or proprietary scores with an equivalent default-probability likelihood; or
5. debt-service-to-income ratio of 50 percent or greater, or an otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

Subprime loans are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase.

This guidance applies to direct extensions of credit; the purchase of subprime loans from other lenders, including delinquent or credit-impaired loans purchased at a discount; the purchase of subprime automobile or other financing "paper" from lenders or dealers; and the purchase of loan companies that originate subprime loans. Subprime lending does not include loans to borrowers who have had minor, temporary credit difficulties but are now current. Also, the subprime-lending guidance does not generally apply 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; and community development loans as defined in the Community Reinvestment Act (CRA) regulations that may have some higher risk characteristics, but are otherwise mitigated by guarantees from government programs, private credit enhancements, or other appropriate risk-mitigation techniques.

Subprime loans command higher interest rates and loan fees than those offered to standard-risk borrowers. Subprime loans can be profitable, provided the price charged by the lender is sufficient to cover higher loan-loss rates and overhead costs related to underwriting, servicing, and collecting the loans. The ability to securitize and sell subprime portfolios at a profit while retaining the servicing rights has made subprime lending attractive to a larger number of institutions, further increasing the number of subprime lenders and loans. Some financial institutions have experienced losses attributable to ill-advised or poorly structured subprime-lending programs. The losses have attracted greater supervisory attention to subprime lending and the ability of an insured depository institution to manage the unique risks associated with this activity.

Institutions should recognize the additional risks inherent in subprime lending and determine if these risks are acceptable and controllable given the institution's staff, financial condition, size, and level of capital support. Institutions that engage in a small volume of subprime lending should have systems in place commensurate with their level of risk.

2128.08.1.1 Risk Management

The following items are essential components of a well-structured risk-management program for subprime lenders:

1. *Planning and strategy.* Before engaging in subprime lending, the board and management should ensure that proposed activities are consistent with the institution's overall business strategy and risk tolerances, and that all involved parties have properly acknowledged and addressed critical business risk issues. These issues include the costs associated with attracting and retaining qualified personnel, investments in the technology necessary to manage a more complex portfolio, a clear solicitation and origination strategy that allows for after-the-fact assessment of underwriting performance, and the establishment of appropriate feedback and control systems. The risk-assessment process should extend beyond credit risk and appropriately incorporate operating, compliance, and legal risks. Finally, the planning process should set clear objectives for performance, including the identification and segmentation of target markets or customers, as well as set performance expectations and benchmarks for each segment and the portfolio as a whole. Institutions establishing a subprime-lending program should proceed slowly and

cautiously into this activity to minimize the impact of unforeseen personnel, technology, or internal-control problems and to determine if favorable initial profitability estimates are realistic and sustainable.

2. *Staff expertise*. Subprime lending requires specialized knowledge and skills that many financial institutions may not possess. Marketing, account-origination, and collections strategies and techniques often differ from those employed for prime credit; thus, it may not be sufficient to have the same lending staff responsible for both subprime loans and other loans. Additionally, servicing and collecting subprime loans can be very labor intensive. If necessary, the institution should implement programs to train staff. The board should ensure that staff possess sufficient expertise to appropriately manage the risks in subprime lending and that staffing levels are adequate for the planned volume of subprime activity. The experience, or seasoning, of staff and loans should be taken into account as performance is assessed over time.
3. *Lending policy*. A subprime-lending policy should be appropriate to the size and complexity of the institution's operations and should clearly state the goals of the subprime-lending program. While not exhaustive, the following lending standards should be addressed in any subprime-lending policy:
   a. types of products offered as well as those that are not authorized
   b. portfolio targets and limits for each credit grade or class
   c. lending and investment authority clearly stated for individual officers, supervisors, and loan committees
   d. a framework for pricing decisions and profitability analysis that considers all costs associated with the loan, including origination costs, administrative or servicing costs, expected charge-offs, and capital
   e. evaluation of collateral and appraisal standards
   f. well-defined and specific underwriting parameters (that is, acceptable loan term, debt-to-income ratios, and loan-to-collateral-value ratios for each credit grade and a minimum acceptable credit score) that are consistent with any applicable supervisory guidelines[7]
   g. procedures for separate tracking and monitoring of loans approved as exceptions to stated policy guidelines
   h. credit-file documentation requirements, such as applications, offering sheets, loan and collateral documents, financial statements, credit reports, and credit memoranda to support the loan decision
   i. a correspondent/broker/dealer approval process, including measures to ensure that loans originated through this process meet the institution's lending standards

   If the institution elects to use credit scoring (including applications scoring) for approvals or pricing, the scoring model should be based on a development population that captures the behavioral and credit characteristics of the subprime population targeted for the products offered. Because of the significant variance in characteristics between the subprime and prime populations, institutions should not rely on models developed solely for products offered to prime borrowers. Further, the model should be reviewed frequently and updated as necessary to ensure that assumptions remain valid.
4. *Purchase evaluation*. As they evaluate expected profits, institutions that purchase subprime loans from other lenders or dealers must give due consideration to the cost of servicing these assets and to the loan losses that may be experienced. For instance, some lenders who sell subprime loans charge borrowers high up-front fees, which are usually financed into the loan. This provides an incentive for originators to produce a high volume of loans with little emphasis on quality, to the detriment of a potential purchaser. Further, subprime loans, especially those purchased from outside the institution's lending area, are at special risk for fraud or misrepresentation (that is, the quality of the loan may be less than the loan documents indicate).

   Institutions should perform a thorough due-diligence review before committing to purchase subprime loans. Institutions should not accept loans from originators that do not meet their underwriting criteria, and they should regularly review loans offered to ensure that loans purchased continue to meet

7. Extensions of credit secured by real estate, whether the credit is subprime or otherwise, are subject to the Interagency Guidelines for Real Estate Lending Policies, which establish supervisory loan-to-value (LTV) limits on various types of real estate loans and impose limits on an institution's aggregate investment in loans that exceed the supervisory LTV limits. (See 12 C.F.R. 208, appendix C.)

those criteria. Deterioration in the quality of purchased loans or in the portfolio's actual performance versus expectations requires a thorough reevaluation of the lenders or dealers who originated or sold the loans, as well as a reevaluation of the institution's criteria for underwriting loans and selecting dealers and lenders. Any such deterioration may also highlight the need to modify or terminate the correspondent relationship or to adjust underwriting and dealer or lender selection criteria.

5. *Loan-administration procedures*. After the loan is made or purchased, loan-administration procedures should provide for the diligent monitoring of loan performance and establish sound collection efforts. To minimize loan losses, successful subprime lenders have historically employed stronger collection efforts, such as calling delinquent borrowers frequently, investing in technology (for example, using automatic dialing for follow-up telephone calls on delinquent accounts), assigning more experienced collection personnel to seriously delinquent accounts, moving quickly to foreclose or repossess collateral, and allowing few loan extensions. This aspect of subprime lending is very labor intensive but critical to the program's success. To a large extent, the cost of such efforts can be a tradeoff with future loss expectations, when an institution analyzes the profitability of subprime lending and assesses its appetite to expand or continue this line of business. Subprime-loan-administration procedures should be in writing and at a minimum should detail—
   a. billing and statement procedures;
   b. collection procedures;
   c. content, format, and frequency of management reports;
   d. asset-classification criteria;
   e. methodology to evaluate the adequacy of the allowance for loan and lease losses (ALLL);
   f. criteria for allowing loan extensions, deferrals, and re-agings;
   g. foreclosure and repossession policies and procedures; and
   h. loss-recognition policies and procedures.
6. *Loan review and monitoring*. Once an institution books the loans, designated staff must perform an ongoing analysis of subprime loans, not only on an aggregate basis but also for subportfolios. Information systems should be in place to segment and stratify the institution's portfolio (for example, by originator, loan-to-value, debt-to-income ratios, or credit scores), and assigned staff should produce reports that management can use to evaluate the performance of subprime loans. The review process should focus on whether performance meets expectations. Institutions then need to consider the source and characteristics of loans that do not meet expectations and make changes in their underwriting policies and loan-administration procedures to restore performance to acceptable levels.

   When evaluating actual performance against expectations, it is particularly important that management review credit scoring, pricing, and ALLL-adequacy models. Models driven by the volume and severity of historical losses experienced during an economic expansion may have little relevance in an economic slowdown, particularly in the subprime market. Management should ensure that models used to estimate credit losses or to set pricing allow for fluctuations in the economic cycle and are adjusted to account for other unexpected events.
7. *Consumer protection*. Institutions that originate or purchase subprime loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Higher fees and interest rates combined with compensation incentives can foster predatory pricing or discriminatory "steering" of borrowers to subprime products for reasons other than the borrower's underlying creditworthiness. An adequate compliance-management program must identify, monitor, and control the consumer protection hazards associated with subprime lending.

   Subprime mortgage lending may trigger the special protections of the Home Ownership and Equity Protection Act of 1994, subtitle B of title I of the Riegle Community Development and Regulatory Improvement Act of 1994. This act amended the Truth in Lending Act to provide certain consumer protections in transactions involving a class of nonpurchase, closed-end home mortgage loans. Institutions engaging in this type of lending must also be thoroughly familiar with the obligations set forth in Regulation Z (12 C.F.R. 226.32), Regulation X, and the Real Estate Settlement Procedures Act (RESPA) (12 U.S.C. 2601) and should adopt policies and implement practices that ensure compliance.

   The Equal Credit Opportunity Act makes it unlawful for a creditor to discriminate against an applicant on a prohibited basis regarding any aspect of a credit transaction. Similarly, the Fair Housing Act prohibits discrimination in connection with residential real estate–related transactions. Loan officers and brokers must treat all similarly situated applicants equally and without regard to any prohibited-basis characteristic (for example, race, sex, or age). This is especially important with respect to how loan officers or brokers assist customers in preparing their applications or otherwise help them to qualify for loan approval.

8. *Securitization and sale*. To increase their loan-production and -servicing income, some subprime lenders originate loans and then securitize and sell them in the asset-backed securities market. Strong demand from investors and favorable accounting rules often allow securitization pools to be sold at a gain, providing further incentive for lenders to expand their subprime-lending program. However, the securitization of subprime loans carries inherent risks, including interim credit risk and liquidity risk, that are potentially greater than those for securitizing prime loans. Accounting for the sale of subprime pools requires assumptions that can be difficult to quantify, and erroneous assumptions could lead to the significant overstatement of an institution's assets. Moreover, the practice of providing support and substituting performing loans for nonperforming loans to maintain the desired level of performance on securitized pools has the effect of masking credit-quality problems.

   Institutions should recognize the volatility of the secondary market for subprime loans and the significant liquidity risk incurred when originating a large volume of loans intended for securitization and sale. Investors can quickly lose their appetite for risk in an economic downturn or when financial markets become volatile. As a result, institutions that have originated, but have not yet sold, pools of subprime loans may be forced to sell the pools at deep discounts. If an institution lacks adequate personnel, risk-management procedures, or capital support to hold subprime loans originally intended for sale, these loans may strain an institution's liquidity, asset quality, earnings, and capital. Consequently, institutions actively involved in the securitization and sale of subprime loans should develop a contingency plan that addresses back-up purchasers of the securities or the attendant servicing functions, alternate funding sources, and measures for raising additional capital.

   Institutions should refer to the Statement of Financial Accounting Standards No. 140 (FAS 140), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," for guidance on accounting for these transactions. If a securitization transaction meets FAS 140 sale or servicing criteria, the seller must recognize any gain or loss on the sale of the pool immediately and carry any retained interests in the assets sold (including servicing rights/obligations and interest-only strips) at fair value. Management should ensure that the key assumptions used to value these retained interests are reasonable and well supported, both for the initial valuation and for subsequent quarterly revaluations. In particular, management should consider the appropriate discount rates, credit-loss rates, and prepayment rates associated with subprime pools when valuing these assets. Since the relative importance of each assumption varies with the underlying characteristics of the product types, management should segment securitized assets by specific pool, as well as by predominant risk and cash-flow characteristics, when making the underlying valuation assumptions. In all cases, however, institutions should take a conservative approach when developing securitization assumptions and capitalizing expected future income from subprime lending pools. Institutions should also consult with their auditors as necessary to ensure their accounting for securitizations is accurate.

9. *Reevaluation*. Institutions should periodically evaluate whether the subprime-lending program has met profitability, risk, and performance goals. Whenever the program falls short of original objectives, an analysis should be performed to determine the cause, and the program should be modified appropriately. If the program falls far short of the institution's expectations, management should consider terminating it. Questions that management and the board need to ask may include the following:
   a. Have cost and profit projections been met?
   b. Have projected loss estimates been accurate?
   c. Has the institution been called upon to provide support to enhance the quality

and performance of loan pools it has securitized?

d. Were the risks inherent in subprime lending properly identified, measured, monitored, and controlled?

e. Has the program met the credit needs of the community that it was designed to address?

2128.08.1.2 Examination Review and Analysis

The following supervisory guidance (up to the inspection objectives) applies only to the examination of a bank holding company's federally insured subsidiary banks that have subprime-lending programs equaling or exceeding 25 percent of tier 1 capital and to those insured banks that have other designated subprime programs referenced in SR-01-4.

The heightened risk levels and potential volatility in delinquency and loss rates posed by subprime-lending programs warrant examiners' increased ongoing attention. The risks inherent in subprime-lending programs call for frequent reviews. There are generally two levels of review appropriate for subprime activities:

1. *Portfolio-level reviews* include assessments of underwriting standards, marketing practices, pricing, management information and control systems (quality control, audit and loan review, vendor management, compliance), portfolio performance, and the appropriate application of regulatory and internal allowance and capital policies.
2. *Transaction-level testing* includes the testing of individual loans for compliance with underwriting and loan-administration guidelines; the appropriate treatment of loans under delinquency, re-aging, and cure programs; and the appropriate application of regulatory and internal allowance and capital policies.

Examiners should perform a portfolio-level review and some transaction testing at each institution engaged in subprime lending, during each regularly scheduled examination cycle. The Federal Reserve will perform regular off-site supervisory monitoring and may require subprime lenders to supply supplementary information about their subprime portfolios between examinations. The examiner's findings from transaction-level testing and portfolio-level reviews should be incorporated into the conclusions about overall asset quality, the adequacy of the ALLL and capital, and the adequacy of portfolio risk-management practices.

2128.08.1.2.1 Transaction-Level Testing

Subprime-loan portfolios contain elevated risks, and actual subprime-lending practices often can deviate from stated policy and procedural guidance. Therefore, examiners should supplement the portfolio-level examination procedures with transaction-level testing to determine whether—

1. individual loans adhere to existing policy, underwriting, risk-selection, and pricing standards;
2. individual loans and portfolios are classified in accordance with the subprime-lending guidelines described in this section, or in other Federal Reserve credit-extending supervisory guidance;
3. management, board, and regulatory reporting is accurate and timely;
4. existing loans conform to specified account-management standards (such as over-limits, line increases, reductions, cancellations, re-scoring, or collections);
5. key risk controls and control processes are adequate and functioning as intended;
6. roll rates and other loss-forecasting methods used to determine ALLL levels are accurate and reliable; and
7. lending practices exist that may appear unsafe, unsound, or abusive and unfair.

2128.08.1.3 Adequacy of the ALLL

Examiners should assess the adequacy of the ALLL to ensure that the portion allocated to the subprime portfolio is sufficient to absorb estimated credit losses for this portfolio. Consistent with interagency policy,[8] the term "estimated credit losses" means an estimate of the amount that is not likely to be collected; that is, net charge-offs that are likely to be realized given the facts and circumstances as of the evaluation date.[9] These estimated losses should meet the

8. The Interagency Policy Statement on the Allowance for Loan and Lease Losses was issued December 21, 1993, and the ALLL methodologies and documentation standards were issued July 2, 2001.

9. Estimates of credit losses should include accrued interest and other accrued fees (for example, uncollected credit card fees or uncollected late fees) that have been added to the

criteria for accrual of loss contingency, as set forth under generally accepted accounting principles (GAAP), consistent with supervisory ALLL policy.

2128.08.1.3.1 New Entrants to the Business

In some instances, an institution (for example, a newly chartered institution or an existing institution entering the subprime-lending business) may not have sufficient previous loss experience to estimate an allowance for subprime-lending activities. In such cases, industry statistics or another institution's loss data for similar loans may be a better starting point to determine the ALLL than the institution's own data for developing loss rates. When an institution uses loss rates developed from industry statistics or from other institutions to determine its ALLL, it should demonstrate and document that the attributes of the loans in its portfolio or portfolio segment are similar to those in the other institution's (or industry's) portfolio.

2128.08.1.3.2 Pools of Subprime Loans—Not Classified

The ALLL required for subprime loans should be sufficient to absorb at least all estimated credit losses on outstanding balances over the current operating cycle, typically 12 months. The board of directors and management are expected to ensure that the institution's process for determining an adequate level for the ALLL is based on a comprehensive and adequately documented analysis of all significant factors. The consideration factors should include historical loss experience, ratio analysis, peer-group analysis, and other quantitative analysis as a basis for the reasonableness of the ALLL. 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. The allowance should represent a prudent, conservative estimate of losses that allows a reasonable margin for imprecision. Institutions should clearly document loss estimates and the allowance methodology in writing. This documentation should describe the analytical process used, including—

1. portfolio-segmentation methods applied;
2. loss-forecasting techniques and assumptions employed;
3. definitions of terms used in ratios and model computations;
4. relevance of the baseline loss information used;
5. rationale for adjustments to historical experience; and
6. a reconciliation of forecasted loss rates to actual loss rates, with significant variances explained.

2128.08.1.4 Classification Guidelines for Subprime Lending

Well-managed subprime lenders should recognize the heightened loss characteristics in their portfolios and internally classify their delinquent accounts well before the time frames outlined in the retail classification policy issued by the Federal Financial Institutions Examination Council (FFIEC) on June 12, 2000. Examiners should classify subprime loans and portfolios in accordance with the guidelines in this section and other applicable Federal Reserve supervisory guidelines. Classified loans are loans that are not protected adequately by the current sound worth and paying capacity of the borrower or the collateral pledged. As such, full liquidation of the debt may be in jeopardy. Pools of 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.

2128.08.1.4.1 Individual Loans

Examiners should not automatically classify or place loans in special mention merely because they are subprime. Rather, classifications should

loan balances and, as a result, that are reported as part of the institution's loans on the balance sheet. An institution may include these types of estimated losses in either the ALLL or a separate valuation allowance, which would be netted against the aggregated loan balance for regulatory reporting purposes. When accrued interest and other accrued fees are not added to the loan balances and are not reported as part of loans on the balance sheet, the collectibility of these accrued amounts should nevertheless be evaluated to ensure that the institution's income is not overstated.

reflect the borrower's capacity and willingness to repay and the adequacy of collateral pledged. Loans to borrowers that do not have the capacity to service their loans generally will be classified substandard. When repayment capacity is insufficient to support the orderly liquidation of the debt, and the collateral pledged is insufficient to mitigate risk of loss, then a more severe classification and nonaccrual is warranted. Subprime loans that are past due 90 days or more should be classified at least substandard based on a reasonable presumption that their past-due status indicates an inadequate capacity or unwillingness to repay. A more stringent classification approach may be appropriate based on the historical loss experience of a particular institution. Classification of other subprime loans as doubtful or loss will be based on examiners' analysis of the borrower's capacity to repay, and on the quality of institution underwriting and account-management practices as evidenced in the loan file or by other documentation.

In some cases, the repayment of principal, interest, and fees on some subprime loans may be overly dependent on collateral pledged. This occurs when the risk of default is so high that an abundance of collateral is taken to mitigate risk of loss in the event of default. From a safety-and-soundness perspective, institutions should be discouraged from lending solely on the basis of collateral pledged. Such loans will generally be classified substandard. Further, when the borrower does not demonstrate the capacity to service the loan from sources other than collateral pledged, the loan may be placed on nonaccrual.

2128.08.1.4.2 Portfolios

When the portfolio review or loan sample indicates serious concerns with credit-risk selection practices, underwriting standards, or loan quality, examiners should consider classifying or criticizing the entire portfolio or segments of the portfolio. Such a decision may be appropriate in cases where risk is inordinately high or delinquency reports reflect performance problems. Some subprime-lending portfolios may pose very high risk. These may include portfolios of unsecured loans or secured, high loan-to-value loans to borrowers who clearly exhibit inadequate capacity to repay the debt in a reasonable time frame. Most such portfolios should be classified at least substandard.

2128.08.1.5 Required Documentation for Cure Programs

Cure programs, including such practices as re-aging, extensions, renewals, rewrites, or other types of account restructuring, are subject to the standards outlined in the retail classification policy. In accordance with that policy, cure programs should be used only when the institution has substantiated the customer's renewed willingness and ability to repay. Examiners will expect institutions to maintain documentation supporting their analysis of the customer's renewed ability and willingness to repay the loan at the time it is extended, renewed, or deferred. When the institution cannot demonstrate both the willingness and ability of the customer to repay, the loan should not be renewed, extended, deferred, or rewritten, and the loan should be moved back to its pre-cure delinquency status. Documentation should include one or more of the following:

1. a new verification of employment
2. a recomputed debt-to-income ratio indicating sufficient improvement in the borrower's financial condition to support orderly repayment
3. a refreshed credit score or updated bureau report
4. a file memo evidencing discussion with the customer

When documentation of the customer's renewed willingness and ability to repay the loan is absent or deficient, management practices should be criticized.

2128.08.1.6 Predatory or Abusive Lending Practices

The term ''subprime'' is often misused to refer to certain predatory or abusive lending practices. Lending practices can be designed to responsibly provide service to customers and enhance credit access for borrowers with special credit needs. Subprime lending that is appropriately underwritten, priced, and administered can serve these goals.

Some forms of subprime lending may be abusive or predatory, however. Lending practices may be designed to transfer wealth from the borrower to the lender or loan originator without a commensurate exchange of value. This is sometimes accomplished when the lender structures a loan to a borrower who has little or no ability to repay the loan from sources other than the collateral pledged. When default occurs, the lender forecloses or otherwise takes possession of the borrower's property (generally the borrower's home or automobile). In other cases, the lender may use the threat of foreclosure or repossession to induce duress on the borrower for payment. Typically, predatory lending involves at least one, and perhaps all three, of the following elements:

1. making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation
2. inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced (that is, ''loan flipping'')
3. engaging in fraud or deception to conceal the true nature of the loan obligation or ancillary products from an unsuspecting or unsophisticated borrower

Loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound. Such lending practices should be criticized in the examination report as imprudent. Further, examiners should refer any loans with the aforementioned characteristics to Federal Reserve consumer compliance/fair lending specialists for additional review.

2128.08.1.7 Capitalization

The Federal Reserve's minimum capital requirements generally apply to portfolios that exhibit substantially lower risk profiles than those that exist in subprime-loan programs. Therefore, these requirements may not be sufficient to reflect the risks associated with subprime portfolios.

Subprime-lending activities can present a greater-than-normal risk for financial institutions and the deposit insurance funds; therefore, the level of capital institutions need to support this activity should be commensurate with the additional risks incurred. 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.

The amount of additional capital necessary will vary according to the volume and type of subprime activities conducted and the adequacy of the institution's risk-management program. An institution's overall capital adequacy will be evaluated on a case-by-case basis through on-site examinations and off-site monitoring procedures, considering, among other factors, the institution's own documented analysis of the capital needed to support subprime lending. Institutions that are determined to have insufficient capital must correct the deficiency within a reasonable time frame or be subject to supervisory action. In light of the higher risks associated with this type of lending, higher minimum-capital requirements may be imposed on institutions engaging in subprime lending.

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:

1. portfolio-growth rates
2. trends in the level and volatility of expected losses
3. the level of subprime-loan losses incurred over one or more economic downturns, if such data or analyses are available
4. 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
5. any deterioration in the average credit quality over time due to adverse selection or retention
6. the amount, quality, and liquidity of collateral securing the individual loans
7. any asset, income, or funding-source concentrations
8. the degree of concentration of subprime credits
9. the extent to which current capitalization consists of residual assets or other potentially volatile components
10. the degree of legal or reputation risk associated with the subprime business lines pursued
11. 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 on the amount, quality, and liquidity of collateral securing the loans. Institutions 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 with prime loans, and they 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 percent of the loans outstanding, depending on the level and volatility of risk.

2128.08.1.7.1 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. Stress tests 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-market 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, it is expected that—

1. the process is clearly documented, rational, and easily understood by the institution's board and senior management;
2. the inputs are reliable and relate directly to the subject portfolios (for example, baseline loss history or default probabilities should reflect each segment of the institution's portfolio and not just a blend of prime and subprime borrowers);
3. assumptions are well documented and conservative; and
4. 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 programs 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 Reserve Bank supervisory official to determine the appropriate course of action. Such actions may include requiring additional capital in accordance with the Federal Reserve's capital adequacy rules or requiring the institution to submit an acceptable capital plan in accordance with safety-and-soundness guidelines.

2128.08.1.8 Subprime-Lending Examiner Responsibilities

Using the interagency guidance and any supplemental Federal Reserve guidelines, examiners should assess carefully management's ability to administer the higher risk in subprime portfolios. The examiner should judge management's ability to manage the risk involved in the subprime-lending program, in particular, the quality of the risk-management and control processes in place, and more importantly, the extent to which management is adhering to those processes. When examiners determine that risk-management practices are deficient, they should criticize management and initiate corrective action. Such actions may include formal or informal enforcement actions or a plan to achieve adequate capitalization. When a primary supervisor determines that an institution's risk-management practices are materially deficient, the primary supervisor may instruct the institution to discontinue its subprime-lending programs.

2128.08.1.9 Appendix—Questions and Answers for Examiners Regarding the Expanded Guidance for Subprime-Lending Programs

To assist examiners who review subprime-lending activities, the following questions and answers were developed to provide additional guidance on the expanded interagency guidance that was issued on January 31, 2001.

2128.08.1.9.1 Applicability of the Guidance

Question 1: Does the guidance apply to all institutions?

No. The guidance will not affect the vast majority of insured institutions engaged in traditional consumer lending. The guidance applies to institutions that systematically target the subprime market through programs that employ tailored marketing, underwriting standards, and risk selection.

The guidance does not address traditional consumer lending that has historically been the mainstay of community banking. It does not apply to institutions extending credit to subprime borrowers as part of their standard community-lending process, or making loans to subprime borrowers as an occasional exception to a prime-lending program, even if the aggregate of these loans totals more than 25 percent of tier 1 capital. Such institutions continue to be subject to the normal supervisory process.

Institutions engaging in subprime-lending programs generally have knowingly and purposefully focused on the subprime-lending markets through planned business strategies, tailored products, and explicit borrower targeting. In instances where significant exposures to subprime borrowers are identified, examiners should consider the institution's marketing program, loan products, pricing, underwriting standards and practices, and portfolio performance to determine if the institution has a program that warrants the supervision and safeguards outlined in the guidance.

Question 2: Does the guidance apply when an institution offers a product that attracts a disproportionate number of subprime borrowers, but which the institution does not explicitly identify as subprime?

A subprime program commonly features products specifically tailored to borrowers with weakened credit histories. Such products often differ substantially in pricing and terms from products offered to prime borrowers, and they usually have separate and distinctly different underwriting standards. An institution offering a product that attracts a disproportionate number of borrowers with weakened credit histories likely has a subprime program whether or not the activity is called a subprime program. The guidance will apply to these programs when the resultant aggregate credit exposure is at least 25 percent of the institution's tier 1 capital.

Institutions with significant programs are expected to have the necessary risk-management and internal-control systems in place to properly identify, measure, monitor, and control the inherent risks in their subprime portfolios. Risk management and controls for these programs typically involve enhanced performance monitoring, intensive collection activities, and other loss-mitigation strategies. If an institution systematically targets the subprime market but does not segregate these loans from its prime portfolio, it is doubtful that the institution has the necessary risk-management and control systems in place to safely engage in the activity.

2128.08.1.9.2 Subprime Characteristics

Question 3: Why does the Expanded Guidance for Subprime Lending Programs use a credit bureau risk score (FICO) of 660 as a cutoff point for subprime lending?

The guidance does not use credit scores, or any other single risk factor, as a definitive cutoff point for subprime lending. The characteristics listed are not explicit, bright-line definitions. The range of credit characteristics used to describe subprime borrowers is intended to help examiners identify lenders that are engaged in subprime-lending programs. These characteristics describe borrowers with varying, but significantly higher, probabilities of default than prime borrowers. The guidance states that ''this list is illustrative rather than exhaustive and is not meant to define specific parameters for all borrowers.''

A credit bureau score of 660 (FICO) is used only as an example to illustrate a credit score that generally indicates a higher default probability. The guidance indicates the probability of default, as evidenced by the credit score, will vary by product and collateral. The subprime guidance lists several characteristics that denote a higher probability of default. Examiners are directed to use these characteristics as a starting point to expand their review of lending programs targeting subprime borrowers in accordance with risk-focused examination procedures. The severity of risk may vary significantly for the different characteristics listed, as well as for the type and quality of collateral. Examiners should take this into consideration when reviewing the portfolio and determining the adequacy of loan-loss reserves and capital.

The characteristics used in the guidance are well recognized in the investment and lending industries. A number of public debt rating agencies and financial institutions, including the government-sponsored enterprises (GSEs), use similar credit characteristics to differentiate risk among borrowers. Specific examples include the following:

1. Fitch defines a subprime borrower as ‘‘...one with a credit profile worse than that of a prime A quality borrower, whose credit report would typically reveal no recent mortgage delinquencies and whose credit profile would yield a credit score in the range above 680.’’ Fitch’s mortgage credit grade matrix lists the following credit-history elements for A- the highest subprime grade: one 30-day delinquency in the last 12 months on a mortgage debt; one 30-day delinquency in the last 24 months on installment debt, or two 30-day delinquencies in the last 24 months on revolving debt; bankruptcy in past five years; chargeoff or judgments exceeding $500 in the past 24 months; and/or a debt-to-income ratio of 45 percent.[10]
2. Standard & Poor’s subprime-mortgage underwriting guidelines define subprime A- characteristics as two or more 30-day delinquencies on mortgage and consumer credit, one 60-day delinquency on consumer credit, debt-to-income ratio of 45 percent, and no bankruptcy in the past five years. Standard & Poor’s also ‘‘...considers subprime borrowers to have a FICO credit score of 659 or below.’’[11]
3. Standard & Poor’s has classified nonprime B auto securitization pools as having occasional delinquencies and minor charge-offs on revolving debt, static pool net losses of 3.1 percent to 7.5 percent, and FICO credit scores ranging from 620–679.[12]
4. Freddie Mac has used the FICO score of 660 or below to designate higher-risk borrowers requiring more comprehensive review. Freddie Mac views a score in the 620–660 range as an indication that the ‘‘borrower’s willingness to repay debt as agreed is uncertain.’’ FICO scores below 620 are placed in the ‘‘cautious-review category,’’ and Freddie Mac considers scores below 620 ‘‘as a strong indication that the borrower’s credit reputation is not acceptable...’’[13]

2128.08.1.9.3 Capital Guidance

Question 4: If an institution is engaged in subprime lending as described by the guidance, does the 1.5-to-3-times capital described in the guidance automatically apply?

No. The expanded interagency guidance on subprime lending is flexible examination guidance; the capital range does not automatically apply because the guidance is not a capital rule or regulation. Rather, the guidance describes an expectation that subprime lenders hold sufficient loan-loss reserves and capital to offset the additional risks that may exist in subprime activities. The agencies expect institutions to have methodologies and analyses in place to support and document the level of reserves and capital needed for the additional risks assumed. The higher the risk, the more reserves and capital needed to support the activity. Institutions with lower-risk subprime portfolios may not need additional reserves and capital. In addition, examiners are reminded that subprime lending is only one element in the evaluation of the institution’s overall capital adequacy. If the analysis shows that the institution has adequate capital for all its assets and activities, including subprime lending, there is no additional capital requirement arising from the guidance.

Examiners are instructed not to unilaterally require additional reserves and capital based on the guidance. Any determination made by an examiner that an institution’s reserves or capital are deficient will be discussed with the institu-

10. Fitch IBCA, Duff & Phelps, ‘‘Rating U.S. Residential Subprime Mortgage Securities,’’ March 16, 2001: 2.

11. Standard & Poor’s, ‘‘U.S. Residential Subprime Mortgage Criteria,’’ Structured Finance, 1999: 12, 169.

12. Standard & Poor’s, ‘‘Auto Loan Criteria and Market Overview 1998,’’ Structured Finance Ratings Asset-Backed Securities, 6.

13. Freddie Mac, Single-Family Seller/Servicer Guide, chapter 37, section 37.6, ‘‘Using FICO Scores in Underwriting,’’ March 7, 2001.

tion's management and with each agency's appropriate supervisory office before a final decision is made.

Question 5: Are the regulatory expectations for higher capital levels consistent with capital levels supporting subprime assets outside the insured banking industry?

Yes. The regulatory expectations of higher capital maintenance are consistent with expectations in the capital markets. The 1.5-to-3-times-capital multiple is risk based, for example, the level of additional capital varies by relative loan quality and is applied only to the subprime portfolio, not the institution's entire asset structure. This is consistent with the financial marketplace's assessment of relative risk in subprime assets outside the banking industry. For example, the amount of credit enhancement required for subprime securitization structures varies according to the level and volatility of perceived credit risk in the underlying assets. In addition, publicly traded subprime-finance companies (that are not currently suffering from adverse ratings) maintain equity-capital-to-managed-asset ratios that are 1.5 to as much as 6 times (depending on loan type and relative quality) those of finance companies that do not specialize in subprime loans.

2128.08.2 INSPECTION OBJECTIVES

1. To assess and evaluate the extent of subprime-lending activities; whether management has adequately planned for these activities; and whether management has developed and maintains board-approved policies and procedures, systems, and internal controls that identify, measure, monitor, and control the additional risks in a manner that is commensurate with the risks associated with the subprime-lending program.
2. To conduct portfolio-level reviews and transaction-level testing of the subprime-lending activities, assessing the quality and performance of the subprime-loan portfolios and subprime-lending program, including its profitability, delinquency, and potential and actual loss experience.
3. To assess the adequacy of the ALLL for the subprime-loan portfolio.

2128.08.3 INSPECTION PROCEDURES

1. Determine whether the subprime-lending activities are consistent with the bank holding company's overall business strategy and risk tolerances, and that critical business risks have been identified and considered.
2. Assess whether the bank holding company has the financial capacity, including capital adequacy, to conduct the high-risk activity of subprime lending safely, without any undue concentrations of credit.
3. Ascertain if management has committed the necessary resources, including, in particular, technology and skilled personnel, to manage and control the risks associated with the volume and complexity of the bank holding company's subprime-lending programs.
4. Determine whether the bank holding company's contingency plans (including those of its banking and nonbanking subsidiaries) are adequate to address alternative funding sources, including back-up purchasers of any subprime loan–backed securities issued by the bank holding company or of the attendant servicing functions, and methods of raising additional capital during an economic downturn or when financial markets become volatile.
5. Determine if management has established adequate lending standards that are appropriate for the size and complexity of the bank holding company's operations, including those of its subsidiaries, and if management is maintaining proper controls over the program. (See in section 2128.08.1.1 for the lending standards that should be included in the subprime-loan program.)
6. Incorporate the results of the loan-administration portfolio-level and transaction-level testing reviews into the conclusions about overall asset quality, the adequacy of the ALLL and capital, and the adequacy of portfolio risk-management practices.
7. Review securitization transactions for compliance with FAS 140 and this guidance, including whether the bank holding company and its subsidiaries have provided any support to maintain the credit quality of loan pools they have securitized.
8. Evaluate the ALLL and regulatory capital allocated to support subprime-lending programs, including whether the total protection for subprime-asset programs and the levels for each component are adequate.
9. Ascertain that a sound risk-management program exists that includes the ability of

management to determine and quantify appropriate levels for each component of the program.

10. Evaluate the bank holding company's documented analysis of the capital needed to support its subprime-lending activities. Ascertain whether the capital levels are risk sensitive, that is, does allocated capital reflect the level and variability of loss estimates within reasonably conservative parameters? Determine if there is a direct link between the expected loss rates used to determine the required ALLL and the unexpected loss estimates used to determine capital. Document and reference the bank holding company's overall subprime capital evaluation in the inspection comments and conclusions regarding capital adequacy.
11. Analyze the performance of the subprime-lending program, including its profitability, delinquency, and loss experience.
12. Consider management's response to adverse performance trends, such as higher-than-expected prepayments, delinquencies, charge-offs, customer complaints, and expenses.
13. Determine if the bank holding company's subprime-lending program effectively manages the credit, market, liquidity, reputational, operational, and legal risks associated with subprime-lending operations.
14. Classify loans of the parent bank holding company and its nonbank subsidiaries according to the following criteria:
    a. Classify as substandard loans to borrowers that do not have the capacity to service their loans.
    b. Classify as at least substandard subprime loans that are 90 days or more past due based on a reasonable presumption that their past-due status indicates an inadequate capacity or unwillingness to repay.
    c. Consider classifying or criticizing the entire portfolio or segments of the portfolio when the portfolio review or loan sample indicates serious concerns with credit-risk-selection practices, underwriting standards, or loan quality.
    d. Classify as substandard high-risk unsecured loan portfolios or secured high loan-to-value loans to borrowers who clearly exhibit inadequate capacity to repay the debt in a reasonable time frame.
15. Report as unsafe and unsound imprudent loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the pledged collateral.
16. Carefully assess the ability of the parent bank holding company's board of directors and management to oversee and administer the higher risk in subprime portfolios, including those of its nonbank subsidiaries. If risk-management practices are deficient, criticize management and reach specific agreements with the board of directors and senior management to initiate corrective action.

Banking organizations must establish and maintain sound risk-management policies and procedures and effective internal controls over their use of credit derivatives. Credit derivatives are off-balance-sheet financial instruments that are used to assume or lay off credit risk on loans and other assets, some only to a limited extent. They allow one party (the beneficiary) to transfer the credit risk of a ‘‘reference asset,’’ which it often actually owns, to another party (the guarantor).[1] This arrangement allows the guarantor party to assume the credit risk associated with the reference asset without directly purchasing it. Unlike traditional guarantee arrangements, credit-derivative transactions often are documented using master agreements developed by the International Swaps and Derivatives Association (ISDA) that are similar to those governing swaps or options. Since credit derivatives are privately negotiated financial contracts, they expose the user to credit risk as well as liquidity risk (thin secondary market for credit derivatives), operational risk (instruments used for speculation rather than hedging), counterparty risk (default), and legal risk (the contracts may be deemed illegal).

Banking organizations use credit-derivative instruments either as end-users, purchasing credit protection from or providing credit protection to third parties, or as dealers intermediating such protection. Credit derivatives are used to manage overall credit-risk exposure. A banking organization may use credit derivatives to mitigate its concentration to a particular borrower or industry without severing the customer relationship. In addition, organizations that are approaching established in-house limits on counterparty credit exposure could continue to originate loans to a particular industry, using credit derivatives to transfer the credit risk to a third party.

Banking organizations may also use credit derivatives to diversify their portfolios by assuming the associated credit exposures and revenue returns to different borrowers or industries without actually purchasing the underlying assets. Nonbank companies may serve as counterparties to credit-derivative transactions with banks to gain access to the commercial bank loan market. Such entities may not lend or may not have the facilities or staff to adequately administer a loan portfolio.

Under some credit-derivative arrangements, a beneficiary may pay a fee to the guarantor in exchange for a guarantee against any loss that may occur, usually in excess of a prespecified amount, if the reference asset defaults (a ‘‘credit-default swap’’). Alternatively, the beneficiary may pay the total return on a reference asset, including any appreciation in the asset’s price, to a guarantor in exchange for a spread over funding costs plus any depreciation in the value of the reference asset (a ‘‘total-rate-of-return swap’’).

Credit derivatives and their market are likely to take on various forms, such as the market for put options on specific corporate bonds or loans. While the payoffs of these puts are expressed in terms of a strike price, rather than a default event, if the strike price is sufficiently high, credit risk effectively could be transferred from the buyer of the put to the writer of the put. See SR-96-17.

2129.0.1 SUPERVISORY AND EXAMINER GUIDANCE

In reviewing credit derivatives, examiners should consider the credit risk associated with the reference asset as the primary risk, as they do for loan participations or guarantees. A banking organization providing credit protection through a credit derivative may be as exposed to the credit risk of the reference asset as it would be if the asset were on its own balance sheet. Thus, for supervisory purposes, the exposure generally should be treated as if it were a letter of credit or other off-balance-sheet guarantee.[2] This treatment would apply, for example, in determining a banking organization’s overall credit exposure to a borrower for purposes of evaluating concentrations of credit. The overall exposure should include exposure it assumes

1. For purposes of this supervisory guidance, when the beneficiary owns the reference asset, it will be referred to as the ‘‘underlying’’ asset. However, in some cases, the reference asset and the underlying asset are not the same. For example, the credit-derivative contract may reference the performance of an ABC Company bond, while the beneficiary banking organization may actually own an ABC Company loan. The use of the term ‘‘guarantor’’ does not necessarily refer to a guarantor involving a suretyship contract. The transferred risk can be in a primary liability of the acquiring party that assumes the credit risk.

2. Credit derivatives that are based on a broad-based index, such as the Lehman Brothers Bond Index or the S&P 500 stock index, could be treated for capital and other supervisory purposes as a derivative contract. This determination should be made on a case-by-case basis.

by acting as a guarantor in a credit-derivative transaction where the borrower is the obligor of the reference asset.

Banking organizations providing credit protection through a credit derivative should hold capital and reserves against their exposure to the reference asset.[3] This broad principle holds for all credit derivatives, except for credit-derivative contracts that incorporate periodic payments for depreciation or appreciation, including most total-rate-of-return swaps. For these transactions, the guarantor can deduct the amount of depreciation paid to the beneficiary from the notional amount of the contract in determining the amount of reference exposure subject to a capital charge.

In some cases (for example, total-rate-of-return swaps), the guarantor also is exposed to the credit risk of the counterparty, which for derivative contracts generally is measured as the replacement cost of the credit-derivative transaction plus an add-on for the potential future exposure of the derivative to market price changes. For banking organizations acting as dealers that have matching offsetting positions, the counterparty risk stemming from credit-derivative transactions could be the principal risk to which the dealer banks are exposed.

In reviewing a credit derivative entered into by a beneficiary banking organization, the examiner should review the organization's credit exposure to the guarantor, as well as to the reference asset—if the asset is actually owned by the beneficiary. The degree to which a credit derivative, unlike most other credit-guarantee arrangements, transfers the credit risk of an underlying asset from the beneficiary to the guarantor may be uncertain or limited. The degree of risk transference depends on the terms of the transaction. For example, some credit derivatives are structured so that a payout only occurs when a predefined event of default or a downgrade below a prespecified credit rating occurs.[4] Others may require a payment only when a defined default event occurs *and* a predetermined materiality (or loss) threshold is exceeded. Default payments themselves may be based on an average of dealer prices for the reference asset during some period of time after default using a prespecified sampling procedure or may be specified in advance as a set percentage of the notional amount of the reference asset. Finally, the term of many credit-derivative transactions is shorter than the maturity of the underlying asset and, thus, provides only temporary credit protection to the beneficiary.

Examiners must ascertain whether the amount of credit protection a beneficiary receives by entering into a credit derivative is sufficient to warrant treatment of the derivative as a guarantee for regulatory capital and other supervisory purposes. Those arrangements that provide virtually complete credit protection to the underlying asset will be considered effective guarantees for purposes of asset classification and risk-based capital calculations. On the other hand, if the amount of credit risk transferred by the beneficiary is severely limited or uncertain, then the limited credit protection provided by the derivative should not be taken into account for these purposes.

In this regard, examiners should carefully review credit-derivative transactions in which the reference asset is not identical to the asset actually owned by the beneficiary banking organization. For the derivative contract to be considered as providing effective credit protection, the examiner must review the arrangement and be satisfied that the reference asset is an appropriate proxy for the loan or other asset, whose credit exposure the banking organization intends to offset. To determine this, examiners should consider, among other factors, whether the reference asset and owned asset have the same obligor and seniority in bankruptcy and whether both contain mutual cross-default provisions.

A banking organization's management should not enter into credit-derivative transactions unless it has the ability to understand and manage the credit and other risks associated with these instruments in a safe and sound manner. Accordingly, examiners should determine the appropriateness of these instruments on an entity-by-entity basis, taking into account management's expertise in evaluating the instruments used; the adequacy of relevant policies, including position limits; and the quality of the banking organization's relevant information systems and internal controls.[5]

3. For guidance on risk-based capital treatment of credit derivatives, see section 4060.3.5.3.9.

4. It may also be necessary to review the credit documentation of the primary obligor to determine the degree of transferred risk.

5. For further guidance on examining the risk-management practices of banking organizations, including guidance on derivatives, that examiners may find helpful in reviewing an organization's management of its credit-derivative activity, see sections 2125.0, 2126.0, 2128.0, and 4070.1. See also the *Commercial Bank Examination Manual* and the *Trading and Capital-Markets Activities Manual*.

2129.0.2 TYPES OF CREDIT DERIVATIVES

The most widely used types of credit derivatives are credit-default swaps and total-rate-of-return (TROR) swaps.[6] While the timing and structure of the cash flows associated with credit default and TROR swaps differ, the economic substance of both arrangements is that they seek to transfer the credit risk on the asset(s) referenced in the transaction.

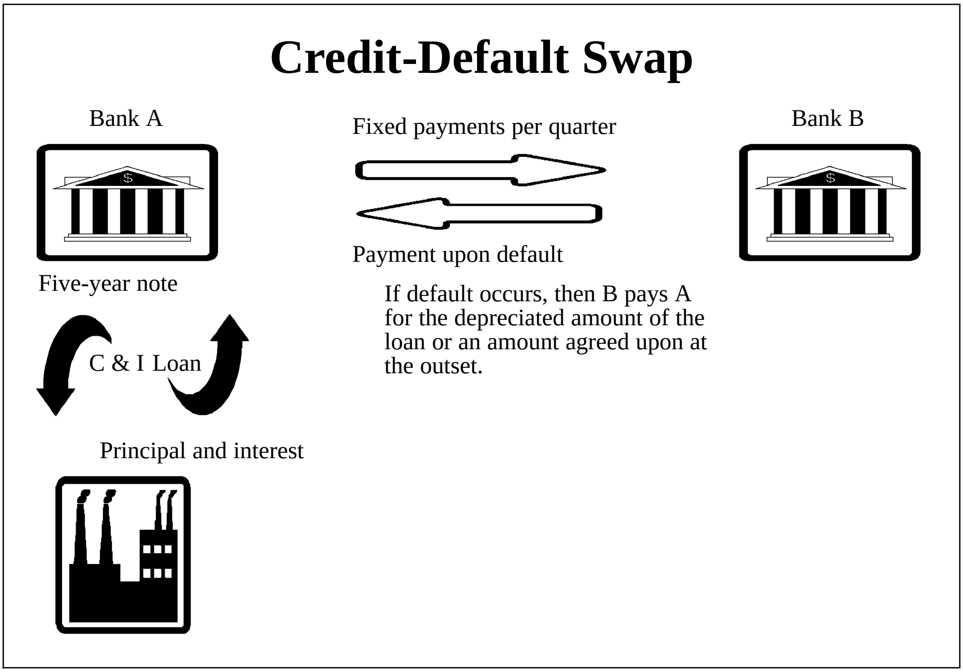
6. Another less common form of credit derivative is the *credit-linked note*, which is an obligation that is based on a reference asset. Credit-linked notes are similar to structured notes with embedded credit derivatives. If there is a credit event, the repayment of the bond's principal is based on the price of the reference asset. A credit-linked note may be a combination of a regular bond and a credit option. The note can promise to make periodic interest payments and a large lump-sum payment when the bond matures. The credit option on the note may allow the issuer to reduce the note's payments if a primary financial indicator or variable deteriorates. When reviewing these transactions, examiners should consider the purchasing banking organization's exposure to the underlying reference asset as well as the exposure to the issuing entity.

2129.0.2.1 Credit-Default Swaps

The purpose of a credit-default swap is to provide protection against credit losses associated with a default on a specified reference asset. The swap purchaser (the beneficiary) "swaps" the credit risk with the provider of the swap (the guarantor). The transaction is very similar to a guarantee or financial standby letter of credit.

In a credit-default swap, illustrated in figure 1, the beneficiary (Bank A) agrees to pay to the guarantor (Bank B) a quarterly or annual fee, typically amounting to a certain number of basis points on the par value of the reference asset. In return, the guarantor agrees to pay the beneficiary an agreed-upon, market-based, post-default amount or a predetermined fixed percentage of the value of the reference asset if there is a default. The guarantor makes no payment until there is a default. A default is strictly defined in the contract to include, for example, bankruptcy, insolvency, or payment default, and the event of default itself must be publicly verifiable. The guarantor may not be obliged to

Figure 1
Credit-Default Swap Cash-Flow Diagram



make any payments to the beneficiary until a preestablished amount of loss has been exceeded in conjunction with a default event (called a materiality threshold).

The swap is terminated if the reference asset defaults before the maturity of the swap. The amount owed by the guarantor is the difference between the reference asset's initial principal (or notional) amount and the actual market value of the defaulted, reference asset. The methodology for establishing the post-default market value of the reference asset should be set out in the contract. Often, the market value of the defaulted reference asset may be determined by sampling dealer quotes. The guarantor may have the option to purchase the defaulted, underlying asset and pursue a workout with the borrower directly, an action it may take if it believes that the ''true'' value of the reference asset is higher than that determined by the swap-pricing mechanism. Alternatively, the swap may call for a fixed payment in the event of default, such as a percentage of the notional value of the reference asset.

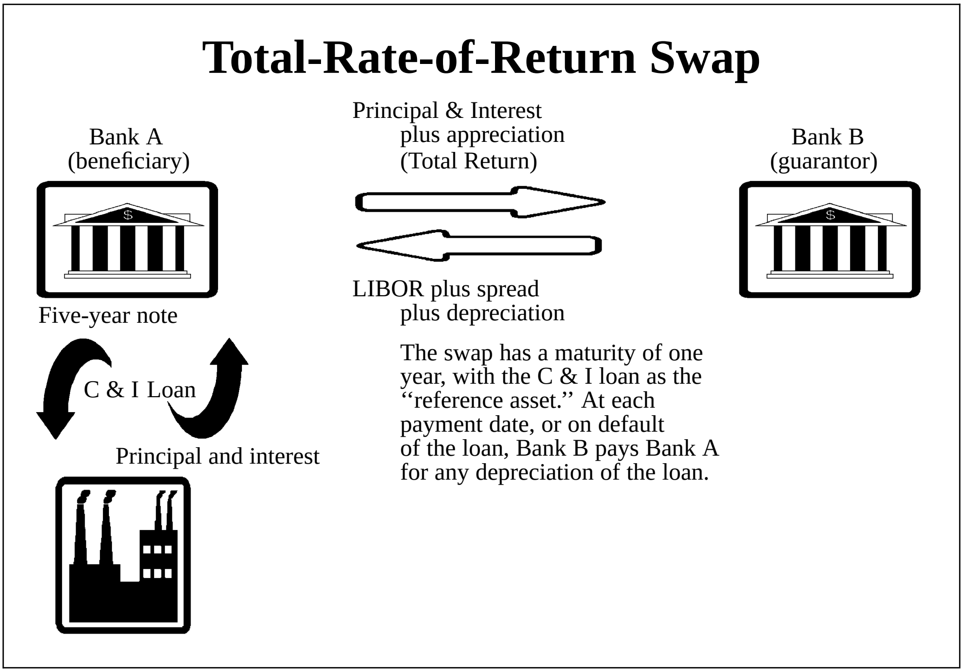
2129.0.2.2 Total-Rate-of-Return Swaps

In a total-rate-of-return (TROR) swap, illustrated in figure 2, the beneficiary (Bank A) agrees to pay the guarantor (Bank B) the ''total return'' on the reference asset, which consists of all contractual payments, as well as any appreciation in the market value of the reference asset. To complete the swap arrangement, the guarantor agrees to pay LIBOR plus a spread and any depreciation to the beneficiary.[7] Since it bears the risks and rewards of ownership over the term of the swap, the guarantor in a TROR swap could be viewed as having synthetic ownership of the reference asset.

At each payment-exchange date (including when the swap matures) or on default, at which point the swap may terminate, any depreciation

7. The reference asset is often a floating-rate instrument, for example, a prime-based loan. Thus, if both sides of a TROR swap are based on floating rates, interest-rate risk is effectively eliminated with the exception of some basis risk.

Figure 2
Total-Rate-of-Return Swap Cash-Flow Diagram



or appreciation in the amortized value of the reference asset is calculated as the difference between the notional principal balance of the reference asset and the "dealer price."[8] The dealer price is generally determined either by referring to a market quotation source or by polling a group of dealers, and the price reflects changes in the credit profile of the reference obligor and reference asset.

If the dealer price is less than the notional amount of the contract (the hypothetical original price of the reference asset), then the guarantor must pay the difference to the beneficiary, absorbing any loss caused by a decline in the credit quality of the reference asset.[9] Thus, a TROR swap differs from a standard direct credit substitute in that the guarantor is guaranteeing not only against default of the reference obligor, but also against a deterioration in that obligor's credit quality, which can occur even if there is no default.

TROR swaps allow banking organizations to diversify credit risk and at the same time maintain confidentiality of their client's financial records since the borrowing entity's financial records are held by the originating lender. When the loans are sold, the records are transferred to the new acquiring lender. TROR swaps generally involve fewer administrative costs than those involved in a loan-sales transaction. Risk diversification can thus be achieved at a reduced cost.

2129.0.3 OTHER SUPERVISORY ISSUES

The decision to treat credit derivatives as guarantees could have significant supervisory implications for the way examiners treat concentration risk, classified assets, the adequacy of the allowance for loan and lease losses (ALLL),[10] and transactions involving affiliates. Examples of how credit derivatives that effectively transfer credit risk could affect supervisory procedures are discussed below.

2129.0.3.1 Credit Exposure

For internal purposes of managing credit risk, banking organizations are encouraged to develop policies to determine how credit-derivative activity will be used to manage credit exposures. For example, a banking organization's internal credit policies may set forth situations in which it is appropriate to reduce credit exposure to an underlying obligor through credit-derivative transactions. Such policies need to address when credit exposure is effectively reduced and how all credit exposures will be monitored, including those resulting from credit-derivative activities.

2129.0.3.2 Concentrations of Credit

Concentrations of credit may be defined as—

- loans collateralized by a common security;
- loans to one borrower or related group of borrowers;
- loans that depend on a particular agricultural commodity;
- aggregate loans to major employers, their employees, and their major suppliers;
- loans within industry groups;
- out-of-territory loans;
- the aggregate amount of paper purchased from any one source; or
- those loans that often have been included in other homogeneous risk groupings.

Credit concentrations, by their nature, depend on common key factors, and when weaknesses develop, they have an adverse impact on each individual loan making up the concentration.[11] Generally, examiners should not consider a banking organization's asset concentration to a particular borrower reduced because of the existence of a nongovernment guarantee on one of the borrower's loans since the underlying concentration to the borrower still exists. However, examiners should consider how the banking organization manages the concentration, which could include the use of nongovernmental guarantees. Asset concentrations are to be listed in the confidential "Administrative and Other Matters" page D of the inspection report to highlight that the ultimate risk to the banking organization stems from these concentrations,

8. Depending on contract terms, a TROR swap may not terminate on default of the reference asset. Instead, payments would continue to be made on subsequent payment dates based on the reference asset's post-default prices until the swap's contractual maturity.

9. As in a credit-default swap, the guarantor may have the option of purchasing the underlying asset from the beneficiary at the dealer price and trying to collect from the borrower directly.

10. See sections 2010.7 and 2065.2.

11. See sections 2010.2, 2010.7, and 2065.2.

although the associated credit risk may be mitigated by the existence of nongovernmental guarantees.

Any nongovernment guarantee will be included with other exposures to the guarantor to determine if there is an asset concentration with respect to the guarantor. Thus, the use of credit derivatives will increase the beneficiary's concentration exposure to the guarantor without reducing the concentration risk of the underlying borrower. Similarly, a guarantor banking organization's exposure to all reference assets will be included in its overall credit exposure to the reference obligor.

2129.0.3.3 Classification of Assets

The criteria used to classify assets are primarily based on their degree of risk and the likelihood of repayment, as well as on the potential effect of the assets on the bank's safety and soundness.[12] When evaluating the quality of a loan, examiners should review the overall financial condition of the borrower; the borrower's credit history; any secondary sources of repayment, such as guarantees; and other factors. The primary focus in the review of a loan's quality is the original source of payment. The assessment of the credit quality of a troubled loan, however, should take into account support provided by a ''financially responsible guarantor.''[13]

The protection that a credit derivative from a financially responsible guarantor provides on an underlying asset may be sufficient to preclude classification of the underlying asset or reduce the severity of classification. Sufficiency *depends on the extent of credit protection that is provided*. To be considered a guarantee for purposes of determining the classification of assets, a credit derivative must transfer the credit risk from the beneficiary to the financially responsible guarantor; the financially responsible guarantor must have *both* the financial capacity and willingness to provide support for the credit; the guarantee (the credit-derivative contract) must be legally enforceable; and the guarantee must provide support for repayment of the indebtedness, in whole or in part, during the remaining term of the underlying asset.

However, credit derivatives tend to have a shorter maturity than the underlying asset being protected. Furthermore, it is uncertain whether the credit derivative will be renewed once it matures. Thus, when determining whether to classify an underlying asset protected by a credit derivative, examiners need to consider the *term* of the credit derivative in relation to the maturity of the protected underlying asset, the probability that the protected underlying asset will default while the guarantee is in force, and whether the credit risk has actually been transferred. In general, the beneficiary banking organization continues to be exposed to the credit risk of the classified underlying asset when the maturity of the credit derivative is shorter than the underlying asset. Thus, in these situations of maturity mismatch, the examiner's presumption may be against a diminution of the severity of the underlying asset's classification.

For guarantor banking organizations, examiners should review the credit quality of individual reference assets in derivative contracts in the same manner as other credit instruments, such as standby letters of credit. Thus, examiners should evaluate a credit derivative in which a banking organization provides credit protection based on the overall financial condition and resources of the reference obligor; the obligor's credit history; and any secondary sources of repayment, such as collateral. As a rule, exposure from providing credit protection through a credit derivative should be classified if the reference asset is classified.[14]

2129.0.3.4 Transactions Involving Affiliates

Credit-derivative transactions can involve two or more legal entities (affiliates) within the same banking organization. Thus, transactions between or involving affiliates raise important supervisory issues, especially whether such arrangements are effective guarantees of affiliate obligations or transfers of assets and their related credit exposure between affiliates. Banking organizations should carefully consider existing supervisory guidance on interaffiliate

12. Loans that exhibit potential weaknesses are categorized as ''substandard,'' while those with well-defined weaknesses and a distinct possibility of loss are either ''doubtful'' or ''loss.''

13. See section 5010.10 of this manual and section 2060.1 of the *Commercial Bank Examination Manual*.

14. A guarantor banking organization providing credit protection through the use of a credit derivative on a classified asset of a beneficiary bank may preclude classification of *its derivative contract* by laying off the risk exposure to another financially responsible guarantor. This could be accomplished through the use of a second offsetting credit-derivative transaction.

transactions before entering into credit-derivative arrangements involving affiliates, particularly when substantially the same objectives could be met using traditional guarantee instruments.

2129.0.4 INSPECTION OBJECTIVES

1. To determine if the banking organization is providing credit protection through a credit derivative.
2. To ascertain whether the banking organization has and maintains sound risk-management policies and procedures and effective internal controls over the use of credit derivatives.
3. To review and evaluate existing risk involving credit-derivative arrangements.
4. To ascertain whether adequate capital and reserves are held against exposures to reference assets, including whether risk-based capital computations have accounted for any additional risk resulting from derivative arrangements.

2129.0.5 INSPECTION PROCEDURES

1. Consider credit risk associated with reference assets as primary risks. Determine whether the credit-risk exposure is treated as if it was a letter of credit or other off-balance-sheet guarantee.
2. Review the organization's credit exposure to the guarantor, as well as to the reference asset. Determine if the asset is actually owned by the beneficiary.
3. Ascertain whether the amount of credit protection a beneficiary receives when entering into a credit derivative is sufficient to warrant treatment of the derivative as a guarantee for regulatory capital and other supervisory purposes.
4. Review credit-derivative transactions in which the reference asset is not identical to the asset actually owned by the beneficiary banking organization.
   a. Ascertain if the reference asset is an appropriate proxy for loans or other assets whose credit exposure the banking organization intends to offset.
   b. Consider whether the reference asset and owned asset have the same obligor and seniority in bankruptcy and whether both contain mutual cross-default provisions.
5. Determine whether management has the ability to understand and manage the credit and other risks associated with credit derivatives in a safe and sound manner. Consider management's expertise in evaluating the instruments; the adequacy of relevant policies, including position limits; and the quality of the banking organization's relevant management information systems and internal controls.
6. Evaluate the management of a banking organization's asset concentration to a particular borrower, which could include the use of nongovernmental guarantees on one or more of the borrower's loans. List the asset concentrations in the confidential "Administrative and Other Matters" page D of the inspection report.
7. Review the quality of loans and the overall financial condition of the borrower; the borrower's credit history; any secondary sources of repayment, such as financially responsible guarantors; and other factors.
8. When determining whether to classify an underlying asset protected by a credit derivative, compare the *term* of the credit derivative in relation to the maturity of the protected underlying asset, the probability that the protected underlying asset will default while the guarantee is in force, and whether the credit risk has actually been transferred.
9. For guarantor banking organizations, review the credit quality of individual reference assets in derivative contracts in the same manner as other credit instruments, such as standby letters of credit.
   a. Evaluate a credit derivative in which a banking organization provides credit protection based on the overall financial condition and resources of the reference obligor; the obligor's credit history; and any secondary sources of repayment, such as collateral.
   b. If the reference asset is classified, classify the exposure from providing credit protection through a credit derivative.

Banking organizations have substantially increased their secondary-market credit activities such as loan syndications, loan sales and participations, credit derivatives, and asset securitizations, as well as the provision of credit enhancements and liquidity facilities to such transactions. These activities can enhance both credit availability and bank profitability, but managing the risks of these activities poses increasing challenges. This is because the risks involved, while not new to banking, may be less obvious and more complex than the risks of traditional lending activities. Some secondary-market credit activities involve credit, liquidity, operational, legal, and reputational risks in concentrations and forms that may not be fully recognized by bank management or adequately incorporated in an institution's risk-management systems. In reviewing these activities, supervisors[1] and examiners should assess whether banking organizations fully understand and adequately manage the full range of the risks involved in secondary-market credit activities.

The heightened need for management attention to these risks is underscored by reports from examiners, surveys of senior lending officers, and discussions with trade and advisory groups. They have indicated that competitive conditions over the past few years have encouraged an easing of credit terms and conditions in both commercial and consumer lending. In addition, indications are that some potential participants in loan syndications have found it necessary to make complex credit decisions within a much shorter time frame than has been customary. Although the recent easing may not be imprudent, the incentives and pressures to lower credit standards have increased as competition has intensified and borrowers have experienced generally favorable business and economic conditions. Supervisors and bank management alike should remain alert to the possibility that loan performance could deteriorate if certain sectors of the economy experience problems. The recent rise in consumer bankruptcies, credit card delinquencies, and credit charge-offs illustrates this concern. These types of developments could have significant implications for the risks associated with secondary-market credit activities.

This section identifies some of the important risks involved in several of the more common types of secondary-market credit activities. Guidance is provided on sound practices along with special considerations supervisors should take into account in assessing the risk-management systems for these activities. A banking institution's failure to understand adequately the risks inherent in secondary-market credit activities and the failure to incorporate for such risk within its risk-management systems and internal capital allocations may constitute an unsafe and unsound banking practice.

A fundamental principle is advanced in this guidance: Banking institutions should explicitly incorporate the full range of risks of their secondary-market credit activities into their overall risk-management systems.[2] In particular, supervisors and examiners should determine whether institutions are recognizing the risks of secondary-market credit activities by (1) adequately identifying, quantifying, and monitoring these risks; (2) clearly communicating the extent and depth of these risks in reports to senior management and the board of directors and in regulatory reports; (3) conducting ongoing stress testing to identify potential losses and liquidity needs under adverse circumstances; and (4) setting adequate minimum internal standards for allowances or liabilities for losses, capital, and contingency funding. Incorporating secondary-market credit activities into banking organizations' risk-management systems and internal capital adequacy allocations is particularly important. This guidance builds on, supports, and is fully consistent with existing guidance on risk management issued by the Federal Reserve.[3]

1. The term ''supervisors'' is intended to refer to Federal Reserve System staff.

2. This guidance applies to the secondary-market credit activities conducted by state member banks, bank holding companies, Edge corporations, and U.S. branches and agencies of foreign banks. For this guidance, secondary-market credit activities include, but are not limited to, loan syndications; loan participations; loan sales and purchases; credit derivatives; asset securitization; and both implied and direct credit enhancements that may support these or the related activities of the institution, its affiliates, or third parties. Asset securitization activities refer to the issuance, underwriting, and servicing of asset-backed securities; the provision of credit or liquidity enhancements to securitized transactions; and investment in asset-backed securities.

3. For a more detailed discussion of risk management, see SR-95-51, ''Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies''; SR-95-17, ''Evaluating the Risk Management and Internal Controls of Securities and Derivative Contracts Used in Nontrading Activities''; SR-93-69, ''Risk Management and Internal Controls for Trading Activities of Banking Organizations''; and SR-90-16, ''Implementation of

Improvements in technology, greater standardization of lending products, and the use of credit enhancements have helped to increase dramatically the volume of loan syndications, loan sales, loan participations, asset securitizations, and credit guarantees undertaken by commercial banks, affiliates of bank holding companies, and some U.S. branches and agencies of foreign banks. In addition, the advent of credit derivatives permits banking organizations to trade credit risk, manage it in isolation from other types of risk, and maintain credit relationships while transferring the associated credit risk. Such developments have improved the availability of credit to businesses and consumers, allowed management to better tailor the mix of credit risk within loan and securities portfolios, and helped to improve overall bank profitability.

Certain credit and liquidity enhancements that banking organizations provide to facilitate various secondary-market credit activities can make the evaluation of their risks less straightforward than the risks involved in traditional on-balance-sheet banking activities. These enhancements, or guarantees, generally manifest themselves as recourse provisions, securitization structures that entail credit-linked early-amortization and collateral-replacement events, and direct credit substitutes such as letters of credit and subordinated interests that, in effect, provide credit support to secondary-market instruments and transactions.[4]

The transactions involving such enhancements tend to be complex and may expose the institutions extending them to hidden obligations that may not become evident until the transactions have deteriorated. In substance, such activities move the credit risk off the balance sheet by shifting risks associated with traditional on-balance-sheet assets into off-balance-sheet contingent liabilities. Given the potential complexity and, in some cases, the indirect nature of these enhancements, the actual credit-risk exposure can be difficult to assess, especially in the context of traditional credit-risk limit, measurement, and reporting systems.

Moreover, many secondary-market credit activities involve new and compounded dimensions of reputational, liquidity, operational, and legal risks that are not readily identifiable and may be difficult to control. For example, recourse provisions and certain asset-backed security structures can give rise to significant reputational- and liquidity-risk exposures, and ongoing management of underlying collateral in securitization transactions can expose an institution to unique operating and legal risks.

For those institutions involved in providing credit enhancements in connection with loan sales and securitizations, and those involved in credit derivatives and loan syndications, supervisors and examiners should assess whether the institutions' systems and processes adequately identify, measure, monitor, and control *all* of the risks involved in the secondary-market credit activities. In particular, the risk-management systems employed should include the identification, measurement, and monitoring of these risks as well as an appropriate methodology for the internal allocation of capital and reserves. The stress testing conducted within the risk-measurement element of the management system should fully incorporate the risk exposures of these activities under various scenarios to identify their potential effect on an institution's liquidity, earnings, and capital adequacy. Moreover, management reports should adequately communicate to senior management and the board of directors the risks associated with these activities and the contingency plans that are in place to deal with adverse conditions. See SR-97-21.

2129.05.1 CREDIT RISKS IN SECONDARY-MARKET CREDIT ACTIVITIES

Institutions should be aware that the credit risk involved in many secondary-market credit activities may not always be obvious. For certain types of loan sales and securitization transactions, a banking organization may actually be exposed to essentially the same credit risk as in traditional lending activities, even though a particular transaction may, superficially, appear to have isolated the institution from any risk exposure. In such cases, removal of an asset from the balance sheet may not result in a commensurate

Examination Guidelines for the Review of Asset Securitization Activities.''

4. Examiners should also review SR-96-30, ''Risk-Based Capital Treatment for Spread Accounts that Provide Credit Enhancement for Securitized Receivables.'' In addition, banking organizations have retained the risk of loss, that is, recourse, on sales and securitizations of assets when, in accordance with generally accepted accounting principles, they record on their balance sheets interest-only strip receivables or other assets that serve as credit enhancements. For more information, see Statement of Financial Accounting Standards No. 125, ''Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities,'' and the instructions to the Reports of Income and Condition.

reduction in credit risk. Transactions that can give rise to such instances include loan sales with recourse; credit derivatives; direct credit substitutes, such as letters of credit; and liquidity facilities extended to securitization programs, as well as certain asset securitization structures, such as the structure typically used to securitize credit card receivables.

2129.05.1.1 Loan Syndications

Recently, the underwriting standards of some syndications have been relaxed through the easing or elimination of certain covenants or the use of interest-only arrangements. Bank management should continually review syndication underwriting standards and pricing practices to ensure that they remain consistent over time with (1) the degree of risk associated with the activity and (2) the potential for unexpected economic developments to adversely affect borrower creditworthiness.

In some cases, potential participants in loan syndications have felt it necessary to make decisions to commit to the syndication within a shorter period of time than is customary. Supervisors and examiners should determine whether syndicate participants are performing their own independent credit analysis of the syndicated credit and make sure they are not placing undue reliance on the analysis of the lead underwriter or on commercial-loan credit ratings. Banking organizations should not feel pressured to make an irrevocable commitment to participate in a syndication until such an analysis is complete.

2129.05.1.2 Credit Derivatives

Credit derivatives are generally off-balance-sheet financial instruments[5] that are used by banking organizations to assume or mitigate the credit risk of loans and other assets.[6] Banking organizations are increasingly employing these instruments either as end-users, purchasing credit protection from—or providing credit protection to—third parties, or as dealers intermediating such protection. In reviewing credit derivatives, supervisors should consider the credit risk associated with the reference asset, as well as general market risk and the risk of the counterparty to the contract.

With respect to credit-derivative transactions in which banking organizations are mitigating the credit risk of their assets, supervisors and examiners should carefully review those situations in which the reference assets are not identical to the assets actually owned by the institutions. Supervisors should consider whether the reference asset is an appropriate proxy for the loan or other asset whose credit exposure the banking organization intends to offset.

5. Credit-linked notes are on-balance-sheet instruments.

6. See SR-96-17, ‘‘Supervisory Guidance for Credit Derivatives,’’ for a discussion of supervisory issues regarding credit derivatives, including the risk-based capital treatment of credit derivatives held in the banking book. SR-97-18, ‘‘Application of Market Risk Capital Requirements to Credit Derivatives,’’ provides guidance on the risk-based capital treatment of credit derivatives held in the trading book.

2129.05.1.3 Recourse Obligations, Direct Credit Substitutes, and Liquidity Facilities

2129.05.1.3.1 Recourse Obligations

Partial, first-loss recourse obligations retained when selling assets, and the extension of partial credit enhancements (for example, 10 percent letters of credit), can be a source of concentrated credit risk by exposing institutions to the full amount of expected losses on the protected assets. For instance, the credit risk associated with whole loans or pools of assets that are sold to secondary-market investors can often be concentrated within the partial, first-loss recourse obligations retained by banking organizations selling and securitizing the assets. In these situations, even though institutions may have reduced their exposure to catastrophic loss on the assets sold, they generally retain the same credit-risk exposure as if they continued to hold the assets on their balance sheets.

2129.05.1.3.2 Direct Credit Substitutes

Institutions also assume concentrated credit risk through the extension of partial direct credit substitutes, such as the purchase of subordinated interests and the extension of letters of credit. For example, banking organizations that sponsor certain asset-backed commercial paper programs, or so-called ‘‘remote origination’’ conduits, can be exposed to high degrees of credit risk even though it may seem that their notional exposure is minimal. Such a remote origination conduit lends directly to corporate customers referred to it by the sponsoring banking organization that used to lend directly to these same borrowers. The conduit funds this lending activity by issuing commercial paper that, in turn, is guaranteed by the sponsoring banking organization. The net result is that the sponsoring institution has much the same credit-risk exposure through this guarantee as if it had made the loans directly and held them on its books. However, this credit extension is an off-balance-sheet transaction, and the associated risks may not be fully reflected in the institution's risk-management system.

2129.05.1.3.3 Liquidity Facilities

Banking organizations that extend liquidity facilities to securitized transactions, particularly asset-backed commercial paper programs, may be exposed to high degrees of credit risk which may be subtly embedded within the facilities' provisions. Liquidity facilities are commitments to extend short-term credit to cover temporary shortfalls in cash flow. While all commitments embody some degree of credit risk, certain commitments extended to asset-backed commercial paper programs to provide liquidity may subject the extending institution to the credit risk of the underlying asset pool, often trade receivables, or of a specific company using the program for funding. Often the stated purpose of such liquidity facilities is to provide funds to the program to retire maturing commercial paper when a mismatch occurs in the maturities of the underlying receivables and the commercial paper, or when a disruption occurs in the commercial paper market. However, depending on the provisions of the facility—such as whether the facility covers dilution of the underlying receivable pool—credit risk can be shifted from the program's explicit credit enhancements to the liquidity facility.[7] Such provisions may enable certain programs to fund riskier assets and yet maintain the credit rating on the program's commercial paper without increasing the program's credit enhancement levels.

2129.05.1.4 Asset Securitization Structures

The structure of various securitization transactions can result in an institution's retaining the underlying credit risk in a sold pool of assets. An example of this contingent credit-risk retention is credit card securitizations in which the securitizing organization explicitly sells the credit card receivables to a master trust but, in substance, retains the majority of the economic risk of loss associated with the assets. This is because of the credit protection provided to investors by the excess yield, spread accounts, and structural provisions of the securitization. Excess yield provides the first level of credit protection that can be drawn upon to cover cash shortfalls between the principal and coupon owed to investors and the investors' pro rata share of the master trust's net cash flows. The excess yield is equal to the difference between the overall yield on the underlying credit card portfolio and the master trust's operating expenses.[8] The second level of credit protection is provided by the spread account, which is essentially a reserve funded initially from the excess yield.

The structural provisions of credit card securitizations generally provide credit protection to investors through the triggering of early amortization events. Such an event usually is triggered when the underlying pool of credit card receivables deteriorates beyond a certain point and requires that the outstanding credit card securities begin amortizing early in order to pay off investors before the prior credit enhancements are exhausted. As the early amortization accelerates the redemption of principal (pay down) on the security, the credit card accounts that were assigned to the master credit card trust return to the securitizing institution more quickly than had originally been anticipated, thus exposing the institution to liquidity pressures and any further credit losses on the returned accounts.

2129.05.2 REPUTATIONAL RISKS

The secondary-market credit activities of many institutions may expose them to significant reputational risks. Loan-syndication underwriting may present significant reputational-risk exposure to lead underwriters because syndicate participants may seek to hold the lead underwriter responsible for actual or perceived inadequacies in the loan's underwriting, even though partici-

7. Dilution essentially occurs when the receivables in the underlying asset pool—before collection—are no longer viable financial obligations of the customer. For example, dilution can arise from returns of consumer goods or unsold merchandise by retailers to manufacturers or distributors.

8. The monthly excess yield is the difference between the overall yield on the underlying credit card portfolio and the master trust's operating expenses. It is calculated by subtracting from the gross portfolio yield the (1) coupon paid to investors; (2) charge-offs for that month; and (3) servicing fee, usually 200 basis points paid to the banking organization sponsoring the securitization.

pants are responsible for conducting an independent due-diligence evaluation of each credit. Such risk may be compounded by the rapid growth of new investors in this market, usually nonbanks that may not have previously endured a downturn in the loan market.

There is the possibility that pressure may be brought to bear on the lead participant to repurchase portions of the syndication if the credit deteriorates in order to protect its reputation in the market, even though the syndication was sold without recourse. In addition, the deterioration of the syndicated credit exposes the lead organization to possible litigation, as well as increased operational and credit risk. One way to mitigate reputational risk in syndications is for banking organizations to know their customers and to determine whether syndication customers are in a position to conduct their own evaluation of the credit risks involved in the transaction.

Asset-securitization programs also can be a source of increasing reputational risk. Often, banking organizations sponsoring the issuance of asset-backed securities act as servicer, administrator, or liquidity provider in the securitization transaction. It is imperative that these institutions are aware of the potential losses and risk exposure associated with reputational risk. The securitization of assets whose performance has deteriorated may result in a negative market reaction that could increase the spreads on an institution's subsequent issuances. In order to avoid a possible increase in their funding costs, institutions have supported their securitization transactions by improving the performance of the securitized asset pool. This has been accomplished, for example, by selling discounted receivables or adding higher-quality assets to the securitized asset pool. Thus, an institution's voluntary support of its securitization in order to protect its reputation can adversely affect the sponsoring or issuing organization's earnings and capital.

Such methods of improving the credit quality of securitized asset pools have been used by banking organizations in providing voluntary support to their securitizations, especially for credit card master trusts. These actions generally are taken to avoid either a rating downgrade or an early amortization of the outstanding asset-backed securities.

2129.05.3 LIQUIDITY RISKS

The existence of recourse provisions in asset sales, the extension of liquidity facilities to securitization programs, and the early-amortization triggers of certain asset-securitization transactions can involve significant liquidity risk to institutions engaged in these secondary-market credit activities. Institutions should ensure that their liquidity contingency plans fully incorporate the potential risk posed by their secondary-market credit activities. With the issuance of new asset-backed securities, the issuing banking organization should determine the potential effect on its liquidity at the inception of each transaction and throughout the life of the securities to better ascertain its future funding needs.

An institution's contingency plans should consider the need to obtain replacement funding and specify the possible alternative funding sources, in the event of the amortization of outstanding asset-backed securities. This is particularly important for securitizations with revolving receivables, such as credit cards, when an early amortization of the asset-backed securities could unexpectedly return the outstanding balances of the securitized accounts to the issuing institution's balance sheet. An early amortization of a banking organization's asset-backed securities could impede its ability to fund itself—either through reissuance or other borrowings—since the institution's reputation with investors and lenders may be adversely affected.

2129.05.4 INCORPORATING THE RISKS OF SECONDARY-MARKET CREDIT ACTIVITIES INTO RISK MANAGEMENT

Supervisors should verify that an institution incorporates the risks involved in its secondary-market credit activities in its overall risk-management system. The system should entail (1) inclusion of risk exposures in reports to the institution's senior management and board to ensure proper management oversight; (2) adoption of appropriate policies, procedures, and guidelines to manage the risks involved; (3) appropriate measurement and monitoring of risks; and (4) assurance of appropriate internal controls to verify the integrity of the management process with respect to these activities. The formality and sophistication with which the risks of these activities are incorporated into an institution's risk-management system should be commensurate with the nature and volume of its secondary-market credit activities. Institutions with significant activities in this area are expected to have more elaborate and formal approaches to manage the risk of their secondary-market credit activities.

2129.05.4.1 Board of Directors and Senior Management Responsibilities

Both the board of directors and senior management are responsible for ensuring that they fully understand the degree to which the organization is exposed to the credit, market, liquidity, operational, legal, and reputational risks involved in the institution's secondary-market credit activities. They are also responsible for ensuring that the formality and sophistication of the techniques used to manage these risks are commensurate with the level of the organization's activities. The board should approve all significant policies relating to the management of risk arising from secondary-market credit activities and should ensure that the risk exposures are fully incorporated in board reports and risk-management reviews.

Senior management is responsible for ensuring that the risks arising from secondary-market credit activities are adequately managed on both a short-term and long-run basis. Management should ensure that there are adequate policies and procedures in place for incorporating the risk of these activities into the overall risk-management process of the institution. Such policies should ensure that the economic substance of the risk exposures generated by these activities is fully recognized and appropriately managed. In addition, banking organizations involved in securitization activities should have appropriate policies, procedures, and controls with respect to underwriting asset-backed securities; funding the possible return of revolving receivables (for example, credit card receivables and home equity lines); and establishing limits on exposures to individual institutions, types of collateral, and geographic and industrial concentrations. Lead banking organizations in loan syndications should have policies and procedures in place that address whether or in what situations portions of syndications may be repurchased. Furthermore, banking organizations participating in a loan syndication should not place undue reliance on the credit analysis performed by the lead organization. Rather, the participant should have clearly defined policies and procedures to ensure that it performs its own due diligence in analyzing the risks inherent in the transaction.

2129.05.4.2 Management Information and Risk-Measurement Systems

An institution's management information and risk-measurement systems should fully incorporate the risks involved in its secondary-market credit activities. Banking organizations must be able to identify credit exposures from all secondary-market credit activities and be able to measure, quantify, and control those exposures on a fully consolidated basis. The economic substance of the credit exposures of secondary-market credit activities should be fully incorporated into the institution's efforts to quantify its credit risk, including efforts to establish more formal grading of credits to allow for statistical estimation of loss-probability distributions. Secondary-market credit activities should also be included in any aggregations of credit risk by borrower, industry, or economic sector.

It is particularly important that an institution's information systems can identify and segregate those credit exposures arising from the institution's loan-sale and securitization activities. Such exposures include the sold portions of participations and syndications, exposures arising from the extension of credit-enhancement and liquidity facilities, the effects of an early-amortization event, and the investment in asset-backed securities. The management reports should provide the board and senior management with timely and sufficient information to monitor the institution's exposure limits and overall risk profile.

2129.05.4.3 System of Internal Controls

One of management's most important responsibilities is establishing and maintaining an effective system of internal controls that, among other things, enforces the official lines of authority and the appropriate separation of duties in managing the risks of the institution. These internal controls must be suitable for the type and level of risks given the nature and scope of the institution's activities. Moreover, these internal controls should provide reasonable assurance of reliable financial reporting (in published financial reports and regulatory reports), including adequate allowances or liabilities for expected losses.

2129.05.5 STRESS TESTING

The use of stress testing, including combinations of market events that could affect a banking organization's credit exposures and securitization activities, is another important element of risk management. Stress testing involves identifying possible events or changes in market behavior that could have unfavorable effects on the institution and assessing the organization's ability to withstand them. Stress testing should not only consider the probability of adverse events, but also likely ''worst-case'' scenarios. Such an analysis should be done on a consolidated basis and consider, for instance, the effect of higher-than-expected levels of delinquencies and defaults, as well as the consequences of early-amortization events with respect to credit card securities that could raise concerns regarding the institution's capital adequacy and its liquidity and funding capabilities. Stress-test analyses should also include contingency plans regarding the actions management might take given certain situations.

2129.05.6 CAPITAL ADEQUACY

As with all risk-bearing activities, institutions should fully support the risk exposures of their secondary-market credit activities with adequate capital. Banking organizations should ensure that their capital positions are sufficiently strong to support *all* of the risks associated with these activities on a fully consolidated basis and should maintain adequate capital in all affiliated entities engaged in these activities. The Federal Reserve's risk-based capital guidelines establish *minimum* capital ratios, and those banking organizations exposed to high or above-average degrees of risk are, therefore, expected to operate significantly above the minimum capital standards.

When evaluating capital adequacy, supervisors should ensure that banking organizations that sell assets with recourse, assume or mitigate credit risk through the use of credit derivatives, and provide direct-credit substitutes and liquidity facilities to securitization programs are accurately identifying and measuring these exposures. Supervisors should also determine whether banking organizations are maintaining capital at aggregate levels sufficient to support the associated credit, market, liquidity, reputational, operational, and legal risks.

Supervisors and examiners should review the substance of secondary-market transactions when assessing underlying risk exposures. For example, partial, first-loss direct-credit substitutes providing credit protection to a securitization transaction can, in substance, involve much the same credit risk as that involved in holding the entire asset pool on the institution's balance sheet. Supervisors and examiners should ensure that banking organizations have implemented reasonable methods for allocating capital against the economic substance of credit exposures arising from early-amortization events and liquidity facilities associated with securitized transactions since such facilities are usually structured as short-term commitments to avoid a risk-based capital requirement, even though the inherent credit risk may be approaching that of a guarantee.[9]

If, in the supervisor's judgment, an institution's capital level is not sufficient to provide protection against potential losses from such credit exposures, this deficiency should be reflected in the banking organization's CAMELS or BOPEC ratings. Furthermore, supervisors and examiners should discuss the capital deficiency with the institution's management and, if necessary, its board of directors. Such an institution will be expected to develop and implement a plan for strengthening the organization's overall capital adequacy to levels deemed appropriate given all the risks to which it is exposed.

2129.05.7 INSPECTION OBJECTIVES

1. To determine whether there are risk-management systems and whether they accurately identify all the risk exposures stemming from secondary-market activities.
2. To evaluate secondary-market credit activities and to determine if there has been a lowering of credit standards that could deteriorate the institution's financial condition during less favorable business and economic conditions.
3. To establish whether the institution's management system performs stress testing to evaluate the risk exposures of secondary-market credit activities under various sce-

9. For further guidance on distinguishing, for risk-based capital purposes, whether a facility is a short-term commitment or a direct-credit substitute, see SR-92-11, ''Asset-Backed Commercial Paper Programs.'' Essentially, facilities that provide liquidity, but which also provide credit protection to secondary-market investors, are to be treated as direct-credit substitutes for purposes of risk-based capital.

narios and their potential effect on the institution's liquidity, earnings, and capital adequacy.
4. To review the substance of the institution's secondary-market transactions when assessing underlying risk exposures.
5. To ascertain whether liquidity contingency plans exist and to determine whether they fully incorporate the potential risk posed by secondary-market credit activities, including the need to obtain replacement funding.
6. To determine whether the board of directors is fully informed of the risks involved in secondary-market activities and whether they approve policies, controls, and procedures to control exposures arising from credit, liquidity, operational, legal, reputational, and other risks.
7. To determine whether the institution has a sufficiently strong capital position to support *all* the risk associated with secondary-market credit activities and that it has a capital plan for strenghtening its overall capital adequacy position.
8. To ascertain whether there is an effective system of internal controls—focused on lines of authority and the separation of duties—to monitor and contain the risks associated with secondary-market activities.

2129.05.8 INSPECTION PROCEDURES

1. Determine whether the institution's senior management is recognizing the risk involved in secondary-market credit activities by—
   a. determining if there is adequate identifying, quantifying, and monitoring of risk;
   b. clearly communicating the extent and depth of those risks in discussions, presentations, and inspection reports that are delivered to the board of directors and senior officials of the institution;
   c. presenting to the board of directors, for their approval, all significant policies relating to the risk management of secondary-market activities and the conditions under which a loan syndication can be purchased;
   d. determining whether management is conducting ongoing stress testing to identify potential losses and liquidity needs under adverse and "worst-case" scenarios; and
   e. making certain that senior management is setting adequate minimum internal standards for allowances or liabilities for losses, capital, and contingency funding.
2. Assess whether the institution's systems and processes adequately identify, measure, monitor, and control all of the risks involved in the institution's secondary-market credit activities.
3. Determine whether the various risks associated with secondary-market activities are incorporated into contingency plans, including replacement funding plans and identified alternative funding sources, to lessen the impact of those risks.
4. Establish whether there is an adequate and effective system of internal controls that enforces official lines of authority and the appropriate separation of duties in managing the risks associated with secondary-market activities.
5. Review loan-syndication contract agreements, underwriting documentation, and relevant correspondence with loan-syndication contractual parties to establish whether—
   a. the bank holding company's management has performed adequate credit investigations and evaluations of the syndicate loans, the syndicate participants, and the extent of the BHC's credit-risk exposures;
   b. the syndication customers are in a position to conduct their own investigations and evaluation of the credit risks involved in the transaction; and
   c. undue reliance is placed on the lead underwriter, the participants, or on their commercial-loan credit ratings.
6. For credit derivatives—
   a. analyze the credit risk associated with the reference asset, the general market risk, and the counterparty risk; and
   b. determine, for those reference assets that are not identical assets actually owned, whether the reference asset is an appropriate proxy for the loan or other assets whose credit exposure is to be offset.
7. Review the substance of secondary-market transactions when evaluating and analyzing underlying risk exposures.
8. Evaluate and determine that there are reasonable methods for internally allocating capital against the economic substance of credit exposures that arise from amortization events and liquidity facilities associated with securitized transactions.
9. Incorporate the evaluation of potential risks and losses from credit exposures, including management deficiencies, into the institution's supervisory ratings.

2130.0.1 INTRODUCTION

Effective March 1, 1983, the Board issued an amended bank holding company policy statement entitled ‘‘Futures, Forward and Options on U.S. Government and Agency Securities and Money Market Instruments.’’ Bank holding companies are now required to furnish written notification to their District Federal Reserve Banks within 10 days after financial contract activities are begun by the parent or a nonbank subsidiary. The policy is consistent with the joint policy statement previously issued by the three federal bank regulators with regard to banks participating in financial contracts, and reflects the Board’s judgment that bank holding companies, as sources of strength for their subsidiary banks, should not take speculative positions in such activities.

If a bank holding company or nonbank subsidiary is taking or intends to take positions in financial contracts, that company’s board of directors should approve written policies and establish appropriate limitations to ensure that the activity is conducted in a safe and sound manner. Also, appropriate internal control and audit procedures should be in place to monitor the activity. The following discussion and inspection procedures apply to futures contract activity generally, but are intended to focus specifically on financial futures contracts. For a discussion of currency futures and options and the examination procedures for those instruments, see sections F and G in the Merchant and Investment Bank Examination Manual.

Information, instructions, and inspection procedures have been provided for verifying compliance with the Board’s policy statement. It is intended that the policy statement will ensure that contract activities are conducted in accordance with safe and sound banking practices. The task of evaluating BHC contract activities is the responsibility of System examiners. The following information and inspection procedures are intended to serve as a guide for Federal Reserve Bank staff in that effort.

2130.0.2 DEFINITIONS

Basis—Basis is defined as the difference between the futures contract price and the cash market price of the same underlying security, money market instrument, or commodity.

Call Option—A contract that gives the buyer (holder) the right, but not the obligation to buy (call), a specified quantity of an underlying security, money market instrument or commodity at or before the stated expiration of the contract. At expiration, if the value of the option increases, the holder will exercise the option or close it at a profit. If the value of the option does not increase, the holder would probably let the option expire (or close it out at a profit) and, consequently, will lose the cost (premium paid) of (for) the option. Alternatively, the option may be sold prior to expiration.

Clearing Corporation—A corporation organized to function as the clearing house for an exchange. The clearing house registers, monitors, matches and guarantees trades on a futures market, and carries out financial settlement of futures transactions. The clearing house acts as the central counterparty to all trades executed on the exchange. It substitutes as a seller to all buyers and as a buyer to all sellers. In addition, the clearing corporation serves to insure that all contracts will be honored in the event of a counterparty default.

Clearing Member—A member firm of the clearing house or corporation. Membership in clearing associations or corporations is restricted to members of the respective commodity exchanges, but not all exchange members are clearing house members. All trades of a nonclearing member must be registered with, and eventually settled through, a clearing member.

Commodities Futures Trading Commission—The CFTC is a federal regulatory agency charged with regulation of futures trading in all commodities. It has broad regulatory authority over futures trading. It must approve all future contracts traded on U.S. commodity exchanges, ensure that the exchanges enforce their own rules (which it must review and approve), and direct an exchange to take any action needed to maintain orderly markets whenever it believes that an ‘‘emergency’’ exists.

Contract Activities—This term is used in this manual to refer to banking organization participation in the futures, forward, standby contract, or options markets to purchase and sell U.S. government and agency securities or money market instruments, foreign currencies and other financial instruments.

Convergence—The process by which the futures market price and the cash market price of a financial instrument or commodity converge as the futures contract approaches expiration.

Covered Call Options—This term refers to the issuance or sale of a call option where the option seller owns the underlying deliverable security or financial instrument.

Cross Hedging—The process of hedging a ''cash'' or derivative instrument position with another cash or derivative instrument that has significantly different characteristics. For example, an investor who wants to hedge the sales price of long-term corporate bonds might hedge by establishing a short position in a treasury bond or treasury bond futures contract, but since the corporate bonds cannot be delivered to satisfy the contract, the hedge would be a cross hedge. To be successful, the price movements of the hedged instrument must be highly correlated to that of the position being hedged.

Difference Check—A difference check is sent by the party which recognizes a loss when a forward contract is closed out by the execution of an offsetting forward contract pursuant to a pair-off clause. In essence, the difference check represents a net cash settlement on offsetting transactions between the same two parties and replaces a physical delivery and redelivery of the underlying securities pursuant to offsetting contracts.

Financial Contract—This term is used in the manual to refer to financial futures, forward, standby contracts, and options to purchase and sell U.S. government and agency securities, money market instruments, foreign currency futures and other financial instruments.

Firm Forward Contract—This term is used to describe a forward contract under which delivery of a security is mandatory. See ''Standby Contract'' for a discussion of optional delivery forward contracts.

Forward Contracts—Over-the-counter contracts for forward placement or delayed delivery of securities in which one party agrees to purchase and another to sell a specified security at a specified price for future delivery. Contracts specifying settlement in excess of 30 days following trade date shall be deemed to be forward contracts. Forward contracts are usually non-standardized and are not traded on organized exchanges, generally have no required margin payments, and can only be terminated by agreement of both parties to the transaction. The term also applies to derivative contracts such as swaps, caps, and collars.

Futures Contracts—Standardized contracts traded on organized commodity exchanges to purchase or sell a specified financial instrument or commodity on a future date at a specified price. While futures contracts traditionally specified a deliverable instrument, newer contracts have been developed that are based on various indexes. Futures contracts based on indexes settle in cash and never result in delivery of an underlying instrument; some traditional contracts that formerly specified delivery of an underlying instrument have been redesigned to specify cash settlement. New financial futures contracts are continually being proposed and adopted for trading on various exchanges.

Futures Commission Merchant (FCM)—An FCM functions like a broker in securities. An FCM must register with the Commodities Futures Trading Commission (CFTC) in order to be eligible to solicit or accept orders to buy or sell futures contracts. The services provided by an FCM include a communications system for transmittal of orders, and may include research services, trading strategy suggestions, trade execution, and recordkeeping services.

Financial Futures Contracts—Standardized contracts traded on organized exchanges to purchase or sell a specified security, money market instrument, or foreign currency on a future date at a specified price on a specified date. Futures contracts on GNMA mortgage-backed securities and Treasury bills were the first interest rate futures contracts. Other financial futures contracts have been developed, including contracts on Eurodollars, currencies, and Euro-Rate differentials. It is anticipated that new and similar financial futures contracts will continue to be proposed and adopted for trading on various exchanges.

Futures Exchange—Under the Commodities Exchange Act (CEA), a ''board of trade'' designated by the Commodity Futures Trading Commission as a contract market. Trading occurs on the floor of the exchange and is conducted by open auction in designated trading areas.

GNMA or GINNIE MAE—Either term is used to refer to the Government National Mortgage Association. Ginnie Mae is a government corporation within the U.S. Department of Housing and Urban Development. In creating GNMA, Congress authorized it to grant a full faith and credit guaranty of the U.S. government to mortgage-backed securities issued by private sector organizations.

Hedge—The process of entering transactions that will protect against loss through compensatory price movement. A hedge transaction is one which reduces the organization's overall level of risk.

Initial Futures Margin—In the futures market, a deposit held by an FCM on behalf of a client against which daily gains and losses on futures positions are added or subtracted. A futures margin represents a good-faith deposit or performance bond to guarantee a participant's performance of contractual obligations.

Interest Rate Cap—A multi-period interest rate option for which the buyer pays the seller a fee to receive, at predetermined future times, the excess, if any, of a specified floating interest rate index above a specified fixed per annum rate (cap or strike rate). Caps can be sold separately or may be packaged with an interest rate swap.

Interest Rate Collar—the combination, in single contract, of a simultaneous sale of a cap and the purchase of a floor, or, a purchase of a cap and sale of a floor. The buyer of the collar is a buyer of a cap and the seller of a floor. By selling the floor, the collar buyer gives up the possibility of benefiting from a decline in interest rates below the strike rate in the floor component. On the other hand, the fee earned in selling the floor lowers the cost of protection against interest rate reversal.

Interest Rate Floor—is the reverse of an interest rate cap. The buyer pays a premium to obtain protection against a decline in interest rates below a specified level.

Long Contract—A financial contract to buy securities or money market instruments at a specified price on a specific future date.

Long Hedge—The long hedge, also called the *anticipatory hedge* is the process by which a market participant protects a cash or risk position by buying a futures or forward contract, i.e. taking a long financial contract position.

Maintenance Margin—Maintenance margin is the minimum level to which an equity position can decline as a result of a price decline before additional margin is required. In other words, it is the minimum margin which a customer must keep on deposit with a member at all times. Each futures contract has specified maintenance margin levels. A margin call is issued when a customer's initial margin balance falls below the maintenance margin level specified by the exchange. Maintenance margin must be satisfied by the deposit of cash or agreed upon cash equivalents. The amount of cash required is that amount which is sufficient to restore the account balance to the initial margin level.

Mandatory Delivery—See ''Firm Forward Contract.''

Mark-to-market—The process by which the carrying value (market value or fair value) of a financial instrument is revalued, and which is recognized as the generally accepted accounting principle for determining profit or loss on securities positions in proprietary trading and investment accounts. Futures positions are typically marked-to-market at the end of each trading session.

Naked Call Option—Refers to the issuance or sale of a call option where the option seller does not own the underlying deliverable security or instrument.

Open Interest—Refers to the number of futures contracts outstanding for a given delivery month in an individual futures contracts. The mechanics of futures trading require that for every open long futures contract there is an open short futures contract. For example, an open interest of 10,000 futures contracts means that there are 10,000 long contract holders and 10,000 short contract holders.

Options Contracts—Option contracts require that the buyer of the option pay the seller (or writer) of the option a premium for the right, but not the obligation, to exercise an option to buy (call option) or sell (put option) the instrument underlying the option at a stated price (strike or exercise price) on a stated date (European style option) or at any time before or on the stated expiration date (American style option). There are also exchange traded options contracts: (1) put and call options on futures contracts that are traded on commodities exchanges; and (2) put and call options that specify delivery of securities or money market instruments (or that are cash settled) that are traded on securities exchanges. The key economic distinction between options on futures and options on securities, is that the party who exercises an option on a futures contract receives a long or short futures position rather than accepting or making delivery of the underlying security or financial instrument.

Pair-Off Clause—A pair-off clause specifies that if the same two parties to a forward contract trade should subsequently execute an offsetting trade (e.g. a long contract against an outstanding short contract), settlement can be effected by one party sending the other party a difference check rather than having physical delivery and redelivery of securities.

Par Cap—This term refers to a provision in the contract of sale for Ginnie Mae mortgage-backed securities which restricts delivery only to pools which bear an interest rate sufficiently high so that the securities would trade at or below par when computed based on the agreed to yield.

Put Option—An option contract which gives the holder the right, but not the obligation, to sell (put) a specified quantity of a financial instrument (money market) or commodity at a specified price on or before the stated expiration date of the contract. If price of the underlying instrument occurs, the purchaser will exercise or sell the option. If a decline in price of the underlying instrument does not occur, the option purchaser will let it expire and will lose only the cost (premium paid) of (for) the option.

Round Turn—Commissions for executing futures transactions are charged on a round turn basis. A round turn constitutes opening a futures position and closing it out with an offsetting contract, i.e. executing a short contract and closing out the position with a long contract or vice-versa.

Short Contract—A financial contract to sell securities or money market instruments at a specified price on a specified future date.

Short Hedge—The process by which a customer protects a cash or risk position by selling a futures or forward contract, i.e. taking a short financial contract position. The purpose of the short hedge is to lock in a selling price.

Standby Contract—Optional delivery forward contracts on U.S. government and agency securities arranged between securities dealers and customers that do not involve trading on organized exchanges. The buyer of a standby contract (put option) acquires, upon paying a fee, the right to sell securities to the other party at a stated price at a future time. The seller of a standby (the issuer) receives the fee, and must stand ready to buy the securities at the other party's option. See the fuller discussion of Standby Contracts under 2130.0.3.1.2)

TBA (To Be Announced) Trading—TBA is the abbreviation used in trading Ginnie Mae securities for forward delivery when the pool number of securities bought or sold is ''to be announced'' at a later date.

Variation Margin—is when, in very volatile markets, additional funds are required to be deposited to bring the account back to its initial margin level, while trading is in progress. Variation margin requires that the needed funds be deposited within the hour, or when reasonably possible. If the customer does not satisfy the variation or maintenance margin call(s), the futures position is closed. Unlike initial margin, variation margin must be in cash. Also refer to ''Maintenance Margin''.

Weighted Hedge—a hedge that is used to compensate for a greater decline in the dollar value of a cash bond as compared to a price decline of an accessible T-bond futures contract.

Yield Maintenance Contract—This is a forward contract written with terms which maintain the yield at a fixed rate until the delivery date. Such a contract permits the holder of a short forward contract to deliver a different coupon security at a comparable yield.

2130.0.3 FINANCIAL CONTRACT TRANSACTIONS

Futures, forward and options contracts are merely other tools for use in asset–liability management. These contracts are neither inherently a panacea nor a speculative vehicle for use by banks and bank holding companies. Rather, the benefit or harm resulting from engaging in financial contract activities results from the manner in which contracts are used. Proper utilization of financial contracts can reduce the risks of interest or exchange rate fluctuations. On the other hand, financial contracts can serve as leverage vehicles for speculation on rate movements.

2130.0.3.1 Markets and Contract Trading

Forward contract (OTC) trading of Government National Mortgage Association (''GNMA'') or ''Ginnie Mae'' Mortgage-Backed Securities preceded exchange trading of GNMA futures contracts in 1975.

2130.0.3.1.1 Forward Contracts

Forward contracts are executed solely in an over-the-counter market. The party executing a contract to acquire securities on a specified future date is deemed to have a ''long'' forward contract; and the party agreeing to deliver securities on a future date is described as a party holding a ''short'' forward contract. Each contract is unique in that its terms are arrived at after negotiation between the parties.

For purposes of illustrating a forward contract, assume that SMC Corporation is an originator of government guaranteed mortgages and issuer of GNMA securities. SMC Corporation has a proven ability to manage and predict the volume of its loan originations over a time horizon of three to four months. To assure a profit or prevent a loss on current loan originations, SMC Corporation may enter binding over-the-counter commitments to deliver 75% of its mortgage production which will be converted into GNMA securities three months in the future. If SMC agrees to sell $3 million of GNMA securities (11% coupon) to the WP Securities Firm at par in three months, SMC Corporation is considered to have entered a "short" (commitment to sell) forward contract. Conversely, WP has entered a "long" (commitment to buy) forward contract. The two parties to the transaction are both now obligated to honor the terms of the contract in three months, unless the contract is terminated by mutual agreement.

It should be noted that executing a "short" forward contract is not the same as executing the short sale of a security. Generally, a short sale of a security is understood to represent the speculative sale of a security which is not owned by the seller. The short seller either purchases the security prior to settlement date or borrows the security to make delivery; however, a "short" forward contract merely connotes the side of the contract required to make delivery on a future date. Short forward contracts should not be considered inherently speculative, but must be considered in light of the facts surrounding the contract.

Forward trading can be done on a mandatory delivery (sometimes referred to as "firm forward" contracts) basis or on an optional delivery basis ("standby" contract). With respect to a "mandatory" trade, the contract can also be written with a "pair-off" clause. A pair-off clause specifies that if the same two parties to a trade should subsequently execute an off-setting trade (e.g., the banking organization executes a long contract against an outstanding short contract), settlement can be effected by one party sending the other party a "difference check" rather than having a physical delivery and redelivery of securities.

When a forward contract is executed by a dealer, a confirmation letter or contract is sent to the other party to the transaction. The contract will disclose pertinent data about the trade, such as the size of the trade, coupon rate, the date upon which final delivery instructions will be issued, and the yield at which the trade was effected. In addition, the contract letter will specify whether it is permissible for the "short" side of the trade to deliver a different coupon security at a comparable yield ("yield maintenance contract") if the coupon specified in the contract is not available for delivery. Contracts which prohibit the delivery of securities requiring a premium over par are considered to have a "par cap." The initial contract letter generally does not specify which specific securities (e.g., GNMA mortgage-backed securities identified by a pool number) will be delivered. Instead, such contracts generally identify the deliverable securities as having been traded on a "TBA" basis ("to be announced"). Prior to settlement, the dealer holding the short contract will send a final confirmation to the other party specifying the actual securities to be delivered, accrued interest, dollar price, settlement date, coupon rate, and the method of payment.

Forward contracts are not typically marked-to-market. Both parties in a forward contract are exposed to credit risk, since either party can default on its obligation.

2130.0.3.1.2 Standby Contracts

Standby contracts are "put options" that trade over-the-counter, with initial and final confirmation procedures that are quite similar to those on forward transactions. Standby contracts were developed to allow GNMA issuers to hedge their production of securities, especially in instances where mortgage bankers have extended loan commitments in connection with the construction of new subdivisions. When a mortgage banker agrees to finance a subdivision with conventional and government guaranteed mortgages it is difficult to predict the actual number of FHA and VA guaranteed loans which will be originated. Hence, it is risky for a GNMA issuer to enter mandatory forward contracts to deliver the entire estimated amount of loans eligible to be pooled as GNMA securities. By entering an option contract and paying a fee for the option to "put" securities to another party, a GNMA issuer or securities dealer obtains downside market protection, but remains free to obtain the benefits of market appreciation since it can "walk away" from the option contract. In addition to the flexibility of walking away and selling securities at the prevailing market price when GNMA prices are rising, a GNMA issuer avoids the potential risk of purchasing mortgages or GNMA securities to cover short forward contracts in the event that production of GNMA securities falls below anticipated levels.

When a securities dealer sells a standby contract granting a GNMA issuer the right "to put" securities to it, the dealer, in turn, will attempt to purchase a matching standby contract from an investor because the dealer does not want to shoulder all of the downside market risk. There is also potential for securities firms to deal in standby contracts having no relationship to the issuance of GNMA securities.

Some illustrations of standby contracts follow. They are intended to illustrate the mechanics of a standby contract when a banking organization has sold or issued a standby contract granting the contra party the option to "put" GNMA securities to the banking organization.

Assumptions

1. Fee paid to banking organization = 1% of contract value
2. Contract delivery price = 98
3. Coupon = 12%

Situation 1

On contract exercise date: Market Price = 100. Therefore, the dealer would sell securities at market rather than put them to the bank.

Dealer		*Banking organization*	
Sale price	100	Purchase price	N/A
Fee paid	(1)	Fee Received	1
	99		1

Result: Dealer sacrificed 1% to insure sale price.

Result: Banking organization earned 1% fee for "standing by."

Situation 2

On contract exercise date: Market price = 95. Therefore, dealer would deliver securities pursuant to the standby contract.

Dealer		*Banking organization*	
Sale price	98	Purchase price	98
Market price	95	Market price	95
Contract gain	3	Contract loss	(3)
Fee paid	(1)	Fee received	1
Actual gain	2	Actual loss	(2)

Result: Dealer paid 1% fee to avoid 3 point market loss.

Result: Banking organization received 1% fee to compensate for purchasing securities 3 points above market.

2130.0.3.1.3 Futures Contracts

Futures Contract transactions involve three types of participants: customers—the buyers or sellers of contracts, brokers, and a futures exchange. As in the forward markets, a buyer (party committed to take delivery of securities specified in the futures contract) of a futures contract has a "long" contract and the seller (party committed to deliver the underlying securities) has a "short" contract. If a customer desires to purchase (sell) a futures contract, the broker—possibly a member of a clearing house of an exchange—will take the order to the exchange floor and purchase (sell) a contract sold (bought) by another customer (through another broker).[1] All futures transactions are made

1. Brokers in commodities are required to register as futures commission merchants ("FCMs") with the Commodities Futures Trading Commission ("CFTC") in order to be eligible to solicit or accept orders to buy or sell futures contracts.

through and carried on the books of clearing house member brokers, who are treated by the exchange as their own customers. Hence, there are always an equal number of long and short contracts outstanding, referred to as the ‘‘open interest,’’ since the auction process requires a buyer and seller for every contract.

All futures contracts are obligations of an exchange’s clearing association or corporation, i.e. the clearing association is on the opposite side of each long and short contract; and all transactions are guaranteed within the resources of the exchange’s clearing association (on most futures exchanges a small fee is collected on each transaction and placed into an insurance fund). Should an FCM default on a futures contract, the association pays the costs of completing the contract.

2130.0.4 MARGIN REQUIREMENTS

In order to insure the integrity of futures markets, the clearing house requires that member brokers (clearing house members) deposit initial margin in connection with new futures positions carried for the firm, other brokers or FCMs for whom the clearing house member clears transactions, and public customers. The clearing house members in turn require their customers—whether they are other FCMs or public customers—to deposit margin.[2] The FCMs generally require that public customers meet initial margin requirements by depositing cash, pledging government securities, or obtaining irrevocable standby letters of credit from substantial commercial banking organizations. Daily maintenance margin or variation margin calls (deposits of cash required to keep a certain minimum balance in the margin account) based upon each day’s closing futures prices are calculated pursuant to rules of the various futures exchanges, and clearing house members are required to meet daily variation margin calls on positions carried for customers and the firm. In turn, the FCMs require customers to reimburse them for posting additional margin.

Once a customer has executed a futures contract to make or accept delivery of securities in the future it is obligated to fulfill the terms of the contract. A futures contract cannot be resold over-the-counter because futures contracts are not transferable. However, a customer may terminate its obligation under a futures contract either by making or accepting delivery of the securities as specified by the contract, or by executing an offsetting futures contract (long contract to cancel a short contract or vice-versa) with the same broker to cancel the original contract on the same exchange. The overwhelming majority of futures contracts are closed out by the execution of an offsetting contract prior to expiration.

The key to understanding futures transactions is the fact that futures contract prices on U.S. government and agency securities move in the same manner as bond prices; e.g. rising interest rates result in falling futures prices and falling interest rates result in rising futures prices. Hence, the purchase of a futures contract (‘‘long’’ futures contract) at a price of 98 will result in a loss if future market participants perceive rising interest rates in the month of contract expiration and act accordingly; then the offsetting of a futures contract (executing a ‘‘short’’ futures contract) would have to be at a lower price; e.g. 96. As in the case of any commercial transaction, the participant has a loss if the sale price is lower than the purchase price, or a gain if the sale price is higher than the purchase price.

2130.0.4.1 Variation Margin Calls

Variation margin calls for each contract and expiration month are based upon the closing futures exchange price. If there is a change from the previous day’s closing prices, the long contract holders will be required to post additional margin which will be passed through via the clearing house process to short contract holders or vice-versa. Subsequent to the computation of variation margin calls, the clearing house member brokers are required to post variation margin on behalf of the clearing firm and its customer accounts prior to commencement of the next day’s trading. Then, the clearing brokers call their FCM and public customers requesting more margin to bring the accounts up to the

2. In general, the futures exchanges set different initial margin requirements based upon the types of activity engaged in by the customer. Margin requirements are higher for customer contracts characterized as ‘‘speculative’’ than for those contracts deemed to be ‘‘hedge’’ positions. The commodities industry traditionally defines someone with a business need for using the futures market as a hedger; others are defined as speculators. Therefore, in instances where there are different initial hedge and speculative margin requirements, it is assumed that banking organizations will only be required to meet margin required for hedgers.

required maintenance margin level.[3] Of course, if a futures position has a gain at the end of the day, the clearing firm receives a deposit in its margin account. The firm, in turn, increases the margin account balances of customers holding contracts with gains.

For illustrative purposes, we will again assume that a customer purchased a futures contract (long contract, face value $100,000) at a price of 98. If the next closing futures price is 97, the customer will have suffered a one point margin loss (if the customer chose to offset the long contract with a short contract, the transaction would be closed out at a one point loss). Conversely, the party with a short contract executed at 98 would receive a one point margin payment to his account.

Assuming that the initial margin requirement is $1,500 and the variation margin requirement is $1,000, the following summarizes the steps followed in administering a customer's (long position) margin account in connection with the previously described transaction.

Transaction	*Margin Account Balance*
1. Deposit initial margin	$1,500
2. Purchase $100,000 contract @ 98	500
3. Day 1—Closing futures price 97 (Reduction of $1,000 in margin account to reimburse broker for posting margin with clearing corporation).	
4. FCM calls customer to request $1,000 to bring account up to required initial margin level.	
5. Reimbursement to FCM of $1,000	1,500

It is important to note that once the margin account balance falls below the variation margin level, the customer is required to deposit additional funds to replenish the account balance to the initial margin level. If there is a drop in the value of the contract which places the margin account balance below the initial margin level but above the variation margin level, the customer is not required to deposit additional margin monies. Alternatively, if there is a positive flow of margin monies the customer is free to withdraw any amount which exceeds the initial margin requirement.

The entire marking-to-the-market process is repeated at the close of the next business day using a comparison of the previous day's closing price (97) to the current closing price. (The preceding example is simplified because it implies that the customer deposits promptly the required margin. In reality, margin is not always deposited so quickly.)

In summary, futures trading is a ''zero sum game'' because of the equal number of long and short contracts outstanding, and the variation margin payments reflect this fact, i.e. for every long contract holder posting variation margin, there is a short contract holder receiving margin.

2130.0.5 THE DELIVERY PROCESS

Futures contracts are defined as ''standardized contracts traded on organized exchanges to purchase or sell a specified financial instrument or physical commodity on a future date at a specified price.'' Even when a participant keeps a contract open for delivery, the ''specified price'' (which corresponds to a specified yield) is actually obtained through a combination of past futures market gains or losses (incurred through the daily mark to market process) and the current futures market price. For invoicing purposes, the actual delivery price is based upon a closing futures market ''settlement price'' on a date designated by the exchange. In addition, the final calculation of a delivery price on a bond contract will typically involve an adjustment reflecting the fact that the coupon issue to be delivered against the contract grade (8 percent) futures contract is not an 8 percent bond. For example, when current U.S. treasury bond coupons are 12 percent it is highly unlikely that a party with a short futures position would deliver a bond with an 8 percent coupon.

2130.0.6 MECHANICS AND OPERATION OF FUTURES EXCHANGES

Certain technical factors should be noted with

3. It should be noted that public customers generally have more time to meet maintenance margin calls than do FCMs. However, if a customer fails to meet a variation margin call within three days, the FCM must take a charge against its net capital if it fails to close out the customer's contract (17 C.F.R. 1.17(c)5(viii)).

respect to futures markets. First, futures markets are not totally free markets. Rules of the exchanges put artificial constraints—daily price movement limits—upon the amount of daily market movement allowed in given types of futures contracts. For example, government securities prices in the cash market will move as far as the market participants deem necessary to reflect the ''market'' for those securities, while the futures market specifying delivery of the underlying security will be constrained from having the same potential unlimited market movement. There have been instances where persons desiring to close out a futures contract by executing an offsetting contract have been unable to do so for one or more days until the exchange's daily trading limits allowed futures prices to ''ratchet'' up or down to the level that reflected the true ''market'' price as perceived by hedgers, speculators, and arbitragers.

Although the preceding illustrates the basic nature of futures price movements, do not assume that futures and cash market prices always move in the same direction at the same velocity. Futures prices by definition predict future events, e.g., a market participant can buy a futures contract to take delivery of a three month Treasury bill two years in the future.[4] In such an instance, the holder of a long T-bill futures contract agrees to the future purchase of a government security which has not yet been issued. There is no reason to assume that a contract with a distant maturity will move in the same manner as the cash market for a three month Treasury bill. In addition, there is a relationship between the cash market price of an existing security and the price of that security in the futures market which is called the basis. The basis can vary significantly over the life of a given futures contract. In the contract delivery month, the futures market price will converge towards the cash market price (the basis approaches zero), adjusted for technical factors that reflect the costs of processing and delivering securities. If the futures market price did not converge towards the cash market price in the delivery month, the arbitragers would take offsetting futures and cash market positions to arbitrage away any profitable discrepancies between the two markets.

4. All financial futures contracts have a number of contract expiration months extending into the future. As the near term contract expires, a contract with a more distant expiration date is added.

2130.0.7 COMPARISON OF FUTURES, FORWARD, AND STANDBY CONTRACTS

Excluding the fact that futures contracts are traded on organized exchanges, there are many similarities between contracts. Conceptually, the contracts are interchangeable; each type of contract can be utilized for hedging, speculating, or arbitrage strategies, but none of the contracts are transferable to third parties. While engaging in contract activities allows the participants to either assume or shift the risks of interest rate changes associated with the security deliverable under the contract, such contracts fail to provide the other benefits of owning the underlying security. Specifically, financial contracts do not pay interest, do not have a U.S. government guaranty of payment of principal at maturity, and cannot be pledged to secure public deposits or be used as collateral for repurchase agreements. The forward markets are perceived to be delivery markets wherein there is a high percentage of delivery of the underlying security.

As in the case of other futures markets, the financial futures markets were not designed to be delivery markets. Nevertheless, there have been a number of instances when a relatively high percentage of financial futures contracts have resulted in delivery. Some persons suggest tax reasons and the deliverable supply of securities as two factors that have contributed to the much higher delivery of securities than delivery of physical commodities. It is, of course, also easier and cheaper to make delivery of securities rather than railroad carloads of grain.

Trading units on futures exchanges are standardized. The standardized trading unit in a physical commodity which may be a railroad car of grain; the typical trading unit in a government or agency security futures contract may be $100,000 or $1 million par principal at a coupon rate (on coupon issues) fixed by the exchange. On the other hand, forward and standby contracts are not traded in standardized units with given contract maturity months. Instead, forward and standby contracts are custom made to suit the needs of the two parties to the transaction.

While all contract holders are involved with market risks, the holders of forward and standby contracts are especially prone to credit risk. Unlike futures contracts where the mechanics of exchange trading provide for the futures exchange clearing association to guaranty performance of each contract, forward and standby contracts are only as good as the entity on the other side of the contract. Anyone who reads the financial press should be aware that prior to the passage of the Government Securities Act of 1986, there were a number of defaults involving forward and standby contracts. In an effort to bring increased integrity into the unregulated forward contract markets, there has been a trend by some of the major securities dealers to require the posting of margin in connection with forward contract trading. There are no uniform margin requirements governing all aspects of forward contract trading, nor is there a uniform application of margin requirements by dealers requiring ''house'' margin (or internal margin requirements established and enforced by individual securities dealers). GNMA has established limited margin requirements (24 C.F.R. 390.52), as described below.

2130.0.8 OPTION CONTRACTS

Subsequent to the Board's initial adoption of a policy statement governing futures, forward, and standby contracts, trading of interest rate options began on organized futures and securities exchanges. Proponents of exchange traded options argue that such instruments are attractive to users because they permit the user to obtain down side price risk protection, yet benefit from favorable price movement. In contrast, futures and forward contracts allow the user to lock in a specific price, but the user must forgo future participation if the market should experience an upward price movement. Furthermore, the purchaser of an option pays a one time premium for this protection and is spared the contingent liabilities associated with futures margin calls.

An option is a contract that gives the buyer, or holder, the right, but not the obligation, to buy or sell a specified financial instrument at a fixed price, called the exercise or strike price, before or at a certain future date. Some options, however do not provide for the delivery of the underlying financial instrument and, instead, are cash settled. Moreover, in some cases, the underlying financial instrument is an index. Options that can be exercised before or at the expiration date are referred to as American options; if an option can be exercised only on the expiration date, it is termed a European option.

There are two basic types of options: calls and puts. The *call option* is any option which obligates the writer to deliver to the buyer at a set price (exercise or strike price) within a specified time limit the underlying financial instrument. When the market price of the underlying instrument is above the exercise (strike) price of the call, the call option is ''in-the-money.'' Conversely, when the market price of the underlying financial instrument is below the exercise (strike) price of the call option, the call is ''out-of-the-money.'' When the market price of the underlying instrument is equal to the strike price, the option is ''at-the-money.'' At expiration, the buyer will exercise the option if it is ''in-the-money'' or let it expire unexercised if it is out-of-the-money. An out-of-the-money call option has no value at expiration, since buyers will not purchase the underlying instrument at a price above the current market price. Prior to expiration, the value of an ''in-the-money'' call option is at least equal to the market value of the underlying instrument minus the strike price. The ownership of a call provides significant leverage, but raises the breakeven price relative to ownership of the underlying instrument. Holding the call limits the amount of potential loss and offers unlimited potential for gains.

A *put option* gives the buyer the right, but not the obligation, to *sell* the underlying instrument at a specified price (exercise or strike price), before or at expiration. When the market price of the underlying instrument is below the strike price of the put option, the put is ''in-the-money,'' and a put option is out-of-the-money when the market price of the underlying financial instrument is above the strike price of the put option. Ownership of a put option offers leveraged profitability if the market value of the underlying instrument declines.

Some portfolio managers commonly employ ''covered'' call writing strategies to gain fee income from options written on securities held in the portfolio. If an option position is covered, the seller owns the underlying financial instrument or commodity or has a futures position. For example, an option position would be ''covered'' if a seller owns cash market U.S. Treasury bonds or holds a long position on a Treasury bond futures contract. Writing ''covered calls'' has only limited potential for gain. Writing ''covered calls'' is not a proper strategy for a market that could rise or fall by substantial amounts. It is generally used in a flat market environment.

Referring to the above example, if a seller holds neither the cash market U.S. Treasury Bonds or was not long on the Treasury bond futures contract, the writer would have an uncovered or ‘‘naked’’ position. In such instances, margin would be required (by the exchange, if an exchange traded option—not the case for an OTC option) since the seller would be obligated to satisfy the terms of the option contract if the option buyer exercises the contract. The risk potential for loss in writing ‘‘naked calls’’ (calls against which there are no securities held in portfolio) is great since the party required to deliver must purchase the required securities at current market prices. Naked ‘‘covered call’’ writing is generally viewed to be speculative since the risks are theoretically unlimited, particularly if it is done solely to generate fee income.

Options are purchased and traded either on organized exchanges or in the over-the-counter (OTC) market. Option contracts follow three-month expiration cycles (example: March/June/September/December). The option contracts expire on the Saturday following the third Friday in the expiration month. Thus, options are considered as ‘‘wasting assets’’ because they have a limited life since they expire on a certain day, even though it may be weeks, months, or years from now. The expiration date is the last day the option can be exercised. After that date the option is worthless.

Option premium valuation. The price (value) of an option premium is determined competitively by open outcry auction on the trading floor of the exchange. The premium value is affected by the inflow of buy and sell orders reaching the exchange floor. The buyer of the option pays the premium in cash to the seller of the option which is credited to the seller’s account. Several factors affect the value of an option premium, as discussed below. The option premium consists of two parts, ‘‘intrinsic value’’ and ‘‘time value.’’ *The intrinsic value* is the gross profit that would be realized upon immediate exercise of the option. Stated another way, it is the amount by which the option is in-the-money. It is the higher of: the value of an option if it is exercised today; or zero. For ‘‘in-the-money’’ *call* options, it is the difference between the price of the underlying financial instrument, and the exercise (strike) price of the option. For ‘‘in-the-money’’ *put* options, it is the difference of the exercise (strike) price of the put option and the price of the underlying financial instrument. The intrinsic value is zero for ‘‘at-the-money’’ or ‘‘out-of-the-money’’ options. The *time value* derives from the chance that an option will gain intrinsic value in the future or that its intrinsic value will increase before maturity of the contract. Time value is determined by subtracting intrinsic value from the option premium. For example,

Time value = Option premium – Intrinsic values

Time value = 5–10/64 – 4.00

Time value = 1.15384

The option premium is affected by several other factors. One factor involves the comparison of the underlying futures price versus the strike price of the option. An option’s price is increased the more that it is in-the-money. A second factor is volatility. Volatile prices of the underlying financial instrument can help stimulate demand for the options, thus increasing the premium. A third factor that affects the premium of an option is the time until expiration. Option premiums are subject to greater price fluctuations because the underlying value of the futures contract changes more with a longer time period. Other factors that affect the option premium are the strike rate(s) and the domestic and foreign (if applicable) interest rates.

An exchange-traded option is often referred to as a ‘‘standardized’’ option, reflecting the fact that the terms of the contract are uniform with respect to the underlying instrument, amounts, exercise prices, and expiration dates. OTC options are characterized by terms and conditions which are unique to each transaction. Large financial institutions are often dealers in customized interest rate or foreign exchange options. For example, a banking organization might write a ‘‘cap,’’ or series of put option on pounds sterling to protect the dollar value of a sterling denominated receivable due in one year. In this case, an option can be tailored to fit the exact needs of the buyer.

Like futures contracts, contract performance on exchange-traded options is guaranteed by the clearing corporation which interposes itself as a central counterparty to all transactions. It substitutes itself as a seller to all buyers and as a buyer to all sellers. Standardization combined with the clearing corporation’s guarantee facilitates trading and helps to insure liquidity in the market. The buyer or seller of an exchange-traded option may always close out an open position by entering into an offsetting transaction, with the same strike price and expiration date, and for the same amount. Indeed, most exchange-traded options are liquidated prior to maturity with an offsetting transaction, rather than by exercising the option in order to buy or sell the underlying instrument.

Buyers of exchange-traded options are not required to post funds to a margin account because their risk is limited to the premium paid for the option. However, writers (sellers) of options are required to maintain margin accounts because they face substantial amounts of risk. The amount of the margin varies depending upon the volatility in the price of the option. As the option moves closer and closer to being in-the-money, the writer is required to deposit more and more into his margin account, in order to guarantee his performance should the option eventually be exercised.

Options on futures contracts provide the holder with the right to purchase (call) or sell (put) a specified futures contract at the option's strike price. The difference between the strike price on the option and the quote on the futures contract represents the intrinsic value of the option. Options on futures contracts differ from traditional options in one key way: the party who exercises an option on a futures contract receives a long or short futures position (depending on whether he is exercising a call or put option) rather than accepting or making delivery of the underlying security or financial instrument. When the holder of a call option on a futures contract exercises the option and the futures contract is delivered, the option writer must pay the option holder the difference between the futures contract's current value and the strike price of the exercised call. The buyer takes on a long position, and the writer a short position in the futures contract. When a futures put option is exercised, the holder takes on a short futures position, and the writer a long position. The writer of the put pays the holder the difference between the current price of the futures contract and the strike price of the put option. The resultant futures position, like any other futures position, is subject to a daily marked-to-market valuation. In order to liquidate the futures position, both the buyer and the seller must undertake offsetting futures transactions.

2130.0.8.1 Other Option Contracts

2130.0.8.1.1 Stock Index Options

A stock index option is a call or a put that is based on a stock market index such as the S & P 500. As opposed to a regular call or put option on equity securities where there must be a sale and delivery of shares of stock, there is no delivery of the underlying instrument when an index option is exercised. Rather, settlement is in cash.

2130.0.8.1.2 Foreign Currency Options

The right to buy (call) or sell (put) a quantity of a foreign currency for a specified amount of the domestic currency is a foreign currency option. The size of the contract is standard for each currency. The contracts are quoted in cents per unit of foreign currency. As an example, one call option for the British pound is 12,500 pounds.

2130.0.8.2 Caps, Floors, and Collars

Caps, floors, and collars provide risk protection against floating interest rates. The market for these products is an outgrowth of the OTC market in fixed income (bond) options.

An interest rate cap contract pays the buyer cash if the short term interest index rises above the strike rate in the contract in exchange for a fee. In combination with a floating rate obligation, it effectively sets a maximum level on interest rate payments. If market rates are below the cap rate, no payments are made under the cap agreement. Thus, the buyer of a cap is able to place a ceiling on his floating rate borrowing costs without having to forego potential gains from any decline in market rates.

Cap agreements typically range in maturity from 6 months to as long as 12 years, with reset dates or frequencies that are usually monthly, quarterly, or semiannual. The London Interbank Offered Rate (LIBOR) is the most widely used reference rate for caps, floors, and collars. Other indexes used as reference rates are commercial paper rates, the prime interest rate, Treasury bill rates, and certain tax-exempt rates. Cap fees depend upon the cap level, the maturity of the agreement, the volatility of the index used as the reference rate, and market conditions. The higher the cap rate, the lower the premium. The fee is usually paid up front, but can be amortized.

An interest rate floor agreement is used to protect the overall desired rate of return associated with a floating-rate asset. In accordance with the agreement, the seller receives a fee for the floor agreement from the holder of the underlying asset. When interest rates fall, the holder of the floor contract is protected by the agreement, which specifies the fixed per annum rate (floor rate) that will be retained on those assets, at specified times during the life of the agreement, even though floating interest rates may decline further.

An interest rate collar is a variation of a cap-only agreement. Under this arrangement the seller of the collar, for a fee, agrees to limit the buyer's floating rate of interest within one agreement by a simultaneous sale of a cap and purchase of a floor, or purchase of a cap and sale of a floor. When the reference rate is above the cap rate the seller makes payments to the buyer sufficient to return the buyer's floating rate interest cost to the cap rate. Conversely, the buyer makes payments to the collar provider to bring its rate back to the floor whenever the reference rate falls below the floor rate. In effect, under a collar agreement the buyer is selling a string of call options (the floor) back to the provider of the cap. The premium received from selling the floor reduces the overall cost of the cap to the buyer of the collar. Thus, the premium for a floor/ceiling, or collar, agreement, is lower than for a cap-only agreement with the cap at the same level. This is because the floor sold to the provider of the collar has a certain value, which is passed along to the buyer in the form of a lower premium.

The disadvantage to collars, of course, is that they limit the buyer's ability to profit from declines in market rates below the specified floor. Clearly, one's interest rate expectations play an important role in determining whether or not to use a collar agreement. It should also be noted that collar agreements involve credit risk on both sides of the agreement, similar to the credit risk considerations found in interest rate swap agreements. The buyer of the collar is exposed to the risk that the provider may default on payments due under the cap agreement; and the provider of the collar is exposed to the risk that the buyer may default on payments due under the floor agreement.

2130.0.9 REGULATORY FRAMEWORK

GNMA has adopted limited margin requirements. Specifically, the GNMA margin requirements (12 C.F.R. 390.52) require marking-to-market and the posting of maintenance margin.[5] However, the GNMA margin requirements exclude the majority of GNMA forward contracts and only pertain to contracts involving GNMA issuers with other parties.[6]

The Commodities Futures Trading Commission ("CFTC") is the agency authorized by Congress to supervise the trading of "commodities," including financial futures. Exchanges which trade commodities must register with the CFTC. In addition, the various futures exchanges must receive CFTC approval before they can begin trading a new futures instrument. Brokers and dealers who execute futures contracts for customers must register as Futures Commission Merchants ("FCM") with the CFTC. There are also CFTC registration requirements pertaining to firms engaging in commodities activities similar to an investment advisor or mutual fund in the securities markets. Finally, the surveillance activities of the various futures exchange examiners are subject to oversight by the CFTC.

With the exception of reporting requirements concerning persons or entities with large futures positions, the CFTC's jurisdiction generally does not extend to financial institutions. Rather, the federal and state banking agencies, state insurance commissions, and the Office of Thrift Supervision are responsible for supervising regulated entities' future activities, if permitted, under statute or regulation.

2130.0.10 EXAMPLES OF CONTRACT STRATEGIES

For purposes of reporting large positions to the CFTC a market participant defines its future activities as "speculative" or as "hedging." Basically, CFTC rules consider a participant to be a hedger if certain facets of such person's business can be hedged in the futures markets; persons who do not have a business need for participating are deemed to be speculators. It is anticipated that bank holding companies characterize their contract activities as "hedging", or possibly as arbitrage between various markets.

5. Initial margin requirements necessitate the pledging of something of value prior to initiation of a transaction. Depositing maintenance margin refers to pledging something of value in reaction to market movements; e.g. depositing cash representing the difference between a forward contract price and its current market value.

6. See SR-625 dated July 23, 1980.

Examiners must scrutinize contract positions for purposes of evaluating risk.

The Board policy statement concerning bank holding companies[7] states:

"... the Board believes that any positions that bank holding companies or their nonbank subsidiaries take in financial contracts should reduce risk exposure, that is, not be speculative." It should be noted, however, that a more liberal interpretation of the policy statement has been permitted for dealer subsidiaries. For example, in a government securities dealer subsidiary, it is permissible to use related financial contracts as a substitute trading instrument for cash market instruments. Thus, the use of financial contracts is not limited solely to reducing the risk of dealing activities.

Some examples of contract strategies are provided which reduce risk when viewed in isolation. A definition of a financial hedge is:

"to enter transactions that will protect against loss through a compensatory price movement."

In looking at a hedge transaction in isolation, there should be certain elements present to make a hedge workable:

1. The interest rate futures or forward contract utilized should have a high positive correlation (prices that tend to move in the same direction with similar magnitude) with the cash position being hedged. In other words, the futures or forward position taken should be structured so that an upward price movement in the contract offsets a downward price movement in the cash or risk position being hedged, and vice versa.

2. The type (e.g. T-bill, T-bond, etc.) and size of the contract position[8] taken should have a proportionate relationship to the cash or risk position being hedged, so that futures gains (losses) will approximately offset any losses (gains) on the hedged position.

3. The contract position taken should have a life which is equal to or greater than the end of the period during which the hedge will be outstanding. For example, if interest rate protection was deemed necessary for a six-month time span, it would not ordinarily be wise to enter a contract expiring in three months.

2130.0.10.1 The Mortgage Banking Price Hedge

Assume that a mortgage banking subsidiary agrees in June to originate mortgages at a fixed yield in the following October. Unless the loan originator has a forward commitment to sell the loans to a permanent investor(s), it is exposed to a decline in the principal value of mortgages due to a rise in interest rates between the commitment date and ultimate sale of the loans. An example of a traditional "short hedge" would be the sale of futures contracts in an attempt to reduce the risk of price fluctuation and insure a profitable sale of the loans. However, in following this strategy the mortgage originator also chooses to forfeit its ability to reap a profit if interest rates should fall.

If interest rates increased, the loss on the sale of mortgages or a pool of mortgage-backed securities will probably be largely offset by a gain on the futures transaction; see example below. If interest rates fall, the mortgage originator would gain on the resale of mortgages but lose on the futures market transaction. Hence, in a true hedge, the hedger's earnings are relatively unaffected by a change in market interest rates in either direction.

Generally accepted accounting principles applicable to mortgage activity require that mortgages held for resale be periodically revalued to the lower of cost or market (Financial Accounting Standards Board Statement No. 65, "Accounting for Certain Mortgage Banking Activities"). Unrealized gains and losses on outstanding futures contracts are matched against related mortgages or mortgage commitments when the inventory is revalued to the lower of cost or market; i.e. the lower of cost or market valuation is based upon a net figure including unrealized related futures gains and losses.

2130.0.10.2 Basis

Basis is the difference between the cash (spot) price of a security (or commodity) and its futures price. In other words:

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7. The Board's policy statement on engaging in futures, forwards, and option contracts.

8. Futures market participants engage in a practice, sometimes known as "factorweighting" or "overhedging," to determine the appropriate number of futures contracts necessary to have the proper amount of compensatory price movement against a hedged cash or risk position. For example, it would require 10 mortgaged-backed futures contracts (8% coupon, $100,000 face value) to hedge an inventory of $1,000,000 mortgage-backed (8% coupon) securities. Alternatively, 14 mortgage-backed futures contracts would be required to hedge a $1 million inventory of mortgage-backed securities with a 13½% coupon. Overhedging or factor weighting is necessary in hedging securities with higher coupons than those specified in futures contracts (currently 8% on bond futures) because higher coupon securities move more in price for a given change in yield than lower coupons.

Basis = Spot price − Future price

For short-term and intermediate futures contracts, the futures price is the quoted futures price times an appropriate conversion factor. For short-term futures contracts the quoted futures price is 100 less the annualized futures interest rate. The invoice price must be determined using yield-to-price conventions for the financial instrument involved.

Basis may be expressed in terms of prices. Due to the complexities involved in determining the futures price, it is thus better to redefine price basis using actual futures delivery prices rather than quoted futures prices. Thus, the price basis for fixed income securities should be redefined as:

Price Basis = Spot price − Futures delivery price.

Basis may also be expressed in terms of interest rates. The *rate basis* is defined as:

Rate basis = Spot rate − Futures rate

The spot rate refers to the current rate on the instrument that can be held and delivered on the contract. The futures rate represents the interest rate that corresponds to the futures delivery price of the deliverable instrument.

The rate basis is useful in analyzing hedges of short-term instruments since it nets out all effects resulting from aging. For example, if a one year T-bill has a rate of 9 percent with a price of 85, and a 3-month T-bill has a rate of 9 percent and a price of 94, the price basis would be −9. If a cash security ages, it does not necessarily mean that a change in the rate basis has taken place.

2130.0.10.3 Trading Account Short Hedge

Another example of a short hedge pertains to securities dealers that maintain bond trading accounts. While bonds are held ''long'' (actually owned by the dealer) in trading accounts, dealers are subject to two risks. First, there is the risk that the cost can change regardless of whether the funds are generated through repurchase agreement financing or the dealer's other funding sources. When there is an inverted yield curve (short-term interest rates are higher than long-term rates), trading portfolio bonds in inventory yield less than the cost of funds required to carry them. Second, there is the risk that bond market interest rates will rise, thus forcing the dollar price of bonds down.

2130.0.10.3.1 Example 1: A Perfect Short Hedge[1]

Month	*Cash Market*	*Futures Market*
June	Mortgage department makes commitment to a builder to originate $1 million of mortgages (based on current GNMA 8's cash price) at 98-28⁄32 for $988,750	Sells 10 December mortgage-backed futures at 96-8⁄32 for $962,500 to yield 8.59 percent
October	Mortgage department originates then *sells* $1 million of pooled mortgages to investors at a price of 95-20⁄32, for $956,250	Buys 10 December mortgage-backed futures at 93, for $930,000 to yield 8.95 percent
	Loss: $32,500	Gain: $32,500

1. The effects of margin and brokerage costs on the transaction are not considered. It should be noted that ''perfect hedges'' generally do not occur.

The following example pertains to a bond trading account. Assume that the dealer purchases Treasury bonds on October 4 and simultaneously sells a similar amount of Treasury bond futures contracts. The illustration ignores commission charges and uses futures contracts maturing in March 19x9 because the dealer's technical analysis discovered an advantage in using the March 19x9, rather than the previous December contract as a hedge. (At that time the previous December contract was the next available contract still trading.)

	Cash Market		Futures Market	
10/04/1998	Purchase $5MM T-bonds maturing Aug. 2005, 8% coupon at 87-$\frac{10}{32}$:		Sell $5MM T-bonds futures contracts expiring Mar. 1999 at 86-$\frac{21}{32}$:	
	Principal =	$4,365,625	Contract value =	$4,332,813
10/23/1998	Sell $5MM T-bonds at 79.0:		Buy $5MM T-bond futures Mar. 1999 at 79-$\frac{1}{32}$	
	Principal =	3,950,000	Contract value =	3,951,563
	Cash loss =	($415,625)	Futures gain =	$381,250

Although the hedge did not prevent the dealer's trading account from losing money, it limited the loss to $34,375 instead of $415,625.

It is worth noting that the preceding example also illustrates some of the dangers of using interest rate futures contracts. Although the futures market proved useful to the trading department, a futures contract could have serious consequences for a dealer using an alleged "long hedge to lock-in an attractive yield."

2130.0.10.4 Long Hedge

In certain areas of the country, financial institutions desiring to hold public deposits are required to bid competitively for deposits. The case discussed below pertains to a situation where the competitive bids must be tendered one calendar quarter in advance of receiving the deposit. In this example, the asset side of the balance sheet is not discussed since it is assumed that a banking organization paying the prevailing one-year C.D. interest rate can utilize the funds at a profitable spread.

In this type of situation the bidding institutions are generally vulnerable to falling interest rates; one can safely assume that an institution selected to hold public deposits would not be dismayed to learn subsequently that interest rates had risen and it had locked-in a funding source at or below market rates. However, the funds will not be received for another 3 months. Thus, there is the possibility that interest rates could drop in the interim, leaving a reduced or possibly negative net interest margin when the funds are deployed.

There are a number of approaches available to attempt to ensure that future time deposits can be obtained without paying higher than market interest rates. One method is forecasting the appropriate interest rate to be paid on a given time deposit three months in the future. However, forecasting has become increasingly difficult to do with accuracy in the recent periods of fluctuating interest rates. An alternative approach would be to quote the current C.D. rate (adjusted slightly for competitive factors) with an intent to hedge in the futures market if the banking organization's interest rate bid is accepted. Upon receiving notification that its deposit bid has been accepted, the institution can then purchase an appropriate number of futures contracts to insure a profitable investment spread three months hence when it actually receives the deposit.

The following example on June 1, 19x0; the facts are as follows:

Size of public deposits offered	$10 million
Date of deposit	September 2, 19x0
Term	1 year
Current C.D. rate	8¼%

For purposes of this illustration, assume that a bid was submitted to pay 8¼% for one year on $10 million. The bids were due June 1 and notification was given June 2 of the intention to provide the funds on September 2; and the banking organization decided to purchase futures contracts on June 2.

A Treasury bill futures contract, expiring in 3 months, is selected as the hedging vehicle because it reflects price movement of an instrument with a comparable maturity to one-year

C.D., and there was no C.D. futures contract trading. For purposes of this illustration, it is assumed that the contract offers sufficient liquidity to enable the banking organization to readily offset its open futures position when necessary. Using the bill contract is an example of "cross hedging" which is defined as the buying or selling of an interest rate futures contract to protect the value of a cash position of a similar, but not identical, instrument. This type of hedging is a measured risk since the outcome of such a transaction is a function of the price correlation of the instruments being hedged. At any given moment it is conceivable that a negative correlation could exist between two unlike instruments despite the presence of a strong correlation over an extended time period.

Date	*C.D. Rate*	*Transactions*	*T-bill*	*Futures* [1]
June 2, 19x0	8.25%	Purchase 40 Contracts	91.84	8.16%
Sept. 2, 19x0	11.00%	Sell 40 Contracts	90.05	9.95%

1. The size of the trading unit is based upon U.S. T-bills having a face value at maturity of $250,000 (40 × 250M = 10MM). Prices are quoted in terms of an index representing the difference between the actual T-bill yield and 100.00. Every one basis point movement on a contract is equal to $25.00 per contract.

2130.0.10.4.1 Evaluation of the Hedge

Total interest (not compounded) to be paid (8¼%)	$ 825,000
Alternative C.D. interest (not compounded) at current rate (11%)	1,100,000
Difference	275,000
Futures trading loss*	(179,000)
Net difference	$ 96,000

*Computation—Purchase price 91.84
Sale price 90.05
1.79 or 179 basis points
(179 × $25.00 × 40 contracts = $179,000)

In retrospect, it would have been better if the banking organization would not have hedged. By agreeing to an interest rate on June 2, it obtained deposits on September 2 and will pay approximately $275,000 less in interest payments to the municipality than is required on an ordinary C.D.(s) issued on September 2. The $179,000 futures trading loss, of course, reduced the windfall interest income due the banking organization. A net interest income spread of approximately $96,000, instead of a $275,000, demonstrates two principles: 1) cross hedging can cause unexpected results; and 2) it is quite difficult to find perfect hedges in the real world. The hedge was structured so that a cash gain was offset by a futures loss—incorporating the offsetting principles of a hedge transaction. If the general level of interest rates had fallen, a futures gain should have occurred to offset the higher (relative to prevailing market rates) cost of funds obtained on September 2.

2130.0.10.5 Using Options to Create an Interest Rate Floor

Assume that on September 28th it is decided to rollover a $1,000,000 investment in 13-week Treasury bills on November 28, which also happens to be the expiration date for call options on the December Treasury bill futures contract. The banking organization, concerned that interest rates will fall between September 28 and the rollover date, wishes to hedge the rollover of its investment. The portfolio manager can set a minimum yield on the rollover investment by either buying a Treasury bill future call option, or by buying a Treasury bill futures contract. Further assume that the December Treasury bill futures contract can be bought for a price of 93.70 which implies a discount yield of 6.30 percent. Treasury bill futures call options with a strike price of 93.75, implying a discount yield of 6.25 percent, sell for a premium of 20 basis points, or $600 (20 basis points × $25/basis point = $500).

If the banking organization could actually buy a Treasury bill futures contract that expired on exactly November 28, then there would be a perfect hedge since the rate of return on the bills would be explicitly fixed by the futures hedging strategy. However, the closest maturing Treasury bill futures contract expires in December, several weeks after the rollover date for the banking organization's investment. Uncertainty over the actual discount yield of the Treasury bills on the rollover date and the yield produced by the hedge is known as ‘‘basis risk,’’ the risk that the yield on the hedge may differ from the expected yield on the hedged item. For purposes of this example, assume that the yield on the futures contract equals the actual discount yield on the 13-week Treasury bills at the rollover date. Thus, the futures hedge in this example will provide an effective discount yield of 6.30 percent on the rollover of the 13-week Treasury bill investment.

Assume that rates fall after September 28 and that the discount yield on Treasury bill futures contracts declines from 6.30 percent to 6.00 percent at the November 28 expiration date of the December Treasury bill futures options contract. The option to buy the Treasury bill futures will be exercised since the strike price of 93.75 is below the market price of 94.00 for the underlying futures contract, yielding a profit of 25 basis points or $625 (25 basis points × $25/basis point). The profit must be offset by the 20 basis point cost of the option, which reduces the net profit to 5 basis points. The effective hedged discount yield is 6.05 percent (6.00 percent on the 13-week Treasury bills—assuming no basis risk—plus the 5 basis point profit from the hedge). The option hedge produces a yield that is 5 basis points higher than the unhedged yield, but 25 basis points lower than the 6.30 percent yield that would have resulted from hedging with futures.

Although the option hedge resulted in a lower effective yield than the futures hedge, it set an absolute floor on the investment. This is because any decline in the discount yield of the Treasury bills below 6.05 percent would be offset dollar for dollar by the additional profits from the hedge. The real advantage of the option hedge is that, although it establishes a floor that is lower than the rate fixed by the futures hedge, it allows the hedger to participate in any increase in interest rates above the cost of the call premium. For example, if interest rates increased such that the price on the December Treasury bill futures contract on November 28 falls to 93.00, implying a discount yield of 7.00 percent, the option would expire unexercised since the strike price is above the price of the underlying futures contract. Again, assuming that the spot price for the 13-week Treasury bills is equal to the futures price, the effective discount yield is 6.80 percent (7.00 percent minus the 20 basis point call option premium), 50 basis points higher than the yield that would have been provided by the futures hedge.

2130.0.10.6 Hedging a Borrowing with an Interest Rate Cap

In order to limit a borrower’s interest rate risk, sophisticated banking institutions may offer cap agreements as part of a loan package to their clients. While such an arrangement provides some comfort that the borrower’s ability to repay will not be jeopardized by a sharp increase in interest rates, it obviously transfers that interest rate risk back to the lender. Nevertheless, many banking institutions feel they are better able to manage that risk than are some of their clients. Cap agreements have also been utilized to cap the rate on issued liabilities. For example, an institution might be able to issue medium-term floating rate notes at 3-month LIBOR plus an eighth of a percent. Alternatively, that institution could issue a capped floating rate note at 3-month LIBOR plus three-eights of a percent. By subsequently selling the cap separately back into the market the institution could, achieve sub-LIBOR funding, depending on the proceeds from the sale of the cap.

A cap agreement is typically specified by following terms: notional principal amount; maturity; underlying index, frequency of reset, strike level. As an illustration, a cap agreement might have the following terms:

Notional Principal Amount	$10,000,000
Maturity	2 Years
Underlying Index	3-month LIBOR
Rate Fixing	quarterly
Payment	quarterly, in arrears, on an actual/360-day basis
Cap Level	9%
Up Front Fee	1.11% of par ($111,000)

Under the terms of this agreement, if at any of the quarterly rate fixing dates 3-month LIBOR exceeds the cap level then the seller of the cap would pay the buyer an amount equal to the difference between the two rates. For example, if at a reset date LIBOR was set at 10 percent, the payment would be:

10%(90/360 × $10,000,000)

–

9%(90/360 × $10,000,000)

=

$25,000

Thus, the writer of the cap would pay the buyer $25,000. If 3-month LIBOR for the quarter were set at or below the cap level of 9 percent, no payment would be made.

2130.0.11 ASSET-LIABILITY MANAGEMENT

Financial contracts can be used as a tool in an overall asset-liability management strategy. In order to use financial contracts in this context, a BHC or nonbank subsidiary must first identify where interest-rate exposure lies as indicated by mismatches between asset and liability structures. In those instances where the BHC or nonbank subsidiary has variable-rate assets and variable-rate liabilities with comparable maturities, there is, in theory, no need to hedge with financial contracts since that portion of the asset-liability structure is already hedged. The same holds true for fixed-rate assets and liabilities (yielding a positive interest-rate margin) of comparable maturities. Once a BHC or nonbank subsidiary has identified the undesired mismatches in assets and liabilities, financial contracts can be used to hedge against the identifiable mismatch—for example, long positions in contracts can be used as a hedge against funding interest-sensitive assets with fixed-rate sources of funds, and short positions in contracts can be used as a hedge against funding fixed-rate assets with interest-sensitive liabilities.

BHCs or nonbank subsidiaries that choose to employ financial contracts as a tool in their general asset-liability management program and properly use financial contracts are striving towards worthwhile goals. The discipline of identifying mismatches between assets and liabilities tends to focus the practitioner's attention on the entire balance sheet. Examiners should be aware that marketing efforts on behalf of the futures exchanges have attempted to focus upon just one side of the balance sheet by ''pairing'' a futures contract with an asset or a liability. In considering financial-contract activities, examiners need to remember that financial-contract activities must be evaluated in light of both sides of a balance sheet.

One final point should be made with respect to ''hedging'' based upon pairing a futures contract against a portfolio security. Since this type of ''hedging'' can be done while considering only the asset side of the balance sheet, it is possible that such a strategy could increase interest-rate risk rather than reduce it. For example, assume (unrealistically) that there is a perfect balance between variable-rate assets and liabilities, and the firm is evaluating fixed-rate assets and liabilities. Management determines that there is a perfect balance between fixed-rate assets and liabilities and then isolates the last fixed-rate asset and liability. Make the further assumption that the organization holds a six-month note yielding 12 percent which is financed by funds maturing in six months which costs the organization 10.5 percent. By executing a short futures contract ''paired'' against the six-month note, the organization would move from an overall ''hedged'' position to an ''unhedged'' position. In other words, the futures contract would move the organization from an overall neutral position and expose the organization to interest-rate risk.

It should be evident why it is more productive to consider the ''big picture'' in inspections rather than focusing upon individual or ''paired'' (futures against each position) transactions. The most meaningful approach is to evaluate hedging strategies and open financial contract positions in light of its business needs, operations, and asset-liability mix.

2130.0.12 INSPECTION OBJECTIVES

1. To determine the purpose of financial-contract positions. Any positions that bank holding companies or their nonbank subsidiaries (except certain authorized dealer subsidiaries) take in financial contracts should reduce risk exposure, that is, not be speculative.
2. To determine whether prudent written policies, appropriate limitations, and internal controls and audit programs have been established and whether management information systems are sufficiently adequate to monitor risks associated with contracts involving futures, forwards, and options (including caps, floors, and collars).
3. To determine whether policy objectives concerning the relationship of subsidiary banking organizations and the parent bank hold-

ing company specify that each banking organization in a holding company system must be treated as a separate entity.

4. To determine reporting compliance in accordance with the Board's bank holding company policy statements. See section 2130.0.17 for the appropriate cites.

2130.0.13 INSPECTION PROCEDURES

The term "banking organization" is used generally to refer to a bank holding company, the parent company, or nonbank subsidiary.

1. Determine if the banking organization's financial-contract activities are related to the basic business of banking.

   Consider whether the financial-contract activities are closely related to the basic business of banking; that is, taking deposits, making and funding loans, providing services to customers, and operating at a profit for shareholders without taking undue risks. Taking financial-contract positions solely to profit upon interest-rate forecasts is considered to be an unsafe and unsound practice. Profitability of contract activities is not the criterion for evaluating such activities. It is quite probable that a bona fide hedge strategy could result in a contract loss which would be offset by increased interest earnings or a higher price for an asset sold, for example, a pool of mortgages. Criticize contracts placed solely to profit upon interest-rate movements. Verify that contract activities are conducted in accordance with the Board's policy statement. Where contract positions are of excessive size and could jeopardize the financial health of the entity under examination, the gains or losses realized because of financial-contract activities should be criticized.

2. Ascertain whether policy objectives highlight the circumstances under which financial contracts should be used.

   Determine whether management and operating personnel have received sufficient guidance. Carefully constructed policy objectives should be formulated with the knowledge that although proper utilization of financial contracts limits loss potential, such utilization also limits potentials for gains. Policy objectives should be formulated to limit required resources (margin monies, commissions, and personnel to execute, monitor, and audit contract activities). A well-constructed policy should be designed to preclude various operating areas of a banking organization from taking offsetting financial contract positions. Finally, there should be established benchmarks for determining whether financial contracts are meeting desired objectives.

3. Determine if policy objectives concerning the relationship of subsidiary banking organizations and the parent bank holding company comply with the Board's directives.

   Each banking organization in a holding company system must be treated as a separate entity. The policy statement accommodates centralized holding companies in that the holding companies are free to provide guidance to subsidiary banking organizations and execute contracts as agent on behalf of the banking organization, provided that each banking organization maintains responsibility for financial contract transactions executed on its behalf. Accordingly, a holding company that has centralized management could, and perhaps should, consider the interest-rate exposure of its subsidiary banks on a consolidated basis in determining whether future contracts can usefully be employed to reduce that exposure, but any future contracts that are executed must be recorded on the books and records of a subsidiary bank that will directly benefit from such contracts.

   The question concerning the relationship of a subsidiary bank to its holding company may also lead one to consider the relationship of a subsidiary bank with its correspondent bank or broker. One might also query to what extent may less sophisticated institutions rely upon brokers and/or correspondent banking organizations for advice in this area?

   Less sophisticated institutions can place only limited reliance on others for advice in this area. The bank holding company policy statement[9] emphasizes that responsibility for financial-contract activities rests solely with management. Additional information on securities transactions and the selections of securities dealers can be found in section 2126.1.

4. Ascertain whether policy objectives and/or position limits require prudence on the part of authorized personnel entering into these new activities. If discretion is left to senior

9. The Board's policy statement on engaging in futures, forwards, and option contracts.

managers, determine whether management has issued instructions to ensure that the level of financial-contract activity is prudent relative to the capabilities of persons authorized to execute and monitor contracts.

A new activity such as financial contracts should, as a general rule, be entered slowly. In developing expertise, management should mandate a low level of activity until persons authorized to execute contracts gain sufficient expertise or until new personnel are employed that have sufficient training and experience to engage in financial-contract activities on a larger scale. Senior management must develop the expertise to understand and evaluate techniques and strategies employed to ensure that an experienced professional does not engage in improper or imprudent activities.

5. If a banking organization uses financial contracts as part of its overall asset-liability management strategy, determine whether the organization developed an adequate system for evaluating its interest-rate risk.

   Without a system for identifying and measuring interest-rate risk, it is impossible to engage in hedging activity in an informed and meaningful manner. Failure to identify the mismatches in the organization's asset-liability mix would make it difficult to select the proper number and types of financial contracts—for example, bond or bill financial contracts—to provide an appropriate amount of interest-rate-risk protection. Evaluate whether the organization's interest-rate-risk measurement techniques appear reasonable to determine whether the financial contracts employed were successful in providing the proper amount of futures gains (losses) to cover the hedged risk position.

6. Determine if the recordkeeping system is sufficiently detailed to permit personnel to document and describe in detail how financial-contract positions taken have contributed to the attainment of the banking organization's stated objectives.

   There is no universal, adequate recordkeeping system for this purpose. Examiners must evaluate each individual system relative to the organization's stated objectives and activities. If the recordkeeping system cannot be used to illustrate how financial contracts contributed to the attainment of the banking organization's stated objectives, the recordkeeping system is inadequate. BHCs with inadequate recordkeeping systems should be instructed to make appropriate modifications.

7. Ascertain whether the banking organization's board of directors has established written limitations with respect to financial-contract positions.

   NOTE: The bank holding company policy statement requires that the board of directors establish written policies and position limitations in connection with financial-contract activities. If a committee has been delegated similar responsibilities within the organization, and a committee makes the decision, its recommendation should be ratified by the board of directors.

8. If there is the potential to exceed the above limitations in certain instances, determine whether there are firm, written procedures in place concerning the authorizations necessary to exceed limits.

9. Determine whether the board of directors, a duly authorized committee thereof, or internal auditors review at least monthly financial-contract positions to ascertain conformance with limitations. (See item (b) of the bank holding company policy statement.)

10. Determine if the banking organization maintains general-ledger memorandum accounts or commitment registers to adequately identify and control all financial-contract commitments to make or take delivery of securities or money market instruments.

11. Determine if the banking organization issues or writes option contracts expiring in excess of 150 days which give the other party to the contract the option to deliver securities to it.

    Examiners should review the facts surrounding standby contracts issued by holding companies. Examiners should also review accounting entries connected with bank holding company standby contracts to determine whether standbys were issued to earn fee income "up front" and exploit the lack of generally accepted accounting principles.

12. Determine whether financial-contract positions are properly disclosed in notes to the statements of financial condition and income and that the contract positions have been properly reported on FR Y-9C, Schedule HC-F, "Off-Balance-Sheet Items."

13. Determine whether the banking organization has implemented a system for monitoring credit-risk exposure associated with

various customers and dealers with whom operating personnel are authorized to transact business.

All financial-contract trading involves market risks. However, forward and OTC options trading, as well as swap activities, also involve credit risk. The key concern is whether the contra party to a transaction will be ready, willing, and able to perform on contract settlement and payment dates. While maintaining control over credit-risk exposure should ensure that a financial organization will not enter excessive (relative to the financial condition of the contra party) forward or standby contracts, monitoring such exposure may not prevent default in all instances.

14. Ascertain whether the banking organization has implemented internal controls and internal audit programs to ensure adherence to written policies and prevent unauthorized trading and other abuses.
15. Determine if the Reserve Bank was notified at the inception of bank holding company futures, forward, and option activities as required by paragraph (f) of the holding company policy statement (*Federal Reserve Regulatory Service* 4–830).
16. Determine if the personnel engaged in financial-contract activities have sufficient knowledge and understanding of the markets to perform those functions.

2130.0.13.1 Evaluating the Risks of Contract Activities

Evaluating the organization's stated objectives and their effects on overall risk is a difficult task involving legitimate cause for concern because of the high degree of leverage involved in contract activities. Although there is an emerging trend towards dealers requiring margin on forward trades, forward contract transactions generally have not required margin deposits, and thus, grant users unlimited leverage. Although the amount of margin required for futures trades is extremely small (for example, $1,500 initial margin to take a $1 million futures position), the rules of the exchanges do require a daily mark to market and a requirement that members of the futures exchanges meet maintenance margin calls on behalf of their customers. Customers, of course, are generally required to promptly reimburse brokers for margin posted on their behalf. Nevertheless, engaging in contract activities requires market participants to assume the market risks of either owning securities or ''shorting'' securities. Issuing (or selling) standby contracts granting the other party to the contract the option to deliver securities is a practice which results in the issuer functioning as an insurer against downside market risk for the other party; in essence, the party receiving the standby fee assumes all of the interest-rate risks of security ownership, but receives none of the benefits.

2130.0.13.2 Reviewing Financial-Contract Positions

The preceding questions were designed to focus the examiner's attention on a bank holding company's stated objectives for engaging in financial contract activities and the manner in which such activities are conducted. It is also vital to review position records with respect to financial contracts or, if necessary, prepare a schedule grouping similar contracts by maturity. Once the various positions have been scheduled it will be possible to evaluate the risk of contract positions relative to the organization under inspection.

2130.0.13.3 Factors to Consider in Evaluating Overall Risk

To determine whether contract positions are reasonable, an examiner must evaluate positions in light of certain key factors: the size of the organization, its capital structure, its business needs, and its capacity to fulfill its obligations. For example, open contracts to purchase $7 million of GNMA securities would be viewed differently in a BHC with $24 million of assets than in a BHC with $1 billion of assets.

There is no guaranty that financial contract prices and cash market prices will move in the same direction at the same velocity; however, contract prices and cash market prices ultimately move towards price convergence in the delivery month. Keeping this fact in mind, the risk evaluating process can be simplified by thinking of the securities underlying the various contracts as a frame of reference. For example, if a BHC holds ''long'' futures contracts on $10 million (par value) of Treasury bonds the examiner should first evaluate the effect (excluding tangible benefits of ownership, e.g., interest income, pledging, etc.) on the organization of holding $10 million of bonds in its portfolio and the resultant appreciation or depreciation if interest rates rise or fall by a given amount. A ''short'' contract of $10 million Treasury bonds would be evaluated as if the banking organization had executed a short sale for $10 million. In addition, the examiner would have to consider the positive or negative flow of funds received or disbursed as margin to reflect daily contract gains and losses. While commissions on futures contracts are not a major factor in hedging transactions, they also should be considered in this evaluation. Typically, commissions are charged on a ''round turn'' basis—meaning that commissions are charged based upon an assumption that each futures contract will be offset prior to maturity. Since each contract will have to be offset, or securities bought or delivered, it should be determined whether funds will be available to offset contracts or fund delivery. In the case of certain short contracts, a determination must be made as to whether deliverable securities are held or committed for purchase by the banking organization.

2130.0.13.4 Contract Liquidity

In addition to looking at the ''big picture,'' examiners should consider a position in a given contract maturity month relative to the volume of contracts outstanding. For example, in futures trading there is generally a greater open interest in the next contract maturity month and perhaps the following one or two contract maturity months. As one moves away from the near term contracts, there is generally less trading and less ''open interest'' in the more distant contracts. ''Open interest'' or the amount of contracts outstanding is reported in financial newspapers and other publications. Generally, the contracts with the largest open interest and daily trading volume are considered to be the most liquid.

To illustrate the concept discussed above, one should consider the following example. A ''red flag'' should be apparent if a contract review discloses that the organization has taken a sizeable position in a contract expiring in two years. When the examiner checks financial newspapers and other publications, he or she may discover that the BHC's position represents 20 percent of the open interest in that contract. Such a situation would clearly be unsafe and unsound because the relatively huge position coupled with the typically less liquid conditions in distant contracts makes it highly unlikely that the BHC could quickly close out its position if necessary. In addition, one should also question why the distant maturity was chosen since there is no immediate reason to expect a close correlation to the cash market for the underlying security.

With respect to forward contracts, there is an active forward market for GNMA securities specifying delivery of the underlying securities up to four or five months in the future. If a banking organization is executing contracts for more distant maturities, management should be queried as to why it is necessary to trade outside the normal trading cycle.

2130.0.13.5 Relationship to Banking Activities

In evaluating contract activities, examiners should verify that contract strategies are carried to fruition in connection with their relationship to overall objectives. Examiners may find it useful to recommend additional recordkeeping in borderline cases when they encounter situations where financial-contract positions are closed out frequently during the hedge period, but not frequently enough to be considered trading rather than hedging activities. Examiners should suggest proper documentation with regard to financial contracts executed and any additional recordkeeping as needed. Specifically, users could be requested to establish written criteria specifying what circumstances will trigger the closing of such contracts. Then users would be judged by how well they adhered to the criteria as well as whether the plan reduced risk. Hopefully, such recordkeeping would give users the latitude to close out a financial-contract position working against them (as determined by some prearranged benchmark), yet still require sufficient discipline to prevent users from selectively executing financial contracts merely to profit upon interest-rate forecasts.

The preceding discussion should reinforce the fact that the actual utilization of financial contracts is not a clear-cut issue in terms of hedging verses speculation. However, certain key concepts should be kept in mind. First, a decision to hedge with futures or forward contracts involves making a decision that one is content to lock in an effective cost of funds, a sale price of a specific asset, etc. However, the decision to hedge which gives downside protection also means forfeiting the benefits which would result from a favorable market movement. Thus, in evaluating hedge strategies, the organization should be judged as to whether it maintained hedge positions long enough to accomplish its objectives.

Caution should be employed in performing the analysis of financial contracts used to obtain targeted effective interest rates. Examiners should not evaluate transactions solely on a "paired" basis, that is, looking at paired cash market and financial-contract positions and forgetting about financial-contract positions relative to the organization's entire balance sheet, nor should examiners fail to review the overall nature of financial-contract activities. For example, individual opening and closing of financial contracts could appear reasonable, but the aggregate activities may be indicative of an organization that is in reality operating a futures trading account solely to profit on interest-rate expectations.

2130.0.13.6 Parties Executing or Taking the Contra Side of a Financial Contract

In addition to monitoring contra-party credit risk, serious efforts should be made to ensure that the banking organization carefully scrutinizes the selection of brokers and dealers. In the case of futures contracts, the Commodity Exchange Act requires that an entity functioning as a futures commission merchant be registered with the CFTC. However, not every FCM may be a member of a commodities exchange. Members of an exchange are given additional supervision by the exchange, while nonmembers are subject to audit by the National Futures Association. In selecting any broker or dealer, an organization should give careful consideration to its reputation, financial viability, and length of time in business. If an organization intends to deal with a newly established FCM or broker-dealer, special efforts should be made to verify the reputation and integrity of its principals. (For additional discussion, see *Federal Reserve Regulatory Service* 3–1562). Although such measures cannot ensure that problems will not subsequently develop with an FCM or broker-dealer, some careful forethought can tend to ensure that relationships will not be developed with persons or firms who had serious problems in the past.

2130.0.14 ACCOUNTING FOR FUTURES CONTRACTS

All futures contracts, except for foreign-currency futures contracts, shall be reported in the Consolidated Financial Statements for Bank Holding Companies in accordance with Financial Accounting Standards Board (FASB) Statement No. 80, "Accounting for Futures Contracts." Foreign-currency futures contracts shall be reported in accordance with the guidance in FASB Statement No. 52, "Foreign Currency Translation."

2130.0.14.1 Performance Bonds under Futures Contracts

When the reporting banking organization, as either buyer or seller of futures contracts, has posted a performance bond in the form of a margin account deposited with a broker or exchange, the current balance (as of the report date) of that margin account shall be reported in Other Assets. The balance in the margin account includes the following:

1. the original margin deposit, plus (less)
2. any additions (deductions) as a result of daily fluctuations in the market value of the related contracts (i.e., "variation margin"), plus
3. any additional deposits made to the account to meet margin calls or otherwise (i.e., "maintenance margin"), less
4. any withdrawals of excess balances from the account

When the performance bond takes the form of a pledge of assets with a broker rather than a margin account, the pledged assets shall be maintained on the books of the pledging banking organization and no other balance-sheet entry is made for the performance bond. In this case, gains and losses resulting from daily fluctuations in the market value of the related contracts are generally settled with the broker in cash. However, if the pledging banking organization also maintains a working balance with the broker against which recognized daily market gains and losses are posted, the working balance should be reported in Other Assets, and treated in the same manner as a margin account.

2130.0.14.2 Valuation of Open Positions

All open positions in futures contracts must be reviewed at least monthly (or more often, if material) and their current market values determined. The market value of a futures contract is to be based on published price quotations. These futures positions must be revalued at their current market values on these valuation dates and any changes in these values reported in accordance with the guidance presented below for hedge or nonhedge contracts, as appropriate.

2130.0.14.3 Criteria for Hedge-Accounting Treatment

A futures contract shall be accounted for as a hedge when the following conditions are met:

1. The banking organization must have determined that the item or group of items to be hedged (that is, the identifiable assets, liabilities, firm commitments, or anticipated transactions) will expose it to price or interest-rate risk.
2. The futures contract must reduce the exposure to risk. This will be demonstrated if, at the inception of the hedge and *throughout the hedge period, high correlation* is expected to exist between the changes in the prices of both the contract and the hedged item or group of items.[10] In other words, the banking organization must monitor the price movements of both the hedge contract and the hedged items to determine that it is probable that changes in the market value of the futures contract will offset the effects of price changes on the hedged items.
3. The futures contract must be designated in writing as a hedge by management at the inception of the hedge.

   In order for a futures contract to qualify as a hedge of an anticipated transaction, the following two additional criteria must be met:

   a. The significant characteristics and expected terms of the anticipated transaction must be identified.
   b. The occurrence of the anticipated transaction must be probable.[11]

2130.0.14.4 Gains and Losses from Monthly Contract Valuations of Futures Contracts That Qualify as Hedges

If the hedge criteria are met, the accounting for the futures contract shall be related to the accounting for the hedged item so that changes in the market value of the futures contract are recognized in income when the effects of related changes in the price or interest rate of the hedged item are recognized. If a banking organization must include unrealized changes in the fair value of a hedged item in income, a change in the market value of the related futures contract shall be recognized in income when the change occurs. Otherwise, a change in the market value of a futures contract that qualifies as a hedge of an existing asset or liability shall be recognized as an adjustment of the carrying amount of the hedged item. A change in the market value of a futures contract that is a hedge of a firm commitment shall be included in the measurement of the transaction that satisfies the commitment. A change in the market value of a futures contract that is a hedge of an anticipated transaction shall be included in the measurement of the subsequent transaction.

Once the carrying amount of an asset or liability has been adjusted for the change in the market value of a futures contract, the adjustment must be recognized in income in the same manner as other components of the carrying amount of that asset or liability (for example, using the interest method). If the item being hedged is an interest-bearing financial instrument otherwise reported at amortized historical cost, then the changes in the market value of the hedge contract that have been reflected as adjustments in the carrying amount of the financial instrument shall be amortized as an adjustment of interest income or expense over the expected remaining life of the hedged item.

If a futures contract that has been accounted for as a hedge of an anticipated transaction is closed before the date of the related transaction, the accumulated change in value of the contract shall be carried forward (assuming high correlation continues to exist) and included in the measurement of the related transaction. When it becomes probable that the quantity of the anticipated transaction will be less than that originally hedged, a pro rata portion of the futures results that would have been included in the measurement of the transaction shall be recognized as a gain or loss.

When futures contracts that are hedges are terminated, the gain or loss on the terminated contracts must be deferred and amortized over the remaining life of the hedged item.

10. Generally, banking practice maintains that correlation in the changes in the market values of the futures contract and the hedged item must be at least 80 percent for the ''high correlation'' criteria in FASB Statement No. 80 to be met.

11. It will be particularly difficult to meet this criteria when an anticipated transaction is not expected to take place in the near future.

2130.0.14.5 Gains and Losses from Monthly Contract Valuations of Futures Contracts That Do Not Qualify as Hedges

For futures contracts that are not accounted for as hedges, the change that has occurred in the market value of open positions since the last call report date shall be reflected in current income, either as ''other noninterest income'' for net gains or ''other noninterest expense'' for net losses.

If high correlation ceases to exist, the banking organization should discontinue accounting for a futures contract as a hedge. When this occurs, the portion of the change in the market value of the contract that has not offset the market value changes of the hedged item, since the inception of the hedge, must be reflected in the Report of Income as ''other noninterest income'' or ''other noninterest expense,'' as appropriate. The contract should thereafter be accounted for as a nonhedge contract with subsequent changes in the contract's market value reflected in current period income.

When futures contracts that are not hedges are terminated, the gain or loss on the terminated contract must be recognized currently in the Report of Income as ''other noninterest income'' or ''other noninterest expense,'' as appropriate.

There is the potential for holding companies and nonbank subsidiaries to follow the referenced accounting applications and break ''hedges'' with unrealized futures gains to recognize income, and maintain hedges with futures losses and adjust the carrying basis of the paired, that is, ''hedged'' asset. Examiners should look for patterns of taking gains and losses with a view to determining whether the opening and closing of contracts is consistent with the organization's risk-reducing strategies.

2130.0.15 PREPARING INSPECTION REPORTS

Unsatisfactory comments pertaining to a bank holding company's financial-contract activities should be noted on the ''Examiner's Comments,'' ''Policies and Supervision,'' and ''Analysis of Financial Factors'' or other appropriate page depending on the severity of the comments within the bank holding company inspection report.

2130.0.16 INTERNAL CONTROLS AND INTERNAL AUDIT

The following is designed to illustrate desirable internal controls and internal audit procedures applicable to the organization's activities in financial contracts. This illustration is not intended to serve as an absolute standard relating to contract activities, but is designed to supplement examiners' knowledge relating to internal controls and internal audits in this context. In evaluating internal controls and audits, the examiner will need to evaluate the scope of futures, forward, and options activities to determine whether internal controls and audit procedures are adequate in relation to the volume and nature of the activities.

2130.0.16.1 Internal Controls

It is a management's responsibility to minimize the risks inherent in financial-contract activities through the establishment of policies and procedures covering organizational structure, segregation of duties, operating and accounting system controls, and comprehensive management reporting. Formal written procedures should be in place in connection with purchases and sales, processing, accounting, clearance and safekeeping activities relating to these transactions. In general, these procedures should be designed to ensure that all financial contracts are properly recorded and that senior management is aware of the exposure and gains or losses resulting from these activities. Some examples of desirable controls follow:

1. Written documentation indicating what types of contracts are eligible for purchase by the organization, which individual persons are eligible to purchase and sell contracts, which individual persons are eligible to sign contracts or confirmations, and the names of firms or institutions with whom employees are authorized to conduct business.
2. Written position limitations for each type of contract established by the banking organization's board of directors and written procedures for authorizing trades, if any, in excess of those limits.
3. A system to monitor the organization's exposure with customers and those broker-dealers and institutions eligible to do business with it. To implement this, management must determine the amount of credit risk permissible with various parties and then institute surveillance procedures to ensure

that such limits are not exceeded without written authorization from senior management.

4. Separation of duties and supervision to ensure that persons executing transactions are not involved in approving the accounting media and/or making accounting entries. Further, persons executing transactions should not have authority to sign incoming or outgoing confirmations or contracts, reconcile records, clear transactions, or control the disbursement of margin payments.
5. A clearly defined flow of order tickets and confirmations. Confirmations generated should, preferably, be prenumbered. In addition to promptly recording all commitments in a daily written commitment ledger, the related documentation should be filed separately for purposes of audit and examination. The flow of confirmations and order tickets should be designed to verify accuracy and enable reconciliations throughout the system, for example, to ensure that a person could not execute unauthorized transactions and bypass part of the accounting system, and to enable the reconcilement of traders' position reports to those positions maintained by an operating unit.
6. Procedures to route incoming confirmations to an operations unit separate from the trading unit. Confirmations received from brokers, dealers, or others should be compared to confirmations (or other control records) prepared by the banking organization to ensure that it will not accept or make delivery of securities, or remit margin payments, pursuant to contracts unless there is proper authorization and documentation.
7. Procedures for promptly resolving fails to receive or fails to deliver securities on the date securities are due to be received or sent pursuant to contracts.
8. Procedures for resolving customer complaints by someone other than the person who executed the contract.
9. Procedures for verifying brokers' reports of margin deposits and contract positions (use an outside pricing source), and reconciling such reports to the records.
10. Procedures for daily review of outstanding contracts and supervision of traders. In addition, there should be periodic reports to management reflecting the margin deposits and contract positions.
11. Selecting and training competent personnel to follow the written policies and guidelines.

2130.0.16.2 Internal Audit

The scope and frequency of the internal audit program should be designed to review the internal control procedures and verify that the internal controls purported to be in effect are being followed. Further, the internal auditor should verify that there are no material inadequacies in the internal control procedures that would permit a person acting individually to perpetrate errors or irregularities involving the records of the organization or assets that would not be detected by the internal control procedures in time to prevent material loss or misstatement of the banking organization's financial statements or serious violation of applicable banking, bank holding company, or securities rules or regulations. Any weaknesses in internal control procedures should be reported to management, along with recommendations for corrective action. If internal auditors do not report to an audit committee, the person to whom they report should not be in a position to misappropriate assets. In addition, auditors should occasionally spot-check contract prices and mark-to-market adjustments.

2130.0.17 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Statement of policy concerning bank holding companies engaging in futures, forward, and options contracts on U.S. government and agency securities and money market instruments		225.142	4–830	
Policy Statement on Financial Contracts			3–1535	
Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities			3–1562	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Financial institutions, including bank holding company subsidiaries, are lending securities with increasing frequency, and, in some instances, a financial institution may lend its own investment or trading-account securities. Financial institutions lend customers' securities held in custody, safekeeping, trust, or pension accounts. Because the securities available for lending often greatly exceed the demand for them, inexperienced lenders may be tempted to ignore commonly recognized safeguards. Bankruptcies of broker-dealers have heightened regulatory sensitivity to the potential for problems in this area.

2140.0.1 SECURITIES-LENDING MARKET

Securities brokers and commercial banks are the primary borrowers of securities. They borrow securities to cover securities fails (securities sold but not available for delivery), short sales, and option and arbitrage positions. Securities lending, which used to involve principally corporate equities and debt obligations, increasingly involves loans of large blocks of U.S. government and federal-agency securities.

Securities lending is conducted through open-ended ''loan'' agreements, which may be terminated on short notice by the lender or borrower. Repurchase agreements are generally used by owners of securities as financing vehicles and, in certain respects, are closely analogous to securities lending. The objective of securities lending, however, is to receive a safe return in addition to the normal interest or dividends. Securities loans in industry practice are generally collateralized by U.S. government or federal-agency securities, cash, or letters of credit.[1] At the outset, each loan is collateralized at a predetermined margin. If the market value of the collateral falls below an acceptable level during the time a loan is outstanding, a margin call is made by the lender institution. If a loan becomes over-collateralized because of appreciation of collateral or market depreciation of a loaned security, the borrower usually has the opportunity to request the return of any excessive margin.

When a securities loan is terminated, the securities are returned to the lender and the collateral to the borrower. Fees received on securities loans are divided between the lender and the customer account that owns the securities. In situations involving cash collateral, part of the interest earned on the temporary investment of cash is returned to the borrower, and the remainder is divided between the lender and the customer account that owns the securities.

1. Broker-dealers borrowing securities are subject to the restrictions of the Federal Reserve's Regulation T (12 C.F.R. 220.10), which specifies acceptable borrowing purposes.

2140.0.2 DEFINITIONS OF CAPACITY

Securities lending may be done in various capacities and with differing associated liabilities. It is important that all parties involved understand in what capacity the lender is acting. For the purposes of these guidelines, the relevant capacities are as follows:

1. *Principal.* A lender offering securities from its own account is acting as principal. A lender institution offering customers' securities on an undisclosed basis is also considered to be acting as principal.
2. *Agent.* A lender offering securities on behalf of a customer-owner is acting as an agent. For the lender to be considered a bona fide or ''fully disclosed'' agent, it must disclose the names of the borrowers to the customer-owners (or give notice that names are available upon request), and must disclose the names of the customer-owner to borrowers (or give notice that names are available upon request). In all cases, the agent's compensation for handling the transaction should be disclosed to the customer-owner. Undisclosed agency transactions, that is, ''blind brokerage'' transactions in which participants cannot determine the identity of the contra party, are treated as if the lender was the principal.
3. *Directed agent.* A lender which lends securities at the direction of the customer-owner is acting as a directed agent. The customer directs the lender in all aspects of the transaction, including to whom the securities are loaned, the terms of the transaction (rebate rate and maturity/call provisions on the loan), acceptable collateral, investment of any cash collateral, and collateral delivery.
4. *Fiduciary.* A lender which exercises *discretion* in offering securities on behalf of and for the benefit of customer-owners is acting as a fiduciary. For purposes of these guidelines,

the underlying relationship may be as agent, trustee, or custodian.

5. *Finder.* A finder brings together a borrower and a lender of securities for a fee. Finders do not take possession of the securities or collateral. Delivery of securities and collateral is direct between the borrower and the lender, and the finder does not become involved. The finder is simply a fully disclosed intermediary.

2140.0.3 GUIDELINES

All bank holding companies or their subsidiaries that participate in securities lending should establish written policies and procedures governing these activities. Other than commercial banks with trust departments, the bank holding company subsidiaries most likely to be engaged in securities lending are non-deposit-taking trust companies and certain discount brokers which provide custody services and make margin loans. At a minimum, policies and procedures should cover each of the topics in these guidelines.

2140.0.3.1 Recordkeeping

Before establishing a securities-lending program, a financial firm or institution must establish an adequate recordkeeping system. At a minimum, the system should produce daily reports showing which securities are available for lending, and which are currently lent, outstanding loans by borrower, outstanding loans by account, new loans, returns of loaned securities, and transactions by account. These records should be updated as often as necessary to ensure that the lender institution fully accounts for all outstanding loans, that adequate collateral is required and maintained, and that policies and concentration limits are being followed.

2140.0.3.2 Administrative Procedures

All securities lent and all securities standing as collateral must be marked to market daily. Procedures must ensure that any necessary calls for additional margin are made on a timely basis.

In addition, written procedures should outline how to choose the customer account that will be the source of lent securities when they are held in more than one account. Possible methods include loan volume analysis, automated queue, a lottery, or some combination of these. Securities loans should be fairly allocated among all accounts participating in a securities-lending program.

Internal controls should include operating procedures designed to segregate duties and timely management reporting systems. Periodic internal audits should assess the accuracy of accounting records, the timeliness of management reports, and the lender's overall compliance with established policies and the firm's procedures.

2140.0.3.3 Credit Analysis and Approval of Borrowers

In spite of strict standards of collateralization, securities-lending activities involve risk of loss. Such risks may arise from malfeasance or failure of the borrowing firm or institution. Therefore, a duly established management or supervisory committee of the lender should formally approve, in advance, transactions with any borrower.

Credit and limit approvals should be based upon a credit analysis of the borrower. A review should be performed before establishing such a relationship and reviews should be conducted at regular intervals thereafter. Credit reviews should include an analysis of the borrower's financial statement, and should consider capitalization, management, earnings, business reputation, and any other factors that appear relevant. Analyses should be performed in an independent department of the lender, by persons who routinely perform credit analyses. Analyses performed solely by the person(s) managing the securities-lending program are not sufficient.

2140.0.3.4 Credit and Concentration Limits

After the initial credit analysis, management of the lender should establish an individual credit limit for the borrower. That limit should be based on the market value of the securities to be borrowed, and should take into account possible temporary (overnight) exposures resulting from a decline in collateral values or from occasional inadvertent delays in transferring collateral. Credit and concentration limits should take into account other extensions of credit by the lender to the same borrower or related interests.

Procedures should be established to ensure that credit and concentration limits are not exceeded without proper authorization from management.

2140.0.3.5 Collateral Management

Securities borrowers generally pledge and maintain collateral at a level equal to at least 100 percent of the value of the securities borrowed.[2] The minimum amount of excess collateral, or ‘‘margin,’’ acceptable to the lender should relate to price volatility of the loaned securities and the collateral (if other than cash).[3] Generally, the minimum initial collateral on securities loans is at least 102 percent of the market value of the lent securities plus, for debt securities, any accrued interest.

Collateral must be maintained at the agreed margin. A daily ‘‘mark-to-market’’ or valuation procedure must be in place to ensure that calls for additional collateral are made on a timely basis. The valuation procedures should take into account the value of accrued interest on debt securities.

Securities should not be lent unless collateral has been received or will be received simultaneously with the loan. As a minimum step toward perfecting the lender’s interest, collateral should be delivered directly to the lender or an independent third-party trustee.

2140.0.3.6 Cash as Collateral

When cash is used as collateral, the lender is responsible for making it income productive. Lenders should establish written guidelines for selecting investments for cash collateral. Generally, a lender will invest cash collateral in repurchase agreements, master notes, a short-term investment fund (STIF), U.S. or Eurodollar certificates of deposit, commercial paper, or some other type of money market instrument. If the lender is acting in any capacity other than as principal, the written agreement authorizing the lending relationship should specify how cash collateral is to be invested.

Using cash collateral to pay for liabilities of the lender or its holding company would be an improper *conflict of interest* unless that strategy was specifically authorized in writing by the owner of the lent securities.

2140.0.3.7 Letters of Credit as Collateral

If a lender plans to accept letters of credit as collateral, it should establish guidelines for their use. Those guidelines should require a credit analysis of the banks issuing the letter of credit before securities are lent against that collateral. Analyses must be periodically updated and reevaluated. The lender should also establish concentration limits for the banks issuing letters of credit, and procedures should ensure they are not exceeded. In establishing concentration limits on letters of credit accepted as collateral, the lender’s total outstanding credit exposures from the issuing bank should be considered.

2140.0.3.8 Written Agreements

Securities should be lent only pursuant to a written agreement between the lender and the owner of the securities, specifically authorizing the institution to offer the securities for loan. The agreement should outline the lender’s authority to reinvest cash collateral (if any) and responsibilities with regard to custody and valuation of collateral. In addition, the agreement should detail the fee or compensation that will go to the owner of the securities in the form of a fee schedule or other specific provision. Other items which should be covered in the agreement have been discussed earlier in these guidelines.

A lender must also have written agreements with the parties who wish to borrow securities. These agreements should specify the duties and responsibilities of each party. A written agreement may detail acceptable types of collateral (including letters of credit); standards for collateral custody and control, collateral valuation and initial margin, accrued interest, marking to market, and margin calls; methods for transmitting coupon or dividend payments received if a security is on loan on a payment date; conditions which will trigger the termination of a loan (including events of default); and acceptable

2. Employee benefit plans subject to the Employee Retirement Income Security Act are specifically required to collateralize securities loans at a minimum of 100 percent of the market value of loaned securities (see section 2140.0.3.10 below).

3. The level of margin should be dictated by level of risk being underwritten by the securities lender. Factors to be considered in determining whether to require margin above the recommended minimum include the type of collateral, the maturity of collateral and lent securities, the term of the securities loan, and the costs which may be incurred when liquidating collateral and replacing loaned securities.

methods of delivery for loaned securities and collateral.

2140.0.3.9 Use of Finders

Some lenders may use a finder to place securities, and some financial institutions may act as finders. A finder brings together a borrower and a lender for a fee. Finders should not take possession of securities or collateral. The delivery of securities loaned and collateral should be direct between the borrower and the lender. A finder should not be involved in the delivery process.

The finder should act only as a fully disclosed intermediary. The lender must always know the name and financial condition of the borrower of any securities it lends. If the lender does not have that information, it and its customers are exposed to unnecessary risks.

Written policies should be in place concerning the use of finders in a securities-lending program. These policies should cover circumstances in which a finder will be used, which party pays the fee (borrower or lender), and which finders the lender institution will use.

2140.0.3.10 Employee Benefit Plans

The Department of Labor has issued two class exemptions which deal with securities-lending programs for employee benefit plans covered by the Employee Retirement Income Security Act (ERISA): Prohibited Transaction Exemption 81-6 (46 FR 7527 (January 23, 1981) and correction (46 FR 10570 (February 3, 1981))), and Prohibited Transaction Exemption 82-63 (47 FR 14804 (April 6, 1982)). The exemptions authorize transactions which might otherwise constitute unintended ‘‘prohibited transactions’’ under ERISA. Any firm engaged in the lending of securities for an employee benefit plan subject to ERISA should take all steps necessary to design and maintain its program to conform with these exemptions.

Prohibited Transaction Exemption 81-6 permits the lending of securities owned by employee benefit plans to persons who could be ‘‘parties in interest’’ with respect to such plans, provided certain conditions specified in the exemption are met. Under those conditions, neither the borrower nor an affiliate of the borrower can have discretionary control over the investment of plan assets, or offer investment advice concerning the assets, and the loan must be made pursuant to a written agreement. The exemption also establishes a minimum acceptable level for collateral based on the market value of the loaned securities.

Prohibited Transaction Exemption 82-63 permits compensation of a fiduciary for services rendered in connection with loans of plan assets that are securities. The exemption details certain conditions which must be met.

2140.0.3.11 Indemnification

Certain lenders offer participating accounts indemnification against losses in connection with securities-lending programs. Such indemnifications may cover a variety of occurences including all financial loss, losses from a borrower default, or losses from collateral default. Lenders that offer such indemnification should obtain a legal opinion from counsel concerning the legality of their specific form of indemnification under federal and/or state law.

A lender which offers an indemnity to its customers may, in light of other related factors, be assuming the benefits and, more importantly, the liabilities of a principal. Therefore, lenders offering indemnification should also obtain written opinions from their accountants concerning the proper financial statement disclosure of their actual or contingent liabilities.

2140.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Securities Lending policy statement of the Federal Financial Institutions Examination Council, adopted by the Federal Reserve Board on May 6, 1985			3–1579.5	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Depository institutions and others involved with the purchase of United States Government and Agency obligations under agreements to resell (reverse repurchase agreements),[2] have sometimes incurred significant losses. The most important factors causing these heavy losses have been inadequate credit risk management and the failure to exercise effective control over securities collateralizing the transactions.[3]

The following minimum guidelines address the need for managing credit risk exposure to counterparties under securities repurchase agreements and for controlling the securities in those transactions, and should be followed when entering into repurchase agreements with securities dealers and others.

Depository institutions and nonbank subsidiaries that actively engage in repurchase agreements are encouraged to have more comprehensive policies and controls to suit their particular circumstances. The examining staffs of the Federal Reserve should review written policies and procedures of dealers to determine their adequacy in light of these minimum guidelines and the scope of each subsidiary's operations.

2150.0.1 CREDIT POLICY GUIDELINES

The apparent safety of short-term repurchase agreements which are collateralized by highly liquid, U.S. Government and Federal agency obligations has contributed to an attitude of complacency. Some portfolio managers have underestimated the credit risk associated with the performance of the counterparty to the transactions, and have not taken adequate steps to assure control of the securities covered by the agreement.

All firms that engage in securities repurchase agreement transactions should establish written credit policies and procedures governing these activities. At a minimum, those policies and procedures should cover the following:

Written policies should establish ''know your counterparty'' principles. Engaging in repurchase agreement transactions in volume and in large dollar amounts frequently requires the services of a counterparty who is a dealer in the underlying securities. Some firms which deal in the markets for U.S. Government and Federal agency securities are subsidiaries of, or related to, financially stronger and better known firms. However, these stronger firms may be independent of their U.S. Government securities subsidiaries and affiliates and may not be legally obligated to stand behind the transactions of related companies. Without an express guarantee, the stronger firm's financial position cannot be relied upon in assessing the creditworthiness of a counterparty.

It is important to know the legal entity that is the actual counterparty to each repurchase agreement transaction. Know about the actual counterparty's character, integrity of management, activities, and the financial markets in which it deals. Be particularly careful in conducting repurchase agreements with any firm that offers terms that are significantly more favorable than those currently prevailing in the market.

In certain situations firms may use, or serve as, brokers or finders in order to locate repurchase agreement counterparties or particular securities. When using or acting as this type of agent the names of each counterparty should be fully disclosed. Do not enter into undisclosed agency or ''blind brokerage'' repurchase transactions in which the counterparty's name is not disclosed.

2150.0.1.1 Dealings with Unregulated Securities Dealers

A dealer in U.S. Government and Federal agency obligations is not necessarily a Federally insured bank or thrift, or a broker/dealer registered with the Securities and Exchange Commission. Therefore, the dealer firm may not

1. A repurchase agreement is a transaction involving the *sale* of assets by one party to another, subject to an agreement by the seller to repurchase the assets at a specified date or in specified circumstances.

2. In order to avoid confusion among market participants who sometimes use the same term to describe different sides of the same transaction, the term ''repurchase agreement'' will be used in the balance of this statement to refer to both repurchase and reverse repurchase agreements. A repurchase agreement is one in which a party that owns securities acquires funds by transferring the securities to another party under an agreement to repurchase the securities at an agreed upon future date. A reverse repurchase (resale) agreement is one in which a party provides funds by acquiring securities pursuant to an agreement to resell them at an agreed upon future date.

3. Throughout this document repurchase agreements are generally discussed in terms of secured credit transactions. This usage should not be deemed to be based upon a legal determination.

be subject to any Federal regulatory oversight.

A firm doing business with an unregulated securities dealer should be certain that the dealer voluntarily complies with the Federal Reserve Bank of New York's minimum capital guideline, which currently calls for liquid capital to exceed measured risk by 20 percent (that is, the ratio of a dealer's liquid capital to risk of 1.2:1). This ratio can be calculated by a dealer using either the Securities and Exchange Commission's Net Capital Rule for Brokers and Dealers (Rule 15c31) or the Federal Reserve Bank of New York's Capital Adequacy Guidelines for United States Government Securities Dealers. To ensure that an unregulated dealer complies with either of those capital standards, it should certify its compliance with the capital standard and provide the following three forms of certification:

1. A letter of certification from the dealer that the dealer will adhere on a continuous basis to the capital adequacy standard;
2. Audited financial statements which demonstrate that as of the audit date the dealer was in compliance with the standard and the amount of liquid capital; and
3. A copy of a letter from the firm's certified public accountant stating that it found no material weaknesses in the dealer's internal systems and controls incident to adherence to the standard.[4]

Periodic evaluations of counterparty creditworthiness should be conducted by individuals who routinely make credit decisions and who are not involved in the execution of repurchase agreement transactions.

Prior to engaging in initial transactions with a new counterparty, obtain audited financial statements and regulatory filings (if any) from counterparties, and insist that similar information be provided on a periodic and timely basis in the future. Recent failures of government securities dealers have typically been foreshadowed by delays in producing these statements. Many firms are registered with the Securities and Exchange Commission as broker/dealers and have to file financial statements and should be willing to provide a copy of these filings.

The counterparty credit analysis should consider the financial statements of the entity that is to be the counterparty as well as those of any related companies that could have an impact on the financial condition of the counterparty. When transacting business with a subsidiary, consolidated financial statements of a parent are not adequate. Repurchase agreements should not be entered into with any counterparty that is unwilling to provide complete and timely disclosure of its financial condition. As part of this analysis, the firm should make inquiry about the counterparty's general reputation and whether there have been any formal enforcement actions against the counterparty or its affiliates by State or Federal securities regulators.

Maximum position and temporary exposure limits for each approved counterparty should be established based upon credit analysis performed. Periodic reviews and updates of those limits are necessary.

Individual repurchase agreement counterparty limits should consider overall exposure to the same or related counterparty. Repurchase agreement counterparty limitations should include the overall permissible dollar positions in repurchase agreements, maximum repurchase agreement maturities and limits on temporary exposure that may result from decreases in collateral values or delays in receiving collateral.

2150.0.2 GUIDELINES FOR CONTROLLING REPURCHASE AGREEMENT COLLATERAL

Repurchase agreements can be a useful asset and liability management tool, but repurchase agreements can expose a firm to serious risks if they are not managed appropriately. It is possible to reduce repurchase agreement risk by negotiating written agreements with all repurchase agreement counterparties and custodian banks. Compliance with the terms of these written agreements should be monitored on a daily basis. If prudent management control requirements of repurchase agreements are too burdensome, other asset/liability management tools should be used.

The marketplace perceives repurchase agreement transactions as similar to lending transactions collateralized by highly liquid Government securities. However, experience has shown that the collateral securities will probably *not* serve as protection if the counterparty becomes insolvent or fails, and the purchasing firm does not have control over the securities. Ultimate responsibility for establishing adequate control procedures rests with management of the firm. Management should obtain a written legal opin-

4. This letter should be similar to that which must be given to the SEC by registered broker/dealers.

ion as to the adequacy of the procedures utilized to establish and protect the firm's interest in the underlying collateral.

A written agreement specific to a repurchase agreement transaction or master agreement governing all repurchase agreement transactions should be entered into with each counterparty. The written agreement should specify all the terms of the transaction and the duties of both the buyer and seller. Senior managers should consult legal counsel regarding the content of the repurchase and custodial agreements. The repurchase and custodial agreements should specify, but should not be limited to, the following:

- Acceptable types and maturities of collateral securities;
- Initial acceptable margin for collateral securities of various types and maturities
- Margin maintenance, call, default and sellout provisions;
- Rights to interest and principal payments;
- Rights to substitute collateral; and
- The persons authorized to transact business on behalf of the firm and its counterparty.

2150.0.2.1 Confirmations

Some repurchase agreement confirmations may contain terms that attempt to change the firm's rights in the transaction. The firm should obtain and compare written confirmations for each repurchase agreement transaction to be certain that the information on the confirmation is consistent with the terms of the agreement. The confirmation should identify specific collateral securities.

2150.0.2.2 Control of Securities

As a general rule, a firm should obtain possession or control of the underlying securities and take necessary steps to protect its interest in the securities. The legal steps necessary to protect its interest may vary with applicable facts and law and accordingly should be undertaken with the advice of counsel. Additional prudential management controls may include:

- delivery of either physical securities to, or in the case of book entry securities, making appropriate entries in the books of a third party custodian designated under a written custodial agreement which explicitly recognizes the firm's interest in the securities as superior to that of any other person; or
- appropriate entries on the books of a third party custodian acting pursuant to a tripartite agreement with the firm and the counterparty, ensuring adequate segregation and identification of either physical or book-entry securities.

Where control of the underlying securities is not established, the firm may be regarded only as an unsecured general creditor of the insolvent counterparty. In such instance, *substantial losses are likely to be incurred.* Accordingly, a firm should not enter into a repurchase agreement without obtaining control of the securities unless all of the following minimum procedures are observed: (1) it is completely satisfied as to the creditworthiness of the counterparty; (2) the transaction is within credit limitations that have been pre-approved by the board of directors, or a committee of the board, for unsecured transactions with the counterparty; (3) periodic credit evaluations of the counterparty are conducted; and (4) the firm has ascertained that collateral segregation procedures of the counterparty are adequate. Unless prudential internal procedures of these types are instituted and observed, the firm may be cited for engaging in unsafe or unsound practices.

All receipts and deliveries of either physical or book-entry securities should be made according to written procedures, and third party deliveries should be confirmed in writing directly by the custodian. It is not acceptable to receive confirmation from the counterparty that the securities are segregated in a firm's name with a custodian; the firm should, however, obtain a copy of the advice of the counterparty to the custodian requesting transfer of the securities to the firm. Where securities are to be delivered, payment for securities should not be made until the securities are actually delivered to the firm or its agent. The custodial contract should provide that the custodian takes delivery of the securities subject to the exclusive direction of the firm.

Substitution of securities should not be allowed without the prior consent of the firm. The firm should give its consent before the delivery of the substitute securities to it or a third party custodian. Any substitution of securities should take into consideration the following discussion of "margin requirements."

2150.0.2.3 Margin Requirements

The amount paid under the repurchase agreement should be less than the market value of the securities, including the amount of any accrued interest, with the difference representing a predetermined margin. Factors to be considered in establishing an appropriate margin include the size and maturity of the repurchase transaction, the type and maturity of the underlying securities, and the creditworthiness of the counterparty. Margin requirements on U.S. Government and Federal agency obligations underlying repurchase agreements should allow for the anticipated price volatility of the security until the maturity of the repurchase agreement. Less marketable securities may require additional margin to compensate for less liquid market conditions. Written repurchase agreement policies and procedures should require daily mark-to-market of repurchase agreement securities to the bid side of the market. Repurchase agreements should provide for additional securities or cash to be placed with the firm or its custodian bank to maintain the margin within the predetermined level.

Margin calculations should also consider accrued interest on underlying securities and the anticipated amount of accrued interest over the term of the repurchase agreement, the date of interest payment and which party is entitled to receive the payment. In the case of pass-through securities, anticipated principal reductions should also be considered when determining margin adequacy.

Prudent management procedures should be followed in the administration of any repurchase agreement. Longer term repurchase agreements require management's daily attention to the effects of securities substitutions, margin maintenance requirements (including consideration of any coupon interest or principal payments) and possible changes in the financial condition of the counterparty. Engaging in open repurchase agreement transactions without maturity dates may be regarded as an unsafe and unsound practice unless the firm has retained rights to terminate the transaction quickly to protect itself against changed circumstances. Similarly, automatic renewal of short-term repurchase agreement transactions without reviewing collateral values and adjusting collateral margin may be regarded as an unsafe and unsound practice. If additional margin is not deposited when required, the firm's rights to sell securities or otherwise liquidate the repurchase agreement should be exercised without hesitation.

2150.0.2.4 Overcollateralization

A firm should use current market values, including the amount of any accrued interest, to determine the price of securities that are sold under repurchase agreements. Counterparties should not be provided with excessive margin. Thus, the written repurchase agreement contract should provide that the counterparty must make additional payment or return securities if the margin exceeds agreed upon levels. When acquiring funds under repurchase agreements it is prudent business practice to keep at a reasonable margin the difference between the market value of the securities delivered to the counterparty and the amount borrowed. The excess market value of securities sold may be viewed as an unsecured loan to the counterparty subject to the unsecured lending limitations for the firm and should be treated accordingly for credit policy and control purposes.

2150.0.3 OPERATIONS

A firm's operational functions should be designed to regulate the custody and movement of securities and to adequately account for trading transactions. Because of the dollar volume and speed of trading activities, operational inefficiencies can quickly result in major problems.

In some cases, a firm may not receive or deliver a security by settlement date. When a firm fails to receive a security by the settlement date, a liability exists until the transaction is consummated or cancelled. When the security is not delivered to the contra-party by settlement date, a receivable exists until that ''fail'' is resolved. ''Fails'' to deliver for an extended time, or a substantial number of cancellations, are sometimes characteristic of poor operational control or questionable trading activities.

Fails should be controlled by prompt reporting and follow-up procedures. The use of multicopy confirmation forms enables operational personnel to retain and file a copy by settlement date and should allow for prompt fail reporting and resolution.

2150.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Federal Financial Institutions Examination Council policy statement, adopted by the Federal Reserve Board on November 12, 1985, on repurchase agreements			3–1579	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Risk management is an important responsibility of any bank holding company. The objective of this responsibility is to determine and limit the extent of the holding company organization's vulnerability to uncontrollable variables. While all companies perform risk evaluation in some form and exercise some degree of control over its magnitude, the precise processes used differ considerably across organizations in terms of formality, extensiveness, and effectiveness. It should be recognized that many organizations have only an implicit risk evaluation process, and that it may be appropriate to recommend that this process be formalized. Ultimately, the board of directors of the parent company should be held accountable for the consolidated risk evaluation and control.

Risk management at any level involves two basic elements: evaluation and control. Risk evaluation involves three steps: determination of exposures; specification of uncontrollable variables that have an impact on each exposure; and quantification of the expected effect of each variable on exposure. After the extent of existing or potential risk is determined, decisions to limit or control risk are made. This procedure is ever present, since most transactions create exposure, and every exposure has some element of risk. The following two sections discuss the risk evaluation and the risk control processes in very broad terms in an attempt to provide a framework that can be applied to most organizations.

2160.0.1 RISK EVALUATION

The risk identification process begins with a determination of exposures that an institution has to the environment.

Exposure conceptually occurs in every transaction undertaken by a banking organization. Because of the magnitude of the list of potential exposures, institutions generally limit their efforts to extremely large exposures, to areas where losses appear likely, and to activities where the market is changing and new exposures are created. The size of an exposure generally is dependent on the size of a transaction. This is true both for transactions recorded on accounting balance sheets and for those which occur off balance sheet. Exposure is not necessarily determined by the likelihood of loss. For example, many holding company organizations have a large "exposure" in Treasury bills, but do not consider these transactions to be risky.

The list of exposures that banks commonly identify has increased dramatically in the past decade. Historically, the primary focus has been on the exposure of the loan portfolio centering on the financial security of each individual loan; recently industry and geographical exposure of loans has increased in importance. The exposure of fixed assets, such as buildings, to fires, floods and other problems also has been recognized. In more recent years, exposure of mismatched maturities of assets and liabilities to interest rate movements has increased in importance as interest-rate movements have sharply fluctuated. While this exposure had always existed, it had not been recognized as particularly dangerous until recently. Another example of an exposure that historically was considered safe is repurchase agreements backed by government securities. When Drysdale Government Securities, Inc. failed, several risks were brought to light—whether the instrument is a loan (that would be tied up in case of bankruptcy) or a sale and potential liability when serving as an agent of a government securities firm that fails. A particularly difficult area to evaluate is exposure to legal action. For example, a suit against a bank over lending terms and representations is difficult to anticipate and the exposure could be significant.

Numerous exposures exist that many holding company organizations may not recognize. For example, the Federal Reserve System encourages evaluation of wire transfer exposure. This exposure is very large and theoretically a breakdown on the framework or compromise of internal systems could result in major failures. Exposure from foreign exchange contracts also can be large, and may not always be recognized. Fraud and exposure of management to kidnapping continue to increase in importance. And finally, some major holding company organizations have found that dependence on short-term market funds creates a risky exposure. When access to a funding market may be suddenly withdrawn, the exposure of the entire funding process is an issue.

The second step of the risk identification process is specification of the variables that could affect an exposure and determination of what the impact would be.

This process is difficult, since any number of variables may influence an exposure. Furthermore, as the environment changes new variables may appear relevant and the effects of variables may change. For example, the recent problems of public sector lending to foreign countries with loans denominated in dollars having floating interest rates during inflationary periods may not have been fully evaluated at the time of the lending process.

Determining influential variables is particularly difficult with new products. A historical examination cannot be made of these new products and questions may go unanswered regarding the stability of the new markets. For example, problems have occurred in hedging operations as underlying instruments did not move as expected, thus negating the hedging contract. Consequently, the hedge created an exposure rather than reducing an exposure.

The final step of the risk identification process is risk quantification.

Conceptually, this involves calculation of an expected loss of value related to variance of a particular environmental factor. This has two parts: (1) estimation of the probability that a given variance will occur; and (2) determination of the cost impact of each potential variance. Probabilities are often drawn up in general terms. In some cases historical records facilitate estimation of probabilities. Measurement of credit risk in an organization that specializes by industry or geography may be an example of this. In the most recent recession, however, many past records have proven not to be accurate predictors. In other situations, the holding company organization may evaluate the effect of a change but be unwilling to estimate probabilities of the change occurring. An example of this is managing asset and liability maturities. The effect of a change in interest rates on profits may be determined; but, in many cases, institutions will not derive probabilities on the direction and/or magnitude of interest rate movements.

The difficulty of quantifying costs and probabilities is exacerbated by emergence of new products and by environmental changes. With a new product, it is particularly difficult to determine the cost of a variance. For example, attention to interest rate risk has induced organizations to resort to hedging to reduce exposure. Innovative instruments are difficult to hedge, however, since the issuer may inaccurately gauge price movements. In this case, the exposure results not from price movements, but from inability to predict the relationship between market and price fluctuations. Furthermore, as the environment changes, the effect of a variable on an exposure changes as does the cost and probability of the occurrence. For example, in the 1970's the impact of inflation on the banking system would have been very different without the concurrent economic downturn and the technological advances.

2160.0.2 RISK CONTROL

After management has identified and evaluated risk, they may decide the risk or cost of an action is sufficiently low (and management is confident all possible variables have been identified) that the holding company can take on the risk as it is; if not there are a number of options that can be used to control the risk. Attempts to control risk can be accomplished through a combination of three general techniques: purchase of insurance, limitation of exposure size, and reduction of the expected cost associated with a variance. The use of insurance to decrease the effect of a loss on the corporation is common for exposure to fire, theft, kidnapping, and internal fraud. Various types of loans are underwritten by third parties. The innovative use of insurance may prove to have various applications to risk control in the banking industry. As with other contracts, the financial strength and reputation of the counterparty (the insurer) are important, and the organization's method of selecting and monitoring underwriters should be evaluated.

Management generally limits the level of exposure in relationship to the size of assets, capital or earnings. In most situations, relating the level of exposure to capital would appear appropriate. Reduction of exposure will automatically reduce risk, assuming other variables remain constant. Constraints should be determined by line management at a seniority level commensurate with the degree of perceived risk. Depending on the degree of risk, there may be a need for the board of directors to approve the constraints.

The third method of reducing the potential loss to the corporation involves decreasing the probability of a variance occurring or decreasing the probable effect when a variance occurs. This is exemplified by the exposure to fire. Installation of fire alarms and other precautions could reduce the expected loss substantially. Similarly, hedging with financial futures is a method used to reduce the effect of interest rate movement on the profits of the holding company organization when the maturities of assets and liabilities are not equal.

The final option management has, after risk has been evaluated, is simply not to participate in the activity if the risk is determined to be too high for the expected return.

The inspection procedures should include a broad-based evaluation of parent level risk management. Management's effectiveness in identifying risk, its willingness to accept risk, and its ability to control risk should be regularly evaluated. In an environment of rapid change and emerging financial instruments, there needs to be sufficient expertise to recognize the existence of ''new'' sources of risk concentration to evaluate the company's command of those sources.

2160.0.3 INSPECTION OBJECTIVES

1. To review the risk evaluation and control process.
2. To determine if management's system of identifying risks is effective, and if the parent company is adequately informed of risks throughout the organization.
3. To determine management's recognition of new risks that may arise from the changing environment.
4. To determine the reasonableness of the holding company's exposure-risk figures.
5. To assess the effect on the holding company's financial condition if the risk figures are realized.
6. To determine what actions are necessary to rebalance transactions of a holding company organization to a prudent level.

2160.0.4 INSPECTION PROCEDURES

1. Review the financial condition and the operations of the holding company organization to detect substantive exposure-risk situations.
2. Review management's policies, procedures, and practices in recognizing exposure-risk factors.
3. Determine awareness that all management levels need to be cognizant of exposures related to transactions of their respective operations.
4. Review the holding company's exposure-risk figures, or constraints placed on types of transactions.
5. Discuss with management the significance of exposure-risks facing the holding company and whether or not those risks are set at seemingly prudent levels.
6. Recommend that the organization address any areas where the holding company is perceived to have assumed an imprudent level of risk.

2170.0.1 INTRODUCTION

On April 10, 1985, the Board approved a supervisory policy, via the Federal Financial Institutions Examination Council, for supervising banking organizations that participate in the purchase and sale of loans guaranteed by the U.S. government. The policy reminds those organizations that premiums received in lieu of servicing fees, with respect to the selling and servicing entity, are to be amortized over the life of the loan; and that, with respect to the purchaser, the premiums paid over the face value of the note are not guaranteed and are not paid by the guaranteeing federal agency when the loans are prepaid or in default. The statement thus cautions against paying inappropriate or excessive premiums.

2170.0.2 RECOMMENDATIONS FOR ORIGINATING AND SELLING INSTITUTIONS

Examiners should review the extent and nature of activities in connection with the sale of government guaranteed loans. Lax or improper management of the selling institution's servicing responsibilities should be criticized. Out-of-trade area lending for the purpose of resale of any portion of U.S. government guaranteed loans should be carefully reviewed to ensure that the practice is conducted in a safe and sound manner.

All income, including servicing fees and premiums charged in lieu of servicing fees, associated with the sale of U.S. government guaranteed loans, should be recognized only as earned and amortized to appropriate income accounts over the life of the loan.

2170.0.3 RECOMMENDATIONS FOR PURCHASING INSTITUTIONS

Purchasers of U.S. government guaranteed loans should be aware that the purchase premiums are not guaranteed and are not paid by the guaranteeing Federal agency when the loans are prepaid. Because payment of premiums which do not reasonably relate to the yield on the loan can distort published financial reports by overstating the value of a banking organization's assets, it will generally be viewed as an unsafe and unsound practice to pay purchase premiums which result in a significant overstatement in the value of bank assets.

Many government guaranteed loans currently being originated and sold are variable rate. These variable rate loans normally should not trade at anything more than a modest premium or discount from par. Examiners will carefully review any loans being sold or purchased at significant premiums and will criticize any involvement with excessive premiums as an unsafe and unsound business practice. Excessive purchase premiums will be classified loss. The loans will be required to be revalued to the market value at the time of the acquisition and the excessive premiums will be charged against current earnings.

In addition, any unamortized loan premium on a government guaranteed loan must be immediately charged against income if the loan is prepaid, regardless of whether payment is received from the borrower or the guaranteeing agency.

2175.0.1 INTRODUCTION

Banking organizations have become increasingly involved in marketing third-party uninsured annuities to their retail customers either directly or through third-party companies. As annuity sales have grown, so have concerns that some methods used to sell these instruments could give purchasers the impression that the annuities are federally insured deposits or that they are obligations of a bank. In the event of default by an annuities underwriter, this impression could cause a loss of public confidence in a depository institution, leading to unexpected withdrawals and liquidity pressures. Moreover, a bank or bank holding company that advertises or markets annuities in a way viewed as misleading could potentially be held liable for losses sustained by annuity holders.

This manual section provides guidelines to examiners for reviewing the sale of uninsured annuities by bank holding companies and banks that have legal authority to act as agent in the sale of annuities. State member banks and bank holding companies should not market, sell, or issue uninsured annuities or allow third parties to market, sell, or issue uninsured annuities on depository-institution premises in a manner that conveys the impression or suggestion that such instruments are either (1) federally insured deposits or (2) obligations of or guaranteed by an insured depository institution. Consequently, state member banks should not sell these instruments at teller windows or other areas where retail deposits are routinely accepted.

2175.0.2 PERMISSIBILITY OF UNINSURED ANNUITY SALES

The legal status of annuities under the Bank Holding Company Act is somewhat uncertain at the present time. The Office of the Comptroller of the Currency has authorized national banks to act as agent in the sale of annuities on the basis that variable-rate annuities are securities and fixed-rate annuities are financial investment instruments.[1] These determinations, however, have been challenged by insurance associations on the basis that annuities are insurance products and, therefore, may be sold by national banks only in a town of less than 5,000.[2]

State member banks generally have been permitted to engage in the brokerage of both variable- and fixed-rate annuities consistent with their general corporate powers. In order to engage in this activity without filing a formal application, staff has advised interested banks that the brokerage of annuities must be expressly authorized under state law (or by the state banking regulatory agency on a case-by-case basis) and constitute an activity incidental to the bank's banking activities.

The authority of state member banks to continue to engage in this activity, in the same manner and subject to the conditions discussed above, does not appear to depend on a resolution of the issues.[3] State member banks have been permitted to engage in general insurance agency activities since 1937,[4] and to engage in brokerage activities under the same limitations applicable to bank holding companies. In addition, the Board has determined that the nonbanking restrictions in the Bank Holding Company Act do not apply to the direct activities of banks owned by a bank holding company.[5]

The authority of bank holding companies to engage directly or through a nonbanking subsidiary in the sale of annuities has not yet been determined. In *Norwest Corporation*,[6] the Board considered a proposal by a nonbanking affiliate to engage in the sale of variable- and fixed-rate annuities. The Board concluded that, under the specific facts of that case, it was unnecessary to reach the question of whether the sale of annuities is an insurance agency activity because Norwest is one of a small number of bank holding companies entitled to act as agent in the

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1. Interpretive Letter No. 331, April 4, 1985, *reprinted in* [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶85,501; OCC Interpretive Letter No. 499 (February 12, 1990), *reprinted in* [1989–1990] Fed. Banking L. Rep. (CCH) ¶83,090. National banks are authorized to buy and sell securities for the account of customers and broker financial investment instruments.

2. *The Variable Annuity Life Insurance Company v. Clarke*, No. H-91-1016 (S.D. Tex. filed Apr. 16, 1991) ("NCNB litigation").

3. NCNB litigation.

4. Prior to 1937, the Board imposed as a condition of membership in the Federal Reserve System that a bank discontinue all insurance activities other than insurance activities in a town of less than 5,000. The purpose of this restriction was to conform insurance activities allowed for state member banks to those allowed for national banks.

5. *Merchants National Corp.*, 75 Federal Reserve Bulletin 388 (1989), *aff'd*, 890 F.2d 1275 (2d Cir. 1989), *cert. denied*, 111 S. Ct. 44 (1990).

6. 76 Federal Reserve Bulletin 873 (1990).

sale of any type of insurance pursuant to Exemption G of the Garn Act.[7]

2175.0.3 CHARACTERISTICS OF ANNUITY INSTRUMENTS

An annuity is an investment from which a person receives periodic payments based on earlier payments made to the obligor. Annuities are commonly underwritten by insurance companies, then marketed and sold either directly or through third parties, such as banks. Insurance companies retain the actuarial and underwriting risks on these annuities.

Annuities may be either variable or fixed-rate. An investor in a variable annuity contract purchases a share in an investment portfolio and then receives payments that vary according to the performance of the portfolio. A purchaser of a fixed-rate annuity contract, in contrast, receives a fixed-rate payment or minimum level of payments. Annuity payments can usually be received monthly, quarterly, semi-annually, or annually.

Variable- and fixed-rate annuities may be purchased in a single lump sum (‘‘single premium’’) or in periodic contributions (‘‘flexible premium’’). Minimum and maximum contributions to annuities vary among vendors. Some single-premium annuities have ‘‘bail-out’’ features which allow holders to withdraw all funds if the rate of return on the annuity contract falls below a specified rate.

The ability to take money out of an annuity prior to maturity varies by product, as does the imposition of a surrender penalty by the insurer when withdrawal occurs prior to maturity. When a penalty is imposed, the insurer generally calculates the penalty as a percentage of the annuity product's accumulated value. The penalty for withdrawal generally declines with the annuity's age. Normally, funds may not be withdrawn prior to the first anniversary date of the annuity.[8]

Annuities sold at depository institutions often include rate guarantees over the life of the instrument. They also frequently mature in one, three, or five years, similar to maturity ranges on certificates of deposit.

Insurance companies arrange for the sale of annuities on the premises of depository institutions in different ways. Some insurance companies approach banks directly. At other times, wholesalers (who market the products of a number of different insurance companies) may approach a bank. Depending on state restrictions on insurance activities, sales might be conducted by bank employees, employees of bank subsidiary insurance agencies, or by third-party insurance agents leasing space on the bank's premises.

Sales commissions on annuities vary by the type of annuity. Commissions earned on single-premium products generally vary from 4 percent to 6 percent, but they decline sharply when the product sold includes a ‘‘bail-out’’ provision. Wholesalers may also give retailers a commission when the annuity is renewed, based on the accumulated value of the annuity. Commissions in some instances are paid on a variable basis, rising as the volume of sales increases.

2175.0.4 IMPROPER MARKETING PRACTICES

Banks have become involved in the sale of uninsured annuities through marketing programs designed to appeal specifically to their retail customers. It is important that these programs not employ marketing practices that could mislead the bank's customers. For example, the use in annuities advertisements of terms such as ‘‘CD,’’ ‘‘deposit,’’ and ‘‘interest plan’’ to imply that the instruments are insured deposits would be inappropriate. Also, advertisements that prominently display the bank's name and logo in a way that suggests the product is an obligation of the bank are similarly inappropriate. Disclosure that the annuities are not federally insured and are not obligations of the bank should be displayed prominently in annuity contracts and related documentation, on printed

7. The Garn Act amended section 4(c)(8) of the Bank Holding Company Act to prohibit generally bank holding companies from engaging in insurance activities as a principal, agent, or broker with certain exceptions. Under the express language of the Garn Act, the sale of insurance is not ‘‘closely related to banking’’ and is not permissible for a bank holding company unless it qualifies under one of the seven specified exceptions (Exemptions A–G) in the Garn Act. Exemption G applies to a limited number of bank holding companies that received approval from the Board prior to January 1, 1971, to conduct insurance agency activities. In order to utilize Exemption G or any other Garn Act exemptions that may be applicable, the bank holding company must file an application and would be subject to the proposed restrictions through the application process.

8. If an investor withdraws tax-deferred income from an annuity before the investor is 59½ years old, the IRS levies a tax penalty on the person equal to 10 percent of the amount of tax-deferred income withdrawn. This penalty may be avoided only if the person reinvests annuity proceeds in another tax-deferred investment within 60 days of the withdrawal.

advices, and verbally emphasized in telemarketing contacts. Finally, personnel selling uninsured annuities should be distinguishable from bank employees conducting normal retail deposit-taking operations.

2175.0.5 INSPECTION OBJECTIVES

1. To review the marketing and sale of uninsured annuities sold by the bank holding company and its member banks, or those sold through a third party.
2. To determine whether the bank holding company and its banks have adequate policies and procedures in place and if they are monitored by the parent company.
3. To determine if, prior to agreeing to sell annuities, a comprehensive financial analysis is made of the financial condition of the annuities underwriter and whether products of only financially secure underwriters are sold.
4. To determine whether the contract and advertising and related documents disclose prominently that the annuities do not represent deposits or obligations of an insured depository institution and that they are not insured by the Federal Deposit Insurance Corporation.
5. To ascertain that annuities are not sold at teller windows or other areas where deposits are routinely accepted.

2175.0.6 INSPECTION PROCEDURES

1. Determine whether the bank holding company and its banks have adequate policies and procedures in place:

a. to assess the financial condition of the annuities underwriter;

Banking organizations engaged in the sale of annuities are expected to sell only products of financially secure underwriters. Prior to agreeing to sell annuities, a comprehensive financial analysis of the obligor should be performed and reviewed with the banking organization's directors. The policies should also include a program to evaluate the underwriter's financial condition at least annually and to review the credit ratings assigned to the underwriter by the independent agencies evaluating annuity underwriters.

b. to ensure that the marketing and sale of uninsured annuities is not misleading and is separated and distinguished from routine retail deposit-taking activities.

(1) With regard to the sale of annuities, determine whether the contract, advertising, and all related documents disclose prominently in bold print that the annuities:

(a) are not deposits or obligations of an insured depository institution; and

(b) are not insured by the Federal Deposit Insurance Corporation.

(2) State member banks should not sell annuity instruments at teller windows or other areas where retail deposits are routinely accepted. In assessing the adequacy of disclosures and the separation of the marketing and sale of uninsured annuities from the retail deposit-taking function, examiners should take into account whether:

(a) advertisements *do not* contain words, such as ‘‘deposit’’, ‘‘CD’’, etc., or a logo that could lead an investor to believe an annuity is an insured deposit instrument;

(b) the obligor of the annuity contract is prominently disclosed, and names or logos of the insured depository institution are not used in a way that might suggest the insured depository institution is the obligor;

(c) adequate verbal disclosures are made during telemarketing contacts and at the time of sale;

(d) retail deposit-taking employees of the insured depository institution *are not engaged* in the promotion or sale of uninsured annuities;

(e) information on uninsured annuities *is not* contained in retail deposit statements of customers or in the immediate retail deposit-taking area;

(f) account information on annuities owned by customers *is not* included on insured deposit statements; and

(g) officer or employee remuneration associated with selling annuities is limited to reasonable levels in relation to the individual's salary.

(3) If a bank allows a third-party entity to market annuities on depository institution premises, examiners should take into account whether:

(a) the depository institution has assured itself that the third-party company is properly registered or licensed to conduct this activity;

(b) depository institution personnel *are not* involved in sales activities conducted by the third party;

(c) desks or offices *are not* used to market or sell annuities, are separate and distinctly identified as being used by an outside party; and

(d) depository institution personnel *do not* normally use desks or offices used by a third party for annuities sales.

2. Determine that advertisements do not prominently display the bank's name and logo that suggests the product is an obligation of a BHC bank.

3. Determine whether the banks obtain a signed statement from the customer indicating that the customer understands that the annuity is not a deposit or any other obligation of the depository institution, that the depository institution is only acting as an agent for the insurance company (underwriter), and that the annuity is not FDIC insured.

Existing regulations permit banks and bank holding companies to engage in a wide range of securities activities in overseas markets. For a number of years these activities were not considered to be significant in the context of total bank and bank holding company assets. Indigenous rules and market practice served to constrain to a degree securities activities of U.S. banking organizations overseas.

Changes in local rules now make it possible for members of the London stock exchange to be wholly-owned by non-member companies and by year-end 1986 will allow stockbrokers to act as principals or market makers in securities. These new rules are expected to change significantly the complexion of the London securities market. In this context, U.S. banking organizations are making substantial investments in U.K. securities firms, and are also significantly expanding their securities business in other foreign and international markets.

The Board has expressed its concerns, in connection with an application by a banking organization to expand its securities activities overseas, that proper safeguards, limits, and controls will be exercised to protect the organization from undue risk. Applications generally state the methods through which the banking organization plans to control risk and establish oversight over securities operations. While these safeguards are initially evaluated at the time the application is made, nevertheless, examinations of bank holding companies and Edge corporations should incorporate an assessment of all overseas securities activities in order to determine the degree to which these activities conform to high standards of banking and financial prudence. The affiliation of a securities company, especially one engaged in corporate debt and equities transactions, with a banking organization raises a potential for conflict of interest and in some cases could pose substantial additional risk to the institution.

In those U.S. banking organizations where overseas securities trading and brokering are significant in scope or are prominent in the scale of the local market, examination procedures must incorporate an assessment of the controls, limits, and safeguards implemented by the organization to monitor and contain risk. Securities activities should be subject to the same degree of scrutiny and rigorous assessment of risk as bank lending activities. In addition, examiners should monitor the substance and nature of all transactions.

In particular, the following kinds of activities should be reviewed to determine whether they raise considerations of safety and soundness or otherwise do not conform to standards of prudence required of U.S. banking organizations:

- The degree of lending by a bank holding company to its securities affiliate, especially when loans are extended to support or enhance the obligations underwritten by the securities affiliate;
- The extent to which securities underwritten by an affiliate are purchased by the bank holding company as principal or trustee; and,
- The extent to which the parent is liable to an exchange for any losses incurred by the affiliate due to failure to deliver securities or settle contracts.

Targeted examinations and investigations by the Federal Reserve and the Enforcement Division of the Securities Exchange Commission (SEC), as well as court actions, have found banks in violation of Regulation U, Credit by Banks for the Purpose of Purchasing or Carrying Margin Stock, (12 C.F.R. 221) when their trust departments, using bank or other fiduciary funds, have extended credit to individuals involved in illegal day trading or free-riding schemes. These activities also involved the aiding and abetting of violations of two other securities credit regulations: Regulation T, Credit by Brokers and Dealers (12 C.F.R. 220), and Regulation X, Borrowers of Securities Credit, (12 C.F.R. 224).

Day trading and free-riding schemes involve the purchase and sale of stock on the same day (or within a very short period of time) and the funding of the purchases with the proceeds of the sale. Banking organizations[1] engaging in such illegal activities may subject themselves to disciplinary proceedings, as well as to substantial credit risk.

Federal Reserve examiners should ensure that banks and bank holding companies (including the broker-dealer and trust activities of banking and nonbanking subsidiaries of state member banks and bank holding companies) are not engaged in such illegal activities. Examiners must make certain that these entities have taken all steps necessary to prevent their customers from involving them in free-riding. Prompt enforcement action may be needed to eliminate free-riding activities. (See SR-93-13.)

2187.0.1 TYPICAL DAY TRADING OR FREE-RIDING ACTIVITIES

The free-riding conduct in question typically involves trading large amounts of securities without depositing the necessary money or appropriate collateral in their customer accounts. The customer seeks to free-ride, that is, purchase and sell the same securities and pay for the purchase with the proceeds of the sale. Often, free-riding schemes involve initial public offerings because broker-dealers are prohibited from financing these new issues. If the money to pay for the securities is not in the account when the securities are delivered in a delivery-versus-payment (DVP) transaction, a bank that permits completion of the transaction creates a temporary overdraft in the customer's account. This overdraft is an extension of credit that subjects the banks to Regulation U.

The typical free-riding scheme involves a new customer's opening a custodial agency account into which a number of broker-dealers will deliver securities or funds in DVP transactions. Although a deposit may be made into the custodial agency account, the amount of trading is greatly in excess of the original deposit, causing the financial institution to extend its own credit to meet the payment and delivery obligations of the account. Therefore, although the financial institution may be earning fees as a result of the activity in these accounts, it is subjecting itself to substantial losses if the market prices for the purchased securities fall or the transactions otherwise fail. In addition, other liabilities under federal banking and securities laws may be involved.

2187.0.2 SECURITIES CREDIT REGULATIONS

2187.0.2.1 Regulation U, Credit by Banks or Persons Other Than Brokers or Dealers for the Purpose of Purchasing or Carrying Margin Stocks

Any extension of credit in the course of settling customer securities transactions, including those occuring in a trust department or trust subsidiary of a bank holding company, must comply with all of the provisions of Regulation U.[2] Regulation U requires all extensions of credit for the purpose of buying or carrying margin

1. The use of the term ''banking organization'' in this section, with regard to Regulation U, means a bank, trust department of a bank, or trust company of a bank holding company that is subject to Regulation U. Regulation U includes any nondealer nonbank subsidiary of a bank holding company that extends purpose credit by margin stock. With regard to Regulation T, it refers to any nonbank company that conducts broker-dealer activities.

2. For purposes of the regulation, the definition of ''bank'' specifically includes institutions ''exercising fiduciary powers.'' (See 12 C.F.R. 221.2, 15 U.S.C. 78(c)(a)(6), and *Federal Reserve Regulatory Service* at 5–795 (1946).) When used in discussing a bank's trust department or any other type of financial institution exercising fiduciary powers, the term ''extension of credit'' includes overdrafts in settling customer's accounts that may be covered by advances from the banking organization, from other fiduciary customers, or from a combination of both.

stock that are secured by margin stock to be within the 50 percent limit. To avoid violations of the Board's securities credit regulations, on settlement date, the customer's account must hold sufficient funds, excluding the proceeds of the sale of the security, to pay for each security purchased. Although Regulation U applies only to transactions in margin stock, free-riding in nonmargin stocks in custodial agency accounts could result in a banking organization's aiding and abetting violations of Regulations T and X and other securities laws, and could raise financial safety-and-soundness issues.

2187.0.2.2 Regulation T, Credit by Brokers and Dealers, and Regulation X, Borrowers of Securities Credit

Because the custodial agency accounts are used to settle transactions effected by the customer at broker-dealers, a banking organization that opens this type of account should have some general understanding of how Regulation T restricts the customer's use of the account at the institution. Regulation T requires the use of a cash account for customer purchases or sales on a DVP basis. Section 220.8(a) of Regulation T specifies that cash-account transactions are predicated on the customer's agreement that the customer will make full cash payment for securities before selling them and does not intend to sell them before making such payment. Therefore, free-riding is prohibited in a cash account. A customer who instructs his or her agent financial institution to pay for a security by relying on the proceeds of the sale of that security in a DVP transaction is causing, or aiding or abetting, the broker-dealer to violate the credit restrictions of Regulation T. Regulation X, which generally prohibits borrowers from willfully causing credit to be extended in violation of Regulations T or U, also applies to the customer in such cases.

As described above, banking organizations[3] involved in customer free-riding schemes may be aiding and abetting violations of Regulation T by the broker-dealers who deliver securities or funds to the banking organization's customers' accounts. As long as a financial institution uses its funds to complete a customer's transactions, broker-dealers may not discover that they are selling securities to the customer in violation of Regulation T. A similar aiding and abetting violation of Regulation X could occur if a customer used the financial institution to induce a broker-dealer to violate Regulation T.

3. For a discussion of Regulation T as it applies to a bank holding company's broker-dealer nonbank subsidiary, see section 3230.0.

2187.0.3 NEW-CUSTOMER INQUIRIES AND WARNING SIGNALS

Examiners should make certain that all banks and other financial-institution subsidiaries of a bank holding company are administering and following appropriate written policies and procedures concerning the establishment of custodial agency accounts or any new account involving customer securities transactions. Such policies and procedures should address, among other things, ways an institution can protect itself against free-riding schemes. One way is to obtain adequate background and credit information from new clients, including whether the customer intends to obtain credit to use with the account. This type of activity requires more extensive monitoring than the typical DVP account in which no credit is extended. It would be prudent to inquire why a new customer is not using the margin-account services of its broker-dealers. If the account is to be used as a margin account, a financial institution must obtain Form FR U-1 from the customer and must sign and constantly update the form.

The financial institution should obtain from the customer a list of broker-dealers that will be sending securities to or receiving funds from the account in DVP transactions. If a number of broker-dealers may be used, the institution should obtain from the customer a written statement that all transactions with the broker-dealer will conform with Regulations T and X and that the customer is aware that a security purchased in a cash account is not to be sold until it is paid for. Similarly, when obtaining instructions for settling DVP transactions for a customer, the financial institution should clarify that it will not rely upon the proceeds from the sale of those securities to pay for the purchase of the same securities.

2187.0.4 SCOPE OF THE INSPECTION FOR FREE-RIDING ACTIVITIES

Examiners, bank holding companies, state member banks, and financial-institution and trust subsidiaries owned by bank holding companies (also U.S. branches and agencies of foreign banks exercising trust powers) should ensure that their banking organizations monitor accounts closely for an initial period to detect patterns typical of free-riding, including intraday overdrafts, and to ensure that sufficient funds or margin collateral are on deposit at all times. Frequent transactions in securities being offered in an initial public offering may suggest an avoidance of Regulations T and X. If it appears that a customer is attempting to free-ride, the financial institution should immediately alert the broker-dealers involved in transferring securities and take steps to minimize its own credit risk and legal liability.

At a minimum, examiners should also evaluate a trust institution’s ability to ensure that it does not extend to a customer more credit on behalf of a bank or other financial institution than is permitted under Regulation U. If there are any questions in this regard, examiners should consult with their Reserve Bank’s trust examiners. Any overdraft that is related to a purchase or sale of margin stock, and that is secured by margin stock, is an extension of credit subject to the regulation, including overdrafts that are outstanding for less than a day. Board staff have published a number of opinions discussing the application of Regulation U to various transactions relating to free-riding.

Free-riding violations that could endanger the banking organization (for example, fraudulent activities that could subject the organization to losses or lawsuits), as well as significant violations that were previously noted but have not yet been corrected, should be noted in the inspection report. Violations of the Board’s Regulation T, U, or X, as applicable to the inspection, should be reported on the Examiner’s Comments and Violations report pages. The report should discuss what action has or will be taken to correct those violations.

2187.0.5 SEC AND FEDERAL RESERVE SANCTIONS AND ENFORCEMENT ACTIONS

The SEC, in exercising its broad authority to enforce the Board’s securities credit regulations, requires banks to (1) establish credit compliance committees to formulate written policies and procedures concerning the extension of purpose credit in their securities-clearance business, (2) establish training programs for bank personnel responsible for the conduct of their securities-clearance business, and (3) submit to outside audits to verify their compliance with the conditions of injunctions. The Board may also institute enforcement proceedings against the banking organizations it supervises and against any institution-affiliated parties involved in these activities, including cease-and-desist orders, civil money penalty assessments, and removal and permanent-prohibition actions.

2187.0.6 INSPECTION OBJECTIVES

1. To make certain that policies of the bank holding company’s board, and the supervisory operating procedures, internal controls, and audit procedures will ensure, in the course of settling customers’ securities transactions—
   a. that bank extensions of credit within the holding company comply with the provisions of Regulation U (including the requirement that initial extensions of credit that are secured by margin stock are within the initial 50 percent margin limit) and
   b. that customer accounts hold sufficient funds on the settlement date for each security purchased.
2. To determine—
   a. whether the banking organizations of the bank holding company can adequately monitor compliance with Regulation U through systems of internal controls, training, and compliance procedures (i.e., use of credit compliance committees) that address free-riding activities within the ‘‘back-office function’’ [4] and
   b. whether noncompliance is properly reported.
3. To initiate corrective action when policies, practices, procedures, or internal controls are not sufficient to prevent free-riding schemes, and when violations of the Board’s regulations have been noted by bank examiners or self-regulatory organizations.

2187.0.7 INSPECTION PROCEDURES

1. Review the bank holding company’s board of directors’ policies for its banking institution subsidiaries regarding supervisory operational policies, procedures, and internal controls for loans extended for the purpose

4. Refers to the movement of cash and securities relating to trades and to the processing and recording of trades. This process is also called the ‘‘securities-clearance cycle.’’

of buying or carrying margin stock and secured directly or indirectly by margin stock.

a. Determine whether the policies require, for *each* extension of credit not specifically exempted under Regulation U, that a Form FR U-1 be executed and signed by the customer and accepted and signed by a duly authorized officer of the banking organization acting in good faith.

b. Determine whether the policies limit extensions of credit to no more than the maximum allowed loan value of the collateral, as set by section 221.7 of Regulation U, and whether those policies require adherence to margin requirements.

2. Review the bank holding company's board of directors' credit policies and operating policies, internal controls, and internal audit procedures to determine if they provide adequate safeguards against customers' free-riding practices. In so doing—

a. determine if new-customer accounts are required to be approved by appropriate personnel; and

b. establish whether the bank holding company's credit-system policies require—

- controlling securities positions and financial-instrument contracts that serve as collateral for loans;
- monitoring established restrictions and limits placed on the amounts and types of transactions to be executed with each customer and the dollar amounts placed on unsettled trades;
- obtaining appropriate documentation consisting of essential facts pertaining to each customer, and in particular, financial information evidencing the customer's ability to pay for ordered securities, repay extensions of credit, and meet other financial commitments;
- monitoring the location of all collateral;
- ensuring that there are no overdrawn margin accounts; and
- monitoring the status of failed transactions for the purpose of detecting free-riding schemes.

3. Determine if the bank holding company's audit committee or its internal or external auditors are required to review a selected random sample of individual or custodial agency accounts for customer free-riding activities.

2187.0.8 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Credit by brokers and dealers		220 (Reg. T)		
Regulation U, Credit by Banks or Persons Other Than Brokers or Dealers for the Purpose of Purchasing or Carrying Margin Stocks		221 (Reg. U)		
Purpose credit—delivery-versus-payment transactions			5–942.15, 5–942.18, 5–942.2, 5–942.21, 5–942.22	
Borrowers of securities credit		224 (Reg. X)		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

2220.3.1 NOTE ISSUANCE FACILITY (NIF)

One type of off-balance-sheet activity is the note issuance facility (NIF). The first public facility was arranged in 1981. A NIF is a medium-term arrangement under which a borrower can issue short-term paper. The paper is issued on a revolving basis, with maturities ranging from as low as 7 days to up to one year. Underwriters are committed either to purchasing any unsold notes or to providing standby credit. Bank borrowing usually involves commercial paper consisting of short-term certificates of deposit and for nonbank borrowers it would generally be promissory notes (Euronotes). NIF is the most common term used for this type of arrangement. Other terms include the revolving underwriting facility (RUF), and the standby note issuance facility (SNIF). NIFs, RUFs, and SNIFs are essentially the same credit product. The NIF is usually structured for 5 to 7 years.

Euronotes are denominated in US dollars and are issued with high face values (often $500,000 or more), being intended for the more sophisticated investor (professional or institutional investors). Holders of the notes show them as an asset on their balance sheets. The underwriting commitment represents an off-balance sheet item. The NIF allows the various functions performed by a single institution in a syndicated credit to be separated and performed by different institutions.

Instead of lending money, as in a syndicated credit, the NIF arranger provides a mechanism for placing notes with other investors when funds are needed. The underwriting commitment transforms the maturity, assuring the borrower access to short-term funds over the medium term, which remains off-balance sheet, unless drawn upon. The underwriters take the short-term credit risk since they face the risk of lending to a borrower that has difficulty in obtaining full confidence from investors.

NIFs can be arranged with an issuer-set margin whereby the issuer determines the margin over LIBOR (the London Interbank Offered Rate), or some other index at which notes will be offered. The issuer thus benefits from any improvement in market conditions. The notes are placed by the placing agent, but senior underwriters have the option of purchasing a prearranged share of any notes issued. Any notes not taken up at the issuer-set margin are distributed to underwriters at the pre- established maximum (cap) rate.

2220.3.2 REVOLVING UNDERWRITING FACILITY (RUF)

Another type of facility, a revolving underwriting facility (RUF), was introduced in 1982. A revolving underwriting facility is a medium-term revolving commitment to guarantee the overseas sale of short-term negotiable promissory notes (usually a fixed-spread over LIBOR) issued by the borrower at or below a predetermined interest rate. RUFs separate the roles of the medium-term risk-taker and the providers of the funding (the short-term investors). RUFs and NIFs allow access to capital sources at interest rates considerably below conventional financing rates. The savings in interest cost are derived because the borrower obtains the lower interest costs prevailing in the short-term markets, while still retaining the security of longer term financing commitments. The notes issued under RUFs are attractive for institutional investors since they permit greater diversification of risk than the certificates of deposit of only one bank. Underwriters favor them because their commitments do not appear on the statement of financial condition. RUFs are usually structured for periods of four to seven years.

A revolving underwriting facility (RUF) differs from a (NIF) in that it separates the functions of underwriting and distribution. With a RUF, the lead bank (manager or arranger) acts as the only placing agent. The arranger retains total control over the placing of the notes. The lead bank provides assistance to a borrower who forms a lending group of banks. The borrower, assisted by a lead bank (arranger), obtains a medium term revolving commitment that guarantees the sale of short-term negotiable promissory notes at or below a pre-determined interest rate. The participating group of banks arrange the funding, subject to certain lending conditions and rates, for the duration of the facility. In return, the borrower pays a facility fee to the revolving credit banks.

When the borrower desires funds, a placement agent or tender panel[1] places short-term notes with other banks and institutional investors (usually having maturities of 90 days, 180 days or 12 months). The short term notes can be issued to these investors at significantly lower interest rates than would be available from a revolving credit facility that the same banks would have been willing to provide. The note purchasers generally have a rollover option at maturity and new note purchasers are added as needed. The note purchasers bear the risk of loss in the event of default by the borrower. New note purchasers are added as needed. In the event the full line of credit is not placed with the note purchasers on any rollover date, the revolving credit banks must make funding available for the difference at the previously committed revolving credit interest rates, subject to the terms and conditions within the agreement.

With the RUF, and the use of a sole placing agent, the underwriters are not assured of securing any notes that they could place themselves nor can they benefit from any improvement in terms available in the market. The hindrance is removed by the use of NIFs with an issuer-set margin whereby the issuer determines the margin over an index at which notes will be offered.

Another form of a RUF is a transferable revolving underwriting facility (TRUF). With this arrangement the underwriter is able, with the borrower's approval, to transfer all rights and obligations under the underwriting commitment to another institution at any time during the life of the facility.

2220.3.3 RISK

The loan commitments involved in NIF and RUF transactions contain substantially the same terms as other loan commitments extended to similar borrowers. The failure of the borrower to satisfy the revolving standby agreement relieves the banks of any obligation to fund the transaction. The major source of risk is thus the liquidity risk that is derived from the uncertainty of the timing or amount of required funding. If the underlying notes cannot be marketed at or below the interest rate specified in the agreement, the bank would need to discount the notes to whatever rate would be necessary to make the notes attractive to investors, perhaps taking an up-front loss to avoid funding a low margin loan.

NIFs and RUFs involve less credit risk than extensions of credit because of the additional step that is required before funding takes place, a step that is not present with a revolving credit agreement. In other words, no funding is required until: (1) a decision is made by the borrower to issue notes; and (2) the placing agent becomes unable to place the short-term notes with short-term investors. Further, the risk of loss rests with the note investors. The underwriter's risk of nonpayment is not present until the rollover date. If there has been a significant deterioration in the issuer/borrower's financial condition on that date, the issuer/borrower may be prevented from drawing under the facility. This would be dependent on the funding conditions or the cancellation provisions stipulated in the agreement.

2220.3.4 PRICING AND FEES

The forms of compensation involving a NIF and RUF are: the underwriting and commitment fee; the one-time arrangement fee, and the periodic placement fees. An annual fixed underwriting fee is paid by the borrower on the amount of underlying commitment. This fee must be paid regardless of the frequency of usage of the facility or whether or not the underwriters are required to make any purchases of the short-term paper. This compensation is for the commitment to underwrite the issuance of the notes. The arranger receives a one-time arrangement fee based on a percentage of the amount of the facility. The issuer pays the borrowing costs on the notes issued, usually at a spread above or below an index. A portion of this borrowing fee is retained by the placement agent or the tender panel members as compensation for placing the paper.

Competitive pricing on NIFs and RUFS causes them to be very thinly margined. Commitment fees may be as low as 5 basis points for blue chip customers, while ''BBB'' credit-rated or equivalent borrowers might be charged as much as 20 basis points. Because of the thin spread some banks may only be serving as an

1. The tender panel was introduced in 1983. It is usually made up of several commercial investment banks and other institutional investors. The panel members bid for any notes issued, up to a predetermined maximum spread. The revolving credit banks can bid as part of the tender panel, but they are not required to do so. Any notes not bid for are purchased by the revolving credit banks or they extend credit of an equal amount. The tender panel may be a continuous tender panel whereby the underwriters are entitled to purchase notes from the lead manager up to their pro rata share at any time during the offer period, if available, at the market price.

arranger, preferring to not participate in the market. Typical fees for this service may consist of: an up-front arrangement fee of 20 basis points on the total principal amount of the facility, and an annual placement fee such as 12.5 basis points on the short-term notes sold. Revolving credit banks usually receive facility fees and annual maintenance fees.

If the underwriters have to purchase the notes, the backup rate of interest may be the index plus 10 to 15 basis points for blue chip companies to plus 37.5 basis points over the index for ''BBB'' rated borrowers. The interest rates charged (if funded) are usually lower because of market-pricing conventions (lower spreads) and the intense competition within the market.

2220.3.5 STANDBY RUFS

Some RUFS may provide for a utilization fee or may provide for a higher yield on the notes in the event that more than a nominal amount of paper is allocated to the underwriters. Such a provision would more likely be found in a standby facility. Standby facilities are backup commitments under which notes are not expected to be issued. This provision essentially protects the underwriter from having to book loans that are earning an insufficient yield. The structure of the facility generally determines its pricing depending upon the requirements of the issuer/borrower.

Standby RUFs substitute for committed bank lines which may be used, for example, as backup commitments for issuance of U.S. commercial paper. Commitment fees will be low because of the low probability that funds will need to be advanced. A standby facility will make borrowing from the underwriter very expensive in relation to what the issuer might have to pay. Otherwise, the underlying notes are issued on a regular basis, the maximum yield on the notes is set to approximate the normal market level for the issuer's short term borrowings.This facility would have a higher underwriting fee than a standby facility, because the regular issuances of notes increase the likelihood that the underwriting bank will have to purchase notes that cannot be placed.

2220.3.6 RUF DOCUMENTS

The *revolving credit agreement* is the primary document in a RUF. It includes the principal agreement of the transaction, executed by the revolving credit banks and the borrower. It contains the terms and conditions under which the borrower can draw on the facility. The document includes the financial covenants and events of default.

An *agency agreement* between the borrower and the placement agent designates the placement agent for the notes and sets forth the conditions of the agent's obligations for arranging the sale of the notes. Included are representations and warranties of the borrower regarding the authority to enter into the agreement and to issue the notes.

A description of the terms and conditions of the facility is contained within an *information memorandum*. Detail is provided with regard to the use of the proceeds, current and historical financial information, a description of the company, its finances and operations. It is distributed to prospective credit banks and note purchasers.

The *note* is the last document involving a RUF. Usually the notes will be unsecured obligations of the borrower and will include representations and warranties of the company regarding authorization and the absence of material litigation and bankruptcy proceedings. It will also contain a statement that a revolving credit facility is available to the borrower.

The Board has a long-standing policy on real estate appraisals, which emphasizes the importance of sound appraisal policies and procedures in a banking organization's real estate lending activity. In December 1987, the Board and the other bank regulatory agencies jointly adopted guidelines for real estate appraisal policies and review procedures. With the passage of the Federal Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the Board, in August 1990, as well as the other federal financial institutions regulatory agencies, adopted regulations to implement the statute's title XI provisions (12 U.S.C. 3310, 3331–3351, and 1844(b)) relating to the performance and use of appraisals by federally regulated financial institutions. On June 7, 1994, the Board and the federal financial institutions regulatory agencies adopted several amendments to their appraisal regulations to clarify the agencies' appraisal requirements.[1] Additionally, the Board revised its guidelines for real estate appraisal and evaluation programs in September 1992 and October 1994. (See SR-94-50, SR-94-55, SR-95-16, SR-95-27, and SR-95-31 (SUP).)

The intent of title XI of FIRREA and subpart G of the Board's Regulation Y (12 CFR 225) is to protect federal financial and public policy interests in real estate–related financial transactions requiring the services of an appraiser. The statute requires that real estate appraisals be prepared in writing, in accordance with uniform standards, and by individuals with demonstrated competency and whose professional conduct is subject to effective supervision.

Title XI permitted each state to establish a program for certifying and licensing real estate appraisers who are qualified to perform appraisals in connection with *federally related transactions*.[2] Additionally, title XI designated the Appraisal Foundation, a nonprofit appraisal industry group, as the authority for establishing qualifications criteria for appraiser certification and standards for the performance of an appraisal. The states were authorized by title XI to establish qualification standards for licensing. It established the Appraisal Subcommittee of the Federal Financial Institutions Examination Council to monitor the requirements established to meet the intent of title XI.

The Board's appraisal regulation requires appraisals performed in connection with federally related transactions entered into after August 9, 1990, to comply with the regulation. Real estate–related financial transactions entered into before August 9, 1990, would have had to comply with the Board's supervisory guidelines, issued in 1987, as well as with safe and sound banking practices. Transactions are deemed to have been entered into and a loan is deemed to have been originated if there was a binding commitment to perform before the effective date. The requirement to use a state-certified or -licensed appraiser has a separate effective date, December 31, 1992.[3]

2231.0.1 APPRAISAL AND EVALUATION POLICY

A banking organization's board of directors is responsible for adopting policies and procedures that establish effective real estate appraisal and evaluation programs. Analyzing real estate collateral at a loan's inception and over its life requires a sufficient understanding of appraisals and evaluations to fully assess credit risk. While the appraisal plays an important role in the loan-approval process, undue reliance should not be placed on the collateral value in lieu of an

1. The appraisal standards for federally related transactions are found in sections 225.61 to 225.67 of subpart G of Regulation Y. Section 225.63 was amended, effective December 28, 1998, to exclude from the Board's appraisal requirements transactions that involve underwriting or dealing in mortgage-backed securities. The amendment permits bank holding company subsidiaries engaged in underwriting and dealing in securities to underwrite and deal in mortgage-backed securities without demonstrating that the loans underlying the securities are supported by appraisals that meet the Board's appraisal requirements. See 1999 FRB 50.

2. *Federally related transaction* refers to any real estate–related financial transaction entered into on or after August 9, 1990, that (1) the Board or any regulated institution engages in or contracts for and (2) requires the services of an appraiser. A *real estate–related financial transaction* is any transaction involving (1) the sale, lease, purchase, investment in, or exchange of real property, including interests in property, or the financing thereof; (2) the refinancing of real property or interests in real property; or (3) the use of real property or interests in property as security for a loan or investment, including mortgage-backed securities.

3. States have the flexibility to adopt an earlier implementation date regarding state requirements that an appraiser be certified or licensed to perform an appraisal within his or her state. Financial institutions doing business in a state that has an earlier effective date for mandatory use of a certified or licensed appraiser than the federally mandated effective date will have to abide by any state laws.

adequate assessment of the borrower's repayment ability. However, when a credit becomes troubled, the primary source of repayment often shifts from the borrower's capacity to repay to the value of the collateral. For these reasons, it is important to have sound appraisal policies and procedures.

2231.0.1.1 Appraisal and Evaluation Programs

The appraisal and evaluation programs should be tailored to the lender's size, its location, and the nature of its real estate market and attendant real estate–related activity. These programs should establish prudent standards and procedures which ensure that written appraisals or evaluations are obtained and analyzed for real estate–related financial transactions before a final credit decision is made.

Appraisal and evaluation programs should also establish the manner in which the institution selects, evaluates, and monitors individuals who perform real estate appraisals or evaluations. Key elements of the programs should ensure that individuals are fairly considered for the assignment, possess the requisite expertise to satisfactorily complete the assignment, hold the proper state certification or license if applicable, and are capable of rendering a high-quality, written appraisal or evaluation.

2231.0.1.2 Real Estate Appraisal Compliance Procedures

To ensure compliance with the Board's real estate appraisal regulation and supervisory guidelines, the banking organization should have established regulatory compliance procedures for all appraisals and evaluations. The compliance review may be part of a loan officer's overall credit analysis and may take the form of a narrative or checklist. The individual who prepared the appraisal or evaluation should take corrective action for noted deficiencies. Unreliable appraisals or evaluations should be replaced before the final credit decision. Formal documentation or evidence of the review should be maintained.

Additionally, a banking organization should have comprehensive analytical procedures that focus on certain types of loans, such as large-dollar credits, loans secured by complex or specialized properties, nonresidential construction loans, or out-of-area real estate loans. The banking organization should establish criteria for identifying which appraisals should be considered for more comprehensive analytical procedures. These comprehensive analytical procedures should be designed to verify the appropriateness of the methods and approaches used in the appraisal and assess the reasonableness of the appraiser's analysis, opinions, and conclusions.

Formal documentation to support the comprehensive analytical procedures should be maintained. An individual performing this analysis, either an employee of the banking organization or an outside consultant, should have real estate–related training or experience and be independent of the transaction. The individual may not change the appraisal's or evaluation's estimate of value as a result of the review—unless that person is appropriately licensed or certified and performs the review according to procedures in the Uniform Standards of Professional Appraisal Practice (USPAP), standard 3.

2231.0.1.3 Reappraisals and Reevaluations

A program should be developed for obtaining reappraisals or reevaluations as part of a program of prudent portfolio review and monitoring techniques—even when additional financing is not being contemplated. Examples include large-credit exposures and out-of-area loans. The decision to reappraise or reevaluate the real estate collateral for a subsequent transaction should be guided by the appraisal exemption for renewals, refinancings, and other subsequent transactions. Loan workouts, debt restructurings, loan assumptions, and similar transactions involving the addition or substitution of borrowers may qualify for the exemption for renewals, refinancings, and other subsequent transactions. Use of this exemption, however, depends upon the condition and quality of the loan, the soundness of the underlying collateral, and the validity of the existing appraisal or evaluation.

A loan may be renewed or refinanced based on a valid appraisal or evaluation if the planned future use of the property is consistent with the use identified in the appraisal or evaluation. However, if the property has reportedly appreciated because of a planned change in use, such as rezoning, an appraisal would be required for a federally related transaction—unless another exemption applied (for example, if the amount financed is below the appraisal threshold).

While the Board's appraisal regulation generally allows appropriate evaluations of real estate collateral in lieu of an appraisal for loan renewals and refinancings, in certain situations an appraisal is required. If new funds in excess of reasonable closing costs are advanced, a new appraisal for the renewal of an existing transaction should be obtained when there is a material change in market conditions that threatens the banking organization's real estate collateral protection.

For loan workouts, a reappraisal or reevaluation may be prudent, even if it is obtained after the modification. If there is an expected delay in obtaining the appraisal or evaluation, the banking organization should first protect its interest to facilitate the orderly collection of the loan or to reduce the risk of loss. In a troubled-loan situation, a reappraisal would not be required when a banking organization advances funds to protect its interest in a property, such as to repair damaged property, because these funds are being used to restore the damaged property to its original condition.

Real estate posted as collateral that has been acquired by a banking organization through foreclosure or deed in lieu of qualifies for the appraisal exemption for subsequent transactions. Therefore, the banking organization is only required to have an evaluation but may first initiate the foreclosure proceedings to protect its collateral interests before obtaining the evaluation. Because the sale or disposal and the financing of the sale of other real estate owned (OREO) do not arise from an existing extension of credit, these OREO transactions do not qualify for the appraisal exemption. Thus, a banking organization is required to have a valid appraisal to support the sale of OREO unless the transaction qualifies for another appraisal exemption. If the banking organization already has a valid appraisal (or an evaluation) of the real estate, it need not obtain a new appraisal.

2231.0.2 TRANSACTIONS NOT REQUIRING THE SERVICES OF A LICENSED OR CERTIFIED APPRAISER

The Board has determined that certain categories of real estate–related financial transactions do not require the services of a certified or licensed appraiser and, as such, are not considered federally related transactions.

Transactions not requiring the services of a certified or licensed appraiser include transactions in which—

1. the transaction value[4] is $250,000 or less;
2. a lien on real property has been taken as collateral in an abundance of caution;
3. the transaction is not secured by real estate;
4. a lien on real estate has been taken for purposes other than the real estate's value;
5. the transaction is a business loan that has a transaction value of $1 million or less and is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment;
6. a lease of real estate is entered into, unless the lease is the economic equivalent of a purchase or sale of the leased real estate;
7. the transaction involves an existing extension of credit at the lending institution, provided that there has been no obvious and material change in market conditions or physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies, or there is no advancement of new monies, other than funds necessary to cover reasonable closing costs;
8. the transaction involves the purchase, sale, investment in, exchange of, or extension of credit secured by a loan or interest in a loan, pooled loans, or interests in real property, including mortgage-backed securities, and each loan or interest in a loan, pooled loan, or real property interest met the Board's regulatory requirements for appraisals at the time of origination;
9. the transaction is wholly or partially insured or guaranteed by a U.S. government agency or U.S. government–sponsored agency;
10. the transaction either qualifies for sale to a U.S. government agency or U.S. government–sponsored agency, or involves a residential real estate transaction in which the appraisal conforms to the Federal National Mortgage Association or Federal Home Loan Mortgage Corporation appraisal standards applicable to that category of real estate;

4. *Transaction value* is defined as the amount of the loan or extension of credit under consideration. For a pool of loans or a mortgage-backed security, the transaction value is the amount of each individual loan. In determining transaction value, the senior and junior debt are considered separate transactions under the appraisal rule. However, a series of related transactions will be considered one transaction if it appears that an institution is attempting to avoid the appraisal requirement by structuring the transactions below the appraisal threshold.

11. the regulated institution is acting in a fiduciary capacity and is not required to obtain an appraisal under any other law;
12. the transaction involves underwriting or dealing in mortgage-backed securities;[5] or
13. the Board determines that the services of an appraiser are not necessary to protect federal financial and public policy interests in real estate–related financial transactions or to protect the safety and soundness of the institution.

For transactions below the appraisal threshold, qualifying for the $1 million or less business-loan exemption, or qualifying for the existing extension-of-credit exemption, the Board still requires an appropriate evaluation of the real property collateral that is consistent with safe and sound banking practices.

The Board reserves the right to require an appraisal on an exempt transaction whenever it is necessary to address safety-and-soundness concerns. Whether a banking organization will be required to obtain an appraisal for a particular transaction or an entire group of credits will depend on its condition. For example, if a banking organization is in troubled condition that is attributable to underwriting problems in its real estate loan portfolio, the Board may require the banking organization to obtain an appraisal for all new transactions below the threshold. However, regardless of a banking organization's condition, an examiner may require an appraisal for a particular real estate–related transaction to address safety-and-soundness concerns.

2231.0.3 OBTAINING AN APPRAISAL

The banking organization or its agent is responsible for engaging the appraiser and must have sufficient time to analyze the appraisal as part of its decision process to enter into the transaction. A banking organization may not accept an appraisal prepared for a potential borrower as the appraisal for a federally related transaction. An appraisal obtained by a financial services institution may be used by a federally regulated institution so long as procedures have been established for reviewing appraisals, the review indicates that the appraisal meets the regulation's requirements, and the review is documented in writing.

For a multiphased development or construction loan, the appraisal of an earlier phase cannot be used for a new phase due to the change in risk. However, if the original appraisal was prepared for all phases of the project, the project appraisal may be used if the appraisal's value for the new phase is still valid at the time additional credit is extended.

2231.0.4 USEFUL LIFE OF AN APPRAISAL

Since a banking organization may wish to use an existing appraisal or evaluation for a subsequent loan or investment, its appraisal and evaluation program should include criteria to determine the validity of an existing appraisal or evaluation. The useful life of an appraisal will vary, depending on the circumstances surrounding the property and the marketplace. When deciding if an appraisal or evaluation may be used for a subsequent transaction, a banking organization should determine if any material changes to the underlying assumptions have occurred that would affect the original estimate of value.

Examples of factors that could cause material changes to reported values include the passage of time; the volatility of the local market; the availability of financing; the inventory of competing properties; new improvements to, or lack of maintenance of, the subject or competing, surrounding properties; a change in zoning; or environmental contamination. The banking organization should document its information sources and analyses used to determine if an existing appraisal or evaluation remains valid. It should also document whether the banking organization will be using that appraisal or evaluation in a subsequent transaction.

2231.0.5 APPRAISAL REQUIREMENTS

The objective of an appraisal is to communicate the appraiser's reasoning and conclusions logically so that the reader is led to the appraiser's estimation of market value. The contents of appraisals should conform to the standards of the Board's appraisal regulation and to those established in USPAP as promulgated by the Appraisal Standards Board of the Appraisal Foundation. The actual form, length, and content of appraisal reports may vary, depending on the type of property being appraised and the nature of the assignment. Standard forms com-

5. This Regulation Y exemption from the Board's appraisal standards was effective on December 28, 1998.

pleted in compliance with the regulation and USPAP are also acceptable.

2231.0.5.1 Appraisal Standards

The minimum standards for appraisals performed in connection with federally related transactions are those set forth in USPAP, as well as any other standards that the Board deems necessary. In summary, an appraisal must—

1. conform to the generally accepted appraisal standards as evidenced by USPAP, unless principles of safe and sound banking require compliance with stricter standards;
2. be written and contain sufficient information and analysis to support the banking organization's decision to engage in the transaction;
3. analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, nonmarket lease terms, and tract developments with unsold units;
4. be based on the definition of market value as set forth in the regulation; and
5. be performed by state-licensed or -certified appraisers in accordance with the requirements in the regulation.

The Board's appraisal regulation also permits banking organizations to use appraisals prepared according to the USPAP Departure Provision, which permits limited exceptions to ‘‘specific guidelines’’ in USPAP. Appraisers using the Departure Provision still must comply with all ‘‘binding requirements’’ of USPAP and must be sure that the resulting appraisal will not be misleading.

2231.0.5.2 Appraisal Assignment

A banking organization may engage an appraiser to perform an appraisal assignment, either a complete or a limited appraisal. In a complete appraisal assignment, an appraiser must meet all USPAP standards and guidelines in estimating market value. In a limited appraisal assignment, the appraiser elects to depart from certain specific guidelines by invoking the Departure Provision. Before beginning the appraisal, the appraiser must obtain the banking organization's concurrence that the use of the Departure Provision is appropriate for the transaction. The appraiser must ensure that the resulting appraisal report will not mislead the banking organization or other intended users of the appraisal report. The banking organization should realize that as the degree of departure increases, the extent of reliability of the limited appraisal decreases, resulting in a higher level of risk.

2231.0.5.3 Appraisal Reports

The appraisal report usually includes a disclosure of sales history and an opinion as to the highest value and best use of the property. After preparing a report, appraisers must certify that—

1. statements of fact are true and correct,
2. limiting conditions have been disclosed,
3. they have no interest (present or future) in the transaction or property,
4. compensation is not contingent on rendering a specified value,
5. they have complied with USPAP,
6. an inspection of the property was or was not performed, and
7. assistance was or was not received in the preparation of the appraisal.

Three different report formats can be used for either the complete or the limited appraisal assignment: a self-contained report, a summary report, and a restricted report. Since USPAP requires all appraisal reports to encompass all aspects of the assignment, reports will differ based on the degree of detail presented. The self-contained appraisal report provides the most detail; the summary appraisal report condenses the information; and the restricted appraisal report presents minimal information, with supporting details maintained in the appraiser's work files.

The restricted report is not appropriate for a significant number of federally related transactions because the minimal amount of information limits the usefulness of the document for underwriting, compliance, and other decision-making purposes. However, a restricted report might be used when providing ongoing collateral monitoring of a banking organization's real estate transactions and under other circumstances when a banking organization's program requires an evaluation.

2231.0.5.4 Appraisal Content

The appraisal must reflect a market value of the real estate. The regulation defines market value as the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from the seller to the buyer under conditions whereby—

1. the buyer and seller are typically motivated,
2. both parties are well informed or well advised and acting in what they consider their own best interests,
3. a reasonable time is allowed for exposure in the open market,
4. payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto, and
5. the price represents the normal consideration for the property sold, unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

To properly underwrite a construction loan, a banking organization may need to know the prospective value of a property and its market value as of the appraisal date. Prospective value is based on events yet to occur, such as completion of construction or renovation, reaching stabilized occupancy, or some other event yet to be determined. Thus, more than one value may be reported in an appraisal as long as all values are clearly described and reflect the projected dates when future events could occur. Assumptions and projections used to develop prospective value estimates must be fully supported and reasonable in light of current market conditions.

2231.0.6 APPRAISAL VALUATION APPROACHES

The appraiser typically uses three market-value approaches to analyze the value of property:

1. cost approach
2. comparable-sales approach
3. capitalization-of-income approach

All three approaches have particular merits depending on the type of real estate being appraised. For single-family residential property, the cost and comparable-sales approaches are most frequently used since the common use of the property is the personal residence of the owner. However, if a single-family residential property is intended to be used as a rental property, the appraiser would have to consider the income approach as well as the cost and comparable-sales approaches. For special-use commercial properties, the appraiser may have difficulty obtaining sales data on comparable properties and may have to base the value estimate on the cost and capitalization of income approach. If an approach is not used in the appraisal, the appraiser should disclose the reason the approach was not used and whether this had an impact on the value estimate.

2231.0.6.1 Value Correlation

The three value estimates—cost, market, and income—must be evaluated by the appraiser and correlated into a final value estimate based on the appraiser’s judgment. Correlation does not imply averaging the value estimates obtained by using the three different approaches. When these value estimates are relatively close together, correlating them and setting the final market-value estimate presents no special problem. However, if widely divergent values are obtained by using the three appraisal approaches, the appraiser must exercise judgment in analyzing the results and determining the estimate of market value.

2231.0.6.1.1 Cost Approach

In the cost approach to value estimation, the appraiser obtains a preliminary indication of value by adding the estimated depreciated reproduction cost of the improvements to the estimated land value. This approach is based on the assumption that the reproduction cost is the upper limit of value and that a newly constructed building would have functional and mechanical advantages over an existing building. The appraiser would evaluate any depreciation, that is, disadvantages or deficiencies, of the existing building in relation to a new structure.

The cost approach consists of four basic steps: (1) estimate the value of the land as though vacant, (2) estimate the current cost of reproducing the existing improvements, (3) estimate depreciation and deduct from the reproduction-cost estimate, and (4) add the estimate of land value and the depreciated reproduction cost of improvements to determine the value estimate.

2231.0.6.1.2 Comparable-Sales Approach

The focus of this approach is to determine the recent sales price of similar properties. Through an appropriate adjustment for differences in the subject property and the selected comparable properties, the appraiser estimates the market value of the subject property based on the sales price of the comparable properties. To determine the extent of comparability of two or more properties, the appraiser must judge their similarity with respect to age, location, condition, construction, layout, and equipment. The sales or list price of those properties that the appraiser determines to be most comparable will tend to set the range for the value of the subject property.

2231.0.6.1.3 Income Approach

The income approach estimates the project's expected income over time converted to an estimate of its present value. The income approach typically is used to determine the market value of income-producing properties such as office buildings, apartment complexes, hotels, and shopping centers. In the income approach, the appraiser can use several different capitalization or discounted-cash-flow techniques to arrive at a market value. These techniques include the band-of-investments method, mortgage-equity method, annuity method, and land-residual technique. The use of a particular technique will depend on whether there is project financing, there are long-term leases with fixed-level payments, and the value is being rendered for a component of the project such as land or buildings.

The accuracy of the income approach depends on the appraiser's skill in estimating the anticipated future net income of the property and in selecting the appropriate capitalization rate and method. The following data are assembled and analyzed to determine potential net income and value:

1. Rent schedules and the percentage of occupancy for the subject property and for comparable properties for the current year and several preceding years. This information provides gross rental data and the trend of rentals and occupancy, which are then analyzed by the appraiser to estimate the gross income the property should produce.
2. Expense data such as taxes, insurance, and operating costs being paid from revenues derived from the subject property and comparable properties. Historical trends in these expense items are also determined.
3. Timeframe for achieving "stabilized" or normal occupancy and rent levels (also referred to as holding period).
4. An appropriate capitalization rate and valuation technique, selected and applied to net income to establish a value estimate.

Basically, the income approach converts all expected future net operating income into a value estimate. When market conditions are stable and no unusual patterns of future rents and occupancy rates are expected, the direct-capitalization method is used to value income properties. This method calculates the value of a property by dividing an estimate of its stabilized annual income by a factor called a "cap" rate. Stabilized income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions. The cap rate—usually defined for each property type in a market area—is viewed by some analysts as the required rate of return stated in terms of current income.

The use of this technique assumes that either the stabilized income or the cap rate, used accurately, captures all relevant characteristics of the property relating to its risk and income potential. If the same risk factors, required rate of return, financing arrangements, and income projections are used, explicit discounting and direct capitalization will yield the same results.

For special-use properties, new projects, or troubled properties, the discounted-cash-flow (net present value) method is the more typical approach to analyzing a property's value. In this method, a timeframe for achieving a stabilized or normal occupancy and rent level is projected. Each year's net operating income during that period is discounted to arrive at the present value of expected future cash flows. The property's anticipated sales value at the end of the stabilization period (its terminal or reversion value) is then estimated. The reversion value represents the capitalization of all future income streams of the property after the projected occupancy level is achieved. The terminal or reversion value is then discounted to its present value and added to the discounted income stream to arrive at the total present market value of the property.

Most importantly, the analysis should be based on the ability of the project to generate income over time based on reasonable and supportable assumptions. Additionally, the discount rate should reflect reasonable expectations about the rate of return that investors require under normal, orderly, and sustainable market conditions.

2231.0.7 OTHER DEFINITIONS OF VALUE

The Board's appraisal regulation requires that the appraisal contain a market value of the real estate collateral. Some other definitions of value that are encountered when appraising and evaluating real estate transactions are described below.

1. *Fair value* is an accounting term that is generally defined as the amount in cash or cash-equivalent value or other consideration that a real estate parcel would yield in a current sale between a willing buyer and a willing seller (selling price), other than a forced or liquidation sale.[6] According to accounting literature, fair value is generally used in valuing assets in nonmonetary transactions, troubled-debt restructuring, quasi-reorganizations, and business combinations accounted for by the purchase method. An accountant generally defines fair value as market value; however, depending on the circumstances, these values may not be the same for a particular property.
2. *Investment value* is based on the data and assumptions that meet a particular investor's criteria and objectives for a specific property or project. The investor's criteria and objectives are often substantially different than those of participants in a broader market. Thus, investment value can be significantly higher than market value in certain circumstances and should not be used in credit-analysis decisions.
3. *Liquidation value* assumes that there is little or no current demand for the property and that the property needs to be disposed of quickly. In this situation, the owner may have to sacrifice property appreciation for an immediate sale.
4. *Going-concern value* is based on the value of the business entity, rather than the value of the real estate. The valuation is based on the existing operations of a business that has a proven operating record, with the assumption that the business will continue to operate.
5. *Assessed value* represents the value on which a taxing authority bases its assessment. The assessed value and market value may differ considerably due to tax assessment laws, timing of reassessments, and tax exemptions allowed on properties or portions of a property.
6. *Net realizable value (NRV)* is recognized under generally accepted accounting principles[7] as "the estimated selling price in the ordinary course of business less estimated costs of completion (to the stage of completion assumed in determining the selling price), holding, and disposal." The NRV is generally used to evaluate the carrying amount of assets being held for disposition and properties representing collateral. While the market value or future selling price is generally used as the basis for the NRV calculation, the NRV also reflects the current owner's costs to complete the project and to hold and dispose of the property. For this reason, the NRV will generally be less than the market value.

The appraiser should state the definition of value reported in the appraisal, and, for federally related transactions, the value must meet the definition of market value in the regulation. This is the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, assuming the buyer and seller are both acting prudently and knowledgeably, and the price is not affected by undue stimulus. Other presentations of value, in addition to market value, are allowed and may be included in the appraisal at the request of the banking organization.

2231.0.8 EVALUATION REQUIREMENTS

The Board's appraisal regulation requires an evaluation for certain real estate–related financial transactions that are exempt from the title XI appraisal requirement. These transactions include—

6. FASB Statement No. 67, "Accounting for Costs and Initial Rental Operations of Real Estate Projects," Appendix A—Glossary.

7. FASB Statement No. 67, "Accounting for Costs and Initial Rental Operations of Real Estate Projects," Appendix A—Glossary.

1. transactions below the $250,000 threshold;
2. transactions qualifying for the exemption for business loans of $1 million or less, when rental income or sales proceeds from real estate is not the primary source of repayment; and
3. subsequent transactions resulting from an existing extension of credit (for example, renewals and refinancings).

An evaluation should provide a general estimate of the value of the real estate and need not meet the detailed requirements of a title XI appraisal.[8] An evaluation must provide appropriate information to enable the banking organization to make a prudent decision regarding the transaction. Moreover, a banking organization is not precluded from obtaining an appraisal that conforms to the regulation for any exempt transaction. At a minimum, an evaluation should—

1. be written;
2. include the preparer's name, address, and signature, and the effective date of the evaluation;
3. describe the real estate collateral, its condition, and its current and projected use;
4. describe the sources of information used in the analysis;
5. describe the analysis and supporting information; and
6. provide an estimate of the real estate's market value, with any limiting conditions.

2231.0.8.1 Form and Content of Evaluations

The documentation for evaluations should fully support the estimate of value and include sufficient information to understand the evaluator's analysis, assumptions, and conclusions. The evaluator is not required to use a particular form or valuation approach, but the analysis should apply to the type of property and fully explain the value rendered.

An individual who conducts an evaluation should have real estate–related training or experience relevant to the type of property. However, the individual does not have to be a state-licensed or -certified appraiser. Prudent practices require that a more detailed evaluation be performed as the banking organization engages in more complex real estate–related financial transactions or as its overall exposure in a real estate–related financial transaction increases.

An evaluation for a transaction that needs a more detailed analysis should describe the property; give its location; and discuss its use, especially for nonresidential property. An evaluation for a transaction that requires a less detailed analysis may be based on information such as comparable property sales information from sales-data services (for example, the multiple-listing service or current tax-assessed value in appropriate situations).[9] Further, an evaluation may be based on the banking organization's own real estate loan portfolio experience and on value estimates prepared for recent loans on comparable properties, when appraisals meeting the regulatory requirements were obtained. Regardless of the method, the banking organization must document its analysis and findings in the loan file.

2231.0.9 SELECTION AND QUALIFICATIONS CRITERIA FOR APPRAISERS AND EVALUATORS

The accuracy of an appraisal or evaluation depends on the competence and integrity of the individual performing the appraisal or evaluation, as well as on that person's expertise at developing and interpreting pertinent data for the subject property. Appraisers and evaluators should have adequate training, experience, and knowledge of the local real estate market to make sound judgments concerning the value of a particular property. Their level of training, experience, and knowledge should be commensurate with the type and complexity of the property to be valued. Additionally, appraisers and evaluators should be independent of the credit decision, have no interest in the property being appraised, and have no affiliations or associations with the potential borrower. Absent absolute lines of independence, a banking organization must be able to demonstrate that it has prudent safeguards in place to isolate its collateral-evaluation process from influence or interference from the loan-production process.

8. An appraisal means the kind of specialized opinion on the value of real estate that contains certain formal elements recognized by appraisal industry practices and standards.

9. Assessed values for tax purposes may be a specified fraction of market value, as determined by the tax assessor. Therefore, tax-assessed values should be adjusted to a market-value equivalent. In cases where the assessed value does not have a reliable correlation to current value, the use of assessed value would be inappropriate as the basis for an evaluation.

2231.0.9.1 Appraiser Qualifications

Title XI of FIRREA identified two classifications of appraisers to be used in federally related transactions: state-certified appraisers and state-licensed appraisers. For a state-certified appraiser, title XI anticipated that the states would adopt similar standards for certification based on the qualification criteria of the Appraiser Qualifications Board of the Appraisal Foundation. The Appraisal Foundation standards set forth minimum educational, testing, experience, and continuing-education requirements. For a licensed appraiser, the states have some latitude to establish qualification standards, provided criteria are adequate to protect federal financial and public policy interest.

The Appraisal Subcommittee of the FFIEC is responsible for monitoring state compliance with title XI. The Board also has the authority to impose additional certification and licensing requirements on those adopted by a given state.

2231.0.9.2 Selection of an Appraiser

An independent appraisal is one in which the appraiser is not participating in the administration of the credit or in the approval of the transaction and has no interest, financial or otherwise, in the property. In certain instances involving small banking organizations, officers and directors who perform appraisals must take appropriate steps to ensure that they are independent from the transaction under consideration.

When selecting an appraiser for an appraisal assignment, a banking organization is expected to consider whether the individual holds the proper state certification or license and has the appropriate experience and educational background to complete the assignment. Financial institutions may not exclude a qualified appraiser from consideration for an appraisal assignment solely because the appraiser lacks membership in a particular appraisal organization or does not hold a particular designation from an appraisal association, organization, or society.

In that regard, banking organizations are expected to treat all appraisers fairly and equitably in determining whether to use the services of a particular appraiser. Generally, banking organizations have established procedures for selecting appraisers and maintaining an approved appraiser list. The practice of pre-approving appraisers for ongoing appraisal work and maintaining an approved appraiser list is acceptable so long as all appraisers are required to follow the same approval process. However, a banking organization that requires appraisers who are not members of a particular appraisal organization to formally apply, pay an application fee, and submit samples of previous appraisal reports for review—but does not have identical requirements for appraisers who are members of other appraisal organizations—would be viewed as having a discriminatory selection process.

2231.0.9.3 Appraisals Performed by Certified or Licensed Appraisers

In summary, a banking organization is required to use a certified appraiser for (1) all federally related transactions over $1 million, (2) nonresidential federally related transactions of more than $250,000, and (3) complex residential federally related transactions of more than $250,000.[10] A banking organization may use either a state-certified or a state-licensed appraiser for noncomplex residential federally related transactions that are under $1 million.

2231.0.9.4 Other Appraiser Designations

Some states have adopted other appraiser designations that may cause confusion about whether a particular appraiser holds the appropriate designation for a given appraisal assignment. Additionally, some states use designations such as ‘‘certified residential’’ appraiser and ‘‘certified general’’ appraiser, which leads to further confusion. Other states have no specified license designation but have used the term ‘‘certified residential’’ based on the standards for licensing. For this reason, a banking organization needs to understand the qualification criteria set forth by the state appraiser regulatory body and whether these standards are equivalent to the federal designations accepted by the Appraisal Subcommittee.

The Appraisal Subcommittee has recognized two other appraiser designations: certified residential appraiser and transitional licensed appraiser. For the certified residential appraiser, the minimum qualification standards are those

10. Complex one- to four-family residential property appraisal means one in which the property to be appraised, the form of ownership, or the market conditions are atypical.

established by the Appraiser Qualifications Board for “certified residential real estate appraiser.” Under the Board’s regulation, a certified residential appraiser would be permitted to appraise real estate in connection with a federally related transaction designated for a “certified” appraiser, provided the individual is competent for the particular appraisal assignment.

The Appraisal Subcommittee and the Board are also willing to recognize a transitional license that would allow a state to issue a license to an appraiser, provided the individual has passed an examination and has satisfied either the education or experience requirement. A transitional licensed appraiser is permitted to appraise real estate collateral in connection with a federally related transaction as if licensed. The transitional licensed appraiser is expected to complete the missing requirement within a set timeframe or the license expires. Recognition of a transitional license was believed to be necessary to ease the initial problems and inefficiencies resulting from a new regulatory program. The Appraisal Subcommittee has advised the states that the use of the transitional licenses should be phased out once the appraiser regulatory program is fully established. As a result, the use of a transitional license and the applicable timeframe will vary from state to state.

2231.0.9.5 Qualifications of Individuals Who Can Perform Evaluations

Evaluations can be performed by a competent person who has experience in real estate–related activities, including, but not limited to, appraisals, real estate lending, real estate consulting, and real estate sales. A banking organization may also augment in-house expertise by hiring an outside consultant familiar with a certain market or a particular type of real estate. The evaluation procedures should have established standards for selecting qualified individuals to perform evaluations and for confirming their qualifications and independence to evaluate a particular transaction. An individual performing an evaluation need not be licensed or certified. However, if a banking organization desires, it may use state-licensed or -certified appraisers to prepare evaluations.

2231.0.10 EXAMINER REVIEW OF APPRAISAL AND EVALUATION POLICIES

A banking organization’s appraisal and evaluation policies and procedures will be reviewed as part of the inspection of the organization’s overall activities. This includes a review of the procedures for selecting an appraiser for a particular appraisal or evaluation assignment and for confirming that the appraiser is qualified, independent, and if applicable, licensed or certified to undertake the assignment. If an institution maintains a listing of qualified real estate appraisers acceptable for the banking organization’s use, the examiner should ascertain whether the board of directors or senior management has reviewed and approved the list.

If a banking organization is in troubled condition that is attributable to underwriting problems in its real estate loan portfolio, the Board may require the banking organization to obtain appraisals for all new real estate–related financial transactions below the threshold that are not subject to another exemption. The Reserve Bank will determine if a particular banking organization will have to obtain appraisals below the threshold.

When analyzing individual credits, examiners will analyze appraisals or evaluations to determine that the methods, assumptions, findings, and conclusions are reasonable and comply with the Board’s rule, policies, and supervisory guidelines. Examiners should not challenge the underlying assumptions, including the discount and capitalization rates used in appraisals, that differ only in a limited way from norms that would generally be associated with the property under review. Furthermore, an examiner is not bound to accept the appraisal or evaluation results, regardless of whether a new appraisal or evaluation was requested during the examination. An examiner who concludes that an appraisal or evaluation is deficient for any reason will take that fact into account when judging the quality of the credit.

When the examiner can establish that the underlying facts or assumptions are inappropriate and can support alternative assumptions, he or she may adjust the estimated value of the property for credit-analysis purposes. It is important to emphasize that an examiner’s overall analysis and classification of a credit may be based on other credit or underwriting standards, even if the loan is secured by real property whose value is supported by an appraisal or evaluation.

Significant failures to meet standards and procedures as outlined above will be criticized and corrective action will be required. Furthermore, banking organizations that fail to maintain a sound appraisal or evaluation program or that fail to comply with the agencies' appraisal regulations and policies, or to the Board's supervisory guidelines, will be cited in inspection reports and may be criticized for unsafe and unsound banking practices. Deficiencies will require corrective action.

The appraisal regulation and guidelines require that banking organizations use the services of qualified, independent, and certified or licensed appraisers to perform appraisals. Furthermore, a banking organization that knowingly uses the services of an individual who is not properly certified or licensed to perform an appraisal in connection with a federally related transaction is violating the Board's Regulation Y. Any action of a state-certified or -licensed appraiser that is contrary to the purpose of title XI should be reported to the Federal Reserve Bank for referral to the appropriate state appraiser regulatory agency for investigation.

2231.0.11 INSPECTION OBJECTIVES

1. To determine whether policies, practices, procedures, and internal controls regarding real estate appraisals and evaluations for real estate–related financial transactions are adequate.
2. To determine whether the banking organization's officers and employees are conforming with the board of directors' appraisal policies.
3. To determine whether appraisals performed in connection with federally related transactions comply with the minimum standards of the Board's appraisal regulation and the Uniform Standards of Professional Appraisal Practice.
4. To determine if appraisers used in connection with federally related transactions are certified or licensed as appropriate.
5. To determine whether appraisers are competent to render appraisals in federally related transactions and whether they are independent of the specific transaction or other lending, investment, or collection functions as appropriate.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient, or when violations of laws or regulations or noncompliance with provisions of supervisory guidelines have been noted.

2231.0.12 INSPECTION PROCEDURES

1. Test real estate–related financial transactions for compliance with approved real estate appraisal policies and established practices, procedures, and internal controls. Also, obtain a listing of any deficiencies noted in the latest review performed by internal and/or external auditors and determine if appropriate corrections have been made. Based on these results, determine the scope of the inspection for appraisals.
   a. Provide copies of the banking organization's appraisal and evaluation policies and procedures to examiners assigned to functional areas when real estate–related transactions may require the services of an appraiser or evaluator.
   b. Review appraisals and evaluations of individual real estate–related transactions during the inspection of loans, BHC premises, DPC assets, or OREO transactions. Review the appraisals and evaluations for compliance with the Board's appraisal regulation and appraisal guidelines and with the banking organization's appraisal and evaluation programs.
   c. When real estate–related transactions are examined on a portfolio basis, review the appraisal and evaluation processes. Determine whether the processes ensure that appraisals and evaluations comply with the Federal Reserve Board's appraisal regulation, the interagency appraisal guidelines, and the banking organization's appraisal and evaluation programs.
2. When performing the above procedures, determine whether—
   a. the board of directors approves and periodically reviews the appraisal policies and procedures that establish the appraisal and evaluation programs for real estate lending, as required by the Board's real estate lending regulation;
   b. the appraisal and evaluation programs include comprehensive analytical procedures;
   c. the banking organization engages competent individuals who are independent of the transaction to perform appraisals and evaluations, and whether the appraisal and evaluation programs establish the manner in which it selects, evaluates, and monitors those individuals;
   d. the appraisal program ensures that appraisals conform to the Board's appraisal regulation;
   e. the evaluation program ensures that eval-

uations conform to the Board's guidance on evaluations (SR-94-55 and SR-94-50);
f. the appraisal and evaluation programs appropriately reflect the banking organization's size, its location, and the nature and complexity of its real estate–related activities;
g. policies and procedures require appraisals and evaluations to be written;
h. criteria have been established for determining when to obtain reappraisals or reevaluations as part of a program of prudent portfolio review and monitoring; and
i. the banking organization has appropriate procedures to assess the validity of appraisals and evaluations for certain subsequent transactions that are exempt from the Board's appraisal requirements, or whether new appraisals or evaluations were obtained.

3. Review and assess the banking organization's compliance procedures to ensure that the appraisal and evaluation programs are effective and in compliance with regulatory requirements and that they review the appropriateness of appraisals and evaluations before final credit decisions. Determine if—
   a. The monitoring procedures demonstrate that appraisals and evaluations comply with the Board's appraisal regulation and the Board's appraisal and evaluation guidelines.
   b. The program provides that appraisals and evaluations are obtained before the final credit or other decision. However, for transactions involving loan workouts or restructurings to facilitate the orderly collection of the credit or to reduce the risk of loss, appraisals or evaluations were obtained in a reasonable time after the transaction occurs.
   c. The programs have review procedures to verify that the methods, assumptions, and conclusions in the appraisals or evaluations are reasonable and appropriate for the transaction and the property.
   d. Criteria are established to identify which transactions should have their appraisal or evaluation considered for more comprehensive analytical procedures. For example, certain types of transactions, such as large-dollar credits, loans secured by complex or specialized properties, nonresidential real estate construction loans, or out-of-area real estate, should ensure that the appraisal or evaluation provides adequate support for the particular transaction.
   e. The banking organization ensures that individuals who perform these reviews have appropriate training and experience and are independent of the transaction.
   f. There is adequate documentation to demonstrate that the review has occurred. While a checklist may serve this purpose for many of these transactions, a more comprehensive review would require a more detailed written analysis.
   g. Appropriate procedures exist for any deficiencies noted in the review, thus requiring (1) the individual who prepared the appraisal or evaluation to correct the deficiencies or (2) a new appraisal or evaluation to be obtained before the final credit or other decision.
   h. The program ensures that changes of an appraisal's estimate of value were made in accordance with standard 3 of the Uniform Standards of Professional Appraisal Practice (USPAP), and whether the changes were made by an appropriately qualified licensed or certified appraiser.
   i. Appropriate procedures exist for referring potential cases of misconduct by licensed and certified appraisers to the appropriate state appraiser regulatory authority.

4. Assess the procedures for determining whether a real estate–related transaction requires an appraisal or evaluation, or is otherwise exempt from the Board's appraisal regulation.
   a. For appraisals required under the appraisal program, determine that—
      • the banking organization engaged the appraiser or, if the appraiser was engaged directly by another financial services entity, the banking organization determined that the appraisal complies with its own program and the Board's appraisal regulation. (The banking organization may *not* accept an appraisal prepared for the borrower.);
      • the appraisal was obtained in sufficient time to be analyzed before the final credit or other decision;
      • the appraisal conforms to the generally accepted appraisal standards as evidenced by USPAP, for example—
         — the appraiser uses the three market-value approaches—cost, comparable sales, and income—and corre-

lates the results into a final value estimate;
- — if the above-mentioned approaches were not used, the appraiser discloses the reason and whether this affected the value estimate;
- — the appropriate type of appraisal was obtained (complete or limited), and the appropriate report format (self-contained, summary, or restricted) was used for the particular transaction; and
- — if a limited appraisal was used (that is, the appraiser invoked the Departure Provision), the appraisal fully discloses the limiting conditions;

- the appraisal is written and contains sufficient information and analysis to support the banking organization's decision to enter into the transaction;
- if the appraisal is for proposed construction or renovation, partially leased buildings, nonmarket lease terms, or tract developments with unsold units, the appraisal includes an appropriate analysis and disclosure of deductions and discounts for holding costs, marketing costs, leasing commissions, rent losses, tenant improvements, and entrepreneurial profits;
- the appraisal contains an estimate of the current market value of the property in its actual physical condition and current zoning, as defined by the Board's appraisal regulation;
- the appraisal contains an estimate of the property's prospective market value based on the completion of improvements or stabilized occupancy, if the appraisal is for a property where improvements or renovations are to be made;
- the appraisal clearly identifies each value estimate and, for the prospective value, gives the projected dates when future events are expected to occur when more than one estimate of value is reported;
- the individual who performed the appraisal was independent of the transaction and appropriately licensed and certified for the assignment:
  - — A certified appraiser must perform the appraisal for a transaction of $1,000,000 or more, a nonresidential transaction of $250,000 or more, or a complex residential transaction of $250,000 or more.
  - — A licensed or certified appraiser must perform the appraisal for any other type of federally related transaction.
- the individual who performed the appraisal had appropriate training and experience demonstrating expertise in appraising similar types of properties and knowledge of the property's market; and
- incidents of possible appraiser misconduct are documented for possible referral by the Reserve Bank to the state appraiser regulatory agency.

b. For exempt transactions requiring an evaluation, such as transactions below the $250,000 threshold, business loans less than $1 million, and subsequent transactions, including renewals and refinancings, determine that—
- the evaluation at a minimum—
  - — is written;
  - — includes the preparer's name, address, and signature and the effective date;
  - — describes the real estate collateral, its condition, and its current and projected use;
  - — describes the source of information used in the analysis;
  - — describes the analysis and supporting information; and
  - — gives an estimate of the real estate's value with limiting conditions;
- the evaluation provides sufficient detail to support the estimate of collateral value in more complex real estate–related transactions, or when the overall exposure is high;
- the individual who performed the evaluation had the appropriate real estate training and sufficient experience and knowledge of the market to prepare the evaluation; and
- the individual who performed the evaluation, regardless of whether the banking organization's staff performed the evaluation, was independent of the transaction, credit decision, or function.

5. Assess management's compliance with its policies and procedures and with the Board's appraisal regulation and guidance by reviewing appraisals and evaluations.
6. If the review of appraisals or evaluations on one- to four-family residential loans or multi-

family loans indicates that the appraisals or evaluations do not meet the Board's requirements, or that the loan-to-value ratio at origination was higher than 80 percent for fixed-rate loans or 75 percent for floating-rate loans, then these loans may not be eligible for the 50 percent risk weight permitted under the Board's risk-based capital rule.

7. Evaluate the banking organization with respect to—
   a. the adequacy of written appraisal and evaluation programs;
   b. the methods used by the banking organization's officers to conform with established policy;
   c. internal control deficiencies or exceptions;
   d. the integrity of the appraisal and evaluation process, including appraisal and evaluation compliance procedures;
   e. the integrity of individual appraisals and evaluations for their adequacy, their reasonableness, and the appropriateness of the methods, assumptions, and techniques used, and for their compliance with the Board's appraisal regulation and real estate appraisal and evaluation guidelines;
   f. recommended corrective action when policies, practices, or procedures are deficient;
   g. the degree of any violations of the Board's appraisal regulation, and the extent of noncompliance with interagency appraisal guidelines, if noted; and
   h. the existence of other matters of significance, for example—
      - misrepresentation of data such as the omission of information on favorable financing, seller concessions, sales history, feasibility, zoning, easements, or deed restrictions;
      - inadequate techniques of analysis, that is, failure to use the cost, comparable sales, or income approach in the appraisal, when the approach is appropriate for the type of property;
      - use of dissimilar comparables in the comparable-sales approach to valuation (for example, the age, size, quality, or location of the comparable is significantly different from the subject property, making reconciliation of value difficult);
      - underestimating of factors such as construction cost, construction period, lease-up period, and rent concessions;
      - use of best-case assumptions for the income approach to valuation without performing a sensitivity analysis on the factors which would identify the lender's downside risk;
      - overly optimistic assumptions, such as a high absorption rate in an overbuilt market; and
      - demographic factors, such as existing housing inventory, projected completions, and expected market share, that are not reconciled to the value rendered, but are only discussed as background information.
8. Report any instances of questionable conduct by appraisers along with supporting documentation to the Reserve Bank for possible referral to the appropriate state appraisal authorities.
9. Update workpapers with any information that will facilitate future inspections.

2231.0.13 INTERNAL CONTROL QUESTIONNAIRE

Review the internal controls, policies, practices, and procedures for real estate appraisals and evaluations. The appraisal and evaluation system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. *The items marked with an asterisk (*) require substantiation by observation or testing.*

2231.0.13.1 Appraisal and Evaluation Policies

1. Has the board of directors, consistent with its duties and responsibilities, adopted written appraisal and evaluation policies that define—
   a. management's responsibility for selecting, evaluating, and monitoring the individual who is performing the appraisal or evaluation?
   b. the basis for selecting staff appraisers and engaging fee appraisers for a particular appraisal assignment? (This ensures that the individual is independent of the transaction, possesses the requisite expertise, and holds the proper state certification or license, if applicable.)
   c. the procedures as to when appraisals and evaluations should be obtained?

d. the procedures for when to obtain a reappraisal or reevaluation, including frequency and scope?
e. appraisal and evaluation compliance and review procedures? Will those procedures ascertain that the bank holding company's appraisals and evaluations are consistent with USPAP and the Board's regulations, policies, and guidelines?

2. Does the board of directors periodically review its appraisal, evaluation, and review policies and procedures to ensure that they meet the needs of the bank holding company's real estate lending activity?

2231.0.13.2 Appraisals

*1. Are appraisals in writing, dated, and signed?
*2. Does the appraisal meet the minimum standards of the Board's regulation and USPAP, including—
   a. purpose;
   b. market value;
   c. effective date;
   d. marketing period;
   e. sales history of subject property;
   f. reflection of the valuation using the cost, income, and comparable-sales approaches;
   g. evaluation and correlation of the three approaches into a final value estimate based on the appraiser's judgment;
   h. explanation of why an approach is inappropriate if not used in the appraisal; and
   i. full support for the assumptions and the value rendered through adequate documentation?
*3. Are appraisals received before making the final credit or other decision? (For example, is the date of the loan commitment letter later than the date of the appraisal—unless the loan commitment letter is conditioned on receipt of the appraisal?)
*4. If the bank holding company is depending on an appraisal obtained for another financial services institution as support for its transaction, does the bank holding company have appraisal review procedures to ensure that the appraisal meets the standards of the appraisal regulation? These types of transactions would include loan participations and mortgage-backed securities.
*5. If an appraisal for one transaction is used for a subsequent transaction, are the determinations that the appraisals are still valid sufficiently documented?

2231.0.13.3 Appraisers

1. Are appraisers fairly considered for assignments regardless of their membership or lack of membership in a particular appraisal organization?
2. Do appraisers have requisite knowledge and experience to complete the appraisal before taking the assignment?
3. Do appraisers who discover deficiencies in their expertise before taking the assignment or while performing the appraisal—
   a. disclose their lack of knowledge and/or experience to the client before accepting the assignment or when the deficiencies become readily apparent?
   b. describe in the appraisal their lack of knowledge and/or experience and the steps taken to competently complete the assignment?
4. Are appraisers independent of the transaction?
   a. Are staff appraisers independent of the lending, investment, and collection functions, and are they uninvolved, except as an appraiser, in the federally related transaction, with no direct or indirect interest, financial or otherwise, in the property?
   b. Are fee appraisers engaged directly by the banking organization or its agents, and are written assurances obtained that those appraisers have no direct or indirect interest, financial or otherwise, in the property or transaction?
5. If staff appraisers are used, does the bank holding company periodically have test appraisals performed by independent appraisers to check the organization's knowledge of trends, values, and markets?
6. If fee appraisers are used, are investigations performed to determine their qualifications and reputation?
7. Is the status of an appraiser's state certification or license verified with the state appraiser regulatory authority to ensure that the appraiser is in good standing?
8. Are fee appraisers paid the same fee whether or not the loan is granted?
9. If the transaction is outside the local geographic market, does the bank holding company engage appraisers or consultants with knowledge of the market where the real estate collateral is located?

2231.0.13.4 Evaluations

1. Are individuals performing evaluations independent of the transaction?
*2. Are evaluations required to be in writing, dated, and signed?
*3. Does the bank holding company require sufficient information and documentation to support the estimate of value and the evaluator's analysis?
*4. If an evaluation obtained for one transaction is used for a subsequent transaction, is the determination that the evaluation is still valid sufficiently documented?
*5. Are evaluations received before making the final credit decision?
*6. If the bank holding company is depending on an evaluation obtained for another financial services institution as support for its transaction, does the holding company have evaluation review procedures to ensure that the evaluation meets the Board's regulation and guidance?

2231.0.13.5 Evaluators

1. Are individuals who perform evaluations competent to complete the assignment?
2. Are evaluations prepared by individuals who are independent of the transaction?

2231.0.13.6 Reappraisals and Reevaluations

1. Is a formal reappraisal and reevaluation program followed?
2. Does the bank holding company sufficiently document and follow its criteria for obtaining reappraisals or reevaluations?

2231.0.14 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Appraisal standards for federally related transactions	3310, 3331, 3351	Subpart G, 225.61–67	4-053–4-054.4	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference

2231.0.15 APPENDIX A—GUIDELINES FOR REAL ESTATE APPRAISAL AND EVALUATION PROGRAMS

INTERAGENCY APPRAISAL AND EVALUATION GUIDELINES
October 27, 1994

Purpose

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (the agencies) are jointly issuing these guidelines, which supersede each of the agencies' appraisal and evaluation guidelines issued in 1992.[a] These guidelines address supervisory matters relating to real estate appraisals and evaluations used to support real estate–related financial transactions and provide guidance to examining personnel and federally regulated institutions about prudent appraisal and evaluation policies, procedures, practices, and standards.

Background

Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) requires the agencies to adopt regulations on the preparation and use of appraisals by federally regulated financial institutions.[b] Such real estate appraisals are to be in writing and performed in accordance with uniform standards by an individual whose competency has been demonstrated and whose professional conduct is subject to effective state supervision.

Common agency regulations[c] issued pursuant to section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) also require each regulated institution to adopt and maintain written real estate lending policies that are consistent with safe and sound banking practices and that reflect consideration of the real estate lending guidelines attached to the regulation. The real estate lending guidelines state that a real estate lending program should include an appropriate real estate appraisal and evaluation program.

Supervisory Policy

An institution's real estate appraisal and evaluation policies and procedures will be reviewed as part of the examination of the institution's overall real estate–related activities. An institution's policies and procedures should be incorporated into an effective appraisal and evaluation program. Examiners will consider the institution's size and the nature of its real estate–related activities when assessing the appropriateness of its program.

When analyzing individual transactions, examiners will review an appraisal or evaluation to determine whether the methods, assumptions, and findings are reasonable and in compliance with the agencies' appraisal regulations, policies,[d] supervisory guidelines, and the institution's policies. Examiners also will review the steps taken by an institution to ensure that the individuals who perform its appraisals and evaluations are qualified and are not subject to conflicts of interest. Institutions that fail to maintain a sound appraisal or evaluation program or to comply with the agencies' appraisal regulations, policies, or these supervisory guidelines will be cited in examination reports and may be criticized for unsafe and unsound banking practices. Deficiencies will require corrective action.

Appraisal and Evaluation Program

An institution's board of directors is responsible for reviewing and adopting policies and procedures that establish an effective real estate appraisal and evaluation program. The program should—

a. FRB: "Guidelines for Real Estate Appraisal and Evaluation Programs," September 28, 1992; OCC: BC-225, "Real Estate Appraisal and Evaluation Guidelines," September 28, 1992; FDIC: FIL-69-92, "Guidelines for Real Estate Appraisal and Evaluation Programs," September 30, 1992; OTS: Thrift Bulletin 55, "Real Estate Appraisal and Evaluation Guidelines," October 13, 1992.

b. OCC: 12 CFR 34, subpart C; FRB: 12 CFR 208.18 and 12 CFR 225, subpart G; FDIC: 12 CFR 323; and OTS: 12 CFR 564.

c. OCC: 12 CFR 34, subpart D; FRB: 12 CFR 208, subpart C; FDIC: 12 CFR 365; and OTS: 12 CFR 545 and 563.

d. The appraisal guidance contained in the "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans," November 7, 1991, generally applies to all transactions.

- establish selection criteria and procedures to evaluate and monitor the ongoing performance of individuals who perform appraisals or evaluations,
- provide for the independence of the person performing appraisals or evaluations,
- identify the appropriate appraisal for various lending transactions,
- establish criteria for contents of an evaluation,
- provide for the receipt of the appraisal or evaluation report in a timely manner to facilitate the underwriting decision,
- assess the validity of existing appraisals or evaluations to support subsequent transactions,
- establish criteria for obtaining appraisals or evaluations for transactions that are otherwise exempt from the agencies' appraisal regulations, and
- establish internal controls that promote compliance with these program standards.

Selection of Individuals Who May Perform Appraisals and Evaluations

An institution's program should establish criteria to select, evaluate, and monitor the performance of the individuals who perform a real estate appraisal or evaluation. The criteria should ensure that—

- the institution's selection process is nonpreferential and unbiased;
- the individual selected possesses the requisite education, expertise, and competence to complete the assignment;
- the individual selected is capable of rendering an unbiased opinion; and
- the individual selected is independent and has no direct or indirect interest, financial or otherwise, in the property or the transaction.

Under the agencies' appraisal regulations, the appraiser must be selected and engaged directly by the institution or its agent. The appraiser's client is the institution, not the borrower. An institution may use an appraisal that was prepared by an appraiser engaged directly by another financial services institution, as long as the institution determines that the appraisal conforms to the agencies' appraisal regulations and is otherwise acceptable.

Independence of the Appraisal and Evaluation Function

Because the appraisal and evaluation process is an integral component of the credit underwriting process, it should be isolated from influence by the institution's loan production process. An appraiser and an individual providing evaluation services should be independent of the loan and collection functions of the institution and have no interest, financial or otherwise, in the property or the transaction. If absolute lines of independence cannot be achieved, an institution must be able to clearly demonstrate that it has prudent safeguards to isolate its collateral evaluation process from influence or interference from the loan production process.

The agencies recognize, however, that it is not always possible or practical to separate the loan and collection functions from the appraisal or evaluation process. In some cases, such as in a small or rural institution or branch, the only individual qualified to analyze the real estate collateral may also be a loan officer, other officer, or director of the institution. To ensure their independence, such lending officials, officers, or directors should abstain from any vote or approval involving loans on which they performed an appraisal or evaluation.

Transactions That Require Appraisals

Although the agencies' appraisal regulations exempt certain categories of real estate–related financial transactions from the appraisal requirements, most real estate transactions over $250,000 are considered federally related transactions and thus require appraisals.[e] A "federally related transaction" means any real estate–related financial transaction in which the agencies engage, contract for, or regulate, and that requires the services of an appraiser. An agency also may impose more stringent appraisal requirements than the appraisal regulations require, such as when an institution's troubled condition is attributable to real estate loan underwriting problems.[f]

e. To facilitate recovery in designated major disaster areas, subject to safety-and-soundness considerations, section 2 of the Depository Institutions Disaster Relief Act of 1992 authorized the agencies to waive certain appraisal requirements for up to three years after a presidential declaration of a natural disaster.

f. As a matter of policy, OTS requires problem associations and associations in troubled condition to obtain appraisals for all real estate–related transactions over $100,000 (unless the transaction is otherwise exempt).

Minimum Appraisal Standards

The agencies' appraisal regulations include five minimum standards for the preparation of an appraisal. The appraisal must—

- conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board (ASB) of the Appraisal Foundation unless principles of safe and sound banking require compliance with stricter standards;

  Although allowed by USPAP, the agencies' appraisal regulations do not permit an appraiser to appraise any property in which the appraiser has an interest, direct or indirect, financial or otherwise.

- be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction;

  As discussed below, appraisers have available various appraisal development and report options; however, not all options may be appropriate for all transactions. A report option is acceptable under the agencies' appraisal regulations only if the appraisal report contains sufficient information and analysis to support an institution's decision to engage in the transaction.

- analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, nonmarket lease terms, and tract developments with unsold units;

  This standard is designed to avoid having appraisals prepared using unrealistic assumptions and inappropriate methods. For federally related transactions, an appraisal is to include the current market value of the property in its actual physical condition and subject to the zoning in effect as of the date of the appraisal. For properties where improvements are to be constructed or rehabilitated, the regulated institution may also request a prospective market value based on stabilized occupancy or a value based on the sum of retail sales. However, the sum of retail sales for a proposed development is not the market value of the development for the purpose of the agencies' appraisal regulations. For proposed developments that involve the sale of individual houses, units, or lots, the appraiser must analyze and report appropriate deductions and discounts for holding costs, marketing costs, and entrepreneurial profit. For proposed and rehabilitated rental developments, the appraiser must make appropriate deductions and discounts for items such as leasing commission, rent losses, and tenant improvements from an estimate based on stabilized occupancy.

- be based upon the definition of market value set forth in the regulation; and

  Each appraisal must contain an estimate of market value, as defined by the agencies' appraisal regulations.

- be performed by state-licensed or -certified appraisers in accordance with requirements set forth in the regulation.

Appraisal Options

An appraiser typically uses three market value approaches to analyze the value of a property—cost, income, and comparable sales—and reconciles the results of each to estimate market value. An appraisal will discuss the property's recent sales history and contain an opinion as to the highest and best use of the property. An appraiser must certify that he or she has complied with USPAP and is independent. Also, the appraiser must disclose whether the subject property was inspected and whether anyone provided significant assistance to the person signing the appraisal report.

An institution may engage an appraiser to perform either a Complete or Limited Appraisal.[g] When performing a Complete Appraisal assignment, an appraiser must comply with all USPAP standards without departing from any binding requirements and specific guidelines when estimating market value. When performing a Limited Appraisal, the appraiser elects to invoke the Departure Provision, which allows the appraiser to depart, under limited conditions, from standards identified as specific guidelines. For example, in a Limited Appraisal, the appraiser might not utilize all three approaches

g. USPAP Statement on Appraisal Standards No. 7 (SMT-7)—Permitted Departure from Specific Guidelines for Real Property Appraisal, issued March 30, 1994, effective July 1, 1994.

to value. Departure from standards designated as binding requirements is not permitted. An institution and appraiser must concur that use of the Departure Provision is appropriate for the transaction before the appraiser commences the appraisal assignment. The appraiser must ensure that the resulting appraisal report will not mislead the institution or other intended users of the appraisal report. The agencies do not prohibit the use of a Limited Appraisal for a federally related transaction, but the agencies believe that institutions should be cautious in their use of a Limited Appraisal because it will be less thorough than a Complete Appraisal.

Complete and Limited Appraisal assignments may be reported in three different report formats: a Self-Contained Report, a Summary Report, or a Restricted Report. The major difference among these three reports relates to the degree of detail presented in the report by the appraiser. The Self-Contained Appraisal Report provides the most detail, while the Summary Appraisal Report presents the information in a condensed manner. The Restricted Report provides a capsulized report with the supporting details maintained in the appraiser's files.

The agencies believe that the Restricted Report format will not be appropriate to underwrite a significant number of federally related transactions due to the lack of sufficient supporting information and analysis in the appraisal report. However, it might be appropriate to use this type of appraisal report for ongoing collateral monitoring of an institution's real estate transactions and under other circumstances when an institution's program requires an evaluation.

Moreover, since the institution is responsible for selecting the appropriate appraisal report to support its underwriting decisions, its program should identify the type of appraisal report that will be appropriate for various lending transactions. The institution's program should consider the risk, size, and complexity of the individual loan and the supporting collateral when determining the level of appraisal development and the type of report format that will be ordered. When ordering an appraisal report, institutions may want to consider the benefits of a written engagement letter that outlines the institution's expectations and delineates each party's responsibilities, especially for large, complex, or out-of-area properties.

Transactions That Require Evaluations

A formal opinion of market value prepared by a state-licensed or -certified appraiser is not always necessary. Instead, less formal evaluations of the real estate may suffice for transactions that are exempt from the agencies' appraisal requirements. The agencies' appraisal regulations allow an institution to use an appropriate evaluation of the real estate rather than an appraisal when the transaction—

- has a value of $250,000 or less;
- is a business loan of $1,000,000 or less, and the transaction is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment; or
- involves an existing extension of credit at the lending institution, provided that (i) there has been no obvious and material change in the market conditions or physical aspects of the property that threaten the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies, or (ii) there is no advancement of new monies other than funds necessary to cover reasonable closing costs.

Institutions should also establish criteria for obtaining appraisals or evaluations for safety-and-soundness reasons for transactions that are otherwise exempt from the agencies' appraisal regulations.

Evaluation Content

An institution should establish prudent standards for the preparation of evaluations. At a minimum, an evaluation should—

- be written;
- include the preparer's name, address, and signature, and the effective date of the evaluation;
- describe the real estate collateral, its condition, its current and projected use;
- describe the source(s) of information used in the analysis;
- describe the analysis and supporting information; and
- provide an estimate of the real estate's market value, with any limiting conditions.

An evaluation report should include calculations, supporting assumptions, and, if utilized, a discussion of comparable sales. Documentation should be sufficient to allow an institution to understand the analysis, assumptions, and conclusions. An institution's own real estate loan portfolio experience and value estimates prepared for recent loans on comparable properties might provide a basis for evaluations.

An evaluation should provide an estimate of value to assist the institution in assessing the soundness of the transaction. Prudent practices also require that as an institution engages in more complex real estate–related financial transactions, or as its overall exposure increases, a more detailed evaluation should be performed. For example, an evaluation for a home equity loan might be based primarily on information derived from a sales data services organization or current tax assessment information, while an evaluation for an income-producing real estate property should fully describe the current and expected use of the property and include an analysis of the property's rental income and expenses.

Qualifications of Individuals Who Perform Evaluations

Individuals who prepare evaluations should have real estate–related training or experience and knowledge of the market relevant to the subject property. Based upon their experience and training, professionals from several fields may be qualified to prepare evaluations of certain types of real estate collateral. Examples include individuals with appraisal experience, real estate lenders, consultants or salespersons, agricultural extension agents, or foresters. Institutions should document the qualifications and experience level of individuals whom the institution deems acceptable to perform evaluations. An institution might also augment its in-house expertise and hire an outside party familiar with a certain market or a particular type of property. Although not required, an institution may use state-licensed or -certified appraisers to prepare evaluations. As such, Limited Appraisals reported in a Summary or Restricted format may be appropriate for evaluations of real estate–related financial transactions exempt from the agencies' appraisal requirements.

Valid Appraisals and Evaluations

The agencies allow an institution to use an existing appraisal or evaluation to support a subsequent transaction, if the institution documents that the existing estimate of value remains valid. Therefore, a prudent appraisal and evaluation program should include criteria to determine whether an existing appraisal or evaluation remains valid to support a subsequent transaction. Criteria for determining whether an existing appraisal or evaluation remains valid will vary depending upon the condition of the property and the marketplace, and the nature of any subsequent transaction. Factors that could cause changes to originally reported values include the passage of time; the volatility of the local market; the availability of financing; the inventory of competing properties; improvements to, or lack of maintenance of, the subject property or competing surrounding properties; changes in zoning; or environmental contamination. The institution must document the information sources and analyses used to conclude that an existing appraisal or evaluation remains valid for subsequent transactions.

Renewals, Refinancings, and Other Subsequent Transactions

While the agencies' appraisal regulations generally allow appropriate evaluations of real estate collateral in lieu of an appraisal for loan renewals and refinancings, in certain situations an appraisal is required. If new funds are advanced over reasonable closing costs, an institution would be expected to obtain a new appraisal for the renewal of an existing transaction when there is a material change in market conditions or the physical aspects of the property that threatens the institution's real estate collateral protection.

The decision to reappraise or reevaluate the real estate collateral should be guided by the exemption for renewals, refinancings, and other subsequent transactions. Loan workouts, debt restructurings, loan assumptions, and similar transactions involving the addition or substitution of borrowers may qualify for the exemption for renewals, refinancings, and other subsequent transactions. Use of this exemption depends on the condition and quality of the loan, the soundness of the underlying collateral, and the validity of the existing appraisal or evaluation.

A reappraisal would not be required when an institution advances funds to protect its interest in a property, such as to repair damaged property, because these funds should be used to restore the damaged property to its original condition. If a loan workout involves modification of the terms and conditions of an existing credit, including acceptance of new or additional real estate collateral, which facilitates the orderly collection of the credit or reduces the institution's risk of loss, a reappraisal or reevaluation may be prudent, even if it is obtained after the modification occurs.

An institution may engage in a subsequent transaction based on documented equity from a valid appraisal or evaluation, if the planned future use of the property is consistent with the use identified in the appraisal or evaluation. If a property, however, has reportedly appreciated because of a planned change in use of the property, such as rezoning, an appraisal would be required for a federally related transaction, unless another exemption applied.

Program Compliance

An institution's appraisal and evaluation program should establish effective internal controls that promote compliance with the program's standards. An individual familiar with the appropriate agency's appraisal regulation should ensure that the institution's appraisals and evaluations comply with the agencies' appraisal regulations, these guidelines, and the institution's program. Loan administration files should document this compliance review, although a detailed analysis or comprehensive analytical procedures are not required for every appraisal or evaluation. For some loans, the compliance review may be part of the loan officer's overall credit analysis and may take the form of either a narrative or a checklist. Corrective action should be undertaken for noted deficiencies by the individual who prepared the appraisal or evaluation.

An institution's appraisal and evaluation program should also have comprehensive analytical procedures that focus on certain types of loans, such as large-dollar credits, loans secured by complex or specialized properties, nonresidential real estate construction loans, or out-of-area real estate. These comprehensive analytical procedures should be designed to verify that the methods, assumptions, and conclusions are reasonable and appropriate for the transaction and the property. These procedures should provide for a more detailed review of selected appraisals and evaluations prior to the final credit decision. The individual(s) performing these reviews should have the appropriate training or experience, and be independent of the transaction.

Appraisers and persons performing evaluations should be responsible for any deficiencies in their reports. Deficient reports should be returned to them for correction. Unreliable appraisals or evaluations should be replaced prior to the final credit decision. Changes to an appraisal's estimate of value are permitted only as a result of a review conducted by an appropriately qualified state-licensed or -certified appraiser in accordance with Standard III of USPAP.

Portfolio Monitoring

The institution should also develop criteria for obtaining reappraisals or reevaluations as part of a program of prudent portfolio review and monitoring techniques—even when additional financing is not being contemplated. Examples of such types of situations include large credit exposures and out-of-area loans.

Referrals

Financial institutions are encouraged to make referrals directly to state appraiser regulatory authorities when a state-licensed or -certified appraiser violates USPAP or applicable state law, or engages in other unethical or unprofessional conduct. Examiners finding evidence of unethical or unprofessional conduct by appraisers will forward their findings and recommendations to their supervisory office for appropriate disposition and referral to the state, as necessary.

These guidelines are designed to in ensure that troubled real estate loans receive consistent treatment nationwide. The guidelines are not intended to be a substitute for the examiner's judgment or for careful analysis of applicable credit and collateral factors. Use of the word "institution" in these guidelines refers to any lending source within the bank holding company organization, whether the lender is the parent company, a bank, thrift, or nonbanking subsidiary.

2240.0.1 EXAMINER REVIEW OF COMMERCIAL REAL ESTATE LOANS

2240.0.1.1 Loan Policy and Administration Review

As part of the analysis of an institution's commercial real estate loan portfolio, examiners review lending policies, loan administration procedures, and credit risk control procedures. The maintenance of prudent written lending policies, effective internal systems and controls, and thorough loan documentation are essential to the institution's management of the lending function.

The policies governing an institution's real estate lending activities must include prudent underwriting standards that are periodically reviewed by the board of directors and clearly communicated to the institution's management and lending staff. The institution must also have credit risk control procedures that include, for example, prudent internal limits on exposure, an effective credit review and classification process, and a methodology for ensuring that the allowance for loan and lease losses is maintained at an adequate level. The complexity and scope of these policies and procedures should be appropriate to the size of the institution and the nature of the institution's activities, and should be consistent with prudent banking practices and relevant regulatory requirements.

2240.0.1.2 Indicators of Troubled Real Estate Markets and Projects, and Related Indebtedness

In order to evaluate the collectibility of an institution's commercial real estate portfolio, examiners should be alert for indicators of weakness in the real estate markets served by the institution. They should also be alert for indicators of actual or potential problems in the individual commercial real estate projects or transactions financed by the institution.

There are several warning signs that real estate markets or projects are experiencing problems that may result in real estate values decreasing from original appraisals or projections. Adverse economic developments and/or an overbuilt market can affect a project's economic feasibility and may cause a real estate project and the loan to become troubled. Available indicators, such as permits for—and the value of—new construction, absorption rates, employment trends, and vacancy rates, are useful in evaluating the condition of commercial real estate markets. Weaknesses disclosed by these types of statistics may indicate that a real estate market is experiencing difficulties that may result in cash flow problems for individual real estate projects, declining real estate values, and ultimately, in troubled commercial real estate loans.

Indicators of potential or actual difficulties in commercial real estate projects may include:

- An excess of similar projects under construction.
- Construction delays or other unplanned adverse events resulting in cost overruns that may require renegotiation of loan terms.
- Lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions.
- Changes in concept or plan (for example, a condominium project converted to an apartment project because of unfavorable market conditions).
- Rent concessions or sales discounts resulting in cash flow below the level projected in the original feasibility study or appraisal.
- Concessions on finishing tenant space, moving expenses, and lease buyouts.
- Slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project's income potential, resulting in protracted repayment or default on the loan.
- Delinquent lease payments from major tenants.
- Land values that assume future rezoning.
- Tax arrearages.

As the problems associated with a commercial real estate project become more pronounced, problems with the related indebtedness may also arise. Such problems include diminished cash flow to service the debt and delinquent interest and principal payments.

While some commercial real estate loans become troubled because of a general downturn in the market, others become troubled because they were originated on an unsound or a liberal basis. Common examples of these types of problems include:

- Loans with no or minimal borrower equity.
- Loans on speculative undeveloped property where the borrowers' only source of repayment is the sale of the property.
- Loans based on land values that have been driven up by rapid turnover of ownership, but without any corresponding improvements to the property or supportable income projections to justify an increase in value.
- Additional advances to service an existing loan that lacks credible support for full repayment from reliable sources.
- Loans to borrowers with no development plans or noncurrent development plans.
- Renewals, extensions and refinancings that lack credible support for full repayment from reliable sources and that do not have a reasonable repayment schedule.[1]

2240.0.1.3 Examiner Review of Individual Loans, Including the Analysis of Collateral Value

The focus of an examiner's review of a commercial real estate loan, including binding commitments, is the ability of the loan to be repaid. The principal factors that bear on this analysis are the income-producing potential of the underlying collateral and the borrower's willingness and capacity to repay under the existing loan terms from the borrower's other resources if necessary. In evaluating the overall risk associated with a commercial real estate loan, examiners consider a number of factors, including the character, overall financial condition and resources, and payment record of the borrower; the prospects for support from any financially responsible guarantors; and the nature and degree of protection provided by the cash flow and value of the underlying collateral.[2] However, as other sources of repayment for a troubled commercial real estate loan become inadequate over time, the importance of the collateral's value in the analysis of the loan necessarily increases.

The appraisal regulations of the federal bank and thrift regulatory agencies require institutions to obtain appraisals when certain criteria are met.[3] Management is responsible for reviewing each appraisal's assumptions and conclusions for reasonableness. Appraisal assumptions should not be based solely on current conditions that ignore the stabilized income-producing capacity of the property.[4] Management should adjust any assumptions used by an appraiser in determining value that are overly optimistic or pessimistic.

An examiner analyzes the collateral's value as determined by the institution's most recent appraisal (or internal evaluation, as applicable). An examiner reviews the major facts, assumptions, and approaches used by the appraiser (including any comments made by management on the value rendered by the appraiser). Under the circumstances described below, the examiner may make adjustments to this assessment of value. This review and any resulting adjustments to value are solely for purposes of an examiner's analysis and classification of a credit and do not involve actual adjustments to an appraisal.

A discounted cash flow analysis is an appropriate method for estimating the value of income-producing real estate collateral.[5] This analysis should not be based solely on the current performance of the collateral or similar

1. As discussed more fully in Manual section 2240.0.2, the refinancing or renewing of loans to sound borrowers would not result in a supervisory classification or criticism unless well-defined weaknesses exist that jeopardize repayment of the loans. Consistent with sound banking practices, institutions should work in an appropriate and constructive manner with borrowers who may be experiencing temporary difficulties.

2. The treatment of guarantees in the classification process is discussed in subsection 2240.0.3.

3. Department of the Treasury, Office of the Comptroller of the Currency, 12 CFR Part 34 (Docket No. 90–16); Board of Governors of the Federal Reserve System, 12 CFR Parts 208 and 225 (Regulation H and Y; Docket No. R–0685); Federal Deposit Insurance Corporation, 12 CFR 323 (RIN 3064–AB05); Department of the Treasury; Office of Thrift Supervision, 12 CFR Part 564 (Docket No. 90–1495).

4. Stabilized income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions.

5. The real estate appraisal regulations of the federal bank and thrift regulatory agencies include a requirement that an appraisal (a) follow a reasonable valuation method that addresses the direct sales comparison, income, and cost approaches to market value; (b) reconcile these approaches; and (c) explain the elimination of each approach not used. A discounted cash flow analysis is recognized as a valuation method for the income approach.

properties; rather, it should take into account, on a discounted basis, the ability of the real estate to generate income over time based upon reasonable and supportable assumptions.

When reviewing the reasonableness of the facts and assumptions associated with the value of the collateral, examiners may evaluate:

- Current and projected vacancy and absorption rates;
- Lease renewal trends and anticipated rents;
- Volume and trends in past due leases;
- Effective rental rates or sale prices (taking into account all concessions);
- Net operating income of the property as compared with budget projections; and
- Discount rates and direct capitalization (“cap”) rates.

The capacity of a property to generate cash flow to service a loan is evaluated based upon rents (or sales), expenses, and rates of occupancy that are reasonably estimated to be achieved over time. The determination of the level of stabilized occupancy and rental rates should be based upon an analysis of current and reasonably expected market conditions, taking into consideration historical levels when appropriate. The analysis of collateral values should not be based upon a simple projection of current levels of net operating income if markets are depressed or reflect speculative pressures but can be expected over a reasonable period of time to return to normal (stabilized) conditions. Judgment is involved in determining the time that it will take for a property to achieve stabilized occupancy and rental rates.

Examiners do not make adjustments to appraisal assumptions for credit analysis purposes based on worst case scenarios that are unlikely to occur. For example, an examiner would not necessarily assume that a building will become vacant just because an existing tenant who is renting at a rate above today’s market rate may vacate the property when the current lease expires. On the other hand, an adjustment to value may be appropriate for credit analysis purposes when the valuation assumes renewal at the above-market rate, unless that rate is a reasonable estimate of the expected market rate at the time of renewal.

When estimating the value of income-producing real estate, discount rates and “cap” rates should reflect reasonable expectations about the rate of return that investors require under normal, orderly and sustainable market conditions. Exaggerated, imprudent, or unsustainably high or low discount rates, “cap” rates, and income projections should not be used. Direct capitalization of nonstabilized income flows should also not be used.

Assumptions, when recently made by qualified appraisers (and, as appropriate, by institution management) and when consistent with the discussion above, should be given a reasonable amount of deference. Examiners should not challenge the underlying assumptions, including discount rates and “cap” rates used in appraisals, that differ only in a limited way from norms that would generally be associated with the property under review. The estimated value of the underlying collateral may be adjusted for credit analysis purposes when the examiner can establish that any underlying facts or assumptions are inappropriate and can support alternative assumptions.

2240.0.2 CLASSIFICATION GUIDELINES

As with other types of loans, commercial real estate loans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or the underlying collateral generally are not classified. Similarly, loans to sound borrowers that are refinanced or renewed in accordance with prudent underwriting standards, including loans to creditworthy commercial or residential real estate developers, should not be classified or criticized unless well-defined weaknesses exist that jeopardize repayment. An institution will not be criticized for continuing to carry loans having weaknesses that result in classification or criticism as long as the institution has a well-conceived and effective workout plan for such borrowers, and effective internal controls to manage the level of these loans.

In evaluating commercial real estate credits for possible classification, examiners apply standard classification definitions. In determining the appropriate classification, consideration should be given to all important information on repayment prospects, including information on the borrower’s creditworthiness, the value of, and cash flow provided by, all collateral supporting the loan, and any support provided by financially responsible guarantors.

The loan’s record of performance to date is important and must be taken into consideration. As a general principle, a performing commercial real estate loan should not automatically be classified or charged-off solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. However, it would be appropriate to classify a performing loan when well-defined weaknesses exist that jeopardize repayment, such as the lack of credible support for full repayment from reliable sources.

These principles hold for individual credits, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each credit should be based upon the fundamental characteristics affecting the collectibility of the particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits that are not affected by the problems of the troubled sectors.

2240.0.2.1 Classification of Troubled Project-Dependent Commercial Real Estate Loans[6]

The following guidelines for classifying a troubled commercial real estate loan apply when the repayment of the debt will be provided solely by the underlying real estate collateral, and there are no other available and reliable sources of repayment. The guidelines are not intended to address loans that must be treated as ''Other Real Estate Owned'' for bank and BHC reporting purposes.

As a general principle, for a troubled project-dependent commercial real estate loan, any portion of the loan balance that exceeds the amount that is adequately secured by the value of the collateral, and that can clearly be identified as uncollectible, should be classified ''loss.''[7] The portion of the loan balance that is adequately secured by the value of the collateral should generally be classified no worse than ''substandard.'' The amount of the loan balance in excess of the value of the collateral, or portions thereof, should be classified ''doubtful'' when the potential for full loss may be mitigated by the outcomes of certain pending events, or when loss is expected but the amount of the loss cannot be reasonably determined.

If warranted by the underlying circumstances, an examiner may use a ''doubtful'' classification on the entire loan balance. However, this would occur infrequently.

2240.0.2.2 Guidelines for Classifying Partially Charged-off Loans

Based upon consideration of all relevant factors, an evaluation may indicate that a credit has well-defined weaknesses that jeopardize collection in full, but that a portion of the loan may be reasonably assured of collection. When an institution has taken a charge-off in an amount sufficient that the remaining recorded balance of the loan (a) is being serviced (based upon reliable sources) and (b) is reasonably assured of collection, classification of the remaining recorded balance may not be appropriate. Classification would be appropriate when well-defined weaknesses continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally be classified no more severely than ''substandard.''

A more severe classification than ''substandard'' for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined, e.g., where significant risk exposures are perceived, such as might be the case for bankruptcy situations or for loans collateralized by properties subject to environmental hazards. In addition, classification of the remaining recorded balance would be appropriate when sources of repayment are considered unreliable.

2240.0.2.3 Guidelines for Classifying Formally Restructured Loans

The classification treatment previously discussed for a partially charged off loan would also generally be appropriate for a formally restructured loan when partial charge-offs have been taken. For a formally restructured loan, the focus of the examiner's analysis is on the ability of the borrower to repay the loan in accordance with its modified terms. Classification of a formally restructured loan would be appropriate, if, after the restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan in accordance with reasonable modified

6. The discussion in this section is not intended to address loans that must be treated as ''other real estate owned'' for bank regulatory reporting purposes or ''real estate owned'' for thrift regulatory reporting purposes. Guidance on these assets is presented in supervisory and reporting guidance of the agencies.

7. For purposes of this discussion, the ''value of the collateral'' is the value used by the examiner for credit analysis purposes, as discussed in a previous section of this policy statement.

terms.[8] Troubled commercial real estate loans whose terms have been restructured should be identified in the institution's internal credit review system, and closely monitored by management.

2240.0.3 TREATMENT OF GUARANTEES IN THE CLASSIFICATION PROCESS

Initially, the original source of repayment and the borrower's intent and ability to fulfill the obligation without reliance on third party guarantors will be the primary basis for the review and classification of assets.[9] The federal bank and thrift regulatory agencies will, however, consider the support provided by guarantees in the determination of the appropriate classification treatment for troubled loans. The presence of a guarantee from a ''financially responsible guarantor,'' as described below, may be sufficient to preclude classification or reduce the severity of classification.

For purposes of this discussion, a guarantee from a ''financially responsible guarantor'' has the following attributes:

- The guarantor must have both the financial capacity and willingness to provide support for the credit;
- The nature of the guarantee is such that it can provide support for repayment of the indebtedness, in whole or in part, during the remaining loan term; and[10]
- The guarantee should be legally enforceable.

The above characteristics generally indicate that a guarantee may improve the prospects for repayment of the debt obligation.

2240.0.3.1 Considerations Relating to a Guarantor's Financial Capacity

The lending institution must have sufficient information on the guarantor's financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor's financial capacity to fulfill the obligation. Also, it is important to consider the number and amount of guarantees currently extended by a guarantor, in order to determine that the guarantor has the financial capacity to fulfill the contingent claims that exist.

2240.0.3.2 Considerations Relating to a Guarantor's Willingness to Repay

Examiners normally rely on their analysis of the guarantor's financial strength and assume a willingness to perform unless there is evidence to the contrary. This assumption may be modified based on the ''track record'' of the guarantor, including payments made to date on the asset under review or other obligations.

Examiners give due consideration to those guarantors that have demonstrated their ability and willingness to fulfill previous obligations in their evaluation of current guarantees on similar assets. An important consideration will be whether previously required performance under guarantees was voluntary or the result of legal or other actions by the lender to enforce the guarantee. However, examiners give limited credence, if any, to guarantees from obligors who have reneged on obligations in the past, unless there is clear evidence that the guarantor has the ability and intent to honor the specific guarantee obligation under review.

Examiners also consider the economic incentives for performance from guarantors:

- Who have already partially performed under the guarantee or who have other significant investments in the project;
- Whose other sound projects are cross-collateralized or otherwise intertwined with the credit; or
- Where the guarantees are collateralized by readily marketable assets that are under the control of a third party.

2240.0.3.3 Other Considerations as to the Treatment of Guarantees in the Classification Process

In general, only guarantees that are legally

8. An example of a restructured commercial real estate loan that does *not* have reasonable modified terms would be a ''cash flow'' mortgage which requires interest payments *only* when the underlying collateral generates cash flow but provides no substantive benefits to the lending institution.

9. Some loans are originated based primarily upon the financial strength of the guarantor, who is, in substance, the primary source of repayment. In such circumstances, examiners generally assess the collectibility of the loan based upon the guarantor's ability to repay the loan.

10. Some guarantees may only provide for support for certain phases of a real estate project. It would not be appropriate to rely upon these guarantees to support a troubled loan after the completion of these phases.

enforceable will be relied upon. However, all legally enforceable guarantees may not be acceptable. In addition to the guarantor's financial capacity and willingness to perform, it is expected that the guarantee will not be subject to significant delays in collection, or undue complexities or uncertainties about the guarantee.

The nature of the guarantee is also considered by examiners. For example, some guarantees for real estate projects only pertain to the development and construction phases of the project. As such, these limited guarantees would not be relied upon to support a troubled loan after the completion of those phases.

Examiners also consider the institution's intent to enforce the guarantee and whether there are valid reasons to preclude an institution from pursuing the guarantee. A history of timely enforcement and successful collection of the full amount of guarantees will be a positive consideration in the classification process.

During the early 1980s, open-end credit primarily consisted of credit card accounts with small lines of credit to the most creditworthy borrowers. Currently, open-end credit consists of much larger lines of credit that have been extended to diverse borrowers with a variety of risk profiles. In 1980, the Federal Financial Institutions Examination Council (FFIEC) (the Federal Reserve Board, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and, in 1987, the Federal Home Loan Bank Board (now the Office of Thrift Supervision)) adopted a uniform policy for the classification of installment credit based on delinquency status. The 1980 policy also provided for different charge-off time frames for open-end and closed-end credit.

Because open-ended borrowing practices had changed and institutional practices for charging off open-end accounts based on their past-due status were inconsistent, the agencies (the FRB, FDIC, OTS, and OCC) undertook a review of the 1980 FFIEC classification policy in concert with a review of all written policies, as mandated by section 303(a) of the Riegle Community Development and Regulatory Improvement Act of 1994 (RCDRIA). In February 1999, an updated policy was issued, effective for use on FFIEC bank call reports beginning December 31, 2000. This new policy was revised again and reissued in June 2000, with the same effective date. (The June 2000 policy supersedes both the 1980 policy and the updated February 1999 policy.) The June policy provides supervisory guidance for residential and home equity loans; fraudulent loans; loans to deceased persons; loans to borrowers in bankruptcy; treatment of partial payments involving past-due loans; and re-aging, deferrals, renewals, or rewrites of open-end and closed-end credit. The agencies are to use this expanded supervisory guidance when applying the uniform classifications to retail-credit loans extended by depository institutions. See SR-00-8.

While the terms of the revised policy apply only to federally insured depository institutions, the Federal Reserve believes the guidance is broadly applicable to bank holding companies (BHCs) and their nonbank lending subsidiaries. Accordingly, examiners should apply the revised policy, as appropriate, in the inspection of consumer finance subsidiaries of BHCs.

When reviewing consumer finance subsidiaries of banking organizations, examiners should consider the methodology used for aging retail loans. In accordance with the FFIEC bank call report instructions, banks and their consumer finance subsidiaries are required to use the contractual method, which ages loans based on the status of contractual payments. BHCs, in preparing their financial statements, are permitted to use the range of options available under GAAP. This, in effect, allows uninsured, nonbank consumer finance subsidiaries of BHCs to employ the recency method, which ages loans according to the date of the most recent payment, regardless of the contractual terms of the loan.

In general, the contractual method provides a more accurate reflection of loan performance and, therefore, is the *preferred* methodology, especially from the standpoint of financial-statement transparency and public disclosure. Examiners should encourage BHCs and their consumer finance subsidiaries to use the contractual method. However, BHCs should not change their aging methodology from contractual to recency without the prior concurrence of the Federal Reserve. A BHC subsidiary may not change its methodology if the intent or effect of such a change is to mask asset quality or financial weaknesses. Moreover, in the event that consumer receivables are transferred from a bank to its BHC or the BHC's nonbanking subsidiaries, the BHC or the nonbanking subsidiaries should continue to age the receivables according to the contractual method.

When a BHC uses the recency method, it should have adequate controls in place to accurately track the performance of loans within the retail portfolio and to demonstrate sound and compelling business reasons for the use of the recency method. Examiners should see section 3100.0 for further guidance on the review of consumer finance operations.

2241.0.1 UNIFORM RETAIL-CREDIT CLASSIFICATION AND ACCOUNT-MANAGEMENT POLICY

The uniform retail-credit classification and account-management policy issued by the FFIEC (and approved by the Federal Reserve Board) is reproduced below. The Board has clarified certain provisions of this policy. In this text, the Board's revisions are in brackets. Section numbers have also been added to the subtitles of the text.

The Uniform Retail-Credit Classification and Account-Management Policy[1] establishes standards for the classification and treatment of retail credit in financial institutions. Retail credit consists of open- and closed-end credit extended to individuals for household, family, and other personal expenditures, and includes consumer loans and credit cards. For purposes of this policy, retail credit also includes loans to individuals secured by their personal residence, including first mortgage, home equity, and home-improvement loans. Because a retail-credit portfolio generally consists of a large number of relatively small-balance loans, evaluating the quality of the retail-credit portfolio on a loan-by-loan basis is inefficient and burdensome for the institution being examined and for examiners.

Actual credit losses on individual retail credits should be recorded when the institution becomes aware of the loss, but in no case should the charge-off exceed the time frames stated in this policy. This policy does not preclude an institution from adopting a more conservative internal policy. Based on collection experience, when a portfolio's history reflects high losses and low recoveries, more conservative standards are appropriate and necessary.

The quality of retail credit is best indicated by the repayment performance of individual borrowers. Therefore, in general, retail credit should be classified based on the following criteria:

1. Open- and closed-end retail loans past due 90 cumulative days from the contractual due date should be classified substandard.
2. Closed-end retail loans that become past due 120 cumulative days and open-end retail loans that become past due 180 cumulative days from the contractual due date should be classified loss and charged off.[2] In lieu of charging off the entire loan balance, loans with non–real estate collateral may be written down to the value of the collateral, less cost to sell, if repossession of collateral is assured and in process.
3. One- to four-family residential real estate loans and home equity loans that are past due 90 days or more with loan-to-value ratios greater than 60 percent should be classified substandard. Properly secured residential real estate loans with loan-to-value ratios equal to or less than 60 percent are generally not classified based solely on delinquency status. Home equity loans to the same borrower at the same institution as the senior mortgage loan with a combined loan-to-value ratio equal to or less than 60 percent need not be classified. However, home equity loans where the institution does not hold the senior mortgage, that are past due 90 days or more should be classified substandard, even if the loan-to-value ratio is equal to, or less than, 60 percent.

   For open- and closed-end loans secured by residential real estate, a current assessment of value should be made no later than 180 days past due. Any outstanding loan balance in excess of the value of the property, less cost to sell, should be classified loss and charged off.
4. Loans in bankruptcy should be classified loss and charged off within 60 days of receipt of notification of filing from the bankruptcy court or within the time frames specified in this classification policy, whichever is shorter, unless the institution can clearly demonstrate and document that repayment is likely to occur. Loans with collateral may be written down to the value of the collateral, less cost to sell. Any loan balance not charged off should be classified substandard until the borrower re-establishes the ability and willingness to repay for a period of at least six months.
5. Fraudulent loans should be classified loss and charged off no later than 90 days of discovery or within the time frames adopted in this classification policy, whichever is shorter.
6. Loans of deceased persons should be classified loss and charged off when the loss is determined or within the time frames adopted in this classification policy, whichever is shorter.

1. [For the Federal Reserve's depository institution classification guidelines, see section 2060.1, "Classification of Credits," in the *Commercial Bank Examination Manual.]*

2. For operational purposes, whenever a charge-off is necessary under this policy, it should be taken no later than the end of the month in which the applicable time period elapses. Any full payment received after the 120- or 180-day charge-off threshold, but before month-end charge-off, may be considered in determining whether the charge-off remains appropriate.

OTS regulation 12 CFR 560.160(b) allows savings institutions to establish adequate (specific) valuation allowances for assets classified loss in lieu of charge-offs.

Open-end retail accounts that are placed on a fixed repayment schedule should follow the charge-off time frame for closed-end loans.

2241.0.1.1 Other Considerations for Classification

If an institution can clearly document that a past-due loan is well secured and in the process of collection, such that collection will occur regardless of delinquency status, then the loan need not be classified. A well-secured loan is collateralized by a perfected security interest in, or pledges of, real or personal property, including securities with an estimable value, less cost to sell, sufficient to recover the recorded investment in the loan, as well as a reasonable return on that amount. ''In the process of collection'' means that either a collection effort or legal action is proceeding and is reasonably expected to result in recovery of the loan balance or its restoration to a current status, generally within the next 90 days.

2241.0.1.2 Partial Payments on Open- and Closed-End Credit

Institutions should use one of two methods to recognize partial payments. A payment equivalent to 90 percent or more of the contractual payment may be considered a full payment in computing past-due status. Alternatively, the institution may aggregate payments and give credit for any partial payment received. For example, if a regular installment payment is $300 and the borrower makes payments of only $150 per month for a six-month period, [the institution could aggregate the payments received ($150 × six payments, or $900). It could then give credit for three full months ($300 x three payments) and thus treat the loan as] three full months past due. An institution may use either or both methods in its portfolio, but may not use both methods simultaneously with a single loan.

2241.0.1.3 Re-aging, Extensions, Deferrals, Renewals, and Rewrites

Re-aging of open-end accounts, and extensions, deferrals, renewals, and rewrites of closed-end loans[3] can be used to help borrowers overcome temporary financial difficulties, such as loss of job, medical emergency, or change in family circumstances like loss of a family member. A permissive policy on re-agings, extensions, deferrals, renewals, or rewrites can cloud the true performance and delinquency status of the portfolio. However, prudent use is acceptable when it is based on a renewed willingness and ability to repay the loan, and when it is structured and controlled in accordance with sound internal policies.

Management should ensure that comprehensive and effective risk management and internal controls are established and maintained so that re-ages, extensions, deferrals, renewals, and rewrites can be adequately controlled and monitored by management and verified by examiners. The decision to re-age, extend, defer, renew, or rewrite a loan, like any other modification of contractual terms, should be supported in the institution's management information systems. Adequate management information systems usually identify and document any loan that is re-aged, extended, deferred, renewed, or rewritten, including the number of times such action has been taken. Documentation normally shows that the institution's personnel communicated with the borrower, the borrower agreed to pay the loan in full, and the borrower has the ability to repay the loan. To be effective, management information systems should also monitor and track the volume and performance of loans that have been re-aged, extended, deferred, renewed, or rewritten and/or placed in a workout program.

2241.0.1.4 Open-End Accounts

Institutions that re-age open-end accounts should establish a reasonable written policy and adhere to it. To be considered for re-aging, an account should exhibit the following:

1. The borrower has demonstrated a renewed willingness and ability to repay the loan.

3. These terms are defined as follows. *Re-age:* Returning a delinquent, open-end account to current status without collecting (at the time of aging) the total amount of principal, interest, and fees that are contractually due. *Extension:* Extending monthly payments on a closed-end loan and rolling back the maturity by the number of months extended. The account is shown current upon granting the extension. If extension fees are assessed, they should be collected at the time of the extension and not added to the balance of the loan. *Deferral:* Deferring a contractually due payment on a closed-end loan without affecting the other terms, including maturity, (or the due date for subsequently scheduled payments,) of the loan. The account is shown current upon granting the deferral. *Renewal:* Underwriting a matured, closed-end loan generally at its outstanding principal amount and on similar terms. *Rewrite:* Underwriting an existing loan by significantly changing its terms, including payment amounts, interest rates, amortization schedules, or its final maturity.

2. The account has existed for at least nine months.
3. The borrower has made at least three consecutive minimum monthly payments or the equivalent cumulative amount. Funds may not be advanced by the institution for this purpose.

Open-end accounts should not be re-aged more than once within any twelve-month period and no more than twice within any five-year period. Institutions may adopt a more conservative re-aging standard; for example, some institutions allow only one re-aging in the lifetime of an open-end account. Additionally, an over-limit account may be re-aged at its outstanding balance (including the over-limit balance, interest, and fees), provided that no new credit is extended to the borrower until the balance falls below the predelinquency credit limit.

Institutions may re-age an account after it enters a workout program, including internal and third-party debt-counseling services, but only after receipt of at least three consecutive minimum monthly payments or the equivalent cumulative amount, as agreed upon under the workout or debt-management program. Re-aging for workout purposes is limited to once in a five-year period and is in addition to the once-in-twelve-months/twice-in-five-years limitation described above. To be effective, management information systems should track the principal reductions and charge-off history of loans in workout programs by type of program.

2241.0.1.5 Closed-End Loans

Institutions should adopt and adhere to explicit standards that control the use of extensions, deferrals, renewals, and rewrites of closed-end loans. The standards should exhibit the following:

1. The borrower should show a renewed willingness and ability to repay the loan.
2. The standards should limit the number and frequency of extensions, deferrals, renewals, and rewrites.
3. Additional advances to finance unpaid interest and fees should be prohibited.

Management should ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained to support the collection process and to ensure timely recognition of losses. To be effective, management information systems should track the subsequent principal reductions and charge-off history of loans that have been granted an extension, deferral, renewal, or rewrite.

2241.0.1.6 Examination Considerations

Examiners should ensure that institutions adhere to this policy. Nevertheless, there may be instances that warrant exceptions to the general classification policy. Loans need not be classified if the institution can document clearly that repayment will occur irrespective of delinquency status. Examples might include loans well secured by marketable collateral and in the process of collection, loans for which claims are filed against solvent estates, and loans supported by valid insurance claims.

The Uniform Retail-Credit Classification and Account-Management Policy does not preclude examiners from classifying individual retail-credit loans that exhibit signs of credit weakness regardless of delinquency status. Similarly, an examiner may also classify retail portfolios, or segments thereof, where underwriting standards are weak and present unreasonable credit risk, and may criticize account-management practices that are deficient.

In addition to reviewing loan classifications, the examiner should ensure that the institution's allowance for loan and lease losses provides adequate coverage for probable losses inherent in the portfolio. Sound risk- and account-management systems, including a prudent retail-credit lending policy, measures to ensure and monitor adherence to stated policy, and detailed operating procedures, should also be implemented. Internal controls should be in place to ensure that the policy is followed. Institutions that lack sound policies or fail to implement or effectively adhere to established policies will be subject to criticism.

Issued by the Federal Financial Institutions Examination Council on June 6, 2000.

In carrying out its regulatory and supervisory responsibilities, the Board requires the submission of various reports from bank holding companies. These reports are an integral part of the Board's supervision, monitoring, and surveillance functions. Information from these reports is used to evaluate the performance of bank holding companies, appraise their financial condition, and determine their compliance with applicable laws and regulations. The examiner must review the reports (submitted to the Federal Reserve System) for accuracy and timeliness and insist on their being amended if material errors are found. If inaccurate data are submitted, the resulting ratios could conceal deteriorating trends in the company's financial condition and performance. Bank holding companies should maintain sufficient internal systems and procedures to ensure that reporting is accomplished according to appropriate regulatory requirements. Clear, concise, and orderly workpapers should support the data presented and provide a logical tie between report data and the financial records. For detailed current information on who must submit reports and what the reporting requirements are, see the Board's public site on the Internet at the following address: www.federalreserve.gov/boarddocs/reportforms.

2250.0.1 PENALTIES FOR ERRORS IN REPORTS

Section 8 of the Bank Holding Company Act (the act) was amended to provide for the assessment of civil money penalties for the submission of late, false, or misleading reports filed by bank holding companies that are required by the act and Regulation Y and for the failure to file the required regulatory reports. Financial institutions that have adequate procedures to avoid any inadvertent errors but that unintentionally submit incorrect information or are minimally late in publishing or transmitting the reports can be fined up to $2,000 per day. The financial institution has the burden of proving that the error was inadvertent. If the error was not inadvertent, a penalty of up to $20,000 per day can be assessed. If the submission was done in a knowing manner or with reckless disregard for the law, a fine of up to $1 million or 1 percent of the institution's assets can be assessed for each day of the violation. Institution-affiliated parties who participate in any manner in the filing of an institution's false or misleading required regulatory report, or who cause the failure to file or a late filing of a required regulatory report, may be assessed a civil money penalty of up to $25,000 per day.

2250.0.2 APPROVAL OF DIRECTORS AND SENIOR OFFICERS OF DEPOSITORY INSTITUTIONS

The Federal Deposit Insurance Act (12 U.S.C. 1811) was amended to require each insured depository institution and depository institution holding company to give 30 days' prior notification to the federal banking authority of (1) the proposed addition of any individual to its board of directors or (2) the employment of any individual as a senior executive officer. This requirement applies to the following institutions:

1. institutions that have been chartered less than two years
2. institutions that have undergone a change in control within the preceding two years
3. institutions that are in a troubled condition or whose capital is below minimum standards

The agencies have the authority to issue a notice of disapproval to stop the appointment or employment of an individual if they feel that appointing or employing the person would not be in the interests of the public, taking into account that individual's competence, experience, character, and integrity.

2250.0.3 INSPECTION OBJECTIVES

1. To determine that required reports are being filed on time.
2. To determine that the contents of reports are accurate and complete.
3. To recommend corrective and, if needed, formal enforcement action when official reporting practices, policies, or procedures are deficient.

2250.0.4 INSPECTION PROCEDURES

1. A bank holding company's historical record concerning the timely submission of reports should be ascertained by reviewing relevant

Reserve Bank files. The examiner should determine, from documentation in the files, which reports should have been filed because of the passage of time or the occurrence of an event. If a report is delinquent, the bank holding company should be instructed to prepare and submit the report expeditiously.

2. Copies of regulatory reports filed since the prior inspection should be reviewed and compared with company records on a random, line-by-line basis, using a significance test. In some cases, the review will necessarily extend to supporting schedules and workpapers that substantiate the data reflected in the reports. If the initial reports reviewed are found to be substantially correct, then the scope of subsequent reviews may be curtailed. If the reports are found to be incorrect, the overall review procedures should be intensified. When an error or misstatement is considered significant, the matter should be brought to management's attention and the bank holding company should be required to submit adjusted data. Improper methods used in preparing reports should be called to management's attention. The examiner should explain all changes carefully and assist bank holding company personnel in whatever way possible to ensure proper reporting in future reports.
3. At the conclusion of the review process, the examiner should discuss the following with management, when applicable:
   a. inaccuracies found in reports and the need for submission of amended pages or reports
   b. violations of law, rulings, or regulations
   c. recommended corrective action when policies or procedures have contributed to deficiencies noted in the reports or the untimely submission of report(s)
4. Details concerning the late or inaccurate preparation of reports should be listed in the inspection report on the Other Supervisory Issues report page. If the matter is considered significant, it should be noted on the Examiner's Comments and Matters Requiring Special Board Attention report page, as well. When the exceptions are considered minor and have been discussed with management and corrected, it will suffice to state this on the Other Supervisory Issues workpaper supporting page.
5. When it is determined that false, misleading, or inaccurate information is contained in financial statements or reports, consider whether formal enforcement action is needed to ensure that the offending bank holding company, financial institution, or other entity under the holding company structure will correct the statements and reports.

2250.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Submission of reports concerning compliance with the act, or regulations or orders under it	1844(c)			
Annual reports	1844(c)	225.5(b)		
Report on intercompany transactions	1844(c)	225.5(b)		
Reports emanating from inspection report recommendations	1844(c)	225.5(b)		
Reports emanating from cease-and-desist orders	1818(b), (c)			
Civil money penalties for errors on bank call and BHC Reports	324 1847			

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

2260.0.1 INTRODUCTION

Venture capital activities are usually conducted through one or more of the following types of entities: Small Business Investment Companies (SBIC); Minority Enterprise Small Business Investment Companies (MESBIC); Non-licensed Venture Capital Companies; and Partnerships or Venture Capital Funds. SBIC's and MESBIC's are licensed and regulated by the Small Business Administration (SBA); the other types are not. Both SBIC's and MESBIC's are limited by regulation to investing in and lending to small businesses; whereas, non-licensed venture capital companies and partnerships have greater latitude. The activities of MESBIC's (section 103d companies) are specifically limited to small firms owned by socially or economically disadvantaged persons. Most banks and bank holding companies engage in venture capital activities through an SBIC because of its broad ability to take equity positions in other companies. SBIC's are permitted to own up to 49.9 percent of the voting shares of a company. By contrast, a non-licensed venture capital company that is a subsidiary of a bank holding company may not own more than 4.9 percent of the voting shares of a business. To escape from this limitation some bank holding companies have formed partnerships or venture capital funds. However, a bank holding company can only participate as a limited partner with an ownership interest not to exceed 24.9 percent. Limited partnerships are preferred by those bank holding companies who do not possess the expertise for this type of activity but seek the potential opportunity for high returns.

Through the use of private capital and, in some cases, borrowed money, venture capital companies invest in and lend to new and growing business enterprises. They prefer to invest in and lend to companies that exhibit strong management talent and clearly defined strategies. Many of the companies are yet unknown to the public. Their products either have been introduced to the market or are due to arrive in the next few years. Venture capital companies do not favor pioneering research. Instead, they are interested in financing innovative products, i.e., those next in generation to existing ones, that have a wide market appeal and the potential for strong growth. Such products are preferred because of their shorter development time and possible faster realization of profits. One of the ways a venture capital company makes money is by purchasing the common stock of an emerging company and selling it when the company has grown and the stock has appreciated in value. It also generates earnings by making convertible preferred stock investments and by lending money in the form of subordinated debentures and term loans. Usually lending agreements contain provisions which enable a venture capital company to acquire shares or increase existing holdings through the exercise of warrants or stock options at a later date. Although in most cases some equity interest is taken, venture capital companies, generally, do not acquire a controlling interest in a business they finance.

Once financing commences, venture capital companies typically take an active role in the management of the companies. They usually receive representation on the company's board of directors, which enables them to review budgets and assist in structuring the company's long-range strategic plan. Guiding a company through its developing stages is considered essential for the achievement of equity appreciation and realization of the high returns sought by venture capital companies.

2260.0.2 LOANS AND INVESTMENTS

Investments and lending philosophy may differ among venture capital companies. Some choose to be equity-oriented; that is, they look for higher returns on investments through capital appreciation, while others favor lending in the form of loans or convertible debt securities which provide cash flow to fund operations and service debt. However, most companies will strive for a diversified portfolio in terms of the type of investment and industry mix. The range of financing possibilities associated with lending and/or investing is as follows:

First Step Financing	Funds needed for seed capital to help develop an idea.
Start-up Financing	Funds needed to cover the cost of preparing a business plan, conducting market studies and opening a business.
First Stage Financing	Funds needed to start manufacturing and selling the product(s).
Second Stage Financing	Funds needed for working capital to expand production and build inventories. Company is operating but not yet profitable.
Third Stage Financing	Funds needed to improve the product, build working capital and expand marketing and production facilities. At this point, the company should be generating a profit.
Fourth Stage Financing	Additional working capital funds needed prior to initial public offering which may be as much as a year later.

In addition to the above, venture capital companies will consider financing leveraged buyouts and turnaround situations.

The degree of risk assumed varies according to the stage of financing, i.e., lower stages contain greater risk because of the requirement for longer-term investment discipline than higher stages. Investments in start-up companies typically take five to seven years or more to mature. Because of the high risk involved, most bank-affiliated venture capital companies will avoid the earlier or lower stages of financing. Newly established venture capital companies and especially those that use leverage tend to focus on the intermediate and latter stages of financing. These stages are represented primarily by debenture financing, preferred stock investments, and straight term loans. In structuring a portfolio, a venture capitalist should consider both liquidity and capital protection. The ideal financing mix might entail a limited amount of money invested in common stock with the remainder distributed between debentures, loans, and preferred stock. These instruments will provide income to cover operating expenses and service debt as well as give some protection should the business start to decline. Limited holdings of common stock give the company the opportunity to enhance earnings through capital gains without adversely effecting cash flow. Regardless of the type of financing offered, the ability to exist from an investment or loan through either the issuance of public stock or a cash buyout by a larger company is the goal of a venture capital company.

2260.0.3 FUNDING

A venture capital company may use private capital, leverage, or a combination of both to fund its portfolio of loans and investments. Venture capital companies obtain private capital from their parent organization, either banks or bank holding companies. Generally, private capital is used to fund high-risk, lower-stage investments, although some companies may diversify their portfolio and deploy a portion of capital in loans, debentures and preferred stock. Leverage may be derived from internal and external borrowings. SBIC's that are banking subsidiaries may receive funding in the form of loans from their parent bank. For those companies that are a subsidiary of a bank holding company, internal funding may be provided by the bank holding company from internal cash flow or its external borrowing sources. A bank holding company might borrow from its available bank lines or other borrowing sources to fund venture capital operations. There is, however, one exception; that is, the use of commercial paper proceeds to fund venture capital investments and loans does not appear to qualify under the exemptive provisions of section 3(a)(3) of the Securities Act of 1933. SBIC's and MESBIC's can obtain external financing from the U.S. government and the private sector, while, non-licensed venture capital companies are limited to only private sources for their external financing. Under current SBA regulations, an SBIC can borrow up to $35 million from the federal financing bank with no limit as to the aggregate amount of private debt. Because of the investment restrictions on MESBIC's, the SBA allows them to incur higher leverage. MESBIC's are permitted to borrow up to four times their capital base and issue preferred stock to the SBA up to two times their capital base. MESBIC's also have no limit on the aggregate amount of private debt. All government borrowings ings are through the federal financing bank and carry the guarantee of the SBA. Such borrowings are classified as senior debt.

2260.0.4 PROFITABILITY

Earnings of venture capital companies can fluctuate widely depending on the nature of their activities. Those companies that blend their portfolios with loans, debentures and preferred stock investments tend to be more predictable and less erratic in earnings performance than companies that are strictly equity-oriented. The difference being that loans, debentures and preferred stock provide income to cover operating expenses and debt service requirements, while common stock investments may not yield positive returns for several years. Portfolio diversification tends to smooth out earnings, although the potential for major fluctuations in earnings exists in the future should capital gains be realized on equity investments. In measuring earnings performance, one should consider the combination of net realized earnings (net investment income plus net realized gains (losses) on sale of investments) and net unrealized appreciation or depreciation on investment holdings found in the capital structure of the balance sheet. It is not uncommon to see aggregate returns on capital reach 50

or more. Typically, returns of this magnitude are influenced by either large gains realized on the sale of investments or a substantial amount of unrealized appreciation on investments held or a combination of both. Appreciation or depreciation in portfolio investments represents potential realized gains or losses and, therefore, should be considered in evaluating the company's earnings performance. Specifically, the change in year-to-year net unrealized appreciation or depreciation is a factor that should be considered in analyzing results. When measuring the company's contribution to consolidated earnings, net unrealized appreciation or depreciation should be ignored.

2260.0.5 CAPITALIZATION

In addition to the usual equity components of capital stock, surplus and retained earnings, the capital structure of a venture capital company includes a separate category for net unrealized appreciation (depreciation) on equity interests. Net unrealized appreciation (depreciation) on equity interests represents the gross amount reported under loans and investments less an appropriate provision for taxes. Since unrealized appreciation (depreciation) on equity interests represents future profits (losses) they are measured separately in the equity account rather than in earnings.

There are no industry norms with which to measure capital adequacy. What is known, however, is that the SBA requires a minimum capital investment of $1,000,000 to establish an SBIC. Moreover, regulations governing SBIC's limit the dollar amount of investments and/or loans to a single customer to 20 percent of an SBIC's capital base. Although banks are limited by statute to a maximum capital investment in an SBIC of 4.9 percent of their primary capital, statistics show that SBIC's have substantially less than this limit. By contrast, there are no restrictions as to the amount of capital that a bank holding company may invest in a nonbank affiliated venture capital company. Dependence on capital to fund portfolio loans and investments seems to be preferred as the cost of leverage, at present, cannot provide meaningful spreads. It can be assumed that the larger the capital position the higher the dollar amount available for investing and/or lending to a single customer.

Sustained profitability and satisfactory asset quality are required to maintain financial soundness and capital adequacy. The SBA will consider an SBIC's capital as impaired if net unrealized depreciation and/or operating losses equal 50 percent or more of its capital base. It would seem appropriate to use this guideline for measuring the adequacy of capital of non-licensed venture capital companies that are affiliated with a bank holding company.

2260.0.6 INSPECTION OBJECTIVES

1. To determine whether the company is operating within the scope of its approved activities and within the provisions of the Act and Regulation Y.
2. To determine whether transactions with affiliates, especially banks, are in accordance with applicable statutes and regulations.
3. To determine the quality of the asset portfolios and whether the allowance for losses is

adequate in relation to portfolio risk and whether the nonaccrual policy is appropriate.

4. To determine the viability of the company as a going concern, and whether its affiliate status represents a potential or actual adverse influence upon the parent holding company and its affiliated bank and nonbank subsidiaries and the condition of the consolidated corporation.

5. To determine whether the company has formal written policies and procedures relating to lending and investing.

6. To determine if such policies and procedures are adequate and that management is operating in conformance with the established policies.

7. To assess management's ability to operate the company in a safe and sound manner.

8. To suggest corrective action when policies, practices or procedures are deficient, or when asset quality is weak, or when violations of laws or regulations have been noted.

2260.0.7 INSPECTION PROCEDURES

2260.0.7.1 Pre-Inspection

All SBIC's and MESBIC's are subject to comprehensive regulations and annual examinations administered by the SBA. Therefore, it is not necessary to conduct a full scope inspection of these subsidiaries. The bank holding company inspection should focus on the quality of assets, as disclosed in the annual director's valuation and financial statements submitted to the SBA on an annual basis, transactions with affiliates and an overall financial evaluation.

The decision whether the operations of a non-licensed venture capital company will be inspected ''on-site'' is based on the availability and adequacy of data from either the parent holding company or that which is obtained upon request from the subsidiary. The following information should be obtained and thoroughly reviewed prior to making a decision to go ''on-site'':

1. Minutes of the board and executive committee meetings since inception of company or the date of the previous inspection;

2. Comparative interim and fiscal financial statements containing value accounting adjustments, including the year-end filing with the SBA;

3. Listing of contingent liabilities, including any pending material litigation;

4. Latest director's valuation of loans and investments and results of latest internal loan or credit review;

5. Copies of the most recent internal and external audit reports;

6. Trial balance of all loans and investments, indicating the percent ownership of a company involving an equity interest;

7. Listing of loans, debentures and preferred stock on which scheduled payments are in arrears 30 days or more or on which payments are otherwise not being made according to original terms;

8. Details of internal and external borrowing arrangements; and

9. Any agreements, guarantees or pledges between the subsidiary and its parent holding company or affiliates.

After reviewing the above information, a decision whether or not to conduct an on-site inspection must be made. Some of the determinants of this decision would include: relative size; current level and trend of earnings; asset quality as indicated in the director's valuation of loans and investments; and the condition of the company when last inspected. From the information provided, it might be determined that the company is operating properly and is in sound condition. In such a case, an on-site inspection may not be warranted. Conversely, a deteriorating condition might be detected which would warrant a visit even though a satisfactory condition had been determined during the previous inspection. All non-licensed venture capital companies should be inspected on-site at least once every three years.

2260.0.7.2 On-Site Inspection

If the decision was made to conduct an ''on-site'' inspection of the subsidiary, the examiner should expand the scope of the review to include these additional procedures:

1. Hold a brief meeting with the chief executive officer of the company to establish contact and present a brief indication of the scope of the inspection;

2. Review the company's policy statements for loans, investments, nonaccruals, and charge-offs;

3. Review the latest internal review by the company's directors or the loan review department of the bank affiliate or bank holding company;

4. Conduct an independent review of the portfolio;

a. Establish the minimum dollar of loans and investments to be reviewed to achieve at least 70 percent coverage of the portfolio;

b. Review loans and investments in sample, giving consideration to the following:

- Latest balance sheet and income data;
- Profitability projections;
- Product(s) being produced by customer and their market acceptance;
- Business plan;
- Extent of relationship with customer;
- Funding sources; and
- Ultimate source of repayment.

c. Discuss the more serious problem loans and investments with management;

d. Classify, if necessary, those loans and investments that exhibit serious weaknesses where collectibility is problematical or worse. Lower classification criteria must accompany these assets, which possess a higher degree of credit risk than found in other types of nonbank lending;

e. Determine the diversification of risk within the portfolio, i.e., the mix of loans and investments and the type of industries financed;

f. Review the adequacy of the allowance for loan losses and determine the reasonableness of the amount of unrealized appreciation or depreciation reported on the balance sheet in conjunction with the asset evaluation; and

g. Determine whether the board of directors or parent holding company has established credit limits for the maximum amount of loans and investments to be extended to a single customer. Verify adherence to the limits.

5. Review equity investments for compliance with the 4.9 percent maximum limitation to any one customer;

6. Verify office locations and activities with system approvals;

7. Compare company's general ledger with statements prepared for the latest FR Y–6;

8. Review the quality and liquidity of other investment holdings;

9. Review and classify, if necessary, assets acquired in liquidation of a customer's business due to default. Determine compliance of divestiture period with section 4(c)(2) of The Bank Holding Company Act;

10. Review the manner and frequency in which subsidiary management reports to the parent holding company;

11. Follow-up on matters criticized in the most recent audit reports and the previous inspection report on the subsidiary; and

12. Assess the expertise of subsidiary management and awareness of subsidiary directors.

2260.0.7.3 Matters Warranting Recommendation in Inspection Report

Deficiencies or concerns that warrant citation in the inspection report for the attention of management are:

1. Lack of policies and/or controls in the lending and investing functions;

2. Improper diversification of risk in the loan and investment portfolio;

3. Adverse tie-in arrangements with the affiliate bank(s):

4. Lack of management expertise;

5. Impairment of capital as a result of operating losses or high unrealized depreciation on equity interests or a combination of both; and

6. Lack of adequate reporting procedures to parent holding company management.

2260.0.8 LAWS, REGULATIONS, INTERPRETATIONS AND ORDERS

Subject	*Laws* [1]	*Regulations* [1]	*Interpretations* [3]	*Orders*
Acquisition of SBIC by a bank holding company	1843(c)(8) 1843(c)(5)	225.111	4–173 4–175 4–174	
Limitations of an SBIC's control over business enterprises		13 C.F.R. 107.901(a)		
Criteria for various types of business investments of an SBIC		13 C.F.R. 121.3–10 13 C.F.R. 121.3–11		
Acquisition of a non-licensed venture capital company by a bank holding company	1843(c)(8)	225.112		
Formation of joint ventures (limited partnerships) for purpose of conducting venture capital activities	1843(c)(6)			
Limitation on equity interests of a non-licensed venture capital company affiliated with a bank holding company	1843(c)(6)			
Loans to affiliates—Section 23A of FR Act	371c			
Restrictions on transactions with affiliates	371c			
Acquisition of shares acquired DPC	1843(c)(2)			
Acquisition of assets acquired DPC	1843(c)(2)	225.132	4–175.1	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

2260.0.9 APPENDIX 1—VENTURE CAPITAL COMPANY SAMPLE BALANCE SHEET

	December 31, 19XX
ASSETS	
Cash	XXXX
Money Market investments	XXXX
Loans and investments	XXXX
Loans	XXXX
Debt securities	XXXX
Equity interests	XXXX
Total loans and investments	XXXX
Less: Allowance for losses on loans and investments	XXXX
Plus: Unrealized appreciation (depreciation) on equity interests	XXXX
Net loans and investments	XXXX
Interest and dividends receivable	XXXX
Assets acquired in liquidation of loans and investments	XXXX
Other assets	XXXX
Total assets	XXXX
LIABILITIES	
Notes payable—affiliates	XXXX
Notes payable—others	XXXX
Accrued taxes payable	XXXX
Deferred tax credits	XXXX
Other liabilities	XXXX
Total liabilities	XXXX
STOCKHOLDER'S EQUITY	
Common stock (par value XXX)	XXXX
Surplus	XXXX
Retained earnings	XXXX
Net unrealized appreciation (depreciation) of equity interests	XXXX
Total stockholder's equity	XXXX
Total liabilities and stockholder's equity	XXXX

2260.0.10 APPENDIX 2—VENTURE CAPITAL COMPANY—SAMPLE INCOME STATEMENT

	For Fiscal Year Ended December 31, 19XX
INTEREST INCOME	
Interest on loans and debt securities	XXX
Dividends on equity interests	XXX
Interest on money market investments	XXX
Total interest income	XXX
INTEREST EXPENSE	
Interest on notes payable to affiliates	XXX
Interest on notes payable to others	XXX
Total interest expense	XXX
NET INTEREST INCOME	XXX
PROVISION FOR LOAN LOSSES	XXX
Net interest after provision for loan losses	XXX
OTHER REVENUE	
Income from assets acquired in liquidation of loans and investments	XXX
Management Fees	XXX
Total other revenue	XXX
Net interest and other revenue	XXX
NONINTEREST EXPENSE	
Salaries and benefits	XXX
Management and service fees	XXX
Other expenses	XXX
Total noninterest expense	XXX
Income before taxes	XXX
Applicable taxes	XXX
Net investment income	XXX
Realized gain (loss) on sale of securities, net of tax	XXX
Net income	XXX

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	3000.0.3	Appendix 2—Activities Considered ‘‘Closely Related to Banking’’ Under Section 4(c)(8) of the Bank Holding Company Act
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The Bank Holding Company Act of 1956 (BHC Act) was enacted to limit the expansion of banking institutions into nonbanking activities. A bank holding company was defined in the BHC Act as an entity that owned or controlled 25 percent or more of the voting shares of two or more banks; companies owning only one bank were exempted from regulation under the BHC Act.

During the 1960s, the number of commercial enterprises that purchased one bank, engaged in nonbanking activities, and remained exempt from regulation grew dramatically. As a result of this change in the structure of bank ownership, Congress enacted the Bank Holding Company Act Amendments of 1970. Of these amendments, the most significant is the extension of the act to grant to the Federal Reserve Board the authority to regulate the activities of one-bank holding companies.

In 1978, Congress passed the International Banking Act (IBA). Section 8 of the IBA expanded the nonbanking prohibitions of the BHC Act to foreign banks that engage in the business of banking in the United States directly through a branch or agency or indirectly through a subsidiary commercial lending company. This expanded the nonbanking restrictions beyond simply covering foreign banks that own or control U.S. banks or bank holding companies. However, section 2(h) of the BHC Act provides foreign organizations that are principally engaged in the business of banking outside the United States with exemptions from the nonbanking prohibitions of the BHC Act. Further exemptions have been granted by the Board's discretionary authority under section 4(c)(9) when such exemptions were in the public interest and were consistent with the purposes of the BHC Act.

Under section 4(c) of the BHC Act, Congress exempted a limited number of investments from the general prohibition against owning or controlling shares of nonbank concerns. Section 4(c)(8) permitted investment in ''shares of any company the activities of which the Board after due notice and opportunity for hearing has determined by regulation to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.'' The act also provided that any bank holding company might apply to the Board for permission to engage in an activity that had not yet been determined to be permissible if the applicant was of the opinion that the activity in its particular circumstances was closely related to banking or managing or controlling banks. Section 225.28(b) of the Board's Regulation Y lists permissible nonbanking activities that the Board has deemed to meet these criteria. (See appendix 1.) The list of permissible nonbanking activities has been expanded at various times.

The Board also has permitted by order, on an individual basis, certain activities that it has considered to be closely related to banking under section 4(c)(8) of the BHC Act. In doing so, the Board did not expand the list of permissible activities under section 225.28(b) of Regulation Y. (For a list of such activities, see appendix 2.)

In determining whether the performance of a nonbank activity by a bank holding company or the acquisition of a nonbank firm by a bank holding company was a proper incident to banking, the Board applied a ''public interest test.'' The Board determined whether the proposed new activity or proposed acquisition ''[could] reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.''

An interpretation of Regulation Y (12 C.F.R. 225.126) dated April 28, 1972, and amended September 20, 1972, listed activities that the Board determined do not satisfy the ''so closely related'' test under section 4(c)(8). The Board subsequently determined that a number of other activities do not satisfy the closely related test. (For a complete list of these impermissible activities, see appendix 3, and, for a brief description of a selected number of the activities denied by the Board, see section 3700.0 et seq.)

As the primary regulator for bank holding companies and their directly held nonbank subsidiaries, the Federal Reserve System conducts inspections of their operations, financial condition, and compliance with appropriate banking and other related statutes and regulations. Inspection personnel are called upon to evaluate the current condition of the organizations, as well as their future prospects.

On August 10, 1987, the Competitive Equality Banking Act of 1987 was signed into law. This act redefined the definition of ''bank'' in section 2 of the BHC Act so that an FDIC-insured institution is deemed a bank.

State-Authorized Activities of Savings Banks

A special rule was established for qualified savings banks (state-chartered, FDIC-insured institutions organized before March 5, 1987) that are subject to the BHC Act. (See section 2090.7.) In accordance with section 3 of the BHC Act, a qualified savings bank may engage in any nonbanking activity, except insurance activities, either directly or through a subsidiary, that it is permitted to conduct directly as a state-chartered savings bank, even if those activities are not otherwise permissible for bank holding companies. To engage in those activities, however, a qualified savings bank must remain a savings bank and a subsidiary of a savings bank holding company (a company that controls one or more qualified savings banks whose total aggregate assets, upon formation and at all times thereafter, constitute at least 70 percent of the assets of the holding company). With respect to insurance activities, qualified savings banks may engage in underwriting and selling savings bank life insurance if the savings bank is located in Connecticut, Massachusetts, or New York, and if certain other conditions are met.

BHCs Engaging in Nonbanking Activities in Foreign Countries

A bank holding company has greater leeway to perform nonbanking activities abroad than in the United States in that it may engage in nonbanking activities abroad that would not be permissible in the United States. However, activities abroad are subject to limitations. Section 211.8 of Regulation K requires a bank holding company to limit its direct and indirect activities abroad to those usual in connection with banking and financial activities and to necessary related activities. Section 211.10 also lists particular activities that are permissible abroad and provides rules regarding when a bank holding company must submit an application to engage in such activities directly or through investments.

Edge Act or Agreement Corporations

A bank holding company may own an Edge Act or agreement corporation. The Federal Reserve Act and Regulation K govern the permissible activities of Edge Act or agreement corporations. An Edge Act or agreement corporation is an international banking vehicle that may only engage in listed or approved activities that are incidental to international or foreign business. (See 12 C.F.R. 211.6) The restriction generally permits an Edge Act or agreement corporation to engage only in international banking or financial activities. (See 12 C.F.R. 211.8.) A separate manual, *Guidelines and Instructions for Examination of Edge Corporations*, sets forth the rules and procedures for examining Edge Act or agreement corporations and for determining whether their activities are permissible.

Companies that own only an Edge Act or agreement corporation. Any company, other than a bank, that acquired an Edge Act or agreement corporation after March 5, 1987, must conform its activities to section 4 of the BHC Act.

Underwriting and Dealing in Debt and Equity Securities

Beginning in January 1989, certain nonbanking subsidiaries of bank holding companies were approved to underwrite and deal in debt or equity securities (excluding open-end investment companies), subject to the prohibition on affiliation with an organization dealing in securities under section 20 of the Glass-Steagall Act. (See 1989 FRB 192.) The Board delayed commencement of the activity by each applicant until it determined that the applicant had established the necessary managerial and operational infrastructure to commence the expanded underwriting and dealing activity and to comply with the Board order. The applicant's capital plan had to be determined to be adequate along with the necessary policies and procedures needed to comply with the Board's order. The Board's order requires that loans to and capital investments in the underwriting subsidiary be deducted from the bank holding company's capital, as provided for in the Board's capital adequacy guidelines. The Board further confirmed that the activities could not be conducted in any other subsidiary other than the Board-approved section 20 subsidiary. (See section 3600.21.4.)

As for underwriting and dealing in equity securities, the Board stated in the order that it would review within a year whether applicants could commence the activity. The first Board authorization to commence underwriting and dealing in equity securities was given on September 20, 1990, subject to the commitments given by the bank holding company in connection with its respective Board order, including its commitment to maintain the capital of its section 20 subsidiary at levels necessary to support its activities and commensurate with industry standards, and to increase the capital of the section 20 subsidiary accordingly as it grew.

Modifications to the Board's Orders Authorizing BHC Subsidiaries to Underwrite and Deal in Bank-Ineligible Securities Consistent with Section 20 of the Glass-Steagall Act

The Board announced its approval of modifications to its previous section 20 authorizations by order on September 21, 1989 (1989 FRB 751). The modifications (1) raised from 5 percent to 10 percent (currently 25 percent) the revenue limit on the amount of total revenues a section 20 subsidiary might derive from bank-ineligible securities underwriting and dealing activities, and (2) permitted underwriting and dealing in the securities of affiliates, consistent with section 20 of the Glass-Steagall Act, if the securities were rated by an unaffiliated, nationally recognized statistical rating organization or were issued or guaranteed by the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (FHLMC), or the Government National Mortgage Association (GNMA), or if they represented interests in such obligations.

Acting as Agent in the Private Placement of All Types of Securities and Acting as Riskless Principal in Buying and Selling Securities

In another Board order, the Board authorized a bank holding company to transfer its private-placement activities from its commercial bank subsidiary to its section 20 subsidiary. The section 20 subsidiary would act as agent in the private placement of all types of securities, including the provision of related advisory services, and would buy all types of securities on the order of investors as a "riskless principal." The Board concluded that the section 20 subsidiary's private placement of debt and equity securities within the limits proposed did not involve the underwriting or public sale of securities for the purposes of section 20 of the Glass-Steagall Act. The revenues derived therefrom should not be subject to the 25 percent revenue limitation placed on bank-ineligible securities activities. (See section 3230.4.)

Foreign Banks Authorized to Operate Section 20 Subsidiaries to Underwrite and Deal in Corporate Debt, Commercial Paper, and Other Securities

In a Board order (1990 FRB 158), the Board authorized a foreign bank to operate a section 20 subsidiary under the bank to underwrite and deal in corporate debt, commercial paper, and other securities. (Securities issued by open-end investment companies are not included.) The foreign bank operated outside the United States but owned a subsidiary bank in the United States. To achieve equality between the domestic and foreign banking operations in the United States and in an effort to negate any advantages that a foreign bank might have over a domestic bank, the Board considered the foreign bank as a bank holding company even though the bank was not part of a bank holding company structure. In so doing, the Board imposed restrictions on the section 20 subsidiary. The foreign bank might fund the section 20 subsidiary, but that action required prior Board approval. In addition, the section 20 subsidiary might not borrow from its parent bank. Any loans to, transfers of assets to, or investments in the section 20 subsidiary also required Board approval. (See 1990 FRB 158, 455, 554, 568, 573, 652, and 683.)

Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)

FIRREA became law on August 9, 1989. The law revised section 4(c)(8) of the BHC Act and authorized the Board to approve applications from bank holding companies for the acquisitions of savings associations. The Board thus revised section 225.28(b)(4)(i) of Regulation Y to include as a permissible nonbanking activity the owning, controlling, or operating of a savings association, if the savings association engaged only in deposit-taking, lending, and other activities permissible for bank holding companies. The legislation required the Board to remove tandem restrictions found in previous Board orders that were not prohibited by FIRREA and, in approving applications, to confine limitations on transactions between the savings association and its bank holding company affiliates to those required by sections 23A and 23B of the Federal Reserve Act. FIRREA made sections 23A and 23B applicable to savings associations as though they were member banks. Two exceptions apply: (1) no extensions of credit may be granted by a savings association to an affiliate unless the affiliate is engaged only in activities permissible for bank holding companies under the BHC Act, and (2) savings associations may not purchase or invest in securities of an affiliate other than shares of a subsidiary. The legislation also provided for a ''sister-bank'' exemption from the provisions of sections 23A and 23B of the Federal Reserve Act. (See sections 2020.1.1.6 and 2090.8.1.)

1992 Revisions to the Regulation Y List of Nonbanking Activities—the ''Laundry List''

During 1992, the Board initiated several actions that affected certain nonbanking activities. The first action, effective May 18, 1992, amended section 225.28(b) of Regulation Y with regard to tangible personal property leases. Subject to the stated limitations, a bank holding company can rely on estimated residual values of up to 100 percent of the acquisition costs of the leased property in order to recover the bank holding company's leasing costs. Previously, the nonbanking activity had only been approved by Board order. (See the initial Board order at 1990 FRB 462 and the subsequent Board orders at 1990 FRB 960 and 1991 FRB 187 and 490.)

The Board issued a revised interpretive rule, effective August 10, 1992, regarding investment advisory activities of bank holding companies to expressly provide that a bank holding company or its nonbank subsidiary may act as agent for customers in the brokerage of shares of an investment company advised by the holding company or any of its subsidiaries. In addition, the revision provided that a bank holding company or its nonbank subsidiary may provide investment advice to customers regarding the purchase or sale of shares of an investment company advised by an affiliate. In both instances, the Board requires certain disclosures to be made to address potential conflicts of interest or adverse effects. (See 12 C.F.R. 225.125(h) of Regulation Y.)

Effective September 10, 1992, the Board added two nonbanking activities to Regulation Y that were previously approved by Board order. The two activities dealt with full brokerage services and financial advisory services. (See 12 C.F.R. 225.28(b)(6) and (7).)

Comprehensive Revision of Regulation Y

In August 1996, the Board proposed comprehensive revisions to Regulation Y that were designed to significantly reduce regulatory burden, improve efficiency, and eliminate unwarranted constraints on credit availability. The proposal followed a Board review of its regulations that was required by the Riegle Community Development and Regulatory Improvement Act of 1994. The changes (1) removed a number of restrictions on the permissible nonbanking activities of BHCs, (2) expanded and reorganized the regulatory list of permissible nonbanking activities to include numerous nonbanking activities that had been previously approved only by Board order,[1] (3) streamlined the application/notice process for BHCs and the procedures governing change in bank control notices, and (4) revised the tying rules to enhance banking organizations' ability to provide customer discounts on services. Included were changes that streamlined the procedures for well-run BHCs to seek Federal Reserve System approval to acquire additional banks within certain limits. The Board approved these revisions to Regulation Y, effective April 21, 1997.

Limitation on Board-Approved Nonbanking Activities

The Gramm-Leach-Bliley Act (the GLB Act) amended the BHC Act to limit bank holding companies that are not financial holding companies to engaging only in ''activities which had been determined by the Board by regulation or order under section 4(c)(8) of the BHC Act and section 225.28 of Regulation Y before November 12, 1999 (the approval date of the GLB Act), to be so closely related to banking as to be a proper incident thereto (subject to such terms and conditions contained in such regulation or order, unless modified by the Board)'' (12 U.S.C. 1843(c)(8)). Prior to November 12, 1999, the

1. See subsection 3000.0.2, appendix 1. See also section 225.28(b) of Regulation Y. In addition to these activities, other activities have been approved by Board order. For a list of those activities, see subsection 3000.0.3, appendix 2.

Board had determined that ''[a]ny activity usual in connection with making, acquiring, brokering, or servicing loans or other extensions of credit, as determined by the Board'' is closely related to banking. Accordingly, the Board retains authority after the GLB Act to define the scope of this section 4(c)(8) activity and to modify the terms and conditions that apply to the activity.

Financial Holding Companies

The GLB Act, approved in November 1999, amended section 4 of the BHC Act and expanded the powers of qualifying BHCs and foreign banks that elect to become financial holding companies (FHCs). An FHC is defined in the GLB Act as a BHC that meets certain eligibility requirements. The law repealed those provisions of the Glass-Steagall Act and the BHC Act that restricted the ability of BHCs to affiliate with securities firms and insurance companies. For a bank holding company to become an FHC and be eligible to engage in new activities authorized under the GLB Act, the GLB Act requires that all depository institutions controlled by the BHC be well capitalized and well managed. With regard to a foreign bank that operates a branch or agency or that owns or controls a commercial lending company in the United States, the GLB Act requires the Board to apply comparable capital and management standards that give due regard to the principle of national treatment and equality of competitive opportunity.

Qualifying BHCs that elect to become FHCs can engage in a broad array of financially related activities, including (1) securities underwriting and dealing, (2) insurance agency and insurance underwriting activities, and (3) merchant banking activities. With respect to merchant banking, the GLB Act (1) permits an FHC to retain a merchant banking investment only as long as necessary to dispose of the investment on a reasonable basis consistent with the financial viability of its merchant banking activities, and (2) provides that an FHC may not routinely manage or operate a company held as a merchant banking investment except as necessary to obtain a reasonable return on the investment.

The statute also sets forth parameters for the relationships between the Federal Reserve and other regulators. The statute differentiates between the Federal Reserve's relations with regulators of depository institutions and functional regulators, such as those for nonbanking or nonfinancial activities such as insurance, securities, and commodities activities.

An FHC may engage in any other activities that the Board and the Secretary of the Treasury jointly determine to be financial in nature or incidental to financial activities. An FHC may also engage in any nonfinancial activity that the Board determines (1) is complementary to a financial activity and (2) does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. The activities of BHCs and foreign banks that are not FHCs continue to be limited to activities currently authorized under section 4(c) of the BHC Act to be closely related to banking and permissible for BHCs. No additional activities may be found to be so closely related to banking as to be a proper incident thereto after November 11, 1999, thus limiting the ability of BHCs and foreign banks that are not FHCs to expand their activities.

In this manual, the sections in the 3900 series have been designated for FHCs. Those sections discuss FHC qualification requirements (domestic and foreign); permissible nonbanking FHC activities designated by statute (for example, merchant banking activities) or regulation, including activities jointly approved by the Board and the Secretary of the Treasury; and the supervisory approach and guidance for FHCs.

To implement the provisions of the GLB Act that govern FHCs, the Board amended Regulation Y by adding subpart I for FHCs. The provisions of an interim rule became effective March 11, 2000, and the Board approved a final rule effective December 21, 2000. Key provisions of the final rule are discussed within the 3900 sections of this manual. With respect to permissible activities of FHCs, the rule includes activities that previously were determined to be closely related to banking under section 225.28 of Regulation Y, activities that are usual in connection with transactions of banking abroad (including those in section 211.10 of Regulation K), and other activities defined as financial in nature by the GLB Act.

3000.0.1 CATEGORIES OF NONBANKING ACTIVITIES

Section 4(c)(8) of the BHC Act authorizes bank holding companies to engage directly or through a subsidiary in activities that the Board determined before November 12, 1999, to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. The Board and the courts established the following guidelines for determining whether a nonbanking activity is closely related to banking:[2]

1. whether banks have generally provided the service
2. whether banks generally provide services that are operationally or functionally so similar to the proposed service as to equip them particularly well to provide the proposed service
3. whether banks generally provide services that are so integrally related to the proposed service as to require their provision in specialized form

In addition, before November 12, 1999, the Board considered other factors in deciding what activities were closely related to banking.[3] For those activities found to be closely related to banking or to managing or controlling banks, the Board also must find that the proposed activity is a ''proper incident'' to banking and that performance of an activity by a bank holding company could reasonably be expected to produce benefits to the public (such as greater convenience, increased competition, or gains in efficiency) that outweigh possible adverse effects (such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices). The following describes three categories of bank holding company nonbanking activities:

1. those that have been found to be permissible and are listed in Regulation Y, the so-called laundry list activities (see appendix 1)
2. those that are permissible by Board order only (see appendix 2)
3. those that have been denied by the Board (see appendix 3)

2. *National Courier Association v. Board of Governors,* 516 F. 2d 1229 (D.C. Cir. 1975).

3. *Alabama Association of Insurance Agents v. Board of Governors,* 533 F.2d 224 (5th Cir. 1976), *cert. denied,* 435 U.S. 904 (1978).

3000.0.2 APPENDIX 1—Activities Approved by the Board as Being Considered "Closely Related to Banking" Under Section 4(c)(8) of the Bank Holding Company Act (Section 225.28(b) of Regulation Y)

Permitted by Regulation[1]	*Year Added to Regulation Y*
Note: The bulleted items in this appendix are provided for historical reference only. The narrative before the bulleted items reflects the current Regulation Y authorization.	
1. Extending credit and servicing loans	1971
Making, acquiring, brokering, or servicing loans or other extensions of credit (including factoring, issuing letters of credit, and accepting drafts) for the company's account or the account of others.	
2. Activities related to extending credit[2]	
a. Appraising	
(1) Real estate appraising	1980
(2) Personal property appraising	1986
b. Arranging commercial real estate equity financing	1983
c. Check-guaranty services	1986
d. Collection agency services	1986
e. Credit bureau services	1986
f. Asset management, servicing, and collection activities	1997
g. Acquiring debt in default	1995
h. Real estate settlement servicing	1997
3. Leasing personal or real property or acting as agent, broker, or adviser in leasing such property	
• Personal property leasing[3]	1971
• Real property leasing	1974
4. Operating nonbank depository institutions	
a. Owning, controlling, or operating an industrial bank, Morris Plan bank, or industrial loan company so long as the institution is not a bank	1971
b. Owning, controlling, or operating a savings association, if the savings association engages in deposit-taking activities, lending, and other activities that are permissible for bank holding companies	1989
5. Trust company functions or activities	1971
6. Financial and investment advisory activities: acting as an investment adviser or financial adviser to any person, including (without limiting these activities in any way)—	1971

Permitted by Regulation[1]	*Year Added to Regulation Y*
a. Serving as an investment adviser to an investment company registered under the Investment Company Act of 1940, including sponsoring, organizing, and managing a closed-end investment company	1972
• Investment or financial advising	1971
• Advisory services to open-end (mutual fund) investment companies	1972
b. Furnishing general economic information and advice, general economic statistical forecasting services, and industry studies	1984
c. Providing advice in connection with mergers, acquisitions, divestitures, investments, joint ventures, leveraged buyouts, reorganizations, recapitalizations, capital structurings, financing transactions, and similar transactions,[4] and conducting financial feasibility studies[5]	1992
• Financial futures and options on futures	1986
d. Providing information, statistical forecasting, and advice with respect to any transaction in foreign exchange, swaps and similar transactions, commodities, and any forward contract, option, future, option on a future, and similar instruments	1992
• Financial futures and options on futures	1986
• Providing financial advice to—	
— state and local governments and	1973
— foreign governments, including foreign municipalities and agencies of foreign governments, such as with respect to the issuance of their securities	1992
• Inclusion of any investment or financial advisory activity without restriction	1997
• Discretionary investment advice to be provided to any person (includes investment advice regarding derivative transactions to institutional or retail customers as an investment, commodity trading, or other adviser) regarding contracts related to financial or nonfinancial assets (such advice is no longer restricted to institutional customers)	1997
• Financial and investment advice (or any permissible nonbanking activity) can be provided in any combination of permissible nonbanking activities listed in Regulation Y	1997
e. Providing educational courses and instructional materials to consumers on individual financial-management matters	1986
f. Providing tax-planning and tax-preparation services	1986
7. Agency transactional services for customer investments (principal positions)	
a. Securities brokerage services (including securities clearing and/or securities execution services on an exchange) for the account of customers and does not include securities underwriting or dealing	
(1) Securities brokerage services (including securities clearing and/or securities execution services on an exchange), whether alone or	1982
(2) In combination with advisory services and incidental activities (including related securities credit activities and custodial services)	1992
b. Riskless-principal transactions	1997
c. Private-placement services	1997
d. Futures commission merchant activities	1984
• A nonbanking subsidiary may act as an FCM with respect to any exchange-traded futures contract and options on a futures contract based on a financial or nonfinancial commodity	1997

Permitted by Regulation[1]	Year Added to Regulation Y
e. Other transactional services such as providing to customers as agent transactional services with respect to the following:	1997
(1) Swaps and similar transactions	
(2) Investment transactions as principal[6]	
(3) Transactions permissible for a state member bank	
(4) Any other transaction involving a forward contract, an option, futures, an option on a futures or similar contract (whether traded on an exchange or not) relating to a commodity that is traded on an exchange	
8. Investment transactions as principal	
a. Underwriting and dealing in government obligations and money market instruments	1984
b. Investing and trading activities. Engaging as principal in the following:	
(1) Foreign exchange	1984
(2) Forward contracts, options, futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on any rate, price, financial asset (including gold, silver, platinum, palladium, copper, or any other metal approved by the Board), nonfinancial asset, or group of assets, other than a bank-ineligible security, if the transaction meets certain requirements (A bank-ineligible security is any security that a state member bank is not permitted to underwrite or deal in under 12 U.S.C. 24 and 335.)	1997
(3) Forward contracts, options, futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on an index of a rate, a price, or the value of any financial asset, nonfinancial asset, or group of assets, if the contract requires cash settlement	1997
9. Management consulting and counseling activities	
a. Providing management consulting advice on any matter (financial, economic, accounting, or audit) to any other company[7]	
• Unaffiliated banks (depository institutions)	1974
• Nonbank depository institutions	1982
• Other unaffiliated depository institutions	1997
• Any financial, economic, account, or audit matter to any other company	1997
b. Employee benefits consulting services	1997
c. Career counseling services	1997
10. Support services	
a. Courier services	1973
b. Printing and selling MICR-encoded checks and related documents	1997
11. Insurance agency and underwriting	
a. Credit insurance: acting as principal, agent, or broker for insurance (including home mortgage redemption insurance)	
• Acting as insurance agent or broker primarily in connection with credit extensions[8]	1971
• Underwriting credit life and credit accident and health insurance related to an extension of credit	1972

Permitted by Regulation[1]	*Year Added to Regulation Y*
b. Finance company subsidiary: insurance agent or broker for extension of credit by finance company subsidiary	1982
c. Insurance agency activities in small towns	1984
d. Insurance agency activities conducted on May 1, 1982	1984
e. Supervision of retail insurance agents	1984
f. Insurance agency activities by small bank holding companies	1984
g. Insurance agency activities conducted before 1971	1984
12. Community development	
a. Financing and investment in community development activities	1971
b. Advisory and related services designed to promote community welfare	1997
13. Issuance and sale of payment instruments	
a. Issuance and sale of retail money orders	1984
b. Sale of savings bonds	1979
c. Issuance and sale of traveler's checks	1981
14. Data processing	
a. Providing data processing and data transmission services; facilities (including data processing and data transmission hardware,[9] software, documentation, or operating personnel); databases; advice; and access to services, facilities, or databases by any technological means	
• Providing bookkeeping and data processing	1971
• Data processing and transmission services	1982
• Providing data processing and transmission advice to anyone on processing and transmitting banking, financial, and economic data	1997
b. Conducting data processing and data transmission activities not described in "a." that are *not* financial, banking, or economic[10]	1997

1. See section 225.28(b) of Regulation Y for the details of the regulatory authorizations.
2. A Board staff opinion, issued July 9, 2002, concluded that a BHC's certain proposed flood zone–determination services are usual in connection with making mortgage loans and that these activities are within the scope of permissible activities related to extending credit under section 225.28(b)(2) of Regulation Y.
3. The provision of higher residual value leasing for tangible personal property was added to Regulation Y in 1992, including acting as agent, broker, or adviser in leasing such property.
4. The words "and similar transactions" were added in 1997.
5. Feasibility studies do not include assisting management with the planning or marketing for a given project or providing general operational or management advice.
6. Transactions described in section 225.28(b)(8) of Regulation Y.
7. Management consulting services may be provided to other customers not described in section 225.28(b)(9) of the rule, but the revenues derived therefrom are subject to a 30 percent annual revenue limitation.
8. Scope narrowed to conform to court decisions in 1979 and 1981; in 1982, it was further narrowed by title VI of the Garn–St Germain Depository Institutions Act.
9. Beginning in April 1997, the general-purpose hardware may not constitute more than 30 percent (previously 10 percent) of the cost of any package offering.
10. The total revenue may not exceed 30 percent (increased to 49 percent, effective January 8, 2004) of the company's total annual revenues derived from data processing, data storage, and data transmission activities.

3000.0.3 APPENDIX 2—Activities Considered ''Closely Related to Banking'' Under Section 4(c)(8) of the Bank Holding Company Act

	Permitted by Order on an Individual Basis	*Year Approved*	*Manual Section 3600.*
1.	Operating a ''pool-reserve plan'' for the pooling of loss reserves of banks with respect to loans to small businesses	1971	1
2.	Operating an article XII New York investment company	1977	5.1
3.	Underwriting and dealing in commercial paper to a limited extent	1987	21.1
4.	Underwriting and dealing in, to a limited extent, municipal revenue bonds, mortgage-related securities, and commercial paper	1987	21.2
5.	Underwriting and dealing in, to a limited extent, municipal revenue bonds, mortgage-related securities, consumer receivable–related securities, and commercial paper	1987	21.3
6.	Issuing and selling mortgage-related securities backed by the guarantees of the Government National Mortgage Association	1988	23
7.	Engaging in title insurance agency activities (approved under exemption G of the Garn–St Germain Depository Institutions Act of 1982)	1988	17.1
8.	Underwriting and dealing in, to a limited extent, corporate debt and equity securities	1989	21.4
9.	Acting as a sales-tax refund agent	1990	24.1
10.	Providing real estate settlement activities through a permissible title insurance agency (exemption G companies only)	1990	26
11.	Providing administrative and certain other services to mutual funds	1993	27
12.	Acting as a dealer-manager in connection with cash-tender and exchange-offer transactions	1993	21.5
13.	Privately placing limited partnership interests	1994	8
14.	Engaging in real estate title abstracting	1995	30
15.	Providing employment histories to third parties	1995	29
16.	Underwriting ''private ownership'' industrial development bonds by a section 20 company	1995	21.6
17.	Serving as a commodity pool operator of investment funds engaged in purchasing and selling futures and options on futures on certain financial and nonfinancial commodities	1996	13.1

Permitted by Order on an Individual Basis	Year Approved	Manual Section 3600.
18. Development of broader marketing plans and advertising, sales literature, and marketing materials for mutual funds (see 1997 FRB 678)	1997	28
19. Sale of government services involving (see 1998 FRB 481)—	1998	25
a. postage stamps and postage-paid envelopes b. public transportation tickets and tokens c. vehicle registration services (including the sale and distribution of license plates and license tags for motor vehicles) d. notary public services		
20. Operating a securities exchange	1999	6
21. Acting as a certification authority for digital signatures	1999	7

3000.0.4 APPENDIX 3—Activities Considered Not to Be "Closely Related to Banking" Under Section 4(c)(8) of the Bank Holding Company Act

	Activities Denied by the Board	*Year Denied*
1.	Insurance premium funding ("equity funding") (combined sales of mutual funds and insurance)	1971
2.	Underwriting general life insurance not related to credit extension	1971
3.	Real estate brokerage	1972
4.	Land investment and development	1972
5.	Real estate syndication	1972
6.	General management consulting	1972
7.	Property management	1972
8.	Trading in platinum and palladium coin and bullion[1]	1973
9.	Armored car service[2]	1973
10.	Sale of level term credit life insurance	1974
11.	Underwriting mortgage guarantee insurance	1974
12.	Computer output microfilm services[3]	1975
13.	Operating a travel agency	1976
14.	Underwriting property and casualty insurance	1978
15.	Real estate advisory activities	1980
16.	Certain contract key entry services	1980
17.	Offering investment notes with transactional features	1982
18.	Engaging in "pit arbitrage" spread transactions on commodities exchanges to generate trading profits	1982
19.	Engaging in the publication and sale of personnel tests and related materials	1984
20.	Providing credit ratings on bonds, preferred stock, and commercial paper	1984
21.	Providing independent expert actuarial opinions of a general nature for purposes such as divorce action and personal injury litigation	1984
22.	Acting as a specialist in foreign-currency options on a securities exchange	1985

Activities Denied by the Board	*Year Denied*
23. Title insurance activities (See the Board letter dated March 17, 1986, re: Independence Bancorp, Inc. and the Board order at 1989 FRB 31)	
24. Acting as a broker for customers in the purchase and sale of forward contracts based on certain financial and nonfinancial commodities, and acting as the primary clearing firm for professional floor traders[4]	1991

1. Authorized by the Board in 1995 FRB 190 (platinum) and 1996 FRB 571 (palladium).

2. On June 18, 1990, the Board determined that the activity of providing armored car services to the general public is closely related to banking (see 1990 FRB 676). In order for the Board to approve a nonbank activity for a bank holding company, the Board must also find that the activity is a "proper incident thereto." On February 10, 1993, the Board denied the application (1993 FRB 352), finding that the proposed transactions posed potential violations of section 23B of the Federal Reserve Act and that the applicant had failed to prove that the activity is a proper incident to banking.

3. The Board's interpretation of Regulation Y at 12 C.F.R. 225.123 was amended on November 25, 1987, by deleting item (e)(4) relating to the impermissibility of the activity (see 52 *Federal Register* 45160–45161 and 1987 FRB 933).

4. The Board subsequently approved this activity by Board order. (See 1997 FRB 138.)

As an FDIC insured institution, a savings bank qualifies as a ‘‘bank’’ under section 2(c) of the BHC Act, as amended by section 101(a) of the Competitive Equality Banking Act of 1987 (‘‘CEBA’’). CEBA amended the BHC Act, in section 3(f), stating that any qualified savings bank, which is a subsidiary of a bank holding company, could engage directly, or through a subsidiary, in any nonbanking activity, except for certain insurance activities, that it is permitted to engage in by State law—including activities which are not otherwise permitted for bank holding companies under section 4(c)(8) of the BHC Act. In order for a qualified savings bank, that is a subsidiary of a bank holding company, to engage in such activities, however, the bank holding company must be a savings bank holding company as defined in section 2(l) of the BHC Act, in other words, 70 percent of the assets of the bank holding company must consist of one or more savings banks at the time of formation.

Insurance activities of any qualified savings bank which is a subsidiary of a bank holding company are limited to the insurance activities allowed under section 4(c)(8) of the BHC Act. A qualified savings bank that was authorized to engage in the sale or underwriting of savings bank life insurance, as of March 5, 1987, can sell or underwrite such insurance directly, provided that it is permitted to underwrite and engage in the sale of savings bank life insurance as that activity is authorized for savings banks by state law, and is located in Massachusetts, Connecticut, or New York. Should the bank holding company parent of the qualified savings bank cease to be a savings bank holding company, the savings bank must cease engaging in these activities within two years.

In a separate application a nonoperating company, which was formed for the purpose of acquiring a savings bank, insured by the Federal Deposit Insurance Corporation, applied for the Board’s approval to become a bank holding company pursuant to section 3(a)(1) of the Bank Holding Company Act, acquiring all of the voting shares of the savings bank. The savings bank engages through subsidiaries in real estate investment and development activities authorized pursuant to State law.

As part of the Board’s analysis in this case, including its evaluation of the capital and financial resources of the bank holding company and the bank involved, the Board considered the risk to the Applicant and to the savings bank of the real estate development activities to be conducted by the savings bank through its nonbank subsidiaries. The Board expressed serious reservations with regard to this application and similar applications by bank holding companies to acquire savings banks engaged directly or through subsidiaries in real estate development activities. In the Board’s view the conduct of real estate development activities through a holding company subsidiary rather than a bank subsidiary would provide more effective corporate separateness.

The Board approved the application by Order on October 30, 1987 (1987 FRB 925), relying on the Applicant’s commitments.

3010.0.1 INTRODUCTION

The prohibitions against a bank holding company having or acquiring nonbank interests do not apply to bank holding companies meeting the requirements of section 4(c)(i) and (ii) of the Act.

3010.0.2 LABOR, AGRICULTURAL OR HORTICULTURAL ORGANIZATIONS

Section 4(c)(i)—‘‘Any company that was on January 4, 1977, both a bank holding company and a labor, agricultural or horticultural organization exempt from taxation under section 501 of the Internal Revenue Code of 1954, or . . . any labor, agricultural or horticultural organization to which all or substantially all of the assets of such company are hereafter transferred.’’

Exemption under this section was amended when the Financial Institutions Regulatory and Interest Rate Control Act of 1978 became effective early in 1979. The effect of the amendment was to repeal exemption under this section for labor, agricultural or horticultural organizations becoming BHCs after *January 4, 1977*, except for those organizations becoming BHCs by means of acquiring all or substantially all of the assets of a company that was both a BHC and a labor, agricultural or horticultural oganization exempt from taxation on January 4, 1977. In order for a holding company to be entitled to this exemption, net income derived from the organization cannot inure to the benefit of any individual. Organizations must be formed primarily for the betterment of the working conditions of the labor organization's members, or improvement in the grade of agricultural or horticultural products for an agricultural or horticultural organization. The growing of products for profit by agricultural or horticultural organizations would disqualify them for exemption. Thus the phrase ‘‘any labor, agricultural or horticultural organization’’ is intended to include only such organizations that are also exempt from taxation under section 501 of the Internal Revenue Code of 1954.

In order for a labor, agricultural or horticultural organization to receive exemption from taxation under section 501(c)(5) of the Internal Revenue Code of 1954, it must file an application (form 1024) with the IRS. In response to the application, the organization receives a determination letter which should be reviewed to assure that exemption was allowed and to verify the date the company became exempt under section 501. The date of exemption is determined as follows. A company which files for exemption within 18 months after its organization is considered exempt as of the date of its organization. The date of IRS approval is the date of exemption if application for exemption is filed more than 18 months after organization. The date of exemption must be no later than January 4, 1977, for the company to be entitled to exemption from section 4 of the Act. The fact that an organization pays income taxes annually does not disallow its exemption under section 501 of the tax code. Despite its tax exemption, an organization is subject to tax on its unrelated business income.

3010.0.3 FAMILY-OWNED COMPANIES

Section 4(c)(ii)—‘‘A company covered in 1970 more than 85 percentum of the voting stock of which was collectively owned on June 30, 1968, and continuously thereafter, directly or indirectly, by or for members of the same family, or their spouses, who are lineal descendants of common ancestors.’’

The phrase ‘‘voting stock’’ does not limit the form of an organization to an incorporated entity. Exemption under this section extends to other forms of business associations which meet the definition of a company. For example, for a partnership, the 85 percent rule applies to ‘‘general partnership interest’’ and for a trust which meets the definition of a company, the 85 percent rule applies to ‘‘beneficial ownership.’’ A company must continue to control the same subsidiary bank that it controlled on June 30, 1968, to retain its exemption under this section. Lineal descendants of common ancestors include descendants by half as well as full blood and legally adopted children.

In January 1980, the Board approved an application of a one-bank holding company covered by the exemption in 4(c)(ii) to acquire an additional bank, but stated that the holding company could no longer rely on that section for conducting its nonbanking activities. Based upon its review of the legislative intent of Congress in providing this exemption, it was the Board's judgment that the exceptionally broad exemption afforded by section 4(c)(ii) must be limited to family-owned one-bank holding companies that are not engaged in the management of banks. Moreover, in the Board's view, upon the acquisition of an additional bank, a one-bank holding company that is exempt under section 4(c)(ii) of the Act, would become engaged in the management of banks, and would thereby terminate its eligibility for the exemption. In addition, the Board believed that to permit unsupervised nonbank expansion by a multibank holding company would constitute an evasion of the Act, which the Board is authorized to prevent pursuant to section 5(b) of the Act.

3010.0.4 INSPECTION OBJECTIVES

1. To verify that a holding company qualifies for exemption from the prohibitions of section 4 by virtue of either section 4(c)(i) or 4(c)(ii).
2. Review the activities conducted by a company qualifying for an exemption under section 4(c)(ii) of the BHC Act, which may be faced with revocation of the exemption, and determine if there may be eligibility for permanent grandfathering under section 4(a)(2) of the BHC Act.

3010.0.5 INSPECTION PROCEDURES

1. Although bank holding companies qualifying for a section 4(c)(i) or 4(c)(ii) exemption are not routinely inspected on a periodic basis, when inspected their exempt status should be verified. All nonbank activities of exempt organizations should be examined in the inspection. The nature of all such activities and the dates they were commenced should be documented in the work papers to establish their current permissibility in the event the organization should lose its exemption from section 4.
2. For BHCs exempt under section 4(c)(i), the examiner should ascertain the date the company became exempt under section 501 of the tax code. Also, the stock books of the subsidiary bank or other pertinent documents should be reviewed to assure that the company was a BHC on January 4, 1977.
3. When verifying a company's exemption under section 4(c)(ii), the stock records of the subsidiary bank and the stock records, partnership agreements, trust agreements and other records of the bank holding company should be reviewed to assure that the following conditions have been satisfied:
    a. 25 percent or more of the voting stock of the subsidiary bank has been continuously owned by the BHC since June 30, 1968;
    b. Members of the same family have continuously held an 85 percent or more interest in the holding company since June 30, 1968.

3010.0.6 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Acquisition of an additional bank by a company exempt under 4(c)(ii)				1980 FRB 165
"Successor" to a Company Exempt under 4(c)(ii)				1980 FRB 349

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Section 4(c)(1) of the BHC Act (Investment in Companies Whose Activities are Incidental to Banking) Section 3020.0

3020.0.1 INTRODUCTION

By virtue of section 4(c)(1) of the Act, a bank holding company may invest, without supervisory approval, in the shares of companies engaged in activities that Congress felt were incidental to the business of banking. The following activities are permissible investments for bank holding companies under this section.

3020.0.2 PROVIDING BANKING QUARTERS

Section 4(c)(1)(A) provides that a BHC may invest in a company engaged in holding or operating properties used wholly or substantially by any banking subsidiary of such bank holding company in the operations of such banking subsidiary or acquired for such future use.

Normally, bank utilization of 50 percent or more of the property would meet the requirements of this section. Investments in property where usage of such property by subsidiary banks is less than 50 percent will be reviewed on an *ad hoc* basis to determine its permissibility under this section. Future needs of the bank holding company and its bank subsidiaries will be considered when reviewing these cases.

In acquiring property, a bank holding company must have definite plans for use of the property as a subsidiary bank's premises within a reasonable period of time. Property may not be acquired and indefinitely warehoused until a need develops for the property.

This section of the BHC Act does not provide the authority for a BHC to invest in the shares of a company engaged in holding or operating properties used by nonbank subsidiaries. Directly holding or operating properties used by a nonbank subsidiary is considered an incidental activity necessary to carry on the main business activity of the subsidiary and thus is exempt under section 4(a)(2)(A) of the Act and section 225.22(a)(2)(vi) of Regulation Y.

3020.0.3 SAFE DEPOSIT BUSINESS

Section 4(c)(1)(B) of the Act provides that a holding company may invest in the shares of a company whose activities are limited to conducting a safe deposit business. Refer to Section 225.22(b) of Regulation Y.

3020.0.4 FURNISHING SERVICES TO BANKING SUBSIDIARIES

Section 4(c)(1)(C) of the BHC Act provides that a BHC may invest in a company which furnishes services to or performs services for the bank holding company or its banking subsidiaries. Section 225.22(a) of Regulation Y provides that a bank holding company may, without the Board's prior approval, furnish services to or perform services for its banking and nonbanking subsidiaries either directly or indirectly through a subsidiary. Generally, a BHC may only provide services related to the internal operations of the BHC or its subsidiaries. A bank holding company or its subsidiaries may not rely on the servicing exemption to deal with the public as principal, but may deal with outside parties provided they are acting only as agent for the holding company or its subsidiaries.

The term "services" implies servicing operations a bank may carry on itself, but which the BHC chooses to have done through a nonbank subsidiary. Section 225.22(a)(2) states that services for the internal operations of the bank holding company or its subsidiaries include: accounting, auditing, appraising, advertising, public relations, data processing, data transmission services, data bases or facilities, personnel services, courier services, holding or operating property used wholly or substantially by a subsidiary in its operations or for its future use, and selling, purchasing or underwriting insurance such as blanket bond insurance, group insurance for employees, and property and casualty insurance. For the later insurance activities, bank holding companies are permitted under the servicing exemption to act as agent or to underwrite insurance on their own risks (e.g. blanket bond insurance or employee group insurance plans). Refer to section 225.22(a)(2) of Regulation Y for other services permissible for the internal operations of the BHC or its subsidiaries.

The servicing exemption extends to services that are normally performed by a bank for its customers or correspondent banks. These activities generally include computerized billing, payroll, accounting, financial records maintenance and other similar data processing services as long as the subsidiary bank is permitted under applicable State or federal law to provide the service. These services may be provided only upon request by the customers to the subsidiary bank. Furthermore, the contractual arrangements must be made between the customer and the bank. The company can service existing service contracts the bank has originated but is prohibited from purchasing the contracts or entering into contracts to provide services directly to the public.

The purchasing of participations by the parent in loans from subsidiary banks generally is not considered an exempt activity under the authority of sections 4(a)(2) or 4(c)(1). Holding companies that engage in the purchase of participations from their subsidiary banks should file an application pursuant to Section 4(c)(8) of the BHC Act. Purchasing participations in loans for the purpose of providing liquidity or acquiring a portion of a line of credit to facilitate the needs of the bank's customers (overlines) provides a service or benefit to the bank and is considered an acceptable purchase under the services exemption. In all cases where a participation in a loan is purchased, the loan must be made in the name of the bank and serviced by the respective bank. The purchasing of a loan for reasons other than those set forth above may be viewed as a direct lending activity.

3020.0.5 FURNISHING SERVICES TO NONBANK SUBSIDIARIES

The Bank Holding Company Act of 1956 prohibited a BHC itself from engaging in any business except (1) banking, (2) managing or controlling banks, and (3) furnishing services to its bank subsidiaries. In 1970, Congress amended section 4 of the BHC Act to expressly authorize a BHC to furnish services to or perform services for its nonbank subsidiaries as well as its bank subsidiaries under exemption A of section 4(a)(2). While section 4(c)(1) authorizes a BHC to invest in shares of a company engaged in certain activities, exemption A provides the authority for a BHC to engage in those activities directly.

The Board issued an interpretation (12 C.F.R. 225.141), effective August 1980, which stated that it will permit, without any regulatory approval, a bank holding company to form a wholly-owned subsidiary to perform servicing activities for both banking and nonbanking subsidiaries that the holding company itself could perform directly or through a department or a division under section 4(a)(2)(A) of the BHC Act. In addition, an approved section 4(c)(8) company may form a wholly-owned subsidiary to engage in activities that such company could itself engage in.

3020.0.6 LIQUIDATING ASSETS

Section 4(c)(1)(D) provides that a BHC may own shares of a company which engages in liquidating assets acquired from such BHC (not including its nonbank subsidiaries) or its banking subsidiaries or which were acquired from any other source prior to May 9, 1956, or the date on which such company became a BHC, whichever is later.

Assets acquired for liquidation by a section 4(c)(1)(D) subsidiary are subject to the same time limitations as shares acquired D.P.C. pursuant to section 4(c)(2) of the Act.

BHCs seeking to hold the shares of a liquidating or nominee subsidiary organized to dispose of assets acquired D.P.C. by a BHC nonbank subsidiary, can rely on the Board's August 1980 interpretation permitting, without prior regulatory approval, a BHC to form a subsidiary to perform activities which itself could perform under exemption A of section 4(a)(2).

3020.0.7 INSPECTION OBJECTIVES

1. To determine whether the activities conducted by companies in which the BHC has a greater than 5 percent investment in the company and for which the BHC claims exemption under section 4(c)(1) of the BHC Act, are the types of permissible activities contemplated by that section—activities claimed under the premises exemption under 4(c)(1)(A), the safe deposit business exemption under 4(c)(1)(B), the services exemption under (4)(c)(1)(C), or the liquidating subsidiary exemption (4)(c)(1)(D).

3020.0.8 INSPECTION PROCEDURES

The inspection of a nonbank subsidiary exempt under section 4(c)(1) of the Act should center on a review of the activities to assure that those activities are the types permissible under section 4(c)(1) subsections A, B, C and D.

3020.0.8.1 Section 4(c)(1)(A)—Bank Premises

The following procedural steps should be performed in connection with an inspection of a bank premises company.

1. Obtain a list of all real estate held by the company including the following information:
   a. Property description and location;
   b. Date acquired;
   c. Current utilization;
   d. Extent of utilization by banking subsidiaries and others indicating percentage of square feet leased to subsidiaries.
2. When use of the property by a subsidiary bank(s) is less than 50 percent, discuss future plans for the use of the property with management. Note any related discussion contained in the minutes of directors' and committee meetings, and action taken to date to implement these plans. Lease agreements with other tenants should be reviewed to determine the term of a lease including options to renew.
3. Evaluate the permissibility of holding each property under the premises exemption.
4. Review and evaluate other activities engaged in and assets held by the company to establish their permissibility under the premises exemption. Such activities could include leasing property and providing a general maintenance service to other tenants.

3020.0.8.2 Section 4(c)(1)(B)—Safe Deposit Business

Activities exempt under this section are restricted to conducting a safe deposit business. All activities engaged in and assets held by companies for which the BHC is claiming exemption under this section should be reviewed and evaluated to determine their permissibility under this exception.

3020.0.8.3 Section 4(c)(1)(C)—Services

The following procedural steps should be performed when inspecting service companies.

1. List and describe all services provided to subsidiaries in the inspection report.
2. Review and evaluate the types of services provided to the banking and nonbanking subsidiaries to determine their permissibility.
3. Obtain from management any written bank holding company policies concerning the provision of services and the assessment of fees or discuss with management the basis on which service fees are established.
4. Comment on the reasonableness of fees relative to the fair market value, cost, volume, or quality of such services rendered.
5. Indicate if all service contracts have been approved by each subsidiary's board of directors.
6. When reviewing services provided to banking subsidiaries for their customers:
   a. List and describe all services provided;
   b. Determine that the company is operating as an adjunct to its affiliated banks for the purpose of facilitating the bank's operations, and not as a separate, self-contained organization;
   c. Review contractual arrangements to assure that the company has not purchased any service contracts from a subsidiary bank and has not entered directly into agreements to provide services to any party other than the bank;
   d. Review and evaluate all services to determine whether they are services that the subsidiary bank is permitted to provide under applicable State or federal law.

3020.0.8.4 Section 4(c)(1)(D)—Liquidating Subsidiary

The following procedural steps should be followed in connection with an inspection of a liquidation company in which the BHC holds an investment.

1. Obtain a list of all assets acquired by the company for the purpose of liquidation including the following information:
   a. Asset description and location;
   b. Date acquired;
   c. Source of acquisition;
   d. Liquidation plans, including timetable and selling price;
   e. Cost of assets and book value, including detail on any improvements.
2. Verify that assets acquired from sources other than the parent or its subsidiary banks were acquired prior to May 9, 1956, or the date on which the holding company became a BHC, whichever is later.
3. Verify that assets acquired for liquidation did not originate in a nonbank subsidiary. If a section 4(c)(1)(D) liquidating subsidiary is holding a material amount of assets acquired from a nonbank subsidiary, discuss the propriety of these holdings with the Reserve Bank office staff and, if necessary, Board staff in the Division of Banking Supervision and Regulation or the Legal Division.
4. Review the bank holding company's policies, practices and procedures concerning the liquidation of assets and determine if the subsidiary is in compliance with the time limits indicated above.
5. Discuss with management and note the

liquidation plans and progress to date in liquidating assets that have been held in excess of 12 months. Note any related discussion found in the minutes of directors' and committee meetings.

6. Comment on whether management is making a *bona fide* effort to dispose of all assets for fair value.

7. Check improvements made to property by the company to assure that the nature and use of the asset has not substantially changed. The investment of funds to change substantially the nature of the asset (such as undeveloped real estate) to increase its value would generally be viewed as engaging in real estate development, an activity which is not permissible.

3020.0.9 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Purchase of instalment paper for subsidiary banks as furnishing of services		225.104	4–192	
Furnishing insurance not ''services''		225.109	4–193	
Services for banks that are not subsidiaries		225.113	4–194	
Computer services for customers of subsidiary banks		225.118	4–195	
Applicability of Bank Service Corp. Act in certain BHC situations		225.115	4–174.1	
Mortgage company services		225.122	4–196	
Insurance and sale of short-term debt obligations by BHCs		250.221, 225.130	4–867	
Operations subsidiaries of a BHC		225.141		
Shares held by a subsidiary bank in a bank premises company and the applicability of section 4(c)(1)(A)		225.101(g) 225.141	4–185	
Investment in an asset liquidation subsidiary	1843(c)(1)(D)			
Providing services to bank and nonbank subsidiaries	1843(a)(2)(A)	225.22(a)		
BHC dealing for a BHC's own account in futures, and options on futures, on gold and silver bullion to limit price risks in trading				1987 FRB 61
BHC subsidiaries performing services that BHC could itself perform				1980 FRB 774

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Approved 4(c)(8) subsidiary forming an operations subsidiary to perform activities it could itself perform				1979 FRB 566 footnote 1

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Section 4(c)(2) of the Bank Holding Company Act permits a bank holding company or any of its subsidiaries to acquire shares in satisfaction of debts previously contracted (DPC) in good faith. The shares must be disposed of within two years from the date they were acquired, except that the Board is authorized upon application of a company to grant additional exemptions if, in its judgment, the extension would not be detrimental to the public interest and either the bank holding company has made a good faith attempt to dispose of those shares during the five-year period, or the disposal of the shares would have been detrimental to the company. The aggregate duration of the extensions cannot extend beyond 10 years.

Even though the statute refers specifically to shares, the Board has taken the position, in section 225.22(d) of its Regulation Y and in an interpretation (12 C.F.R. 225.140), that the congressional policy evidenced by section 4(c)(2) should apply to DPC acquisitions of other assets, other than shares (assets), and real estate by bank holding companies and their nonbanking subsidiaries. Section 225.22(d)(1) provides the same holding periods (including provision for extensions) for other DPC assets or real estate as are provided by statute for DPC shares.

Regulation Y, section 225.22(d), addresses nonbanking acquisitions that do not require prior Board approval. With respect to DPC acquisitions, voting securities, or other assets or real estate acquired by foreclosure or otherwise, in the ordinary course of collection of a debt previously contracted (DPC property) in good faith, Regulation Y does not require the Board's prior approval if the DPC property is divested within two years of acquisition. Regulation Y further states that the Board may, upon request, extend the two-year period for up to three additional years. Further, the Board may permit additional extensions for up to five years (for a total of 10 years). This provision applies to shares, real estate, or other assets in which the holding company demonstrates that each extension would not be detrimental to the public interest and either the bank holding company has made good faith attempts to dispose of such shares, real estate, or other assets, or the disposal of the shares, real estate, or others assets during the initial period would have been detrimental to the company. Transfers within the bank holding company system do not extend any period for divestiture of the property.

Under the Board's delegated authority, the Reserve Banks may approve a BHC's requests for extensions beyond the two-year divestiture period.[1] In accordance with a Board interpretation (12 C.F.R. 225.138), extensions should not be granted except under compelling circumstances, and periodic progress reports on divestiture plans are generally required. When these permissible extension periods expire, the Board no longer has discretion to grant further extensions. A BHC would be in violation of the act if shares, other assets, or real estate acquired DPC is not disposed of within the prescribed time frame.

In July 1980, the Board issued an interpretation of Regulation Y (12 C.F.R. 225.140) that provided for a possible approval for an additional five-year period for the divestiture of real estate acquired DPC. With respect to DPC real estate, this interpretation requires that (1) the value of the real estate on the books of the company be written down to fair market value, (2) the carrying costs cannot be significant in relation to the overall financial position of the company, and (3) the company must make good faith efforts to effect divestiture. Fair market value should be derived from appraisals, comparable sales, or some other reasonable method. Companies holding real estate for this extended period are expected to make active efforts to dispose of it, and they should advise the Reserve Bank regularly concerning their ongoing efforts.

In accordance with the Board's interpretation (12 C.F.R. 225.140), after two years from the date of acquisition of DPC assets, the holding company is to report annually to the Federal Reserve on its efforts to accomplish divestiture of the assets. The Reserve Bank will monitor the efforts of the company to effect an orderly divestiture. Divestiture may be ordered before the end of the authorized holding period (beyond the initial two-year period that requires no Board authorization) if supervisory concerns warrant such action.

Section 4(c)(1)(D) allows a bank holding company to establish a subsidiary to hold real estate acquired by itself or by any of its banking subsidiaries for debts previously contracted, for the purpose of disposing of the real estate in an orderly manner. Permissible activities of this

1. Each Federal Reserve Bank has been delegated the authority (12 C.F.R. 265.2(f)(12)) to extend the time within which a bank holding company or any of its subsidiaries must divest itself of interests acquired in satisfaction of a debt previously contracted.

liquidating subsidiary include completion of a real estate development project and other activities necessary to make the real estate saleable. The ''date of acquisition'' is the date the bank holding company (or subsidiary of the bank holding company) acquired the DPC asset. Section 4(c)(1)(D) may not be used to extend the time under which a bank holding company may indirectly hold DPC property under section 4(c)(2). In most cases where a subsidiary bank has held property for the statutory holding period, a BHC may not shift the property to another subsidiary or to the parent to avoid disposing of the property. However, due to the complexity and potential impact on the organization of a forced divestment at the end of the holding period, inspection personnel and Reserve Bank staff are encouraged to discuss the situation with Board staff to tailor the supervisory response to the particular situation.

With respect to the transfer by a subsidiary of other DPC shares, other assets, or real estate to another company in the holding company system, including a section 4(c)(1)(D) liquidating subsidiary, or to the holding company itself, such transfers would not alter the original divestiture period applicable to such shares or assets at the time of their acquisition. Moreover, to ensure that assets are not carried at inflated values for extended periods of time, the Board expects, in the case of all such intercompany transfers, that the shares or assets will be transferred at a value no greater than the fair market value at the time of transfer and that the transfer will be made in a normal arm's-length transaction. With regard to DPC assets (except for DPC shares as described above) acquired by a banking subsidiary of a holding company, as long as the assets continue to be held by the bank itself, the Board will regard them as being solely within the authority of the primary supervisor of the bank.

Section 4(c)(3) of the Bank Holding Company Act permits a bank holding company to acquire shares or real estate from any of its subsidiaries if a subsidiary had been requested to dispose of the shares by any federal or state authority having power to examine the respective subsidiary. The Board does not have authority to extend the two-year disposition period under section 4(c)(3) of the act. Section 4(c)(3) may not be used to extend the statutory period in which a bank must dispose of DPC assets (10 years in the case of DPC real estate assets, five years for all other).

3030.0.1 EXEMPTION TO SECTION 4(c)(2) DISPOSITION REQUIREMENTS OF DPC SHARES

Section 4(c)(5) of the Bank Holding Company Act allows a bank to own shares in certain nonbanking companies, specifically, the kinds and amounts eligible for investment by national banking associations under the provisions of section 5136 of the Revised Statutes (see section 3050.0 for a detailed explanation of section 4(c)(5)). The exemption provided by section 4(c)(5) covers any shares, including shares acquired DPC, that meet the conditions set forth in that exemption. Therefore, DPC shares held by a banking subsidiary of a bank holding company which meet section 4(c)(5) conditions are not subject to the disposition requirement prescribed in section 4(c)(2); however, such shares would continue to be subject to requirements for disposition as may be prescribed by provisions of any other applicable banking laws or by the appropriate bank supervisory authorities.

Section 4(c)(6) of the act allows a bank holding company to own shares, including those acquired DPC, of any nonbank company that does not exceed 5 percent of the outstanding voting shares of such company. The Board has expressed an opinion (12 C.F.R. 225.101(f)) that any shares acquired DPC under this section, whether by a holding company or a bank subsidiary, are not subject to the disposition requirements of section 4(c)(2) of the act.

Real property is often shown on an entity's books as other real estate (ORE). Possession of ORE usually results from a distressed loan collateralized by a lien on real estate. In addition, in attempting to salvage other types of credit, an entity may have obtained title to real property through process of law or by voluntary deed. Acquisition costs for other real estate acquired for debts previously contracted usually consist of the principal amount that was due on the defaulted loan at the time the entity took possession, unpaid interest, legal fees and other foreclosure costs, accrued and unpaid taxes, and mechanic's liens. Property acquired DPC may be recorded on the company's books by capitalizing the loan amount and acquisition costs. Advances to complete the project can be included in the capitalized investment if the ORE is an unfinished project. The fact that the additional investment is being used to improve the property and make the property more saleable should be evident.

A company owning a DPC asset should maintain records documenting its efforts to dispose of the asset. Because an ORE asset is normally a nonliquid, nonproductive asset of uncertain value, a company should attempt to dispose of the asset at the earliest date possible. Unless special circumstances are present, a company should sell the ORE asset when a price offer sufficient to cover the acquisition, investment, and carrying costs is obtained.

3030.0.2 INSPECTION OBJECTIVES

1. To determine compliance with applicable laws, rulings, and regulations, and to initiate corrective action when violations appear in these areas.

2. To determine whether policies, practices, and internal controls regarding DPC shares, other assets, or real estate are adequate and to recommend correction when deficiencies are noted.

3. To evaluate the quality of DPC shares, other assets, or real estate and the progress toward their disposition.

4. To determine whether the DPC shares, other assets, or real estate acquired are recorded at fair market value.

3030.0.3 INSPECTION PROCEDURES

1. During the preinspection review, compile a list of shares, other assets, and real estate known to have been acquired DPC by the bank holding company and its nonbank subsidiaries, as well as a list of shares known to have been acquired DPC by the BHC's bank subsidiaries. Information on this list should include—

   a. a description of the shares or asset(s);

   b. the fair market value of the shares and asset(s), and the method of valuation, if available;

   c. the name of the company owning the shares and asset(s); and

   d. the date the shares and asset(s) were acquired.

2. If the shares or asset has been held longer than the initial holding period, determine whether the BHC has requested an extension of time.

3. In the Officer's Questionnaire, request a list of DPC shares, other assets, or real estate owned by the holding company and its nonbanking subsidiaries, and a list of DPC shares owned by the holding company's bank subsidiaries, including a detailed description of the shares or asset, the value of the shares or asset on the entity's books, the date the shares or asset was acquired, and plans for disposal of the shares or asset. In addition, a list of DPC shares, other assets, or real estate which has been disposed of since the previous inspection or within the past year should be obtained. Compare these lists with the list compiled during the preinspection review.

4. Review other real estate owned accounts to evaluate—

   a. the fair market value of the property (A qualified appraiser should appraise the property at the time of acquisition, and subsequent timely appraisals should be conducted to determine the current fair market value of the property.);

   b. the carrying costs of the property; and

   c. the company's efforts to dispose of the property (Information on file should include documentation showing a record of offers made by potential buyers and other information reflecting efforts to sell the property (i.e., advertisement brochures)).

5. Determine whether additional advances have been made on an unfinished project and whether evidence supports that the advances are making the property more saleable.

6. Determine whether a first-lien status exists and whether there are any tax liens or other encumbrances against the property.

7. Discuss DPC shares, other assets, or real estate and their values with management who is familiar with the history and current status of the shares or asset and assign classification, if warranted. A substandard classification may be applied when a company is sustaining losses in maintaining the property, and prospects for sale are not evident or encouraging. A company's acquisition of property through foreclosure often indicates a lack of demand and, as time elapses, the value of the real estate may become more questionable if the lack of demand persists. If the carrying amount of the investment exceeds the estimated value of the property, an adequate allowance reserve for any difference should be established and maintained. Property that is in the process of being sold for an amount in excess of the carrying value should not be classified if it appears that ultimate payment will be forthcoming.

8. List shares, other assets, and real estate acquired DPC under ''other assets'' in the inspection report. For significant shares and assets, the examiner may choose to present in the inspection report or in the workpapers, whichever is deemed appropriate, the following information:

a. a brief description sufficient to identify the property, the manner in which the property was acquired, and the reasons for its acquisition

b. the value of the shares or assets on the books of the company, the method used to determine the booked value, and whether it is the fair market value

c. a brief statement as to management's efforts to sell the property, its opinion of the likelihood of sale, and the anticipated sales price

d. a summary of the carrying costs subsequent to assumption and income generated from the property

e. the date when the holding company or its subsidiary must dispose of the property or request an extension to continue to hold the DPC shares or asset

f. the amount classified, if appropriate

g. any apparent discrepancies with rules or regulations

3030.0.4 Laws, Regulations, Interpretations, and Orders

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Transactions not requiring Board approval:				
1. Acquisition of securities by a BHC with majority control	1843(c)(2)	225.12(b)		
2. Acquisition of securities by a BHC with majority control		225.12(c)	4–020	1980 FRB 654
Required disposal by Regulatory Agency	1843(c)(3)			
Section 4(c)(5) and 4(c)(6) shares with respect to Section 4(c)(2)		225.101	4–187	
Delegation of Authority to extend time to dispose of DPC shares and assets		265.2(f)(12)		
Policy statement concerning divestitures by BHCs		225.138		
Disposition of property acquired in satisfaction of debts previously contracted		225.22, 225.140		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Section 4(c)(4) of the Bank Holding Company Act provides that nonbank shares held or acquired by a bank in good faith in a fiduciary capacity are exempt from the general prohibitions of section 4 of the Act. This exemption is provided to allow banks to carry on their normal fiduciary operations without significant interference and without being subject to the limitations of the Bank Holding Company Act. Without this exemption, a subsidiary bank could act as trustee for up to only 5 percent of a nonbank company's shares as provided by section 4(c)(6) of the Act.

There are certain exceptions which were included within the body of the section 4(c)(4) exemption to prevent utilization of the trust vehicle to circumvent the intent of the Act. The section 4(c)(4) exemption is not applicable when shares acquired are held by a trust which is considered a "company" under section 2(b) of the Act. Under section 2(b), a trust is defined as a company if it does not terminate within 25 years, or within 21 years and 10 months after the death of individuals living on the effective date of the trust. Such trusts are generally referred to as perpetual trusts and include employee benefits and charitable trusts which can operate in perpetuity.

Another exception to the exemption implies that no more than 5 percent of the shares of a nonbank company may be held by a subsidiary bank as trustee under a trust established for the benefit of the bank itself, the bank's parent company or any of its subsidiaries, or the shareholders or employees of the bank, the parent company or its subsidiaries as indicated in section 2(g)(2) of the Act. Employee benefit trusts have become a principal source of banks' trust assets. As strictly applied, section 4(c)(4) would limit acquisition of stock of a nonbank company to 5 percent of its shares for employee trust accounts of banks which are subsidiaries of bank holding companies.

3040.0.1 TRANSFER OF SHARES TO A TRUSTEE

Section 2(g)(3) of the Act is tied to section 4(c)(4) by specific reference as an exception to the fiduciary exemption. Section 2(g)(3) provides that shares transferred by a bank holding company to a transferee are deemed to continue to be controlled by the bank holding company if the transferee is indebted to the bank holding company or has one or more officers, directors, trustees or beneficiaries in common with or subject to control by the holding company. However, the Board may determine after opportunity for hearing in such cases that control does not exist.

Relating this to section 4(c)(4), if a bank holding company transfers nonbank shares to a trustee where the trustee has one or more directors in common with the bank holding company, the nonbank shares are deemed to be controlled by the bank holding company until the Board determines otherwise.

3040.0.2 TRUST COMPANY SUBSIDIARIES

Even though section 4(c)(4) refers by its language to shares held or acquired by a *bank* in good faith in a fiduciary capacity, the exemption also applies to shares held or acquired in a fiduciary capacity by a trust company subsidiary of a bank holding company.

3040.0.3 OTHER REPORTING REQUIREMENTS

Holdings in fiduciary capacities of nonbank stock over 5 percent in certain circumstances, may also trigger reporting requirements under the federal securities laws.

3040.0.4 INSPECTION OBJECTIVES

To determine that nonbank shares held by a bank in a fiduciary capacity are in compliance with section 4(c)(4).

3040.0.5 INSPECTION PROCEDURES

Review the holding company's internal reporting procedures to establish that bank trust departments report 5 percent holdings in nonbank companies. In multibank companies, determine that controls are in place to aggregate nonbank shares held by each bank so that if an aggregate of 5 percent is held, it is reported in the Y–6.

3040.0.6 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Interests In Nonbanking Organizations		225.12(a) 225.22(c)(3)		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Section 4(c)(5) of the Bank Holding Company Act permits (without prior approval) investments by a bank holding company in shares of the kinds and amounts eligible for investment by national banks under the provisions of section 5136 of the Revised Statutes (12 U.S.C. 24(7)).

National banks are prohibited by section 5136 of the Revised Statutes from purchasing and holding shares of any corporation except those corporations whose shares are specifically made eligible by federal statute. This prohibition is made applicable to State member banks by section 9, paragraph 20 of the Federal Reserve Act (12 U.S.C. 335).

In 1968, the Board interpreted section 5136 as permitting a member bank to purchase shares of a corporation engaging in business (at locations the bank is authorized to engage in business) and carrying out functions the bank is empowered to perform directly. Section 5136 is a broad statute with types of permissible activities both explicitly defined and implied indirectly without express definition. Therefore, to limit the need for constant Board interpretation regarding the implied areas of section 5136, the Board curtailed the authority of a bank holding company to acquire shares on the basis of section 4(c)(5) through section 225.22(d) of Regulation Y. As a result, effective June 30, 1971, permissible shares for bank holding company acquisition under section 4(c)(5) are limited to those *explicitly* authorized by any federal statute. Additional reasons for limiting the scope of activities to those explicitly defined by statute, are that section 4(c)(5) acquisitions require neither prior Board approval, nor the opportunity for interested parties to express their views, nor any prior regulatory consideration of anti-trust and related matters.

3050.0.1 COMPANIES IN WHICH BHC'S MAY INVEST

The following is a list of permissible companies expressly authorized by federal statute. The list includes the companies most frequently encountered.

1. Small business investment companies ("SBICs").
2. Agriculture credit companies.
3. Edge and agreement corporations.
4. Bank premises companies (usually exempt under section 4(c)(1)(A)).
5. Bank service corporations (usually exempt under section 4(c)(1)(C)).
6. Safe deposit companies.
7. Obligations of student loan marketing associations.
8. State housing corporations.

3050.0.2 LIMITATIONS

On most 5136 authorizations, share investments are limited in some form, usually based on a percentage of the bank's capital and surplus. Under section 4(c)(5), a holding company's investment in such shares is also limited by amount and type to those permitted for a national bank to prevent avoidance of these limitations by a bank holding company.

3050.0.3 INSPECTION OBJECTIVES

1. To determine the permissibility of each activity encountered during the inspection which claims a section 4(c)(5) exemption.
2. To determine if the operations and financing of the section 4(c)(5) activity is not to the detriment of the bank(s).

3050.0.4 INSPECTION PROCEDURES

1. Review compliance with section 5136 of the Revised Statutes to determine if the activity is expressly permitted by any federal statute.
2. Determine the financial condition of the activity and its impact on the bank affiliate.

3050.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Permissible investments for a national bank	(Section 5136 of the Revised Statutes)			
Investment in bank premise corporation	371d	250.200	4–185	
Investment in bank service corporation	1861–65	250.301	1–329	
Investment in small business investment corporation (SBIC)	15 USC 682b	225.107 225.111 225.112	4–173 4–175 4–174	
Operating subsidiaries/ loan production offices		250.141	3–415.4	
Section 23A Section 23B	371c 371c	250.240	3–1133 1–206.1	
Mortgage company		225.122	4–196	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

3060.0.1 SECTION 4(c)(6)

This section provides an exemption for ownership of shares of any nonbank company that do not exceed 5 percent of the outstanding voting shares of such company. The exemption is designed to permit diversification of investments by a bank holding company and its subsidiaries which do not result in control of a nonbanking organization. The Board has indicated through an interpretation of 12 U.S.C. 225.101, that in its opinion, the 5 percent limitation applies to the aggregate amount of voting stock in a particular nonbank company held by the entire bank holding company organization including the parent company and all of its direct and indirect bank and nonbank subsidiaries. This is to prevent a holding company from acquiring a controlling interest in a nonbank company through ownership of small blocks of stock by numerous subsidiaries in circumvention of the provisions of section 4 of the BHC Act.

3060.0.1.1 D.P.C. Shares

The same interpretation (12 C.F.R. 225.101) also addresses the question of the applicability of section 4(c)(6) to nonbank shares acquired in satisfaction of debts previously contracted (D.P.C.) by a subsidiary bank, any nonbank subsidiaries, or the parent company. In this instance, the Board expressed the opinion that the 5 percent exemption provided by section 4(c)(6) covers any nonbank shares, including those acquired D.P.C. Consequently, shares which meet such conditions are not subject to the disposition requirements of section 4(c)(2) of the Act. It is important to remember that the exemption provided by section 4(c)(6) applies only to shares of any nonbank company. Acquisitions of any bank shares are subject to the provisions contained in section 3(a) of the Act.

Although the 5 percent limitation of this section applies, by its language, to "voting shares" rather than "any class of voting shares" as used elsewhere in the Act, the Board has indicated in 12 C.F.R. 225.137 that it applies to "any class of voting shares" rather than to the aggregate of all classes of voting shares held. Thus section 4(c)(6) is not available to a group of BHCs each owning a "class of voting securities" even if each BHC owns less than 5 percent of all shares outstanding. Further, section 4(c)(6) must be viewed as permitting ownership of 5 percent of a company's voting stock only when that ownership does not constitute "control" as otherwise defined in section 2 of the Act.

Note that section 4 prohibits engaging in nonbank activities other than those permitted by section 4(c)(8). Thus, if a BHC may be deemed to be "engaging in an activity" through the medium of a company in which it owns less than 5 percent of the voting stock it may nevertheless require Board approval, despite the section 4(c)(6) exemption.

3060.0.1.2 Acquisition of Nonbank Interests—Royalties as Compensation

A bank holding company requested an opinion on the permissibility of its subsidiary's receiving limited overriding royalty interests in oil, gas, and other hydrocarbon leasehold interests as partial compensation for investment advisory services in connection with those properties. The bank holding company was not acquiring more than 5 percent interest in any project. The subsidiary was to place the assigned royalties in a compensation plan for assignment to certain professional employees. Neither the subsidiary nor any affiliate were to acquire, hold, locate, sponsor, develop, organize, or manage any other energy property investment or in any other manner control the investment. The subsidiary was to hold interest in energy properties only if the interest had not yet been reassigned to an employee, or if an employee terminates service with the subsidiary and is required to reassign his or her energy properties to the subsidiary. The bank holding company's proposal was consistent with section 4(c)(6) of the Bank Holding Company Act, which exempts passive investments of 5 percent or less from the prohibitions of section 4 of the Bank Holding Company Act.

3060.0.2 SECTION 4(c)(7)

This section provides bank holding companies the opportunity to own, directly or indirectly, shares of an investment company (any amount up to 100 percent of outstanding shares) provided that each of the following conditions is met:

1. The investment company is not itself a bank holding company;
2. The investment company is not engaged in

any business other than investing in securities; and

3. Securities in which the investment company invests do not include more than 5 percent of the outstanding voting securities of any company.

4. As in section 4(c)(6), the 5 percent limitation applies, by its language, to "voting shares" rather than "any class of voting shares," as used elsewhere in the Act. However, the criterion applies to "any class of voting shares" for purposes of this section.

The 5 percent restriction does not prevent an investment company from having direct or indirect subsidiaries of its own, provided that ownership of such subsidiaries is permitted under another provision of the Act. Rather, the limitation is intended to apply only to securities purchased in the ordinary course of investing by the investment company.

The legislative history of this provision of the Act does not provide a clear indication as to the type of institutions encompassed under the term "investment company" as used in this section. It appears, however, that any company primarily engaged in the purchasing and ownership of securities may be regarded as an investment company for purposes of this section. Section 4(c)(7) can be viewed, more or less, as an extension of section 4(c)(6) which permits a bank holding company to directly or indirectly through subsidiaries own up to 5 percent of the voting stock of any nonbank company. In fact, until the Amendments of 1966, the Bank Holding Company Act incorporated both section 4(c)(6) and section 4(c)(7) under one section. From a practical standpoint, the parent company is allowed, under section 4(c)(6), to directly engage in the same activities as an investment company. Accordingly, most holding companies conduct these activities through the parent company, rather than through an investment company subsidiary. Such an arrangement prevents duplicate payment of certain taxes and provides more flexibility for utilizing funds in other areas of the organization.

3060.0.3 INSPECTION OBJECTIVES

3060.0.3.1 Section 4(c)(6)

1. To determine that the investments held pursuant to section 4(c)(6) comply with the Act and 12 C.F.R. 225.101 and 225.137.

2. To determine that no more than 5 percent of the voting shares of any nonbank company (other than those owned pursuant to other provisions of the Act) is held by the bank holding company and its subsidiaries.

3060.0.3.2 Section 4(c)(7)

1. To determine the overall quality of the investments held.

2. To determine the financial impact of the ownership of such shares upon the bank holding company and its subsidiaries.

3. To determine if policies, practices and procedures regarding investments are adequate.

4. To suggest corrective action where necessary in the areas of policies, procedures, or laws and regulations.

3060.0.4 INSPECTION PROCEDURES

3060.0.4.1 Section 4(c)(6)

1. Review investments held to determine that the BHC has a total interest of no more than 5 percent.

2. Determine that 5 percent does not constitute control.

3. Determine that the BHC is not "engaged" in any nonbank activity through its 5 percent ownership.

3060.0.4.2 Section 4(c)(7)

1. Where section 4(c)(7) applies, compare the investment company's general ledgers with statements prepared for the latest FR Y–6.

2. Obtain schedules of investments in voting shares of any companies. Review quality of such shares (utilizing rating service publications, etc.) and check for ownership interests exceeding 5 percent.

3. Review policies (written or oral) regarding purchase and sale of stocks.

4. Obtain and evaluate documentation relating to credit review for securities held. Determine adequacy of procedures to maintain credit updates.

5. Compare carrying value of stocks to current market value to determine market depreciation, if any and determine adequacy of any established reserves.

6. Perform verification procedures, including physical review of stock held in safekeeping, where practical.

7. Determine that purchases and sales of stocks are appropriately approved by directors or designated officers.

8. Review minutes of the board of directors meetings (where an investment company subsidiary is involved).

3060.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
4(c)(6) Applicability to shares acquired D.P.C.		225.101	4–187	
Aggregating shares owned by subsidiaries		225.101	4–187	
Five percent limit on ‘‘any class of voting securities’’		225.137	4–189	
Control with less than 5 percent		225.137	4–189	
4(c)(7) Indirect ownership of shares of investment company		225.102	4–188	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Section 4(c)(8) of the BHC Act (Mortgage Banking)
Section 3070.0

A mortgage banker specializes in the origination, acquisition, and sale of residential real estate loans to permanent investors (the secondary mortgage market). Most mortgage banking firms that are affiliated with banks and bank holding companies primarily originate residential real estate loans, although some firms may engage in interim and other lending secured by real estate. Unlike their nonbank competitors, the vast majority of the loans mortgage banks originate are sold to permanent investors in the secondary mortgage market.

Mortgage banks can retain or sell their loans and sell or retain the servicing of their mortgages. The mortgage banking industry currently offers a wide variety of products, market mechanisms, financing vehicles, and financial strategies due to competitive pressures within the mortgage banking industry and rapid growth in the demand for loans and related securities within the secondary mortgage market. Mortgage bankers use these marketing and financing strategies to differentiate themselves from the competition in terms of interest rates, maturities, down-payment requirements, and product offerings.

The earnings stream, cash flow, and capital needs of a mortgage banking company are all highly influenced by management's decision whether to retain or sell the mortgage loans as well as the related mortgage-servicing rights. The majority of loans that are sold in the secondary market are originated under government-sponsored programs. Such loans are either sold directly or are converted into securities that are collateralized by the underlying mortgages (mortgage-backed securities). The pools of collateralized mortgage loans backing mortgage-backed securities provide a form of risk diversification for the investor.

Originations, secondary market sales, and servicing constitute the primary functional business lines within a typical mortgage company. As an originator of mortgages, the company is responsible for the initial phase of the mortgage, from original contacts with the borrowers to the closing of the loans. At closing, the company disburses its funds and becomes the lender of record. Mortgage loans can also be acquired through a network of correspondent companies. Most mortgage banking companies use a combination of origination and acquisition strategies. The decision about whether to originate or purchase loans also varies over time due to fluctuations in demand and pricing discrepancies.

The secondary marketing department is responsible for selling loans in the secondary market and managing the interest-rate risk associated with loans during the interim period. In most cases, the mortgage company retains the loans until it can find a permanent investor to purchase the loans. The mortgage banker obtains purchase commitments from permanent investors and submits completed loan documentation packages to the investors for their approvals in satisfaction of the commitments.

As part of the overall process, the mortgage banker maintains a relationship with a variety of other permanent investors to whom the originated mortgages are sold. These investors are generally institutional investors such as securities dealers, commercial banks, life insurance companies, pension funds, and other financial and nonfinancial institutions. Some of these investors are restricted by state law, charter, or bylaws as to the type of mortgages and the locations of the property in which they can invest. Accordingly, their purchase commitments should incorporate these limits as well as the price and/or required yield of the mortgage loans or mortgage-backed securities. When these commitments are filled and the mortgages sold to the investors, the mortgage banker may retain the servicing rights to the mortgages it sells to permanent investors or sell the servicing rights in the secondary market.

The servicing department manages the loans that were retained in permanent loan portfolio or those that were sold to another permanent investor. Fees paid for services rendered in administering the mortgage portfolios of investors are a principal source of revenue for most mortgage bankers. In general, the company receives a fee that is usually based on a percent of the unpaid balance of the administered mortgages. In return for the fee, the servicer is responsible for collecting and remitting payments, managing the tax and insurance escrow accounts, inspecting the properties when required, pursuing delinquent borrowers, foreclosing on the mortgages when necessary, and providing accounting support. Considering the services rendered and the generally low fees involved, the servicing portfolio must be sizable for the company to be profitable. The servicing portfolio may represent very little credit risk to the servicer and can be a valuable source of residual income to the company.

The mortgage banking industry is experiencing significant consolidation. To be competitive, participants must maximize economies of scale and efficiencies. Emphasis has been placed on using more efficient systems and technologies that enhance loan processing, underwriting, servicing, and the management of pipeline risk (the interest-rate risk associated with the holding period for the mortgages). Existing mortgage banking firms are larger and operate more efficiently (faster, cheaper, and with higher quality) than they did in the past. Operating efficiencies are achieved through the use of sophisticated information systems, such as electronic data interchange, imaging, optical character recognition, expert systems, and other forms of artificial intelligence.

Within a bank holding company, mortgage banking subsidiaries generally focus on residential mortgage lending. As discussed initially, these mortgage bankers may also engage in other forms of lending. On an industry basis, they extend loans to real estate brokers who buy properties for resale, engage in second mortgage and home improvement lending (usually through dealer agreements), and extend interim loans. Interim loans represent a means of funding a project through one or more phases, with the property and improvements as collateral for the loan. The size of interim loans may range from a single residence under construction to large industrial, commercial, or residential projects. Construction lending and other forms of lending may be provided by other such real estate lending subsidiaries located elsewhere within the bank holding company's organizational structure.

The mortgage banker, as a lender, has the flexibility to fund any and all phases of a project including land acquisition, development, and construction. Land acquisition credit may be extended for the acquisition of more than one parcel of land, which may not necessarily be identified with a specific project. More frequently, acquisition credit is tied into a specific project for which the lender expects to fund more than one phase. In development-phase lending, funds are advanced to ''improve'' the property, bring utilities on-site, cut roadways, and prepare the site for its intended use. Many residential and industrial park projects are funded through this phase, with the sale of individual parcels providing the repayment of the loan. Construction lending funds the project from the foundation to completion. For those loans that fund two or more phases, there may be no clear distinction between the phases as certain elements of each may be underway concurrently.

On large projects funded through completion, such as apartment and office buildings where the construction is to be repaid from a permanent mortgage, the lender will usually require the borrower to obtain a permanent mortgage commitment from a third party. While this ''takeout'' commitment may or may not be arranged through the lender's network of investors, this commitment provides the lender with some assurance of repayment. In some cases, particularly in unsettled market environments, these takeouts are not available, and the lender may issue a ''standby'' commitment. On occasion, no permanent financing will be available upon completion and the lender will extend a ''bridge'' loan for the interim period between project completion and the placement of a permanent mortgage. Making construction loans without takeout commitments from responsible term lenders could expose the construction lender to adverse interest-rate movements as well as the market acceptability of the project. The absence of a takeout can represent a weakness in a loan. The general lack of takeouts in a portfolio should be a criticizable management practice (unless mitigating circumstances prevail) and should be discussed with management.

This section provides inspection guidance and procedures for mortgage banking nonbank subsidiaries of bank holding companies. Except for the limited guidance that pertains only to bank holding companies, they may also serve as examination guidance and procedures for mortgage banking subsidiaries of state member banks. The way in which these procedures are used should be determined on a case-by-case basis depending on the size of a particular company and its business activities. The information in ''Board Oversight and Management,'' ''Financial Analysis,'' and ''Intercompany Transactions'' presented in this section is applicable to all mortgage banking reviews. The subsection ''Mortgage-Servicing Rights'' is recommended for use in companies that have significant risk exposure. The examiner should also target functional areas such as production, marketing, and servicing/loan administration.

3070.0.1 BOARD OVERSIGHT AND MANAGEMENT

The examiner should assess the quality and effectiveness of a mortgage banking company's board of directors (board) and executive management team, the appropriateness of its organizational structure, the nature of its internal control environment, and the effectiveness of internal control programs.[1] Such internal control programs may include internal and external audits, loan review, quality control over mortgage loans originated and/or serviced for investors, compliance, fraud detection, and related employee training programs.

The board and executive management team must be evaluated within the context of the particular circumstances surrounding each mortgage banking company. Since business complexities and operating problems vary according to the institution's size, organizational structure, and business orientation, directors and managers who are competent to effectively discharge their responsibilities under one set of conditions may be less competent as these conditions change.

Board oversight and management should be rated satisfactory, fair, or unsatisfactory based on both objective operating results and more subjective criteria. Performance must be evaluated against virtually all the factors necessary to operate the mortgage banking company's activities in a safe, sound, and prudent manner, including the ability to anticipate and plan for future events that may have a material impact on the company's financial condition. Such a rating should also be considered when assigning a consolidated rating of risk management (see section 4070.1 and SR-95-51).

3070.0.1.1 Board Oversight

The mortgage banking company's board provides oversight, governance, and guidance to the executive management team. The board may include executives of the mortgage banking company, executives of the bank holding company and other affiliated companies, and outside directors.

The examiner should determine whether a separate board exists, as well as the identity and qualifications of the members. Minutes of board meetings should be reviewed to determine whether directors are fulfilling their fiduciary responsibilities. At a minimum, directors should—

- select and retain a competent executive management team;
- establish, with management, the company's short- and long-term business objectives and adopt operating policies to achieve those objectives in a safe and sound manner;
- monitor operations to ensure they are controlled adequately and are in compliance with laws and policies;
- oversee the mortgage banking company's business performance; and
- ensure that the mortgage banking company meets the community's residential mortgage credit needs.

The examiner should assess whether directors exercise independent judgment in evaluating management's actions and competence, attend board and committee meetings regularly, remain well informed regarding the company's activities and the mortgage banking industry overall, and are knowledgeable regarding all applicable state and federal laws and regulations. The examiner should also review the quality of board reporting. Board reports must provide accurate and timely information to directors with respect to operating results, asset-quality trends, liquidity and capital needs, and relevant industry and peer-group performance statistics for each operational area. Directors should also receive information regarding exceptions to established policies and operating procedures, volume-related processing backlogs, and the effectiveness of the internal control programs. Information on hedging products and strategies should be routinely provided to the board and to holding company management. In connection with this portion of the review, examiners should also request and review information regarding all loans to insiders and their related interests to ensure that no preferential transactions have been extended to these parties.

3070.0.1.2 Management

The executive management team generally consists of a president and chief executive officer (CEO), chief operating officer (COO), chief financial officer (CFO), and senior executives in charge of production, marketing, and servicing/

1. See section 1010.1 of the *Commercial Bank Examination Manual* and a report, "Internal Control—Integrated Framework," which was issued in September 1992 by the Committee of Sponsoring Organizations of the Treadway Commission, for a more detailed discussion of internal controls. The Treadway Commission report broadly defines internal control as a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.

loan administration. Management formulates operating policies and procedures and oversees the day-to-day administration of mortgage banking activities. Management should be evaluated in terms of its technical competence, leadership skills, administrative capabilities, and knowledge of relevant state and federal laws and regulations. The management assessment should evaluate management's attitude toward risk, as evidenced by the type of products that are offered; the existence of effective hedging programs; and/or the degree of reliance that is placed on the resources of affiliate banks, nonbanks, and other entities to support mortgage banking company activities.

Prudent operating policies and procedures that are consistent with the business needs and risk-management practices of the parent bank holding company should be in place for each functional area. An effective risk-management program should also be in place. Without adequate management oversight, excessive errors can occur, fraud or other violations of law may go undetected, and financial information may be reported incorrectly. Any of these events can damage the company's image, impair its access to external funding sources, and jeopardize its ability to originate and sell mortgage loans in the secondary market.

It is management's responsibility to develop and maintain management information systems (MIS), which should be dedicated to obtaining, formatting, manipulating, and presenting data to managers when needed. Such systems should generate accurate financial statements; identify the need for financial, human, technological, and physical resources; and produce timely and useful management exception reports.

Management should also be evaluated on its ability to plan effectively. Effective planning entails the annual approval of an operating budget and the development of a long-term strategic plan that helps management anticipate changes in the internal and external environment and respond to changing circumstances. Because losses on the origination of mortgage loans are common in the mortgage banking industry, management should assess the servicing time necessary to recapture costs and achieve required returns. This information is critical to decisions to purchase mortgage-servicing assets, and it should be incorporated into hedging strategies.

The strategic plan should identify the company's strengths and weaknesses, growth targets, and other strategic initiatives (including management's philosophy toward the business, the extent of financial risk-taking, commitments to maintaining procedures and controls in managing the business, and management's commitment to staff development) over a one- to three-year time horizon. Planning efforts should also address system deficiencies and technological advancements within the industry. Without appropriate planning, the company can only react to external events and market forces.

Management should be results-oriented, but not at the expense of sound risk-management practices. Goals and objectives should be specific and measurable. Management should develop a performance measurement system that tracks progress toward achieving both financial and nonfinancial goals.

3070.0.1.3 Organizational Structure

The organizational structure should be reviewed to determine, on a legal-entity basis, the relationship between the mortgage banking company, the bank holding company, and any other bank or nonbank subsidiaries. The structure should also be reviewed to determine whether the lines of authority are clearly defined, the responsibilities are allocated logically, and management depth is sufficient within each division, department, or functional area.

The president and CEO usually reports directly to the mortgage banking company's board of directors, as well as to an executive management committee at the affiliate bank or the bank holding company level. Other reporting lines may exist between functional area executives and their counterparts at either a bank affiliate or the holding company level.

3070.0.1.4 Control Environment

Management's attitude toward risk is communicated to employees through the company's corporate culture. In general, the CEO should establish and communicate a corporate culture that promotes safe, sound, and prudent business practices. The corporate culture should provide a positive control environment, set high standards, and reward ethical, desirable behavior.

Management's failure to communicate acceptable standards of behavior may encourage impermissible or high-risk business practices. For instance, compensation programs that are incentive-based may generate poor-quality loans. Below-market pricing strategies or overly aggressive growth targets may further exacerbate asset-quality problems or generate loans in excess of processing and servicing capabilities.

3070.0.1.5 Control Programs

Management controls in a mortgage banking company consist of an internal audit, an external audit, loan review, compliance, quality control over loans originated and/or serviced for investors, fraud detection procedures and related employee training programs, insurance coverage, and legal review. The examiner should review recent reports conducted by internal loan review, state and federal agencies, and private investors to determine the scope of the review, the nature of any problems noted, and the adequacy of management's response.

3070.0.1.5.1 Internal Audit

The internal audit function in a mortgage banking company is responsible for detecting irregularities; determining compliance with applicable laws and regulations; and appraising the soundness and adequacy of accounting, operating, and administrative control systems. Accounting, operating, and administrative control systems are designed to ensure the prompt and accurate recording of transactions and a proper safeguarding of assets.

Internal audit activities may be conducted through a separate department located on-site or through the internal audit department of the bank holding company. Very small financial institutions that do not maintain a separate audit function may rely solely on their external auditor to perform these functions.

Regardless of the organizational structure, internal auditors must be independent of the line areas being reviewed, have access to all company records, and maintain sufficient status and authority within the company. The internal auditors' findings should be reported directly to the board or a designated committee thereof.

The scope, frequency, and coverage provided through the internal audit program should reflect the size and complexity of the institution. The audit schedule should cover underwriting practices and other high-risk areas of mortgage banking, including the most significant balance-sheet accounts, income statement accounts, and internal control systems.

To yield meaningful results, the department must be adequately staffed with individuals who are experienced and knowledgeable about mortgage banking. Audit staff should receive ongoing training and be encouraged to hold professional industry certifications. Internal audit reports should be issued and responded to by line management in a timely fashion. Follow-up procedures should be in place to ensure that corrective measures are taken.

3070.0.1.5.2 External Audit

External auditors generally review and assess the mortgage company's financial condition and the adequacy of internal controls. The engagement letter sets forth the external auditor's responsibilities, scope, and extent of reliance that is placed on the internal audit department with respect to the type of engagement. When an external audit is to be performed, the audit is an examination that is conducted to determine that the present financial condition of the company and the results of operations are fairly stated and are in conformity with generally accepted accounting principles.

Examiners should review the most recent external audit report to determine whether the opinion regarding the company's financial statements and their disclosures was qualified in any manner. If applicable, examiners should note any significant concerns or weaknesses in the company's internal control structure. Examiners should also review management's written response to the audit to determine whether corrective measures were appropriate, complete, and timely and whether the response reveals any internal control weaknesses.

The reason behind any changes in external audit firms used should be investigated. Unusual items and areas of potential concern should be discussed with management and/or the external auditor. If questions arise during the safety-and-soundness review, the examiner should determine whether the area of concern was considered to be a material item by external auditors, the nature of audit work performed, and the outcome of that review. If questions persist, the examiner may want to request access to specific external audit workpapers.

3070.0.1.5.3 Loan Review

Loan review activities may be conducted at the mortgage banking company or in conjunction with the loan review activities of either an affiliate or the parent bank holding company. In any event, loan review should determine whether mortgage loans that are originated and/or purchased meet underwriting standards as defined in the internal loan policy. Loan review may also sample loans to determine whether they meet underwriting criteria established by investors. The scope of the loan review program should be evaluated. The examiner should also review a copy of the most recent loan review to determine whether problems are identified and addressed in a timely manner.

3070.0.1.5.4 Quality Control

Mortgage banking companies that service loans for investors must also maintain a separate quality control department to test the quality of loans produced and serviced for investors. Investors such as the Government National Mortgage Association (GNMA or Ginnie Mae), Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), and FannieMae issue very specific guidelines that must be met with respect to the scope and frequency of such reviews.

At a minimum, these investors require that the mortgage banking company sample at least 10 percent of all closed loans each month and conduct a quality control review to determine the extent of accuracy, completeness, and adherence to agency underwriting standards. Random samples should include loans originated through the company’s own production network, purchased loans, loans for which work was performed by a third party (outsourced), and loans with various product characteristics, such as a high loan-to-value or a convertible feature.

Quality control personnel reverify loan documentation, including the appraisal, down payment, employment, and income information. After each review, the department should issue a comprehensive report detailing specific quality control findings and recommendations. Quality control reviews must be completed within 90 days of closing. Exceptions to company policy or investor underwriting standards should be documented and communicated to executive management. Corrective measures should be initiated promptly.

The quality control function should serve as an early warning system that alerts management to situations that may jeopardize the financial strength, image, or origination and sale capacity of the company. To function as an effective management control, the quality control department should operate independently from the production and servicing/loan administration departments. Quality control should complement, not substitute, work performed by the internal audit and loan review functions.

3070.0.1.5.5 Insurance Program

The insurance program should be reviewed to determine whether coverage adequately protects the mortgage banking company and its affiliates against exposure to undue financial risk. Insurance policies should be reviewed and approved by the board at least annually.

3070.0.1.5.6 Litigation

The legal department should be contacted to determine whether existing or pending litigation exposes the mortgage banking company or its affiliates to undue financial risk. Particular attention should be paid to the status of any actual or pending class action lawsuits of a material nature.

Examiners should also determine whether procedures exist to detect and investigate suspected fraud, either internal or external. In many instances, the legal department coordinates fraud training and investigations, as well as the submission of criminal referral or suspicious activities reports and the initiation of legal action. If a separate fraud division or unit does not exist, examiners should determine whether procedures governing the detection, investigation, and referral of potentially fraudulent situations exist and function effectively. Examiners should also determine whether management reports adequately detail and track potential exposure.

3070.0.1.6 Inspection Objectives—Board Management and Oversight

1. To assess the composition, qualifications, and degree of oversight provided by the mortgage company’s board and executive management team.

2. To determine whether the organizational structure is appropriate given the nature and scope of the mortgage banking company’s operations.

3. To evaluate the reasonableness of the operating budget, long-term business planning, performance measurement systems, and MIS and related management and board reports.

4. To determine the nature of the company's internal control environment and the effectiveness of its system of internal controls, including internal and external audits, loan review, quality control, suspicious activities and fraud detection (including criminal referral and suspicious activities reporting) and related employee training programs, insurance coverage, and pending litigation.

3070.0.1.7 Inspection Procedures—Board Management and Oversight

Board Oversight

1. Review biographies of the board of directors and minutes from board and committee meetings to determine whether directors are qualified and fulfilling their fiduciary responsibilities.

2. Review the most recent package of information that was provided to directors. Do they receive sufficient detail regarding the financial condition, internal controls, and risk-management techniques employed within the company?

Management

1. Review biographies of members of the executive management team to determine their level of experience, technical knowledge, leadership skills, and administrative capabilities. Discuss whether salaries are commensurate with management's experience level and expertise.

2. Evaluate the quality of operating policies and procedures within each division or functional area and the extent to which compliance with such policies and procedures is monitored and reported.

3. Evaluate the output from the planning process, including the most recent operating budget, business plan, and related performance measurement system reports. Determine whether objectives, goals, and growth targets are reasonable.

Organizational Structure

1. Review the organization chart to determine whether the organizational structure is appropriate, as well as the appropriateness of the division of functional responsibilities and the degree of management depth within each division or functional area.

Internal Control Environment

1. Evaluate the nature of the internal control environment and how risk parameters are communicated to employees.

Internal Control Programs

1. Assess the effectiveness of internal controls in identifying and controlling risks. Internal controls include internal and external audits, quality control for mortgage loans, insurance coverage, and fraud detection procedures and related employee training programs.

Internal Audit

1. Determine whether a separate internal audit function exists and, if so, its degree of independence.

2. Review the qualifications of the internal audit manager and his or her staff for mortgage banking and accounting and auditing expertise. Consider the size of the department and its ongoing training programs, as well as the experience levels, educational backgrounds, and professional certifications of the department's staff.

3. Determine the scope and frequency of the internal audit program to ensure that all high-risk areas are reviewed regularly.

4. Review all internal audit reports, management responses to them, and follow-up audit reports for work conducted since the previous inspection.

5. Select a significant sample of internal audit reports and respective workpapers and conduct an intensive review of the internal audit program. Determine that all issues and exceptions were brought forward to the final audit report, the report was presented to the board or a committee thereof, and that any detected and disclosed problems or control weaknesses received appropriate management attention.

6. Evaluate the internal audit department's system for following up on issues and exceptions. Determine whether prompt, satisfactory resolution of issues was effected.

External Audit

1. Review the engagement letter for the most recent external audit to determine the external

auditor's scope, responsibilities, and extent of reliance on the internal audit department.

2. Review the most recent external audit report to determine whether the opinion regarding the company's financial condition was qualified in any way and whether any internal control weaknesses were noted. Review the notes to the financial statements for appropriate disclosures.

3. Discuss any unusual items and areas of potential concern with management and/or the external auditor. Determine whether any areas of concern were considered to be material items by the external auditors, based on the nature of audit work performed, management's representations in the management letter, and the outcome of that review. If questions persist, consider the need to request and review specific external audit workpapers.

4. Discuss the reasons for any recent changes in external auditors with management.

Compliance and Disaster Recovery

1. Review the methods used to ensure compliance with state and federal laws and regulations by—

a. interviewing the person who is responsible for compliance to determine the nature of outstanding problems and the adequacy of corrective measures that have been taken, and

b. reviewing the system for logging, tracking, and responding to customer complaints.

2. Determine whether the disaster recovery plan is adequate.

Quality Control

1. Review the quality control department's policies and procedures to determine whether the quality control program meets minimum investor requirements.

2. Review a sample of reports issued by the quality control unit to determine whether they were issued in a timely manner and conclusions were adequately documented.

3. Determine whether quality control results are relayed to executive management and whether follow-up procedures are adequate.

4. Determine whether the quality control unit is sufficiently staffed and independent.

5. Determine whether quality control outsources work to outside parties. If so, are adequate controls in place to ensure that such outsourcing meets the company's own quality standards?

Insurance

1. Review insurance policies maintained for the mortgage banking company to determine whether coverage is adequate and whether the majority of insurable risks is included, giving consideration to a cost versus benefits analysis.

2. Review board minutes to ascertain the date the board last reviewed and approved the insurance program.

Litigation

1. Review all current and pending litigation of a material nature and determine whether adequate reserves are maintained to cover anticipated financial exposure.

Fraud Detection and Training

1. Determine whether a separate fraud unit exists and whether procedures are in place regarding the detection and investigation of suspected fraudulent activity and the issuance of related management reports.

2. Evaluate the company's early warning system for detecting potential fraud. Is the level of training adequate?

3. Review any criminal referral or suspicious activities forms filed since the prior inspection and discuss their status with management.

3070.0.2 PRODUCTION ACTIVITIES

Loan production covers the process of originating or acquiring loans. Production begins with the initial loan application and ends when a loan has been underwritten and processed, closed, and reviewed by post-closing.

3070.0.2.1 Types of Loans

Loans are categorized as either government or conventional loans. *Government loans* generally carry a below-market interest rate and are either insured by the Federal Housing Administration (FHA) or guaranteed by the Veterans Administration (VA). Both agencies protect investors holding such securities against losses in the event of a borrower default, thereby slightly reducing investors' required yields. To be insured or guaranteed, a loan must meet agency standards regarding the size, interest rate, and terms. The lender can obtain a certificate of insurance or guaranty to give support to a loan for securitization. A certificate of insurance or guaranty may not be needed for a loan to be securitized.[2]

Loans that are not FHA-insured or VA-guaranteed are referred to as *conventional loans*. Conventional loans are generally originated for larger loan amounts and made to stronger borrowers. Conventional loans typically require higher down payments and bear market interest rates. Most lenders that offer programs with smaller down-payment terms require that the borrower purchase private mortgage insurance for the top 5 to 20 percent of the loan principal balance so that a proportionate share of the credit risk is borne by a private mortgage insurance (PMI) company.

The extent of credit risk associated with a loan often depends on the marketing program under which the loan is originated. Marketing programs and participants are described briefly here; for a more detailed description, see ''Marketing Activities'' later in this section.

The market for residential real estate loans is dominated by three government-sponsored entities: the Government National Mortgage Association (GNMA), the Federal Home Loan Mortgage Corporation (FHLMC), and the Federal National Mortgage Association (FannieMae). GNMA is a government agency that guarantees the timely payment of principal and interest on pass-through securities that are backed by pools of FHA-insured or VA-guaranteed mortgages. These guaranties are backed by the full faith and credit of the U.S. government. Although investors will get paid in full, servicers may retain some risk of loss, particularly with respect to VA loans (see subsection 3070.0.4.5 for additional information on ''VA no-bids'').

Pass-through securities provide for monthly installments of interest at the stated certificate rate plus scheduled principal amortization on specific dates, despite the delinquency status of the underlying loans, as well as any prepayments and additional principal reduction. The issuer collects the mortgage payments and, after retaining servicing and any other specified fees, remits monthly payments to the certificate holders.

Although FHLMC and FannieMae are not extensions of the U.S. government, the market believes that there is an implicit guaranty that their securities will be repaid. FHLMC and FannieMae securitization involves the purchase of conventional loans from lenders and the selling of mortgage-participation certificates, which are similar to GNMA pass-through securities. Participation certificates represent an ownership interest in pools of conventional loans. FHLMC and FannieMae guarantee the monthly pass-through of interest, the scheduled amortization of principal, and the ultimate repayment of principal. Unlike GNMA pass-throughs, however, participation certificates are not backed by the full faith and credit of the U.S. government.

Conventional loans are classified as either conforming or nonconforming. *Conforming* loans must comply with FannieMae's and/or FHLMC's underwriting and documentation guidelines in order to be sold in the secondary market. Conforming mortgages may be sold to FannieMae or FHLMC on either a recourse or nonrecourse basis.

Private pools of *nonconforming* loans that do not meet FannieMae or FHLMC guidelines may be sold in the secondary market under a private label structure. Nonconforming loans are often ''nontraditional'' products such as loans with teaser rates, limited documentation, and graduated payment schedules, as well as ''jumbo'' loans that exceed maximum agency size requirements. To improve salability, pools of nonconforming loans may be insured through third-party credit enhancements (for example, letters of credit) or various senior/subordinate structures. Since the underlying mortgages generally already carry private mortgage insurance, such pools are, in effect, doubly insured.

3070.0.2.2 Production Channels

Mortgage loan applications are generated through either *retail* (internal) or *wholesale* (external) production channels. Retail loans are originated through the company's own branch network. A branch network is relatively costly, since origination costs often exceed the origination fees received from the borrowers.

Wholesale production channels (where contact with the borrower is made by another party) take several forms. Whole loans can be purchased either individually or by using bulk commitments. Bulk commitments either require the correspondent to deliver a set amount of loans (mandatory) or deliver all registered loans that close (best effort or optional).

2. See the appropriate agency seller/servicer guide for standards and requirements regarding certificates of insurance or guaranty.

Loans may be closed in the buyer's own name using its own funds, closed in the seller's name using the buyer's own funds, or closed and funded by the seller with delivery to the buyer within a certain number of days. If the seller closes in its own name, the mortgage and note are generally assigned to the buyer simultaneously upon closing.

Three hybrid production channels are worth mentioning here. Examiners should note that terminology within the industry varies greatly. Under the first method, *table funding*, a mortgage banking company funds loans at closing that have been originated by a correspondent or broker according to the company's own specifications. Historically, the company's ability to record mortgage-servicing rights depended on the degree of independence that was maintained and the extent of risk borne by the originator. See subsection 3070.0.6, on ''Mortgage-Servicing Assets and Liabilities.''

The second hybrid method, *assignment of trade*, involves the bulk purchase of loans and investor commitments to sell the loans in the secondary market. The purchaser bears virtually no market risk under this production method. The third hybrid method, *co-issue*, entails the acquisition of servicing rights only, at the time a security is issued.

Most mortgage originators operate on a nonrecourse basis. For purchasers of correspondent production, credit risk increases to the extent that the lender relies on other parties to correctly process and underwrite the loan. Contracts with correspondents should include representations and warranties from the correspondent that loans delivered meet the underwriting requirements of the agency or investor program for which the loan was originated. Approved correspondent lenders should be continually monitored for the quality of the product delivered and the financial ability to repurchase mortgages that do not meet the standard representations and warranties under which the mortgages are sold.

3070.0.2.3 Production Strategies

A successful production strategy combines high credit-quality standards with cost containment and effective marketing. In contrast, an overly aggressive or inappropriate strategy leads to heightened production risk. High-risk production strategies can be evidenced by relaxed credit standards, low documentation requirements, an executive officer's compensation based on volume, an emphasis on high-risk product types or geographic areas, and/or dependence on a limited number of production channels. Examiners are responsible for recognizing and reaching agreement with management to better control such high-risk production strategies where appropriate.

3070.0.2.4 Production Process

There are five principal steps in the retail production process: (1) pipeline entry, (2) processing, (3) underwriting, (4) closing and funding, and (5) post-closing. Each of these functions should be independent from one another and separately supervised to ensure the quality of the loans produced. Each step is briefly discussed below.

1. *Pipeline entry*. A loan has entered the pipeline when a prospective borrower completes a loan application. The applicant authorizes the lender to verify his or her employment, credit history, bank deposits, and other information that evidences repayment capacity.
2. *Processing*. The application is then processed to qualify the applicant and the property for the loan. Processing personnel verify the applicant's employment history and credit information and order an appraisal on the property. Processing activities should be controlled through standardized procedures, checklists, and systems.
3. *Underwriting*. The underwriting unit approves or disapproves applications based on underwriting criteria that are established by the FHA, VA, FannieMae, and FHLMC and by private mortgage insurers and institutional investors. To ensure objectivity, the underwriting unit should not report to management of the production function.
4. *Closing and funding*. After an application has been approved, the lender generally issues a commitment letter to the borrower, which states the interest rate and terms of the loan. At closing, the lender or its agent obtains all the legal and related documents executed by the parties to the sale, disburses the proceeds of the loan, and collects certain funds from the borrower.
5. *Post-closing*. After closing, a post-closing review is performed to ensure that documents were properly executed and underwriting instructions were followed. The post-closing review also identifies any trailing or missing documents that must be tracked and obtained to meet investors' pool certification requirements. Specific

agency requirements are detailed in the agency seller/servicer guides. Before the loan is transferred to the delivery or shipping department, processing begins for the final mortgage insurance (from the private mortgage insurer or from the FHA/VA guaranty certificate). Receipt of the actual certificate may take 45 to 60 days or longer. Pool custodians and investors will allow the lender to complete the sale if final documentation, including the insurance certificate, is expected to be received within a reasonable timeframe.

3070.0.2.5 Production Risks

The production process can present risks of both a short- and potentially long-term impact. Operational inefficiencies can result in high management and staff turnover, an inability to meet investor documentation requirements, an increasing number of pools that have not received final certification, or an unusually high production cost structure. Operations risk often increases during peak volume periods. If additional resources (which can include independent service providers) are not allocated to the processing, underwriting, closing, and post-closing areas, delinquency levels may increase and workloads may exceed existing capacity.

Management should be prepared to quickly respond to interest-rate cycles and related volume increases or declines, since failure to act promptly can affect earnings and capital. During the pooling and securitization process, for example, if the number of pools that lack final certification exceed a certain limit, the company may be required to seek financial support in the form of a letter of credit from an affiliate bank or bank holding company to ensure that all required loan documentation is secured in a timely manner. Credit risk and operational inefficiencies may also create liquidity problems and additional interest-rate risk if the company is unable to sell its loans in the secondary market.

To the extent a company retains servicing on either its retail or correspondent production, long-term credit risk issues may develop. These include exposure to the pools being serviced through recourse arrangements, potential nonreimbursable foreclosure costs, or costs associated with VA ‘‘no-bid’’ options.

3070.0.2.6 Overages

In certain instances, originators and loan brokers may have the ability to deviate from mortgage loan prices that are established by the marketing department. An overage exists when a lender permits an originator or broker to impose a higher number of points (or a higher interest rate) on a loan to certain borrowers than is imposed for the same product offered to other borrowers at a given point in time. (See CA-94-6.)

Overages are often used as an incentive to compensate originators or brokers. The amount that is received over the expected price is often shared by the mortgage banking company and the originator or broker. The practice of permitting overages may contribute to or result in lending discrimination under the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act (FHAct).

Examiners should review the mortgage banking company’s lending policy and determine whether overages are permitted and whether the practice has resulted in lending discrimination. If a more detailed review of overages is deemed necessary, such review should be performed in conjunction with the appropriate Federal Reserve System’s legal and consumer compliance staff.

3070.0.2.7 Inspection Objectives—Production Activities

1. To determine the types of loans offered to borrowers and any significant changes in product mix.
2. To determine whether mortgage loans are securitized; if so, to determine whether mortgage-backed securities are insured or otherwise guaranteed by government-sponsored agencies or private entities.
3. To determine what channels are used to originate loans.
4. To determine if production processes are consistent with operational risk controls and efforts to minimize risk.
5. To determine whether production processes can handle cyclical changes in volume.
6. To determine whether overages are permitted and to assess whether the practice has resulted in lending discrimination.

3070.0.2.8 Inspection Procedures—-Production Activities

General

1. Review organization charts to determine

the structure of the production function and its status within the company. Verify that functional units such as underwriting and quality control are independently managed.

2. Determine the types of mortgage products offered and the company's target markets. Evaluate portfolio trends for overreliance on one product type and undue concentrations in one geographic area.

3. Discuss the company's credit culture, compensation methods, and growth targets to determine whether income and loan volume are emphasized over credit quality.

4. Determine whether the level of nonconforming or unsalable loans being originated present undue risk and whether the quality and delinquency trends for such loans are adequately monitored.

Originations

1. Review policies and procedures for retail branch originations. How are originators compensated? Determine whether originators have the authority to alter loan pricing parameters set by the marketing unit.

2. Determine the size of the branch network and its cost structure. Is the network growing or shrinking? How does management plan for anticipated changes in loan volume?

3. Determine if the mortgage banking company is involved in overage activities. If so—

a. determine whether management has developed comprehensive policies and procedures, detailed documentation and tracking reports, accurate financial reporting systems and controls, and comprehensive customer complaint tracking systems to adequately monitor and supervise overage activities;

b. review whether overages are an essential component of the mortgage banking company's earnings and origination activities, and review the percentage of mortgages originated since the previous inspection that resulted in overages and the average overage per loan;

c. determine if management reviews overage activity for disparate treatment and disparate impact; and

d. determine if overages are a major component of loan officer and/or broker compensation.

4. Review policies and procedures for wholesale purchases. Which production channels are used and how do they work? Channels may include whole loan purchases (production flow), table funding, assignment of trade, or co-issuances (bulk purchases of servicing rights only). For each production channel, review how brokers and correspondents are compensated.

5. Review the method for reviewing and approving brokers and correspondents and specific programs under which wholesale loans are purchased. Is there an approved list of correspondents? How is it updated and how frequently? Determine whether exceptions to this list are made and by whom, and whether controls are in place to prevent unauthorized purchases.

6. Evaluate the process for conducting financial reviews on correspondents. How often are financial statements obtained, and who analyzes them?

7. Determine whether adequate controls are in place to detect changes in the financial condition of a correspondent, test and monitor the quality of loans purchased, and evaluate the correspondent's financial capacity to perform under contractual repurchase obligations.

8. Select a sample of contracts for the largest correspondents for additional review. Do contracts clearly state pricing structures, maximum dollar volumes, recourse arrangements, and whether loans are purchased on a mandatory delivery or a standby basis? Have any legal issues arisen as a result of the contract language? How frequently does management put back loans to its largest correspondents?

9. Determine whether management information systems adequately track approvals and denials by loan type and production channel. Are exceptions to policy adequately tracked and monitored?

Processing

1. Determine whether processing is performed in-house or by another party (a third-party contractor or the originator). Review checklists and procedures for the processing unit and determine whether loan tracking systems are adequate.

2. Review steps that have been taken to address any audit or quality control findings. Determine whether additional corrective actions are necessary.

Underwriting

1. Determine whether underwriting is performed in-house, by third-party underwriters, or by the originator. Is management planning for

peak volume periods and are controls over the underwriting process adequate?

2. Review policies and procedures to gain a reasonable assurance that underwriting standards are prudent and comply with investor guidelines. If individual underwriters perform this function, determine whether management has established approval limits, developed exception procedures for loans that are rejected or suspended, and receives reports that track loan quality for each underwriter. If a committee performs the underwriting function, review its charter, composition, and minutes. If a scoring system is used, review credit scoring methodology. Can the system be overridden? If so, by whom?

3. Review a representative sample (preferably a statistical sample) of current loans to test the underwriting policies and procedures and also determine the validity and adequacy of documentation supporting loans held for sale or investment.

4. If an unusual increase in unmarketable loan inventory has been noted, select a small sample of loans in current production for additional review. Does underwriting comply with established guidelines? If a credit scoring system is used, focus on loans that are of the lowest acceptable grade. If deficiencies are noted, consider expanding the review sample.

5. Review loans that were rejected and then approved. Did the proper authority approve such loans, and was management's rationale adequately documented?

Closing/Post-Closing

1. Evaluate procedures, checklists, and systems for closing loans. Are all required documents obtained from the borrower before funds are disbursed? If not, evaluate the appropriateness of suspense items.

2. Determine if a post-closing documentation review process exists to differentiate, track, and obtain both trailing and missing documents. Assess its effectiveness.

3. Determine if wholesale loans are re-underwritten at delivery. If not, how does management ensure that loans are re-underwritten in accordance with secondary marketing program requirements?

4. Determine the number of pools that lack final pool certification. Has this number exceeded the maximum allowable limit since the previous review? Why has this problem occurred, and what steps are being taken to secure the necessary documentation? Has a letter of credit been posted? Does the situation pose undue financial risk for the company or any of its affiliates?

3070.0.3 MARKETING ACTIVITIES

The marketing department is typically responsible for the development of mortgage products, determination of products to be offered, and the establishment of daily mortgage prices. The marketing department, which is also referred to as secondary marketing, is also responsible for the sale of mortgage loans to investors. Given these roles, the marketing department acts as an intermediary between the borrower and the investor. All of these activities require close coordination to be effective and are appropriately placed within one department.

3070.0.3.1 Oversight

Marketing activities are generally supervised by a marketing committee, which may consist of the chief executive officer, chief operating officer, chief financial officer, and the executive officers responsible for marketing, production, and servicing/loan administration. The marketing committee is responsible for the formulation of marketing policies, departmental operating procedures, pricing strategies, and parameters governing the use of various mortgage-related products and strategies used to hedge the interest-rate risk associated with certain mortgage loans.

3070.0.3.2 Securitization

The marketing department's primary tool in performing its activities involves securitization outlets. Securitization activities are discussed in SR-90-16, which transmitted the following documents: (1) the Examination Guidelines, (2) An Introduction to Asset Securitization, and (3) Accounting Issues Relating to Asset Securitization. There is also a discussion of these activities in the *Commercial Bank Examination Manual*, section 4030.1. A review of the securitization process can provide a clearer understanding as to the value the marketplace assigns to a mortgage banker's production. Mortgage securities, however, are usually issued by an entity other than the mortgage banking company under inspection (such as government-sponsored agencies, securities affiliates, or brokerage firms).

Many approaches are used for securitization, but the great majority of activity occurs with conduits such as GNMA, FHLMC, and FannieMae. Conduits provide many programs that a mortgage originator can use to deliver a mortgage or pools of mortgages in return for cash or securities. To investigate current program requirements and available options, the examiner should consult the seller guidelines issued by the agencies.

The securitization process presents the marketing department with a complex set of options to consider when deciding how to sell the company's loan production for maximum profit. If the company's own servicing valuation differs from pricing offered by the agencies, for instance, the marketing department can use some flexibility in pool formation guidelines to retain or divest servicing cash flows. Recourse to the originator or servicer can be negotiated to reduce agency guaranty fees. Agencies also alter guaranty fees based on different methods of remitting principal and interest payments. Sales to the agencies can be on a best-efforts or mandatory basis. A best-efforts basis is when loan delivery is not required if the loan does not close. Better prices are received for the lender's acceptance of the more rigid performance requirements of mandatory commitments. Master commitment contracts can be reviewed by the examiner to determine negotiated terms.

Although most securitization activity occurs within the programs already mentioned, private security issues are also used. The private issues are used primarily for loans that do not meet the underwriting criteria of the agencies, commonly due to larger than accepted loan amounts (jumbo loans). Nonconforming loan production is usually sold to brokers or security affiliates who have marketed the product to investors, sometimes using complex real estate mortgage investment conduits (REMICs).

3070.0.3.3 Pooling Practices

As an intermediary between the borrower and the investor, marketing personnel coordinate the flow of loan documents from the shipping department to the pool custodian and the ultimate holder. If servicing is retained, the loan will be input into the company's servicing system soon after closing. Staffing levels should be adequate to ensure that processing backlogs are managed and workloads remain reasonable. Temporary help and/or outsourcing may be used during peak volume periods.

Operating procedures governing the selection of mortgage loans for pooling, packaging, and sale should be evaluated to ensure that the shipping and pooling processes are efficient and that loan files ultimately contain complete documentation. Management reports should identify and track the number of pools that lack final agency certification and the status of missing (unavailable) and trailing (delayed) documentation.

If third-party guaranties are used during the securitization process, procedures should also establish methods for evaluating and monitoring the financial condition of all third-party entities that provide credit enhancement. If loans or securities are sold with recourse, management reports should identify and track potential recourse obligations. Management should also analyze historical recourse losses by investor and product type and determine the appropriate level of reserves to cover estimated recourse exposure.

3070.0.3.4 Marketing Risks and Risk Management

3070.0.3.4.1 Techniques

The marketing department manages several risks, which can be categorized as follows:

- unsalability
- pricing
- fallout
- counterparty performance

3070.0.3.4.2 Unsalability

Under most circumstances, a mortgage banking company will originate mortgage products that are acceptable to GNMA, FannieMae, FHLMC, or other major investors. This minimizes the risk that mortgage products originated will not be marketable to investors and have to be retained as a portfolio investment. However, the marketing department may also initiate certain products that are intended for the loan portfolio of the mortgage company or portfolios of bank or nonbank affiliates. In the case of production for bank affiliates, underwriting and pricing arrangements must be structured to ensure compliance with the restrictions imposed by sections 23A and 23B of the Federal Reserve Act. See the subsections on production activities (3070.0.2) and intercompany transactions (3070.0.7).

3070.0.3.4.3 *Pricing Risk*

The mortgage banking business is volume driven. Because profit margins are thin and fixed costs associated with loan production can be large (especially in the case of a retail origination network), it takes a significant volume of mortgages to generate profits. Mortgage pricing decisions are critical because the price is a major determinant in the volume of mortgages originated.

Pricing strategies can be affected by divisional profit and loss allocations or external industry practices. A neutral price structure sets mortgage prices that are equivalent to the expected price for which the mortgages will be sold to investors, plus a normal servicing spread of 25 to 50 basis points depending on the type of loan. Daily adjustments are usually made to prices to reflect market changes for future settlement of mortgage-backed securities (MBS).

Due to regional or local competition, mortgage banking companies often find it necessary to deviate from a purely neutral pricing strategy to maintain volume in certain markets. However, large deviations from market price in either a lower or even upward direction can have adverse consequences. In addition to causing marketing losses, price cutting could place operational strains on the production and servicing areas. Premium pricing can position the company as a lender of last resort with adverse credit quality implications.

The marketing department attempts to minimize price risk by matching origination pricing with the price it expects to receive from investors. However, estimating the price at which the mortgages can be sold can be difficult because it is determined in large part by external factors such as interest rates. The longer the elapsed time between when the mortgage applicant decides to lock in a loan rate and the time the loan closes, the greater the risk that the prices for which the mortgages can be sold will change. Some companies encourage customers to ‘‘float’’ their interest rate until closing approaches to reduce the volume and costs of hedging.

3070.0.3.4.4 *Fallout*

A third type of risk that the marketing department manages relates to pipeline ‘‘fallout.’’ This is the risk that the proportion of loans in the rate-committed pipeline that are expected to close will change with a given change in interest rates. As market interest rates decline, fewer mortgages in the pipeline will close because applicants will opt to make new applications at the lower rates. As interest rates rise, the proportion of pipeline loans that will close increases as more applicants choose to lock in rates. Mismatches that occur in the long and short positions can result in financial losses when the institution needs to settle its trades.

3070.0.3.4.5 *Hedging Strategies*

The most common hedging strategy used to protect the inventory of closed loans and the rate-committed pipeline against adverse interest-rate movements involves the use of mandatory and optional forward sales of MBS. Under this hedging strategy, the inventory and rate-committed pipeline (the long position) are generally covered through short sales (mandatory delivery contracts with settlements corresponding to expected delivery volumes). Put and call options on MBS are sometimes purchased to manage heightened fallout risks during periods of volatile interest-rate fluctuations.

The typical practice is to hedge 100 percent of the closed loan inventory that is marketable. In addition, pipeline loans very near to closing are generally also hedged at or close to 100 percent. However, a significant degree of uncertainty exists as to the amount and timing of 30- and 60-day rate-committed pipeline closings due to interest-rate fluctuations, underwriting delays, and cancellations. To control exposure to rate movements, management must estimate the percentage of the rate-committed pipeline that is expected to close in the current economic environment.

Although estimation techniques vary, data are generally collected on a number of pipeline characteristics such as product type, whether the loan is a purchase or refinance, and whether it is retail- or wholesale-originated. Fallout behavior can vary depending on these and other factors. Based on this information, management then derives an estimated closing percentage that becomes management’s operating target for coverage of the rate-protected pipeline.

Marketing personnel often use simulation modeling to assess fallout percentages, assist in balance-sheet valuations, and develop appropriate hedging strategies. Such models may be either purchased from outside vendors or developed in-house, and they vary greatly in their degree of sophistication. In any event, the primary assumptions and inputs to the model should be reasonable, well documented, and reviewed periodically by both the marketing committee and by an independent source such as an internal or external audit. Results from the marketing simulation model should be provided to management through summary reports. Information may also be provided to bank holding company personnel for asset/liability management purposes.

Other products may also be used to hedge inventory loans and the rate-committed pipeline, particularly loans with an adjustable rate feature or other specialized characteristics. The marketing committee should review and approve all specialized hedge products used, the degree of correlation between the hedge product and the underlying position being hedged, and the degree of risk that each strategy or position entails. The accounting department should also determine whether such products qualify for hedge accounting treatment, establish appropriate management reports, and establish accounting policies. See subsection 3070.0.6, ‘‘Mortgage-Servicing Rights.’’

3070.0.3.4.6 Position Reports

To limit risk, the marketing committee should place prudent limits on the amount of exposure that can be incurred through hedging operations. Limits, which may be contained in the marketing policy, might establish a constraint on the size of uncovered long positions, require that coverage be maintained at the marketing committee’s current closure estimates, or establish a constraint based on an earnings-at-risk measurement.

Compliance with limits should be monitored through regular position reports, which should be provided to senior management (the marketing committee and perhaps the treasury function of the parent company, if they participate in decisions or policy enforcement) at least weekly. Position reports should detail the company’s long and short positions in relation to limits, as well as unrealized and realized gains and losses on loans and securities. Department managers generally require daily position reports in order to effectively monitor the position. Marketing position reports may not reconcile directly with reports prepared by the accounting department for financial reporting purposes. Significant differences should be investigated.

3070.0.3.4.7 Counterparty Performance

The marketing committee is also generally responsible for managing investor/counterparty performance risk. The marketing committee (or the treasury department of the parent bank holding company) should approve all brokers and dealers to which securities are sold before trading commences. Dealer limits should be established to limit the maximum amount of trades outstanding with each firm. Frequent position reports should be prepared to monitor compliance with established limits. The accounting department may be responsible for the ongoing monitoring of the financial capacity of the brokers and dealers.

3070.0.3.5 Inspection Objectives—Marketing Activities

- To review the types of products developed.
- To determine the pricing strategies offered to borrowers and investors.
- To review pipeline fallout estimation techniques.
- To review hedging methods as they relate to loan production.
- To determine whether information systems are adequate for senior management to monitor fallout behavior and hedge performance.

3070.0.3.6 Inspection Procedures—Marketing Activities

Management Oversight

1. Review the composition of the marketing committee and minutes from recent committee meetings to determine the nature and scope of its responsibilities, the frequency of meetings, and the degree to which oversight over marketing activities is provided.
2. Review the marketing policy as it relates to product offerings, pricing strategies, loan sales, and hedging operations. Are all relevant marketing risks identified? Note the date the marketing policy was last reviewed and approved by the board of directors.
3. Determine how management measures and controls interest-rate risk associated with closed loans in inventory and rate-locked loan applications in the pipeline. How are limits established and quantified (i.e., earnings at risk, economic value of equity at risk, percentage of capital, etc.)? Are such limits reasonable? Evaluate management’s oversight of asset securitization

activities in accordance with SR-90-16, as applicable.

4. Assess the adequacy of management information systems and related management reports that are designed to track compliance with established policy. Determine the extent to which operational practices adhere to policy. How are exceptions handled?

Securitization and Pooling Practices

1. Determine the secondary marketing programs used to sell mortgages to investors and the volume of sales under each program.

2. Discuss the strategies and procedures used for the selection of mortgage loans for pooling, packaging, and sale. Are there quality control procedures in place to ensure that the files of pooled loans contain complete documentation? What impact does strategy have on departmental profitability?

3. Evaluate the company's securitization practices:

- Determine how much risk the company retains and in what form.
- Determine the source, conditions, and costs of third-party guaranties. Verify that the financial condition of all third-party credit enhancers is substantiated.
- Determine the procedures used to obtain final pool certifications from investors (coordinate with the examiner(s) assigned to the production function). Determine the number and volume of securities that lack final certification. Is management doing everything possible to obtain missing documents? Are problems volume-driven or due to a lack of internal controls?

4. Determine whether loans or securities are sold with recourse. If so, are management information systems in place to track recourse obligations? Are analyses of recourse losses conducted by investor and product type? Are reserves held for recourse loans? What is the methodology for determining the adequacy of reserves? Review actual and potential losses. Are reserve levels adequate to cover identified exposure? Is compensation tied to trading profit?

Unsalability

1. Review the marketing policy to determine whether all mortgage products originated by the mortgage company are intended to be salable in the secondary market (for example, do they conform to guidelines issued by GNMA, FannieMae, FHLMC, or other major investors?). How is actual salability monitored?

2. Determine if mortgage loans that are not salable are generated specifically for the permanent investment portfolio of either the mortgage banking company or its bank or nonbank affiliates.

3. Determine who is responsible for the review of temporarily unsalable loans, the frequency of such reviews, the actions taken to correct documentation and/or credit deficiencies, and if internal controls are adequate. This information is needed to ensure that hedge volumes are accurate.

Pricing Strategies

1. Review the current list of mortgage product offerings and the daily price sheet. Are prices determined centrally and are they uniform? Discuss pricing strategies with management to determine whether the company uses a neutral, above-market, or below-market pricing strategy.

2. Ascertain what procedures are in place to ensure that deviations from the approved pricing policies receive the proper degree of scrutiny and approval by senior management. If such discrepancies are common, why is this occurring (competition, compensation schemes, or departmental profitability considerations)? What impact have such deviations had on production volumes and the company's overall profitability?

3. Determine what policies are in effect regarding customer rate-locks. If a rate-lock expires, is it automatically renewed or is it renegotiated at current interest rates? Are the number and dollar volume of loans with expired rate-locks adequately monitored and tracked?

Fallout

1. Discuss the methodology used to predict the volume of applications that are expected to ''fall out'' of the mortgage pipeline. Is fallout methodology well documented?

ALCO/Simulation Modeling

1. Determine whether the expected fallout ratio is based on intuition, historical data, or an empirical model. Are assumptions reasonable? Are volatility assumptions based on historical performance or on implied volatility levels in the market? Who is responsible for reviewing model assumptions, and are these individuals sufficiently independent from the process itself? Does management also engage in sensitivity analyses to determine the impact interest-rate fluctuations will have on expected fallout levels?

2. Determine to what extent management uses output from these models in business planning, financial management, and budgeting.

3. Assess the degree to which mortgage banking activities are incorporated into the parent company's asset/liability management reports and program.

Hedging Practices

1. Discuss management's philosophy and strategy to determine the amount of interest-rate risk they are willing to accept. How successful has the company's marketing strategy been over the past few years and how is it changing? What are management's primary sources of market information? Are sources sophisticated enough given the size of the company and the scope of its activities?

2. Review the marketing policy to determine products and strategies used to hedge the interest-rate risk associated with inventory loans and rate-locked loan applications in the pipeline. Review actual hedging practices to determine whether they conform with established policy limitations and guidelines. What percentage of closed loans held in inventory and loan applications in the pipeline are matched against specific investor commitments? How are coverage levels determined and how have they changed over time? Is the basis for this coverage ratio adequately documented? Determine whether the current coverage ratio exposes the company to undue risk associated with potential marketing losses.

3. Determine the adequacy of management's strategies for hedging loans that have special risks (ARMs with interest-rate caps and floors).

4. Ascertain if basis risk exists for any hedging products, whether such risks are significant, and the impact on correlation. How is basis risk identified, monitored, and controlled?

5. Determine whether call options are written to enhance inventory yields. If so, verify that they are written against covered positions. Determine whether management is speculating in any way and whether this activity subjects the company to undue risk.

6. Obtain profit/loss reports on hedging activities. How frequently are they prepared, how are they used, and to whom are they distributed? Evaluate the financial results of the hedging program over the past three years. Is management taking on excessive risk to record profits in this area?

7. Review management reports relating to pipeline and closed-loan hedging operations. Determine whether such reports are complete, accurate, and timely. Do such reports adequately limit excesses, record exception approvals, and detail risk exposures?

8. Review information provided to executive management and the board to determine whether hedging practices are adequately supervised.

Counterparty Risk

1. Review the marketing committee's list of approved brokers and dealers. Have appropriate dealer limits been established and are such limits adhered to? How are exceptions monitored, reported, and controlled?

3070.0.4 SERVICING/LOAN ADMINISTRATION

Mortgage banking companies that originate and sell residential real estate loans in the secondary market often retain the right to service those loans for the investor for a fee. In return, the servicer collects monthly payments from mortgagors, collects and maintains escrow accounts, pays the mortgagors' real estate taxes and insurance premiums, and remits principal and interest payments to the ultimate investors. The servicer also maintains records for the mortgagor, collects late payments on delinquent accounts, inspects property, initiates and conducts foreclosures, and submits regular reports to investors. Such functions and responsibilities should be documented within a formal written servicing agreement.

3070.0.4.1 Revenue Generation

The right to service mortgage loans provides a stable source of earnings and the potential for one-time gains. For this reason, servicing portfolio growth has become a primary objective for many mortgage banking companies.

Mortgage-servicing revenues are derived from six sources. The primary source is the contractual servicing fee. Because this fee is usually expressed as a fixed percentage of each outstanding mortgage loan's principal balance, servicing-fee revenues decline over time as the loan balance declines.

The second source of servicing income arises from the interest that can be earned by the servicer from the escrow balance that the borrower often maintains with the servicer for the payment of taxes and insurance on the underlying property. This income may vary, however, as some states require that interest payments on escrow balances be paid to the borrower.

The third source of revenue is the float earned on the monthly loan payment. This opportunity for float arises because of the delay permitted between the time the servicer receives the payment and the time that the payment must be remitted to the investor.

The fourth source of revenue consists of income late fees charged to the borrower if the monthly payment is not made on time. A fifth source is income in the form of commissions that many servicers receive from cross-selling credit life and other insurance products to the borrowers. The sixth and last source is when the servicer might generate fee income by selling mailing lists to third parties.

3070.0.4.2 Cost Containment

Long-term profitability is achieved through cost containment, technological improvements, and economies of scale, which reduce the per-unit cost of servicing. Servicing costs vary widely across institutions depending on portfolio characteristics such as product type, loan size and age, delinquency status, and foreclosure statistics. Nevertheless, two efficiency measures frequently used within the industry to measure cost containment are unit-servicing costs and the number of loans serviced per employee. The minimum size of a loan-servicing portfolio needed to achieve economies of scale varies across institutions and depends on portfolio characteristics and the servicer's expertise and technological capabilities.

Servicing data are available through the Mortgage Bankers Association's publication, ''Mortgage Banking Performance Report.'' Based on detailed financial-statement information from a sample of companies, the report presents a compilation of performance data on all aspects of the mortgage banking industry.

3070.0.4.3 Growth Strategies

Many companies have established aggressive growth targets for their servicing portfolios. The size of the portfolio may be increased through originations, purchases of loans (individual or bulk), or purchased servicing rights. Portfolio size is reduced through normal runoff, prepayments, and sales of either loans or servicing rights only. Management's growth strategy should be examined in light of its expertise and systems capabilities.

3070.0.4.4 Servicing Agreements

The servicer generally operates under a written contract with each investor. This contract, also known as a servicing agreement, establishes minimum conditions for the servicer such as its fiduciary responsibilities, audit requirements, and fees. Contracts may be standardized or tailored to the individual investor.

Under most servicing agreements, the servicer warrants that full principal has been advanced, the mortgage is in fact a first mortgage on the property, and that the first mortgage position will be maintained by the servicer. Additional warranties that are either unwritten or implied may create significant exposure for the servicer.

A servicer may also enter into an agreement with another company to subservice certain loans or portfolios of loans. The company's method of evaluating and monitoring the financial condition of its subservicers should also be reviewed. Servicing and subservicing agreements should be evaluated in terms of the subservicer's responsibilities, reporting requirements, performance, and fees. They should also be reviewed to determine that no additional liabilities, real or contingent, are imposed upon the company beyond its responsibilities as a servicing agent.

3070.0.4.5 Recourse Obligations

A servicing agreement may contain specific recourse obligations that go beyond the servicer's customary fiduciary obligations. A mortgage banking company can choose to service loans for investors either with or without recourse back to the mortgage banking company. Servicing agreements should be reviewed to determine the extent of any recourse obligations. The risk of recourse should also be discussed with management to assess whether the risk is being identified and effectively managed.

The degree of recourse varies by investor. FannieMae offers either ''regular'' or ''special'' servicing options. With FannieMae's regular option, the servicer retains all risk of loss from mortgage default. With FannieMae's special servicing option, the mortgage banking company only retains exposure for normal representations and warranties. FHLMC offers similar servicing options. FannieMae and FHLMC generally limit eligibility for the regular servicing option to participants with the knowledge and financial wherewithal to make good on their recourse obligations.

GNMA servicing carries no contractual recourse. However, in the event of mortgage default, the servicer may have exposure to principal loss and other nonreimbursable expenses, particularly with respect to VA-guaranteed loans. If a borrower defaults on a VA-guaranteed loan, the VA can exercise a ''no-bid'' put option, which allows the VA to pay out its guaranty and leave the property with the servicer for disposition.

When a borrower defaults on a VA-guaranteed loan, the VA makes a calculation that will guide its decision to accept or reject conveyance of the property. The VA's decision to exercise its no-bid option is based on the net value of loan collateral and the VA's guaranteed percentage of the indebtedness. The mortgage servicer, at its option, could pay down the outstanding principal balance on the loan to a point where the VA would not be expected to exercise its no-bid option. Such ''buydowns'' result in additional foreclosure losses for the servicer.

The risk-based capital guidelines require a charge to capital when any risk of loss is retained on such recourse obligations. The charge would be at the bank holding company, the bank, or both,[3] depending on ownership of the risk. For this reason, the accuracy of reported recourse obligations should be verified.

3. If at the bank, then it is also consolidated at the bank holding company level.

3070.0.4.6 Guaranty Fees

The amount of guaranty fee the mortgage banking company pays the government-sponsored agencies (or private issuer) is negotiated. Guaranty fees vary based on the amount of recourse assumed by the mortgage banking company (the servicer) and the timing of the cash flows. A smaller guaranty fee is negotiated when the guarantor assumes less risk or receives payments sooner in the remittance cycle. Remittance cycles vary by investor.

The examiner should discuss with servicing personnel the amount of risk that has been taken on by the marketing department in exchange for reduced guaranty fees. Excessive risk accepted by the mortgage banking company should be incorporated into the assessment of management.

3070.0.4.7 Internal Controls

The servicing process begins after the post-closing review has been completed and the loan has been set up on the mortgage banking company's servicing computer system. Servicers are responsible for adequately safekeeping loan documents. Documents must be stored in a secured and protected area such as a fireproof vault. Servicers must also maintain a tracking system for following up on missing documents.

The control environment that sets the tone of a servicing department's operation should be assessed. A servicing department's management faces a variety of risks that it should identify and control. In addition to identifying and controlling risks, management also needs to institute adequate and effective internal controls to match a servicing portfolio's growth and the department's technological changes. When assessing the control environment, the examiner needs to consider the extent to which management uses internal and external audits, quality control reports, and investor audits to ensure that its policies and procedures are followed.

The servicer's performance should be evaluated, with any loss of servicing due to operating inefficiencies or excessive risk-taking discussed and noted. A discussion of the risks within each operational area, as well as the management reports and internal controls, follows.

- *Loan accounting*. Incoming payments may be processed in-house, through a lockbox, or through some combination of both. Payments are deposited into a clearing account and then transferred to the respective investor custodial bank accounts the next day. Investor remittances may be required daily, weekly, monthly, or as funds are received. In certain cases, servicing agreements may specify that payments be sent directly to security holders. Numerous accounts through which incoming and outgoing payments pass should be reconciled daily to avoid costly processing errors. The reconcilement process should be reviewed with management to ensure that reconcilements are performed on a timely basis and without chronic discrepancies.

- *Escrow administration.* In addition to receiving and remitting payments, servicers are also responsible for paying taxes and insurance on the underlying property. Accurate information must be maintained for each loan regarding a legal description of the property; the appropriate taxing authority, due dates, and amounts for taxes owed; and the insurance provider and due dates and amounts for insurance owed. Failure to maintain such information may result in missed tax and insurance payments on the property, which may lead to penalties and/or lapsed insurance coverage. The servicer's record of tax penalties paid over the past several years should be reviewed to determine whether a problem exists in this area.

  Escrow account balances should be adequate to meet expected tax and insurance obligations. If the servicer advances its own funds to cover an escrow overdraft, such payments may be capitalized and recorded as a receivable only if the servicer is to be reimbursed by either the mortgagor or the investor. Escrow receivables should be aged, with stale or otherwise uncollectible receivables charged off.

  Escrow accounts should be analyzed at least annually, with a copy of the analysis sent to the mortgagor. Shortages (overdrafts) may be billed or spread out over 12 months. Overages should be returned to the borrower or handled in a manner consistent with federal and state laws and regulations. For loans that were set up without an escrow account, the examiner should verify that adequate information has been obtained from the mortgagor to ensure that taxes and insurance are current.

- *Investor reporting.* Investor remittance and reporting requirements vary greatly. Remittances are contractually arranged. In some instances, the servicer may be required to advance to investors funds that have not yet been received from the mortgagor (for example, cash advances to ensure timely payment of principal and interest). In such cases, a receivable is created on the balance sheet. Receivables relating to investor remittances should be aged in the same manner as escrow receivables and periodically reviewed by a supervisor. Stale or otherwise deemed uncollectible receivables should be periodically charged off in a timely manner.

  Investor reports should include detailed account reconciliations and information on the mortgagor's name, principal balance outstanding, escrow balance, delinquency status of the account, and any foreclosure activity or transfer to the servicer's other real estate owned account. The quality and accuracy of investor reporting should be periodically reviewed by internal or external auditors.

- *Collections, foreclosures, and other real estate (ORE).* Investor requirements also vary concerning contact with delinquent borrowers, forbearance policies, and reimbursement for foreclosure expenses, ORE write-downs, and related losses. Detailed policies concerning collection efforts and foreclosures should be in place and followed. The property should be inspected regularly to ensure that its condition is adequately monitored. Delinquency and foreclosure statistics should be tracked by product type and originator.

  Foreclosures are generally initiated after three full installments are due and unpaid. The servicer notifies the mortgagor of its intent in writing and refers the case to an attorney. Detailed records should be maintained for all expenses that are incurred. If the loan is insured, claims may ultimately be filed against the FHA, VA, or private mortgage insurance (PMI) company. However, it should be noted that certain interest expenses and collection or foreclosure costs are not reimbursable.[4] These expenses are a cost of doing business that must be factored into the servicing fee charged for providing these services.

  The timeframe for taking title on foreclosed property varies widely and is determined by state law. *Once title is taken, the property should be classified as ORE.* Although

4. For a detailed list of both reimbursable and nonreimbursable expenses, see the agency seller/servicer guides.

all ORE is generally managed through a centralized unit, for accounting purposes, ORE may fall into one of two distinct categories: ORE that is owned by the mortgage banking company, and ORE that is serviced on behalf of the investor. ORE that is owned should reconcile to the balance sheet, whereas ORE that is serviced for others is an off-balance-sheet item. ORE appraisal, valuation, and financing policies should be consistent with regulatory policy. In-substance foreclosures and any troubled debt restructurings should be properly identified and accounted for.

- *Payoffs*. Loans are considered ''paid off'' when the loan matures, the loan is refinanced, or the property is sold. Prior to payoff, the servicer is responsible for sending payoff instructions to the mortgagor. After a loan has been paid off, the servicer makes a satisfaction remittance to the investor or the pool; obtains documentation; cancels the note; and forwards the satisfied mortgage documentation plus an escrow refund check, if applicable, to the mortgagor. A high level of refinance activity may strain payoff personnel's ability to perform this obligation accurately and promptly. Management reports should monitor the level of payoff activity and alert supervisors to operational backlogs, the need to hire temporary personnel, or the need to outsource work to third parties.
- *Customer service*. Poor service may damage the mortgage banking company's business reputation (reputation risk) and ability to originate, sell, and service loans within the community. Because of name recognition, problems in this area may also adversely affect affiliate banks or the bank holding company and its nonbank companies.

  For this reason, servicers should maintain an adequate system for logging, tracking, and responding to customer inquiries and complaints. Management reports should track the volume and disposition of such inquiries and complaints. Inordinate volumes of complaints may be an indication of operational backlogs, inefficiencies, or mishandling of accounts. If this occurs, corrective measures should be initiated immediately.

3070.0.4.8 Data Security/Contingency Planning

The servicing system should be of a complexity and size necessary to accommodate both the current and the projected volume of transactions. Examiners should obtain information on the servicing system in use and any limitations it might pose in terms of future growth plans.

Procedures for maintaining physical security in the workplace, data security, and file backup also should be discussed with management. A contingency plan should describe the use of alternative backup sites, as well as procedures that would be followed to reconstruct altered or destroyed files. Contingency plans should be reviewed and approved at least annually and tested regularly.

3070.0.4.9 Inspection Objectives—Servicing/Loan Administration

1. To assess the adequacy of management oversight of risk through policies and procedures, management information systems and reports, and other internal and external audits, with respect to the following:

- collecting monthly payments from mortgagors
- reporting loan activity and remitting funds to investors
- monitoring escrow account balances
- disbursing property insurance and real estate tax payments
- monitoring delinquencies, initiating collection activities, and initiating foreclosure proceedings in a timely manner

2. To evaluate the level of risk assumed by the mortgage banking company through servicing recourse arrangements.

3070.0.4.10 Inspection Procedures—Servicing/Loan Administration

Management Assessment

1. Obtain an organization chart for the servicing department and resumes for senior management and key staff members. Evaluate management's qualifications and expertise.
2. Review servicing policies and procedures manuals to determine whether reasonable operating standards have been established for each functional area. Also assess whether management reports adequately monitor compliance with established policies and procedures. Determine how exceptions are identified and addressed.

3. Review internal and external audits, quality control reports, and investor audits to determine whether internal controls are functioning effectively.

4. Evaluate safeguards in place for loan documents and determine if an adequate document tracking system exists.

5. Verify that a disaster recovery plan is in place that covers all in-house servicing functions. Verify that backup systems exist should primary systems fail. Determine if backup systems would provide information to substantiate servicing portfolio asset values.

6. Obtain a list of subservicers and vendors, if any, employed to perform servicing functions.

- Determine if a periodic review of services provided by each subservicer is conducted. In addition, the financial condition of each subservicer should be evaluated at least annually.
- Determine whether a contingent operating plan has been established should subservicers and vendors be unable to perform their contractual obligations.

Profitability Analysis

1. Review business line profitability for the servicing department to identify significant trends and/or areas of potential weakness. Discuss and review key efficiency measures such as unit cost and cost per employee.

2. Analyze servicing income and expenses to determine whether operations are profitable and economies of scale are being achieved in line with industry norms:

- Determine whether all direct and indirect costs are included.
- Compare servicing revenues with costs.
- Assess the impact of any bulk servicing purchases or sales on departmental profitability.
- Analyze efficiency in light of management's growth projections.

3. Review servicing portfolio trends and characteristics, including the following:

- investors (GNMA, FannieMae, FHLMC, private)
- recourse provisions
- loan types (30-year fixed, 15-year fixed, ARM, balloon)
- average loan size
- interest rates (particularly those above market)
- remaining contractual life
- projected life
- geographic distribution of mortgagors
- delinquency statistics
- foreclosure statistics
- number of subserviced loans and servicers

Loan Accounting

1. Review with management the procedures for receiving payments from mortgagors and depositing funds into segregated accounts. Determine that the segregation of duties and other controls over custodian accounts are adequate.

2. Review any outstanding advances to investors. Evaluate the collectibility of advances, the timeliness of charge-offs, and the adequacy of reserves.

3. Determine whether outstanding items related to investor account reconciliations are being resolved in a timely manner. Are reconciliations routinely reviewed and approved by a supervisor?

Escrow Administration

1. Review with management the system in place for ensuring the timely payment of taxes, insurance, and other obligations.

2. Review the servicer's method for analyzing the amount and adequacy of escrow account balances, and evaluate its effectiveness. Assess procedures relating to shortages and overages in escrow accounts:

- Determine whether procedures comply with 12 U.S.C. 2609 (RESPA) and to the extent possible with state laws.
- Determine whether the borrower is sent an analysis statement showing the amount of discrepancy, how it occurred, and an explanation of how it is to be corrected.

3. Determine the volume of loans with no escrow requirement and procedures for ensuring that insurance payments and taxes are current.

4. Determine how escrow funds are invested, assess the appropriateness of the investment vehicles, and review management's analysis of yield on escrow funds.

5. Evaluate whether controls are in place to prevent the use of escrow custodial accounts to meet other obligations.

6. Review outstanding escrow advances, and determine if claims for reimbursement are processed in a timely manner. Evaluate the collectibility of outstanding advances and verify that uncollectible advances are charged off in a timely manner.

Investor Reporting

1. Review the list of investors for which servicing is performed.

2. Review servicing contracts to verify that signed, current contracts exist. Discuss with management the nature of any recourse provisions, forbearance requirements, and nonreimbursable collection and/or foreclosure expenses.

3. Review the most recent investor audit reports on the servicing function. Discuss findings with management and evaluate the adequacy of any actions taken to correct deficiencies.

4. Determine whether any servicing contracts have been terminated for cause or are likely to be lost in the near future. Determine the reason for any termination and the extent of any corrective actions taken.

Collections and Foreclosures

1. Review and assess, on a statistical-sample basis, the accuracy and adequacy of loan delinquency reports by product type and originator. Ascertain the reasons for poor or declining asset quality within the servicing portfolio.

2. Review policies and procedures for collecting late payments.

- Determine when collection efforts start once an account becomes delinquent.
- Verify that all attempts at collecting past-due payments are documented, including each date of communication with borrowers, the nature of the communications, and the customers' replies.

3. Select a sample of files for borrowers who are 120 days or more delinquent and determine whether foreclosure proceedings are instituted in a timely manner.

- Determine if borrowers and investors are appropriately notified of the initiation of foreclosure action.
- Verify that contacts with borrowers are documented.
- Determine whether property inspections are conducted in accordance with policy.
- Verify that foreclosure practices comply with FHA/VA/PMI requirements and guidelines.

4. Determine the average foreclosure costs for each product type. Foreclosure costs include inspections, legal and administrative costs in excess of those defined as normal and customary, VA no-bid, and VA write-downs.

5. Obtain a list of loans in foreclosure in which action has been delayed, and determine if the justifications for delay are reasonable.

6. Determine the number and dollar volume of delinquent loans that were purchased from the servicing portfolio (buyouts or buybacks).

- Assess the impact of repurchases on profitability, the appropriateness of this practice, and the accounting procedures for these loans.

7. Discuss with management the effect that negotiated guaranty fees may have on the level of losses associated with foreclosures.

Payoffs

1. Review procedures for payoffs to determine whether—

- payoff instructions are sent to the mortgagor before payoff;
- satisfaction remittances are made to the investor or to the pool, necessary documentation is obtained, notes are canceled properly, and documentation plus any escrow refund checks are sent to the mortgagor in a timely manner; and
- internal controls are in place to ensure that funds are not misappropriated and employee fraud is detected and reported according to policy.

Other Real Estate

1. Determine the number and dollar volume of ORE by geographic location.

- Compare the volume of ORE with historical levels and the industry average for similar-sized servicers.

- Evaluate the impact of ORE on profitability.
- Review the policies and practices for ORE accounting, property supervision, and marketing. Verify that policies are consistent with investor guidelines and regulatory policies.

2. Determine whether ORE parcels are purchased from the servicing unit by the bank holding company or its affiliates.

- Evaluate the controls in place to limit or prevent this practice and the accounting treatment for such loans.
- Verify that information regarding ORE is properly reported to the parent bank or holding company for consolidation into regulatory reports.

Customer Service

1. Review the system for logging, tracking, and responding to customer complaints. Has the volume of complaints grown? Are complaints addressed promptly with any problems resolved in a timely manner?
2. Review the servicer's customer-complaint file to gain more insight into the nature of the complaints. Do complaints suggest that internal policies and procedures are not being followed or that staffing levels are inadequate?

3070.0.5 FINANCIAL ANALYSIS

This section provides the examiner a framework with which to analyze the financial condition of a mortgage banking company. The analysis begins with a review of the mortgage company's balance sheet and income statement. The financial analysis should incorporate a review of primary balance-sheet and income-statement levels and trends, off-balance-sheet assets and liabilities, asset quality, market share and earnings performance, funding sources, liquidity needs, and capital adequacy. Any problems or conditions that expose the mortgage banking company, affiliate banks and nonbanks, and/or its parent bank holding company to undue financial risk should be brought to management's attention and documented in page one, Examiner's Comments and Matters Requiring Special Board Attention. The examiner should focus on items that are either large relative to the company's operations or that may pose undue financial risk. The examiner should also investigate any trends that appear inconsistent with the mortgage banking company's industry peer group, business orientation (such as wholesale versus retail, originations versus servicing, etc.), and future growth plans or with the current economic and interest-rate environment.

Financial-statement presentation may vary across mortgage banking companies. If questions arise, financial-statement presentation and accounting should be reviewed with the company's internal and/or external accountants for propriety. During the review of the financial statements, the examiner should establish whether regulatory reports are prepared accurately. Banks must conform to the reporting requirements of the Commercial Bank Reports of Condition and Income (call report). Bank holding companies and their direct subsidiaries must conform to generally accepted accounting principles (GAAP). Relevant GAAP statements of the Financial Accounting Standards Board include SFAS No. 65, "Accounting for Certain Mortgage Banking Activities," as amended; SFAS No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases"; SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities"; SFAS No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities;" and SFAS No. 80, "Accounting for Futures Contracts." Other relevant accounting pronouncements are identified in appendix B, Accounting Literature.

The financial analysis should also include an assessment of asset quality, earnings, liquidity and funding, and capital. Any problems or conditions that expose the mortgage banking company, affiliate banks and nonbanks, and/or the parent bank holding company to undue financial risk should be brought to management's attention and discussed in the Examiner's Comments and Matters Requiring Special Board Attention.

3070.0.5.1 Balance Sheet

3070.0.5.1.1 Assets

The asset side of the balance sheet may consist of cash, reverse repurchase agreements, marketable securities, receivables and advances, mortgage loans held for sale, mortgage loans held for investment, mortgage-servicing assets (MSAs) (including mortgage-servicing rights), reserves for loan and other credit-related losses (contra accounts), other real estate owned (OREO), and other assets.

3070.0.5.1.1.1 Mortgage-Related Securities

The examiner should determine whether the accounting treatment for mortgage-related securities reported on the balance sheet is consistent with SFAS 115. SFAS 115 applies to equity securities having readily determinable fair values and to all debt securities. It does not apply to loans purchased.

Under SFAS 115, at acquisition and at each subsequent reporting date, all debt and equity securities that fall under the scope of the statement should be classified into one of the following categories:

- trading securities
- available-for-sale securities
- held-to-maturity securities

Both debt and equity securities can be assigned to the above first two categories. The third classification can only consist of debt securities.

Trading. Mortgage-backed securities that are held for sale in conjunction with mortgage banking activities should be classified as trading securities and reported at fair value. Debt securities not held to maturity and equity securities that have readily determinable fair values should be classified as trading securities when (1) they are held for short periods of time and (2) they have been acquired with the expectation of a profit from short-term price differences. Securities that are actively traded should be carried at fair value on the balance sheet, with net unrealized gains or losses included in income.

Available-for-sale. Debt and equity securities having readily determinable fair values that are not otherwise classified, as above, should be categorized as available-for-sale and carried at fair value on the balance sheet. Unrealized holding gains and losses should be reported in a separate component of shareholders' equity and should not be included in income.

Held-to-maturity. For a security to qualify as held-to-maturity under SFAS 115, the mortgage banking company must demonstrate the positive intent and ability to hold it until maturity.

3070.0.5.1.1.2 High-Risk Securities

The examiner should also review any high-risk mortgage securities that are on the balance sheet, such as collateralized mortgage obligations (CMOs), real estate mortgage investment conduits (REMICs), CMO and REMIC residuals, and stripped mortgage-backed securities (stripped MBSs). See sections 2126.1 and 2190.0.5.

3070.0.5.1.1.3 Mortgage Loans Held for Sale

The examiner should determine whether the accounting treatment for mortgage loans held for sale is consistent with SFAS 65, as amended. Mortgage loans held for sale shall be reported at the lower of cost or market value, determined as of the balance-sheet date.[5] The amount by which the cost exceeds market value shall be accounted for as a valuation allowance. Changes in the valuation allowance shall be included in net income of the period in which the change occurs.

3070.0.5.1.1.4 Mortgage Loans Held for Investment

Mortgage loans held for investment may include loans that (1) do not meet secondary-market guidelines and are therefore unsalable, (2) loans that were repurchased from an investor due to poor documentation and/or improper servicing, (3) loans put back to the mortgage banking company under recourse agreements, and (4) loans intentionally originated for portfolio.

SFAS 65 states that a mortgage loan transferred to a long-term investment classification shall be transferred at the lower of cost or market value as of the transfer date. The securitization of a mortgage loan held for sale shall be accounted for as the sale of the mortgage loan

5. According to SFAS 65, as amended, the capitalized costs of acquiring rights to service mortgage loans, associated with the purchase or origination of mortgage loans, shall be excluded from the cost of mortgage loans for the purpose of determining the lower of cost or market value.

and the purchase of an MBS classified as a trading security at fair value. Any difference between the carrying amount of the loan and its principal balance shall be recognized as an adjustment to yield by the interest method.

A mortgage loan shall not be classified as a long-term investment unless the mortgage banking company has both the intent and the ability to hold the loan for the foreseeable future or until maturity. If the ultimate recovery of the carrying amount of the loan is doubtful and the impairment is considered to be other than temporary, the carrying amount of the loan shall be reduced to its expected collectible amount, which becomes the new cost basis. The difference is recognized as a loss. A recovery of the new cost basis shall only be reported as a gain upon sale, maturity, or disposition of the loan.

3070.0.5.1.2 Liabilities

The liability side of the balance sheet may include repurchase agreements, commercial paper, revolving warehouse lines of credit, long-term debt instruments, intercompany payables, and equity capital.

3070.0.5.1.2.1 Repurchase Agreements

A mortgage banking company may finance its mortgage loans or MBSs held for sale by transferring mortgage loans or MBSs temporarily to banks, nonbanks, or other financial institutions under formal repurchase agreements that indicate that control over the future economic benefits relating to those assets and the risk of market loss are retained by the mortgage banking company.

Repurchase agreements can provide a cost-effective method of holding mortgage-backed securities before their sale to investors. Securities dealers repo the securities for a period of 30 to 180 days at a substantial cost advantage to warehouse facilities. Repurchase agreements involve delivery of the security to the dealer with an agreement to repurchase it on a specified date. Upon receipt, the dealer wires the haircut proceeds to the mortgage company. The mortgage company then reduces the amount of its outstanding warehoused loans. If the repo is being handled by the dealer that is arranging the ultimate sale of the security, the amount of that discount should approximate the discount on the sale. If another dealer is involved in the ultimate sale, the haircut may be greater because the security must be repurchased and redelivered to the second dealer. This may also require a rehousing to provide funds to honor the repurchase commitment. Most warehouse lenders allow traditional warehouse lines to be collateralized by individual mortgages and mortgage-backed securities.

A mortgage banking company may use repurchase agreements in conjunction with sales of loan pools. The company may use repurchase agreements to pledge mortgage loans and/or MBSs as collateral for borrowings. In return, it receives advanced funds against future deliveries. The lenders are repaid through the sales of MBSs. The amount outstandings bear interest for the number of days the funds are outstanding.

Under repurchase agreements, the same loans or MBSs are generally reacquired when they are sold to permanent investors. Mortgages or MBSs may also be transferred temporarily without a repurchase agreement. However, some type of informal agreement generally exists. Mortgage loans and MBSs held for sale that are transferred under either formal or informal repurchase agreements shall be accounted for as collateralized financing arrangements and reported as either mortgage loans held for sale or MBSs classified as trading securities on the mortgage banking company’s balance sheet.

3070.0.5.1.2.2 Commercial Paper

Another source of short-term funding is the issuance of commercial paper. In general, commercial paper represents unsecured notes with maturities up to 270 days from the date of sale. Because of its short maturity, proceeds should be limited to current transactions with short-term maturities. Commercial paper proceeds should not be used to fund loans held for sale for a period greater than one year.

Commercial paper can be less reliable than warehouse lines of credit. If commercial paper funding is used, examiners should review related commercial paper backup lines of credit and ratings issued by credit rating agencies. The reason for any rating changes during the prior year should be investigated. Additional guidance on this topic is set forth in sections 2080.05, 2080.1, and 5010.23.

3070.0.5.1.2.3 Revolving Warehouse Lines of Credit

Short-term revolving warehouse credit lines are often used to fund loans held for sale, which is generally the largest asset on the company's balance sheet. Revolving credit lines may be obtained from an affiliate bank, the parent bank holding company, or an unrelated third party.

The extension of credit for a particular loan is paid off when the mortgage lender sells the mortgage loan to a government-sponsored agency such as GNMA, FannieMae, or FHLMC or to a private investor. Lenders who provide warehouse lines of credit typically enter into a warehouse credit agreement with the borrower. Under the agreement, the warehouse lender agrees to extend credit to the mortgage banking company for the purpose of originating loans. The mortgage banking company agrees to repay each extension of credit within the terms of the agreement. Each extension of credit is secured by placing a lien on the originated mortgage loan. The warehouse lender perfects its security interest by taking possession of the original promissory note executed by the borrower, endorsed ''in blank,'' together with an assignment of the mortgage securing the loan. To further protect its security interest, the warehouse lender usually takes the responsibility of delivering the loan package to the secondary market investor for purchase. The investor, in turn, delivers the purchase price of the mortgage directly to the warehouse borrower (mortgage banking company). Each portion of the warehouse line may be priced separately to reflect various levels of risk and the documentation requirements of each.

The details of all credit lines should be specified in formal, written credit agreements. Revolving credit lines may be either unsecured or secured by a lien on the underlying mortgages. Under most secured lines, a formula is used to calculate the borrowing base, which generally consists of cash, cash equivalents, loans held for sale, securities, and a percentage of the mortgage-servicing portfolio less certain short-term indebtedness. Some credit lines require the maintenance of compensating balances.

Internal credit arrangements (conducted either by a mortgage banking subsidiary of a bank or bank holding company) must comply with sections 23A and 23B of the Federal Reserve Act. See sections 2020.1 and 3070.0.7 of this manual.

Examiners should evaluate the adequacy and efficiency of warehouse funding operations. The examiner should determine whether the warehouse lender is of a sufficient size and whether it is well positioned financially to provide adequate lines of credit, as needed. Examiners should ascertain whether funding must be regularly derived from more than one warehouse lender (including whether the warehouse line has to be participated out to other lenders) and whether the lender has proper internal controls to safeguard collateral documents for pool certification. The examiner should also determine what management's contingency plans are for the use of alternative financing sources beyond standard warehouse lines of credit for backup financing and lower-cost efficiency purposes. Has management (1) explored variations in existing lines of credit to reduce overall borrowing costs and (2) determined what competitor lenders are paying for similar financing facilities?

Procedures should be in place to monitor compliance with all short-term debt covenants. Covenants may limit servicing of loans with recourse, limit total debt to specified levels, and/or require minimum tangible net worth, leverage, and current ratios. Most credit agreements also limit the borrower's financial flexibility if the company's long-term debt ratings decline or the company becomes unrated or if certain events occur related to securities.

3070.0.5.1.2.4 Long-Term Debt

Longer-term assets are more appropriately funded through the issuance of longer-term liabilities or capital. Toward this end, mortgage banking companies may issue medium- or long-term public debt securities (including warrants to purchase debt securities). Debt may be issued in the form of fixed-rate or floating-rate notes with various repayment or redemption terms. Loan agreements should specify all relevant terms and conditions and may contain debt covenants similar to those found in the warehouse funding arrangements.

Long-term debt may incorporate restrictive covenants which limit the company's activities in certain respects. These covenants may set limits on the amount of senior debt outstanding and the minimum amount of liquid net worth (as defined by the documents), and may limit the proportions of specific categories of assets. Such covenants should be reviewed to make certain that they are not too restrictive and that they permit financial flexibility.

3070.0.5.1.3 Equity Capital

Funding is also provided through equity capital, which may be supplemented by capital contributions from the parent company or the direct issuance of equity securities.

3070.0.5.2 Income Statement

Mortgage banking revenues generally consist of the following: loan servicing/administration revenue; loan-origination-fee revenue; interest income; gains (losses) on the sale of mortgage loans, mortgage securities, or mortgage-servicing rights; and management and other fee income. The examiner may find that gross gain (loss) on the sale of mortgage loans or securities is reported on the income statement net of loan-origination fees and direct loan-origination costs such as personnel and office expenses.

Expenses may include interest expense; salaries, commissions, and other personnel costs; interest losses on MBS pools; amortization of mortgage-servicing assets and any other purchased intangible assets; electronic data processing and other selling, general, and administrative costs; occupancy and equipment; depreciation; provision for foreclosure and other loan losses; and a provision for income taxes. Some companies net amortization of MSAs directly against loan-servicing revenues.

3070.0.5.3 Unique Characteristics

The financial analysis should reflect certain operational characteristics that are unique to the mortgage banking industry. Many of these characteristics are cyclical based on interest rates and economic conditions.

For example, the cost of funding loans in the warehouse is relatively inexpensive during periods of low interest rates, but may increase significantly as interest rates rise. Marketing operations are also highly dependent on the interest-rate cycle. During periods of falling interest rates, the company may experience substantial gains on the sale of mortgage loans and securities to permanent investors. Alternatively, during periods of rising interest rates, the company will usually experience losses on the sale of mortgages and securities. Interest-rate volatility can cause large fluctuations in warehouse funding costs and marketing gains and losses.

The examiner should also consider the impact of current economic conditions on the size and composition of the mortgage banking company's balance sheet. When the economy expands, loan volume increases and the overall size of the balance sheet tends to grow. During recessions, the balance sheet should contract, reflecting the lower demand for new loans. Management's planning efforts should incorporate this type of economic trend analysis in their growth targets. Steady annual growth may or may not be anticipated.

Efficiency measures, such as activity ratios (inventory turnover and efficiency ratios), should be used to determine management's ability to originate and sell loans efficiently. The inventory of loans held for sale is transitory, lasting between 45 to 60 days. A buildup of loans on the balance sheet may indicate processing delays and/or asset-quality problems that may prevent their ultimate sale to permanent investors. Because of the transitory nature of the balance sheet, traditional leverage ratios (asset-to-equity capital) may not be meaningful and should be used sparingly.

Another unique characteristic of a mortgage banking company is the economic value of its mortgage-servicing operations, which constitutes an off-balance-sheet item. Failure to incorporate this economic value into the financial analysis may overstate the degree of financial leverage that is employed within the company.

3070.0.5.4 Asset Quality

The quality of assets that are on the balance sheet is evidenced by the following: compliance with original underwriting standards; the existence of effective loan review and quality control programs; borrower payment and agreement performance; the fair value of MBSs held for sale or investment; the collectibility, independent valuation, nature, volume, and existence of recorded assets; the application of GAAP in accounting for the assets; and the degree of protection afforded by real estate mortgage collateral, including any private mortgage insurance. The value afforded by real estate mortgage collateral includes the extent of compliance with the Federal Reserve Board's real estate appraisal regulations and guidelines. (See section 2231.0.) Asset quality should be analyzed in terms of regional and national economic factors as well as portfolio and managerial factors.

For any review of any loan portfolio, a sampling of real estate appraisals should be included to determine whether the appraisal results reasonably support the amount loaned. If the property appears to be overappraised or if there is a problem with the appraisal (for example, the appraisal is obsolete or the validity of the appraisal is in question), the examiner should consider recommending that a new appraisal be performed.[6] It may be necessary for the examiner to classify the loan (i.e., as a loss) and for the parent holding company to increase its allowance for loan and lease losses.

Bank holding companies and/or their nonbank subsidiaries should be criticized if initial appraised values appear to be inadequate and/or not properly supported by proper documentation. If corrective action is not taken by management, formal enforcement action should be considered. Such actions may require the bank holding company to revamp its appraisal activities and/or collection procedures and, if warranted, to retain the services of an independent appraiser to conduct an evaluation of loan collateral.

With respect to MBSs, the quality characteristics of the underlying mortgage collateral should be considered. If the securities are backed by GNMA, FannieMae, or FHLMC, the rating agencies consider such securities to be the highest quality asset because of their linkage to the federal government. If the collateral consists of unsecuritized mortgages, the examiner should consider the geographic dispersion, type of mortgage and property, underwriting standards, and term to maturity of the underlying pool of mortgage loans. External factors can affect the value of mortgage securities directly, such as the default or downgrading (by a credit rating agency) of a private mortgage insurer.

To a large extent, insurance and guaranties provided by government-sponsored agencies and other third parties (for example, private mortgage, bankruptcy protection, fraud, and mortgage pool insurers, as well as performance bond insurers and other guarantors) mitigate credit risk for an originator; however, the originator still remains responsible for the quality of loans sold to investors for at least the first 90 days, as well as for any loans sold under recourse arrangements. As a servicer, the company also can be held liable if it does not initiate collection and foreclosure actions in strict accordance with investor-servicing agreements. In addition, certain interest losses and expenses relating to collections, foreclosure, and ORE are not fully reimbursable and should be anticipated.

The mortgage banking company must maintain adequate management reports to measure and track the quality of originated, purchased, and serviced assets. Proper administration over loans and other assets held for sale or investment requires the use of aging and other tracking reports. For assets held for sale, the reports should identify loans and other marketable assets, other than marketable securities,[7] that have been in this category longer than 60 days. In such instances, a determination should be made as to whether credit quality problems and/or documentation deficiencies exist that will prevent the timely sale of the loan in the secondary market. If problems are not correctable within a reasonable timeframe, the loans and other related assets should be revalued and transferred to the held-for-investment category. Procedures governing the valuation and transfer of poor-quality assets should be in writing and should be followed.

The MIS should also generate for management's review reports on the delinquency status of loans held for investment and loans serviced for investors. Such reports provide an early warning system and an analysis tool to evaluate internal collection activities. If a loan becomes delinquent (30 days or two payments past due), the borrower should be contacted. Collection efforts should be strengthened if the delinquency continues. If the loan becomes severely delinquent, foreclosure proceedings should be initiated consistent with the investor-servicing agreement, and the value of the collateral supporting the loans should be assessed. Anticipated shortfalls should be recognized as losses in a timely manner.

MIS should also include an internal loan-grading system, which tracks the borrower's ability to meet its monthly payment obligations. Although MIS should be tailored to meet management's needs, information should be consistent with loan-grading systems that are used by the controlling bank holding company and federal bank regulatory agencies. Reports should also track collection and foreclosure actions initiated by the servicer and repurchase requests initiated by a permanent investor or other third party.

Examiners should also verify that appraisal practices are consistent with the Board's

6. For certain credits, the bank holding company should develop criteria for obtaining reappraisals or revaluations as part of a prudent portfolio review and monitoring program.

7. For mortgage-backed securities available-for-sale, similar account classification procedures apply, but those are accounted for in accordance with SFAS 115.

appraisal regulations,[8] the interagency appraisal and evaluation guidelines (see SR-94-50, SR-94-55, SR-95-16, SR-95-27, and SR-95-31), and any other state and federal laws and regulations. Mortgage banking companies that are subsidiaries of either state member banks or bank holding companies are subject to the same appraisal standards and requirements as their parent companies.

3070.0.5.4.1 Classification Procedures

The classification process begins with an analysis of delinquent loans. The examiner should begin by obtaining an aged listing of all delinquent loans in the held-for-sale and the held-to-maturity portfolios. Clear-cut shortfalls in property values compared with loan or investment values should usually be classified unless there are mitigating circumstances. Usually loans or investments with doubtful or loss elements have other significant weaknesses that will ordinarily justify a classification of substandard for the remaining balance. Loans secured by collateral such as real estate should be classified in accordance with these guidelines and the applicable classification guidance found in sections 2060.1 and 2090.1 of the *Commercial Bank Examination Manual* and sections 2010.2, 2065.1, 2240.0, and 5010.10 of this manual.

Portions of these loans may warrant a more severe classification if the value of the underlying collateral is insufficient to fully repay the loan. The identification of potential or actual loss exposure may warrant the use of either a split (substandard and loss) or a doubtful rating.

The examiner should also review the ORE portfolio, notes and accounts receivable, and other investments on the company's balance sheet for potential classifications. ORE may usually warrant a substandard classification due to an investment's nonearning status and an increased probability of loss on disposal of the underlying assets.

Assets that represent illegal or impermissible holdings or those that are subject to some regulatory concern should not be classified, per se, for these factors. Such holdings should be treated separately within the report. In those instances where a credit-quality issue is also present, the classification and the separate treatment should be cross-referenced.

8. See Regulation Y, subpart G (12 C.F.R. 225.61–67), and its incorporation by reference into Regulation H (12 C.F.R. 208.18).

The examiner should also review any off-balance-sheet exposure for which credit risk is retained. Loans sold to investors on a recourse basis have the potential of being put back to the servicer. The portion of the recourse portfolio that is severely delinquent should be classified according to the guidelines provided previously, since the exercise of this "put option" is highly likely.

At the end of the classification process, the examiner should evaluate the level and trend of classified assets to determine whether asset quality poses undue financial risk to the mortgage banking company or its parent bank holding company. A list of total classifications should be compiled and left with management.

As part of the analysis of asset quality, the aggregate of loss classifications plus an amount expected to ultimately be loss should be compared with the existing allowance for loan and lease losses. If the aggregate exceeds the existing contra asset balance(s) then additional loan-loss provisions are needed. In such situations, the parent company should be advised of the deficiency and reminded of its responsibility to ensure that an adequate allowance for loan and lease losses, as well as other contra asset valuation balances, is maintained by the subsidiary for its asset portfolio.

Any discrepancies between the classifications list and information contained on the company's MIS should also be discussed with management. If asset quality presents undue or excessive risk, appropriate comments should be documented and brought forward on Examiner's Comments and Matters Requiring Special Board Attention, page one of the report.

3070.0.5.4.2 Presentation of Classifications

As a minimum standard, brief write-ups stating the reason for classifications should be provided for any nonbank subsidiary's asset whose doubtful and/or loss classification exceeds the lesser of $100,000 or 5 percent of the subsidiary's total assets. In general, substandard assets should be listed without a write-up, regardless of size. However, a brief write-up is required for any asset whose classification is challenged by management. The examiner has the option to provide a write-up for any classified assets, regardless of size.

While the following presentation guidelines may be useful in structuring the write-ups, the examiner may include any other format appropriate to the situation:

- recapitulation of the status and purpose of the loan, the lien position, type and appraised value of the collateral, its delinquency and accrual status, guarantors and other debit or credit balances related to the loan
- the problems with the loan, borrower, or collateral, presented in a concise, descriptive narrative
- the examiner's evaluation of the situation, indicating estimated values, major assumptions, and mitigating or negative factors
- the classification, which should represent a logical combination of the relevant factors presented in the first three elements

Within the elements presented, the examiner should stress accuracy, brevity, and clarity in the presentation, as well as a logical pattern leading to the classification. Historical information and financial data that are not pertinent or that are too stale to have a direct bearing on the present situation should not be included.

Presentations for OREO properties need not include the original loan date, history, and financial information, unless there is some relevance to the current condition (for example, the property has been foreclosed on for the second time or some circumstance before foreclosure continues to have an impact). For those companies in which numerous loans and OREO properties are classified, a summary of classifications, segmented by loans and real estate owned and indexed to the pages containing the classifications, presents clear benefits to the users of the report. This becomes more pertinent when numerous assets below the write-up line are included in total classifications. In addition, both management and the subsequent examiners will have an official listing of the classifications.

3070.0.5.4.3 Reserves

Management should establish and maintain adequate contra asset allowances and other contingency reserves to cover identified loss exposure. Policies and procedures, and financial statement disclosures, should clearly state the purpose of and intended accounting treatment for each reserve. Management should evaluate the level of each reserve account at least quarterly, document this analysis, and replenish each reserve as necessary.

The financial presentation for reserves varies. Reserves maintained for on-balance-sheet exposure are generally reported as a contra asset. Reserves maintained for contingent liabilities relating to the sale of loans and servicing of loans for investors may be shown as a liability in practice.

Disclosures relating to valuation reserves should be consistent with GAAP. Examiners may wish to confer with the mortgage banking company's external auditors regarding the nature or appropriateness of any reserve accounts that are unusual.

3070.0.5.5 Earnings Performance

Earnings performance should be assessed in terms of the level, composition, quality, and trend of net income. The earnings analysis should consider internal factors such as the company's business orientation and management's growth plans, as well as relevant external factors such as interest rates and economic trends.

Unusual aspects of origination and servicing-fee income, marketing gains and losses, the net interest margin, provisions for losses, salaries and overhead items, or income taxes should be discussed with management, as well as with internal or external auditors. Large write-downs or amortization adjustments relating to mortgage-servicing rights should also be investigated. (See section 3070.0.6.)

Current and historical ratio trend analysis, compared with published industry results (for example, see the Mortgage Bankers Association's annual statistics in the ''Mortgage Banking Performance Report''), should also be incorporated into the profitability analysis, where appropriate. This includes income structure, expense structure, and operating performance ratios. However, ratios that compare earnings to average assets or equity may be of limited use unless the examiner also considers the transitory nature of the balance sheet and the impact of off-balance-sheet servicing activities on the company's use of financial leverage. Finally, the examiner should consider the company's ability to generate sustainable positive earnings consistently over time, as well as the proportionate share of consolidated earnings (or losses).

3070.0.5.6 Liquidity and Funding

Management's ability to satisfy the company's liquidity needs and plan for contingencies without placing undue strain on affiliate bank or nonbank resources or reliance on the parent bank holding company is crucial. Liquidity needs depend on the size of the warehouse, the nature and extent of longer-term assets, opportunities to issue debt at a reasonable price, and management's ability to forecast and plan for contingencies. Liquidity is often dependent on cash generated through short-term liquid assets and on short-term borrowings to fund operations. Earnings performance, capital adequacy, the degree of market contact with underwriters and credit rating agencies, maintenance of debt covenants, and contingent liquidity plans are all significant factors in the evaluation of liquidity. Liquidity can quickly erode if investor perceptions of a company's credit standing change. Consequently, the ability to fund mortgage operations under economic duress and access to alternate liquidity sources become key considerations.

Funding needs are driven by the need to temporarily finance mortgage loans and MBSs before their sale to a permanent investor. The examiners should do a trend review of external liquidity to assess how easy it is to sell mortgage-backed securities by the firm in the secondary market. The analysis should include the normal trading volume in MBS securities, the volume of loans held for sale and their market value, and the size of the ‘‘floating’’ supply of mortgage securities or loans that are not closely held. Liquidity needs must also take into consideration longer-term assets such as fixed assets, mortgage-servicing rights, and permanent loan and MBS portfolios. (See section 2080.05.)

3070.0.5.6.1 Financial Flexibility

The liquidity analysis should include a determination as to the company's financial flexibility. Financial flexibility is the ability to obtain the cash required to make payments as needed. Cash can be obtained from (1) business operations; (2) liquid assets already held by the company either in the form of cash or marketable securities or by selling liquid assets such as receivables or inventories for cash; and (3) external lines of credit, bank borrowings, or the issuance of debt or equity securities in the capital markets.

3070.0.5.6.2 Cash-Flow Analysis

The liquidity analysis should also include a review of the net current items on the cash-flow statement pertaining to cash flow from operations, cash flows from investing activities, and cash flows from financing activities on a year-by-year trend basis. The examiner's analysis of cash flows may reveal transactional trends between cash inflows and outflows. For example, within the Cash Flows from Operating Activities, cash flow from the sale and principal repayments on mortgage loans held for sale may correlate with originations and purchases of mortgage loans available for sale. With regard to investing activities, attention should be given to the differences between short-term purchases of mortgage loans held for investment versus principal repayments on mortgage loans held for short-term investment. In addition, purchases of real estate owned from the loan-servicing portfolio may correlate with net sales of real estate owned. A review of the financing activities should indicate if there is sufficient cash flow provided from revolving warehouse lines of credit, commercial paper, proceeds from the issuance of any other short-term debt, and net changes in advances payable to affiliates.

The summary analysis of the cash-flow statement should convey how the underlying transactions collectively contribute to a positive cash flow and liquidity. When analyzing liquidity, the examiner needs to consider the principles and guidelines set forth in section 2080.05, ‘‘Funding (Bank Holding Company Funding and Liquidity)’’ of this manual.

3070.0.5.6.3 Asset/Liability Management

In general, funding liability maturities should closely approximate the maturities of underlying assets to mitigate the risk of a funding mismatch. Otherwise, the company is exposed to short-term interest-rate fluctuations unless appropriately hedged. Funding mismatches can lead to significant earnings volatility in the event that interest rates change rapidly. Management's asset/liability management program should be evaluated in terms of the degree of matching, risk aversion, and the accuracy of information that is provided to the holding company through daily, weekly, or monthly management reports.

3070.0.5.7 Capital Adequacy

Capital must be adequate to absorb potential operating losses, provide for liquidity needs and expected growth, and meet minimum requirements set by third-party creditors and investors.

At a minimum, a mortgage banking company must meet the nominal capital levels required by investors such as FannieMae ($250,000) or FHLMC ($1 million, based on financial reporting under GAAP, or $500,000, adjusted for certain assets and any deferred-tax liability). Additional capital is required based on the outstanding principal balance of loans serviced for investors. If these requirements are not met, the company may not be able to sell mortgages to and/or service mortgages for these investors.

As noted above, these are minimum capital requirements. Management should identify the level of capital that is required to support current operations and projected future growth, given the risk tolerance preferences of management and the board. Capital levels, dividend payments, and capital planning should be addressed in a written capital plan that is reviewed and approved by the board at least annually in conjunction with the budgeting and strategic planning activities.

There also may be a need to meet minimum leverage ratios established by the parent bank holding company or to meet debt covenants set forth in either warehouse credit facilities or long-term debt instruments. Companies that have excessive off-balance-sheet risk or high growth expectations may require additional capital. In addition, risk-based capital guidelines impose certain reporting requirements and limitations regarding the amount of MSA mortgage banking companies may include in their regulatory capital.

Capital levels should be monitored and reported to the company's board of directors regularly to mitigate the risk of inadequate or eroding capital. Management and the board are further encouraged to adopt a capital policy that specifically addresses the particular needs of the company.

The examiner should evaluate capital adequacy, the amount of dividends that are upstreamed to the parent bank holding company, and the extent to which the parent company can be relied on to augment the ongoing capital needs of its bank and nonbank subsidiaries. In some instances, the parent company may operate on the premise that the mortgage banking company requires little capital of its own as long as the parent company remains adequately capitalized.[9] Under the Federal Reserve's source-of-strength doctrine, the parent company must be prepared to support its subsidiaries should the financial need arise. If the parent is not prepared to inject capital and capital levels have declined, the examiner should comment on the mortgage banking company's extended leveraged position on page one of the inspection report. Under extreme circumstances, the examiner should also recommend that its leverage be reduced and its capital structure augmented to ensure that mortgage operations are conducted in a safe, sound, and prudent manner.

3070.0.5.8 Overall Assessment

The overall financial condition of the mortgage banking company should reflect its financial statement presentation, asset quality, earnings, liquidity and funding practices, and capital adequacy. Report comments should be prepared to the extent necessary.

3070.0.5.9 Inspection Objectives

1. To evaluate the financial condition of the mortgage banking company based on a review of the following:

- primary balance-sheet and income-statement levels and trends
- off-balance-sheet exposure such as the servicing portfolio
- asset quality
- earnings performance
- funding sources and liquidity needs
- capital adequacy

2. To determine the accuracy of regulatory reporting (regulatory accounting practices (RAP) and GAAP) and compliance with applicable state and federal laws and regulations.

3. To evaluate the quality of the mortgage banking company's assets for collateral sufficiency, performance, credit quality, and collectibility.

4. To assess earnings performance through the analysis of the level, composition, and trend of net income. If material, interest income, impairment of mortgage-servicing assets, gains and losses on asset sales, and personnel and other expenses should be factored into the analysis.

9. When MSAs are valued for inclusion in capital, the risk-based capital guidelines for banks and BHCs require the discount rate to be not less than the original discount rate inherent in the intangible asset at the time of its acquisition, based on the estimated future net cash flows and price paid at the time of purchase.

5. To assess the funding and liquidity needs of the mortgage banking company through ratio analysis and a review of the funding instruments used.

6. To assess capital adequacy by ensuring that investor minimum requirements are met and by comparing capital levels with peer and industry data. Consideration of the capital needs of the individual mortgage banking company should override any comparison with peers.

3070.0.5.10 Inspection Procedures

Financial Statement Level and Trends

1. Review the mortgage banking company's financial statements and related notes over the previous three-year period.

2. Discuss significant balance-sheet and income-statement categories with management, as well as with internal and external auditors.

3. Determine whether financial trends are consistent with the economic environment, interest-rate movements, the company's business orientation, and management's intended growth strategy.

4. Determine whether reports filed with regulatory agencies are prepared accurately and submitted in a timely manner, with particular attention paid to the reporting for mortgage-servicing assets and recourse obligations retained by the mortgage banking company.

Asset Quality

1. Spread past-due and nonaccrual loans by balance-sheet asset category (for example, mortgage loans held for sale, mortgage loans held for investment), product type, and delinquency status (for example, 31–90 days, 91–180 days, and 181 days and over). Include any loans in the process of foreclosure.

2. Obtain a trial balance and delinquency listing for loans held for sale and loans held for investment.

a. Reconcile balances of the real estate held for sale and investment to the respective general ledger accounts.

b. Classify severely delinquent loans as required based on the financial condition of the borrower, his or her inability to make monthly payments as required, and the protection afforded by current collateral values.

c. Determine accounting policies and practices with respect to these loans. Review aging reports for loans held for sale and for investment. Discuss the frequency of reviews for loans held for sale, revaluation practices, and transfers among accounts. Verify that accounting practices are consistent with GAAP and RAP.

3. Obtain a listing of loans in the process of foreclosure and bankruptcy and discuss these with management for potential classification.

4. Reconcile all other real estate owned by the mortgage banking company to the general ledger and classify based on risks and any income-producing characteristics of the properties. Compare current appraisals to carrying value for potential write-downs.

5. Obtain a list of loans sold under recourse arrangements and assess for potential classification.

6. Discuss the methodology used to establish foreclosure reserves and related accounting procedures. Review analysis used to project future foreclosures.

- Evaluate the adequacy of foreclosure reserves based on the volume of projected foreclosure actions, average foreclosure costs, and the past history of reinstated loans.

7. Review other reserve accounts and assess for reasonableness.

Earnings Performance

1. Assess earnings performance in terms of the level, composition, and trend of net income. Consider internal factors, such as the company's business orientation and management's growth plans, and external factors, such as interest rates and the economic environment, when evaluating earnings trends.

2. Discuss any unusual aspects of origination and servicing-fee income, marketing gains and losses, the net interest margin, reserves, write-downs or adjustments in MSA amortization, salaries and overhead items, or income taxes with management, as well as with internal or external auditors.

3. Incorporate ratio and industry comparisons into the earnings analysis, where appropriate. Bear in mind that ratios that compare earnings to total assets or equity are of limited use unless the transitory nature of the balance sheet and the impact of off-balance-sheet servicing

activities on the company's use of financial leverage are taken into consideration.

Liquidity and Funding

1. Determine the mortgage banking company's liquidity needs based on a review of the size of its warehouse and the nature and extent of other longer-term assets.

2. Determine whether sources of liquidity are adequate, both under current conditions and economic duress. Consider earnings performance, capital adequacy, the degree of market contact with underwriters and credit rating agencies, maintenance of debt covenants, and contingent liquidity-planning capabilities.

3. Evaluate financial instruments used to fund mortgage operations. Financial instruments may include repurchase agreements, commercial paper, revolving warehouse lines of credit, and/or long-term debt. Review related credit agreements and systems used to monitor compliance with debt covenants.

4. Establish whether excessive borrowing activities have led to a highly leveraged financial condition that exposes the company to money market changes in the cost of funds. Evaluate the impact a change in the company's cost of funds would have on its net interest margin and earnings.

5. Determine the degree of financial flexibility the company maintains. Financial flexibility is the ability to obtain the cash required to make payments as needed. Does the company possess adequate financial strength and have access to lines of credit and/or assets that can be easily collateralized?

6. Review the net current items on the cash-flow statement pertaining to cash flow from operations, cash flows from investing activities, and cash flows from financing activities on a year-by-year trend basis. Determine whether sufficient positive cash flow exists from the level of current transactions. The summary analysis of the cash-flow statement should convey how the underlying transactions collectively contribute to a positive cash flow and liquidity.

7. Review asset/liability management practices to determine whether funding maturities closely approximate the maturities of underlying assets or whether a funding mismatch exists. Is the company exposed to short-term interest-rate fluctuations that may lead to significant earnings volatility in the event that interest rates change rapidly?

Capital Adequacy

1. Determine whether capital levels are adequate to absorb potential operating losses, provide for liquidity needs and expected growth, and meet minimum requirements set by investors whose loans are serviced and other external parties.

2. Review policies and procedures to determine whether management adequately monitors and reports capital levels to the board of directors. Review the capital plan to determine whether it adequately addresses the particular needs of the company.

3. Evaluate the amount of dividends that are upstreamed to the parent bank holding company, as well as the extent to which the parent company can be relied on to augment the ongoing capital needs of its bank and nonbank subsidiaries. Is the parent company prepared to support its subsidiaries should the financial need arise? Are cash dividends paid by the mortgage banking subsidiary to the parent company reasonable?

Accounting

1. Review accounting procedures for retail loans. Determine whether loan fees in excess of cost are deferred in accordance with SFAS 91. Verify that income is recognized over the estimated life of the asset and not in the current period and that fees and costs are allowable under SFAS 91. Are controls in place to ensure proper recognition for net fee income when loans are sold? (SFAS 91 applies to loans held in portfolio, as well as to loans swapped for securities when the securities are retained.)

2. Determine if the accounting for recognizing sales of loans and mortgage-backed securities (including participation agreements) is in accordance with the three conditions for true sales recognition specified in SFAS 77, ''Reporting for Transfers of Receivables with Recourse.''[10] Also determine if the sales price

10. A transfer is recognized as a sale if—

a. The transferor surrenders control of the future economic benefits of the receivables;

b. The transferor's obligation, under the recourse provisions of the sale agreement, can be reasonably estimated. The transferor should have had past experience with the recourse provisions so that a reasonable estimate can be made. The current transferred receivables should possess characteristics was adjusted for all probable adjustments (as defined in SFAS 5, ''Accounting for Contingencies''). If the mortgage banking company is a subsidiary of a bank, refer to the bank call report, glossary entry on ''sales of assets.''

3. If servicing is retained, determine if a ''normal servicing fee'' is set and how it conforms to FannieMae/FHLMC fees and to FASB Technical Bulletin 87-3, ''Accounting for Mortgage-Servicing Fees and Rights.''[11] If the mortgage banking subsidiary is a subsidiary of a bank, see the reporting instructions for Schedule F of the bank call report (Schedule RC-F for Other Assets, Item 3—Excess residential mortgage-servicing fees receivable).

Overall Financial Condition

1. Evaluate the overall financial condition of the mortgage banking company, considering its asset quality, earnings, liquidity, and capital adequacy. Update the financial component of the supervisory rating and prepare report comments as necessary.

3070.0.6 MORTGAGE-SERVICING ASSETS AND LIABILITIES

This subsection discusses mortgage-servicing assets (MSAs) and liabilities and provides guidance with respect to the measurement, impairment testing, and financial reporting requirements of MSAs. The subsection concludes with a discussion of MSA hedging practices and instruments.

SFAS No. 125 ''Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,'' was issued in June 1996 as an amendment to SFAS Nos. 65, 76, 77, and 115. The provisions of SFAS 125 supersede SFAS 122 and are to be applied prospectively in fiscal years beginning after December 31, 1996. The statement requires that a liability be derecognized when either (1) the debtor pays the creditor and is relieved of its obligation for the liability or (2) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor.

Under SFAS 125, a mortgage banking company is required to recognize as separate assets or liabilities the right to service mortgage loans for others, however those servicing rights are acquired. Servicing of mortgage loans includes, but is not limited to, collecting principal, interest, and escrow payments from borrowers; paying taxes and insurance from escrowed funds; monitoring delinquencies; executing foreclosure if necessary; temporarily investing funds pending distribution; remitting fees to guarantors, trustees, and others providing services; and accounting for and remitting principal and interest payments to the holders of beneficial interest in the mortgage loans. Servicing is inherent in all mortgage loans; however, it becomes a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing.

3070.0.6.1 Measurement

A mortgage banking company initially acquires MSAs either by (1) purchasing the right to service mortgage loans separately or (2) purchasing or originating mortgage loans and selling those loans with servicing rights retained. When a mortgage banking company purchases or originates mortgage loans, the cost of acquiring those loans includes the cost of the related MSAs.

With respect to SFAS 125, when an entity incurs an obligation to service financial assets, it must record servicing assets or a servicing liability for each servicing contract, unless it securitizes the assets and retains all of the resulting securities, classifying them as debt securities that are to be held to maturity. When servicing assets or liabilities are assumed, rather than being acquired by a sale or undertaken in a securitization of the financial assets that are to

similar to previously transferred receivables evidencing the transferor's relevant prior experience.

c. The transferor cannot require the transferee to repurchase the receivables, except as stated in the agreement's recourse provisions.

11. According to FASB Technical Bulletin No. 87-3, the servicing-fee rates set by GNMA, FHLMC, and FannieMae in servicing agreements should be considered a normal servicing-fee rate for transactions with those agencies. If the normal service fees are expected to be less than the estimated servicing costs, the expected loss should be recognized at the time the loans are sold. If a seller/servicer sells mortgage loans directly to private-sector investors and retains servicing on the loans, the seller/servicer should consider the normal servicing-fee rate that would have been specified in comparable servicing agreements if the loans had been sold to or securitized by one of the federally sponsored secondary market makers. As of May 1995, normal servicing-fee rates established by GNMA, FHLMC, and FannieMae were 44, 25, and 37.5 basis points, respectively.

be serviced, they are measured initially at fair value (that is, the price paid). A servicing asset or liability is amortized in proportion to and over the period of estimated net servicing income (loss). Any impairment of a servicing asset or liability is determined based on fair value.

When the mortgage banking company sells or securitizes the loans and retains the MSAs, management shall allocate the total cost of the mortgage loans (the recorded investment in the mortgage loans including net deferred loan fees or costs and any purchase premium or discount) to the MSAs and the loans (without the MSAs) based on their relative fair values if it is practicable to estimate those fair values. If a mortgage banking organization undertakes a servicing liability in a sale or securitization, the servicing liability should initially be measured at fair value.

The fair value of an asset is the amount at which the 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 in active markets are the best evidence of fair value and shall be used as the basis for measurement, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information that is available, including prices for similar assets and the results of valuation techniques used by management. Valuation techniques may include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved; option-pricing models; matrix pricing; option-adjusted spread models; and fundamental analysis. Valuation techniques for measuring MSAs should be consistent with the objective of measuring fair value and should incorporate assumptions that market participants would use in their estimates of future servicing income and expense, including assumptions about prepayment, default, and interest rates. If it is not practicable to estimate the fair values of the MSAs and the mortgage loans (without the MSAs), the entire cost of acquiring the mortgage loans shall be allocated to the mortgage loans (without the MSAs) and no cost shall be allocated to the MSAs.

The amount capitalized as MSAs shall be amortized in proportion to and over the period of estimated net servicing income. Estimates of future servicing revenue shall include expected late charges and other ancillary revenue. Estimates of expected future servicing costs shall include direct costs associated with performing the servicing function and appropriate allocations of other costs. Estimated future servicing costs may be determined on an incremental-cost basis.

MSAs are highly subject to interest-rate and prepayment-rate risk since the amount of future cash flows that are provided to the holder is derived from, and is thus dependent on, the outstanding balances of the underlying mortgage loans.[12] Prepayments of underlying mortgage loans accelerate during periods of declining interest rates as borrowers take advantage of the option they hold to refinance their loans. As interest rates decline, holders of MSAs are exposed to a risk of prepayment of the underlying loans, and thus a diminished amount of cash flow from their investment. Holders of interest-only stripped securities (I/O strips) are exposed to similar interest-rate and prepayment risks when interest rates decline. I/O strips possess very similar prepayment risk characteristics.

A particular mortgage company's exposure to prepayment risk can also be influenced by portfolio composition factors such as geographical mix, loan-to-value ratios, and the proportion of government (FHA/VA) and conventional loans in the portfolio. Government loans that may be assumable by the purchaser of a home are generally for smaller amounts and may be extended to borrowers with limited financial resources. As a result, government loans tend to prepay more slowly than conventional loans.

Unanticipated changes in interest rates, prepayment speed, or other valuation assumptions may impair the carrying value of MSAs and require accelerated amortization or a write-down. Therefore, the recoverability of the unamortized balance should be evaluated periodically, and amortization and/or the value of the asset should be adjusted accordingly. To the extent that impairment is not recognized, MSA values may be inflated. As a result, assets, earnings, and capital may be overstated.

12. Several conventions exist for quantifying prepayment speed. The most common convention is a measure developed by the Public Securities Association (PSA). The PSA measure was based on actual historical experience of FHA mortgages, but it is not predictive. The PSA measure assumes that mortgages prepay at a rate of .2 percent per year in the first month, increase by .2 percent each subsequent month up to 30 months, and remain at 6 percent per year thereafter until maturity. This 6 percent level is referred to as 100 percent PSA. Mortgages that prepay at 200 percent PSA pay off twice as fast as a mortgage that is performing at 100 percent PSA. Another convention is known as the conditional prepayment rate (CPR) measure. CPR assumes that a constant fraction of the remaining principal is prepaid each period, ''conditional'' on the previous period's remaining balance. Typically, CPR is computed over a one-month time period. The PSA model simply represents a series of stable CPR assumptions.

3070.0.6.2 Impairment Testing

SFAS 125 states that a mortgage banking company shall measure impairment of capitalized MSAs[13] based on their fair value. For the purpose of evaluating and measuring impairment of capitalized MSAs, management should stratify those assets based on one or more of the predominant risk characteristics of the underlying loans.[14] Those characteristics may include loan type, loan size, note rate, date of origination, term, and geographic location.

Impairment shall be recognized through a valuation allowance for an individual stratum. The amount of impairment that is recognized shall be the amount by which the capitalized MSAs for a given stratum exceed their fair value. The fair value of MSAs that have not been capitalized shall not be used in the evaluation of impairment.

Subsequent to the initial measurement of impairment, management shall adjust the valuation allowance to reflect changes in the measurement of impairment. Fair value in excess of the capitalized MSAs shall not be recognized. If the fair value of a mortgage-servicing liability increases above the book value, the increased obligation shall be recognized as a loss in current earnings. SFAS 125 does not address when a mortgage banking company should record a direct write-down of capitalized MSAs; therefore, examiner judgment in this area is required.

3070.0.6.3 Disclosures

SFAS 125 requires that the fair value of capitalized MSAs, and the methods and significant assumptions used to estimate that fair value, be disclosed. If no cost is allocated to certain MSAs, management shall describe those MSAs and describe the reasons why it is not practicable to estimate the fair values of the MSAs and the mortgage loans (without the MSAs). The risk characteristics of the underlying loans used to stratify capitalized MSAs for the purposes of measuring impairment shall also be disclosed. For each period for which results of operations are presented, the activity in the valuation allowances for capitalized MSAs, including the aggregate balance of the allowances at the beginning and end of each period, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances shall be disclosed.

3070.0.6.4 Intercompany MSAs

Intercompany MSAs may arise when a mortgage banking company originates loans, sells the loans to an affiliate bank, and the affiliate bank records related MSAs. Intercompany MSAs should be evaluated closely to determine whether a valid business purpose exists, the loans are actually sold, the entity holding the MSAs has revalued the rights correctly, and such intercompany MSAs are eliminated in consolidation. If the purpose of the transaction is merely to bolster capital levels at the bank, the practice may constitute an unsafe and unsound banking practice.

3070.0.6.5 Table Funding

One method of acquiring mortgage loans, and recording related MSAs, is through so-called ‘‘table-funding arrangements.’’ In a table-funding arrangement, the mortgage banking company provides the original funding when a mortgage broker or correspondent closes the mortgage loan with the borrower. Concurrent with the loan closing, the mortgage banking company acquires the loan and the related MSAs.

Emerging Issues Task Force Issue No. 92-10 (EITF 92-10), ‘‘Loan Acquisitions Involving Table Funding Arrangements,’’ clarified under what conditions these arrangements could be characterized as loan purchases. According to EITF 92-10, a mortgage banking company may account for a loan acquired in a table-funding arrangement as a purchase only if *all* of the following conditions are met:

- The correspondent is registered and licensed to originate and sell loans under the applicable laws of the states or other jurisdictions in which it conducts business.
- The correspondent originated, processed, and closed the loan in its own name and is the first titled owner of the loan, with the mortgage banking company becoming a holder in due course.

13. The term ‘‘capitalized mortgage-servicing rights’’ refers to the cost originally allocated to the MSAs less the amount amortized.

14. SFAS 65, as amended, applies to impairment evaluations of all capitalized MSAs. However, a mortgage banking company may continue to apply its previous accounting policies for stratifying MSAs to MSAs that were capitalized before the adoption of the amendments to SFAS 65.

- The correspondent is an independent third party and not an affiliate of the mortgage banking company as defined in SFAS 65. As a nonaffiliate, the correspondent must bear all of the costs of its place of business, including the costs of its origination operations.
- The correspondent must sell loans to more than one mortgage banking enterprise and not have an exclusive relationship with the purchaser.
- The correspondent is not directly or indirectly indemnified by the mortgage banking company for market or credit risks on loans originated by the correspondent. However, a commitment by the mortgage banking company for the purchase of loans from the correspondent is not considered to be an indemnification for purposes of this requirement.

If any one of the above criteria is not met, the mortgage banking company must account for the loan as an origination. MSAs that were recorded before the adoption of the SFAS 65 amendments should be reviewed to ensure that they were originated and funded consistent with the above requirements. MSAs that are recorded under SFAS 125 may arise in connection with either originated or purchased mortgage loan transactions.

3070.0.6.6 Regulatory Reporting

The examiner should also determine whether the method used to value MSAs is in accordance with the instructions for the Bank Report of Condition and Income (call report) and the BHC reporting instructions (FR Y-9C). If capitalized MSAs are not appropriately valued, they cannot be included in capital. Management should review the carrying amount at least quarterly, adequately document this review, and adjust the book value as necessary.

3070.0.6.7 Risk-Based Capital

Readily marketable MSAs may be included in a bank or bank holding company's tier 1 capital subject to certain limitations. Tier 1 capital for bank holding companies includes common equity, minority interest in the equity accounts of consolidated subsidiaries, qualifying noncumulative perpetual preferred stock, and limited qualifying cumulative perpetual preferred stock.[14a] Tier 1 capital excludes goodwill; amounts of mortgage-servicing assets, nonmortgage-servicing assets, and purchased credit-card relationships that, in the aggregate, exceed 100 percent of tier 1 capital; amounts of nonmortgage-servicing assets and purchased credit-card relationships that, in the aggregate, exceed 25 percent of tier 1 capital;[15] all other identifiable intangible assets; and deferred-tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations.

The amount of MSAs which may be included in capital is also limited to the *lesser* of—

- the amount recorded on the balance sheet under GAAP, or
- 90 percent of their fair market value. If both the application of the limit on MSAs and the adjustment of the balance-sheet amount for MSAs would result in an amount being deducted from capital, the bank holding company would deduct only the greater of the two amounts from its core capital elements in determining tier 1 capital.

3070.0.6.8 Previously Recognized Excess Servicing-Fee Receivables

SFAS No. 125, ''Accounting for the Transfers and Servicing of Financial Assets and Extinguishments of Liabilities'' (paragraph 20), addresses the accounting treatment for excess servicing-fee receivables based on contracts that were in existence before January 1, 1997. Previously recognized servicing rights and excess servicing-fee receivables are to be combined, net of any previous servicing obligations under the contract, as a servicing asset or a servicing liability. Any previously recognized excess servicing-fee receivables that exceed contractually specified servicing fees are to be reclassified as interest-only strips receivables.

3070.0.6.9 MSA Hedging Practices and Instruments

During the refinancing waves of 1992 and 1993, several mortgage banking companies experi-

14a. Cumulative perpetual preferred stock is limited to 25 percent of tier 1 capital.

15. Amounts of MSAs, non-MSAs, and PCCRs in excess of these limitations, as well as all other identifiable intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from an organization's core capital requirements in determining tier 1 capital. Identifiable intangible assets, however, exclusive of MSAs and PCCRs, acquired on or before February 19, 1992, generally will not be deducted from capital for supervisory purposes. They will, however, continue to be deducted for applications purposes.

enced large losses due to the impact of rising prepayments on the value of servicing rights. As a result, many companies have begun to hedge MSAs. An effective hedge program should reflect a solid understanding of the underlying MSA risk characteristics.

3070.0.6.9.1 Hedging Practices

Interest-rate and prepayment-rate risk are often reduced through the natural offset between the production and servicing functions; however, the degree of protection afforded by this relationship depends on the company's business orientation (originations versus purchases) and can be very difficult to measure.[16] Other financial instruments are also used to mitigate interest-rate and prepayment-rate risks. The remainder of this subsection discusses existing hedge accounting guidance and rudimentary descriptions of certain customized MSA hedge products. Examiners should also refer to the Federal Reserve System's *Trading Activities Manual* for additional guidance on derivatives.

3070.0.6.9.2 Hedge Accounting

Existing accounting literature is vague with respect to the accounting treatment for MSA hedge products, particularly in the area of derivatives. However, analogies exist that facilitate the application of existing accounting standards. SFAS No. 80, ''Accounting for Futures Transactions,'' provides financial reporting standards for exchange-traded futures contracts on both interest-rate products and raw materials (commodities). Several EITF issues releases provide financial reporting guidance for interest-rate swap transactions. Finally, an issues paper prepared by the American Institute of Certified Public Accountants (AICPA), ''Accounting for Options,'' provides informal but nonauthoritative guidance relating to options contracts. The AICPA issues paper addresses options on all tangible goods, including both exchange-traded options and nonexchange traded options on interest-rate caps and floors.

16. When interest rates fall, increases in production volumes and related revenues tend to offset runoff in the servicing portfolio and reductions in servicing-fee income. Alternatively, to the extent that the marketing department hedges less than 100 percent of its estimated long position (closed loans plus rate-locked loans that are expected to close) and interest rates fall, the resulting marketing gains on the uncovered position tend to offset a portion of any required write-downs in the servicing portfolio.

To qualify for hedge-accounting treatment under SFAS 80, a financial instrument must meet two criteria:

- The hedged item exposes the entity to price or interest-rate risk.
- The financial instrument used as a hedge reduces that exposure and is designated as a hedge.

SFAS 80 states that at the inception of the hedge and throughout the hedge period, changes in the market value of the financial instrument used as a hedge should correlate highly with changes in the fair value of, or interest income or expense associated with, the hedged item(s) so that the results of the financial instrument(s) used as a hedge will substantially offset the effects of price or interest-rate changes on the exposed item(s). Although required correlation levels are not specifically defined, the accounting industry has determined that 80 percent is a reasonable benchmark.

Before claiming hedge-accounting treatment, management must obtain an opinion from its CPA or internal accountant confirming that the instrument that is proposed would qualify for such treatment. If these criteria are not met, the financial instrument should be carried at its market value (i.e., marked to market). Hedge performance should be monitored daily and reported to the responsible management or board committee at least quarterly.

3070.0.6.9.3 Relevant MSA Characteristics

To evaluate a mortgage banking company's hedge program for MSAs, one must first understand how MSAs perform. Duration, convexity, and amortization are useful concepts that will be reviewed as they relate to MSAs. Duration measures the change in the value of MSAs (or their cash flows) for a given change in interest rates. Duration can be either positive or negative. An asset with a positive duration, such as a fixed-income bond, tends to increase in value as interest rates fall. Conversely, an asset with a negative duration, such as an MSA, tends to decrease in value as interest rates fall.

Convexity measures the rate of change in an instrument's duration, or the nonlinearity of its price/yield curve. Like duration, convexity can be either positive or negative. An asset with a positive convexity will rise more in value for a given change in interest rates than it will fall if interest rates move equally in the opposite direction. Conversely, an asset with a negative convexity will decline more in value for a given change in interest rates than it will increase in value if interest rates move equally in the opposite direction. Because of their prepayment characteristics, MSAs and most other mortgage-related assets are negatively convex within a specified range of interest rates. Borrowers can be expected to exercise their option to prepay a loan at a time that is most disadvantageous to the MSA holder.

MSAs are also an amortizing asset. When a prepayment occurs, the loss of value is permanent and cannot be recovered. The use of a nonamortizing asset as a hedge would necessitate an active hedge-management strategy to adjust the position as the unamortized balance of the MSAs declines. If the position is not adjusted correctly, this strategy may expose earnings and capital to additional risks that are not within the scope of the company's MSA hedge program.

3070.0.6.9.4 Hedge Instruments

An effective MSA hedge instrument will possess characteristics that mitigate the interest-rate and prepayment risks associated with MSAs without assuming additional basis risk. Basis risk measures how well changes in the value of the hedge instrument correlate to changes in the value of the MSA. An effective hedge should also be reasonable in terms of transaction costs and management's time.

Several types of specialized derivative products have evolved to meet the needs of mortgage banking companies. Early MSA hedge products were interest-rate-driven, utilizing zero-coupon Treasury bonds or interest-rate swaps. However, the basis risk of such hedges proved to be excessive. Next came principal-only (PO) and super-principal only (SPO) bonds, which were prepayment-driven.[17] However, these products also proved ineffective due to geographic basis risk, potential average-life mismatches, additional capital requirements, and dissimilar accounting treatment which led to accounting losses.

MSA hedge products generally fall into three categories: bond hedges, short-term option hedges, and long-term option hedges. Bond hedges use Treasury bonds, ''plain vanilla'' interest-rate swaps, interest amortizing rate swaps, positive convexity swaps, POs, and SPOs. Bond hedges may be either interest-rate-driven or prepayment-rate-driven. Prepayment-rate-driven products reduce more basis risk and are therefore more expensive. Although most bond hedges are positively convex, they fail to provide enough positive convexity to offset the negative convexity in MSAs. In other words, when interest rates decline, the value of the bond hedge will not increase in an amount sufficient to offset the simultaneous decline in the MSAs. Another disadvantage to bond hedges is that the downside risk is generally unlimited.

Short-term option hedges consist of over-the-counter (OTC) Treasury options, options on futures contracts, and options on OTC mortgage securities. Short-term option hedges generally contain enough positive convexity to offset the negative convexity of MSAs, and the downside risk is limited to the option premium paid at inception. However, option strategies using these products require frequent rebalancing, are therefore expensive, and do not work well in a rapidly changing interest-rate environment because they are not amortizing assets.

Long-term option hedges include prepayment caps, interest amortizing rate (IAR) servicing hedges, LIBOR floors, and swaptions. These products may protect the servicer and/or seller against changes in either interest rates or prepayments. As off-balance-sheet products, they impose very few capital constraints on the MSA holder.

A prepayment cap is an off-balance-sheet, prepayment-driven option product that can be used to hedge a mortgage-servicing portfolio. In exchange for paying a fee, either up-front or over the life of the hedge, the servicer and/or seller receives a payment from the counterparty every month that the option is ''in the money.'' The option is in the money if the difference between the ''strike balance'' and the actual balance of a ''reference portfolio,'' less the sum of previous balance differences, is positive. Each month the option is in the money, the counterparty will pay the ''strike price,'' usually the book cost of the servicing portfolio, multiplied by this balance shortfall. The reference portfolio, strike price, and strike balance can be customized to match the servicer and/or seller's risk parameters and individual portfolio.

17. A special class of REMIC securities backed by POs. SPOs are a more leveraged type of PO.

An IAR servicing hedge is an off-balance-sheet, interest rate–driven option product that can be used as either a revenue or a balance-sheet hedge of a mortgage-servicing portfolio. In exchange for paying a fee, either up-front or over the life of the hedge, the servicer and/or seller receives a series of payments from the counterparty to the extent that amortization of a "reference balance" exceeds scheduled amortization of a "strike balance." The main difference between an IAR and a prepayment cap is that with an IAR, option payments are based on the performance of a "reference portfolio" rather than the seller and/or servicer's actual portfolio. For an IAR revenue hedge, the option payout is based on the current balance shortfall between the reference and strike balances. For an IAR balance-sheet hedge, option payouts are based on the cumulative excess amortization of the reference balance over the strike balance. IAR hedges are less expensive than comparable prepayment-linked hedges because they contain basis risk. If actual prepayments occur more rapidly than predicted at the onset of the hedge, the servicer and/or seller will be underhedged.

Numerous other types of customized hedge products are available. The advantages and disadvantages of each product should be well understood before it is incorporated into a mortgage banking company's interest-rate risk management strategies.

3070.0.6.10 Inspection Objectives

1. To determine whether MSAs pose a significant financial risk to earnings and capital.

2. To evaluate management's expertise and the oversight provided by the board of directors.

3. To determine whether policies and procedures used to initially record, amortize, and reevaluate MSAs are in conformance with GAAP and risk-based capital requirements, and whether actual practice is consistent with stated policies and procedures.

4. To verify that asset values are fairly stated.

5. To evaluate the methods used to hedge interest-rate and prepayment risks associated with MSAs, the degree of oversight provided by management or the board of directors, the adequacy of written policies and procedures, and the effectiveness of the company's hedge program for MSAs.

6. To identify any excessive risk-taking which is caused by the company's business mix and/or strategy.

3070.0.6.11 Inspection Procedures

1. Determine the extent of financial risk associated with MSAs through a review of the following:

a. Significant changes in the size of the servicing portfolio. Obtain a reconciliation for the servicing portfolio for the prior fiscal year and the most recent interim period. If significant growth has occurred, determine whether loans were originated, purchased individually (on a flow basis), purchased in bulk transactions, or acquired through whole company acquisitions. If the portfolio size has declined, determine the reason for such decline (sales of servicing rights, prepayments) and the impact on the remaining servicing portfolio.

b. The proportion of capitalized MSAs relative to the outstanding principal balance of mortgage loans in the servicing portfolio.

c. Other unusual characteristics of the servicing portfolio that may present undue risk, such as the weighted average coupon rates, weighted average maturities, delinquency characteristics, or mix of government (FHA/VA) loans versus conventional loans.

If the level of financial risk is sufficient to place earnings and capital at risk, the examiner should complete the remainder of the MSA procedures.

2. Review the qualifications of the individuals who are responsible for initially recording, amortizing and evaluating MSAs. Does management possess the necessary accounting expertise and experience with respect to valuation methodologies?

3. Review the accounting systems used to track MSAs. Is the necessary information being maintained in an understandable and useable form? Does the adoption of SFAS 65, as amended, and 125 pose any system problems for the company? Are such problems being addressed in a timely manner? At a minimum, MSAs should be tracked by product type and year of origination. The following information should be maintained for each pool of loans: the original and current principal balance for each pool; original and current book values of related MSAs; prepayment speeds, normal servicing fees, and the original discount rate used; and the actual historical payment experience for each pool.

4. Review written policies and procedures for initially recording, amortizing, and periodically revaluating MSAs. Determine the manage-

ment or board committees responsible for approval of such policies, the date of last approval, and the frequency of their review.

5. Determine whether MSA policies and procedures are in conformance with GAAP and risk-based capital requirements and whether actual practice conforms with established policies and procedures. At a minimum, policies and procedures should clearly address the following areas:

a. Initial valuation of MSAs and related pricing policies. With respect to MSAs, policies and procedures should describe the method for allocating the total cost of originated and purchased mortgage loans to the MSAs and the related loans (without the MSAs) based on their relative fair values at the date of origination or purchase; procedures to be followed if a definitive plan for sale of the loans does not exist and loans are sold at a later date; procedures to be followed in the event that it is not practicable to estimate the fair value of the MSAs and the related loans (without MSAs); and MSAs recorded under table funding relationships with correspondents and/or brokers.

b. The method for amortizing MSAs over the estimated lives of the assets, and instances where amortization lives may be adjusted.

c. The method for measuring impairment of capitalized MSAs based on their fair value. Policies and procedures should address the basis for stratification of MSAs based on the risk characteristics of the underlying loans; the types of valuation allowances used to reflect changes in the measurement of impairment; the method used to arrive at the fair value of assets (quoted market prices, estimated prices for similar assets, and the results of valuation techniques); the frequency of revaluation tests; the presentation of valuation test results to senior management and the board of directors; instances where write-downs would be required; disclosures; and the basis for assumptions used.

6. Verify that the valuation techniques for measuring MSAs are consistent with the objective of measuring fair value. Review model output and related manuals and/or marketing materials. Evaluate the reasonableness of all key parameters and assumptions, with an emphasis on the source for prepayment speed estimates, the number of interest-rate ‘‘paths’’ used (vectoring or binomial models being more desirable than a single interest-rate projection path), the basis for the interest rate used to discount cash flows, and the source of servicing revenue and cost data.

7. Review the most recent quarterly valuation process and the related output to determine whether necessary write-downs or amortization adjustments were made, management or board oversight was adequate, and actual practice is consistent with established policies and procedures. Ensure that any significant changes to the model’s parameters and/or output are approved by the appropriate management or board committee and that such changes are adequately documented.

8. Verify that disclosures are accurate with respect to the following:

- the fair value of capitalized MSAs
- the methods and significant assumptions used to estimate that fair value
- a description of MSAs for which no cost has been allocated and the reasons why it is not practicable to estimate the fair values of those MSAs and the mortgage loans (without the MSAs)
- the risk characteristics of the underlying loans used to stratify capitalized MSAs for the purposes of measuring impairment
- the activity in the valuation allowances for capitalized MSAs, including the aggregate balance of the allowances at the beginning and end of each period; aggregate additions charged and reductions credited to operations; and aggregate direct write-downs charged against the allowances

9. Obtain a list of intercompany MSAs as of the close of business for the most recent quarter-end. Determine whether a valid business purpose exists, the loans are actually sold, the entity holding the MSAs has revalued the rights correctly, and such intercompany MSAs are eliminated in consolidation. If the purpose of the transaction is merely to bolster capital levels at the bank, the practice may constitute an unsafe and unsound banking practice.

10. Review policies and practices regarding the sale of MSAs and liabilities to investors.

11. If the company sells loans with recourse, are recourse reserves established at the time of sale? Are estimated losses factored into the calculation of gain/loss on sale of loans?

12. Obtain an organizational chart to determine the individuals responsible for hedging MSAs. Review biographies to ensure that staff members responsible for this function are knowledgeable regarding accounting guidance, hedge products, and related strategies.

13. Review methods used to hedge the interest-rate and prepayment-rate risk associated with MSAs. Verify the management or board committee responsible for approving hedge instruments, the list of approved products, and the frequency and date of last review.

14. Review management reports to determine the correlation between hedge instruments and the underlying assets, the accounting treatment for hedges, related gains and losses, and the overall effectiveness of the company's hedge program. If hedge accounting treatment is being used, management and/or the company's external accountants must perform the appropriate level of due diligence and maintain adequate supporting documentation. In determining the effectiveness of the hedging program, the examiner should compare the actual results of hedge performance with the expected results.

15. Evaluate the quality of information that is communicated to senior management, the board of directors (if applicable), and the parent company's senior management and board of directors to determine whether management and directors are adequately informed regarding the financial risks associated with MSAs, amortization methods and hedging techniques, and the degree of risk inherent in the company's strategic focus and business mix with respect to the projected volume of MSAs.

3070.0.7 INTERCOMPANY TRANSACTIONS

A mortgage banking company that is organized as a nonbank subsidiary of a bank holding company often sells assets to, receives funding from, or services loans for its bank affiliates. Given the trend toward managing mortgage banking activities as a line function rather than by legal entity, such intercompany transactions have become an area of heightened supervisory concern.

In general, sections 23A and 23B of the Federal Reserve Act are designed to prevent a bank from being disadvantaged through the purchase of low-quality assets from an affiliate, the pressure to fund the majority of an affiliate's working-capital needs, and intercompany transactions that either inadequately compensate the bank or are not conducted on an arms-length basis.

3070.0.7.1 Section 23A of the Federal Reserve Act

Section 23A was enacted as part of the Banking Act of 1933 (the Glass-Steagall Act) for state member banks and later extended to all federally insured banks.[18] Section 23A defines companies that control or are under common control with the bank as affiliates of the bank. For example, the term ''affiliates'' includes bank holding companies and their subsidiaries as well as banks and nonbanking companies that are under common individual control.[19] The two primary aspects of section 23A—quantitative restrictions and collateral requirements—are discussed next.

3070.0.7.1.1 Quantitative Restrictions

The quantitative restrictions imposed by section 23A generally limit the aggregate amount of so-called ''covered transactions'' to 10 percent of the bank's capital and surplus for transactions with a given affiliate, and 20 percent of the bank's capital and surplus for transactions with all of its affiliates.[20] Covered transactions include—

- a loan or extension of credit by a bank to an affiliate, such as a warehouse line of credit provided to the affiliate;
- the purchase of or investment in securities such as a privately issued MBS issued by an affiliate;
- the purchase of assets from an affiliate, such as a loan purchased either as an accommodation to a bank customer or for the bank's asset/liability management purposes;
- the acceptance by a bank of securities issued by an affiliate as collateral for a loan or extension of credit by the bank to any person or company (Securities might include either the stock of a publicly held affiliate or the stock from one of its officer's own business enterprises.); or

18. As originally enacted, the Banking Act of 1933 covered only member banks. In 1966, Congress amended section 18(j) of the Federal Deposit Insurance Act, 12 U.S.C. 1828(j), to extend the coverage of section 23A to include insured nonmember banks. As a result, section 23A now applies to all federally insured banks. (12 U.S.C. 371c)

19. Nonbank subsidiaries of banks, as opposed to nonbank subsidiaries of bank holding companies, are not affiliates for purposes of section 23A, unless the Board of Governors of the Federal Reserve System determines otherwise. Banks that are part of a chain banking organization are subject to the restrictions of section 23A.

20. For section 23A purposes, the definition for capital and surplus includes the allowance for loan and lease losses.

- the issuance by a bank of a guaranty, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate (A letter of credit might be posted by the bank to cover an excessive number of GNMA pools that lack final pool certification.).

The examiner should determine the bank's method for identifying covered transactions and applying the quantitative limits for section 23A purposes. If a covered transaction is found that exceeds these quantitative limits, either on an individual or an aggregate basis, an apparent violation of section 23A has occurred. All such apparent violations of law should be discussed with management and cited in the report.

Particular attention should be paid to intercompany asset transfers and funding arrangements to determine whether they constitute covered transactions under section 23A. In Interpretation 250.250 (12 C.F.R. 250.250)[21] the Board determined that a member bank's purchase, without recourse, and at face value, of a mortgage note, or a participation therein, from a mortgage banking subsidiary of the parent bank holding company, which had no financial interest in the underlying asset on which it had granted credit through the note, did not involve a ''loan'' or ''extension of credit''[22] from the member bank to the seller of the mortgage note within the meaning of section 23A if—

- the member bank's commitment to purchase the loan or participation therein was obtained by the affiliate within the context of a proposed transaction or series of proposed transactions in anticipation of the affiliate's commitment to make such loan(s),
- the commitment to purchase the loan was based on the bank's independent credit evaluation of the creditworthiness of the mortgagor(s),[23] and
- there could be no blanket advance commitment by the member bank to purchase a stipulated amount of loans that bore no reference to specific proposed transactions. Accordingly, the nonbank affiliate must have adequate and independent working capital to fund its operations.

The Board stated that if the bank followed these procedures, then the bank would be taking advantage of an individual investment opportunity and thus should be exempt from section 23A. However, the Board was concerned that the bank should not be allowed to set up a business relationship with any affiliate which could create the opportunity for the bank, at some time in the future, to engage in unsafe transactions because the bank felt impelled by an improper incentive to alleviate the working-capital needs of the affiliate. Accordingly, the bank's transactions with the affiliate should not be of such a volume as to create pressure on the bank to relax its sound credit judgment concerning the individual loans involved and thereby result in an inappropriate risk to the soundness of the bank.

3070.0.7.1.2 Collateral Requirements

In addition to the quantitative restrictions, certain covered transactions between a bank and an affiliate must also be secured at the time of the transaction by collateral having a certain market value. Unless otherwise exempted, covered transactions that must be adequately secured include loans or extensions of credit, guaranties, acceptances, and letters of credit issued on behalf of the affiliate.

Collateralization requirements range from 100 percent to 130 percent depending on the type of collateral used. Acceptable forms of collateral include U.S. government or U.S. government–guaranteed obligations, instruments that are acceptable at the Federal Reserve's discount window, bank deposits that are segregated into accounts specifically earmarked for this purpose, other debt instruments, stock, leases, or other real or personal property. According to an August 31, 1987, Board interpretation (at FRRS 3–1164.3), mortgage-servicing rights do not constitute a permissible form of collateral for purposes of section 23A because of (1) their inherent volatility, making it difficult to accurately value the rights, and (2) the need to secure permission to transfer servicing rights from the legal owner of the underlying mortgage.[24]

21. See also *Federal Reserve Regulatory Service*, 3–1133.
22. Under section 23A, as amended by the Garn–St Germain Act in 1982, a member bank's purchase of a loan from its nonbank affiliate that was made to an unaffiliated party is now considered a purchase of an asset from the affiliate unless it is excepted under interpretation 250.250.
23. Dual employees may not be used to satisfy the independent credit evaluation requirement.
24. Item (2) refers to the bank's ability to sell the mortgage-servicing rights if the affiliate defaults on its loan.

An example of a covered transaction that is subject to both the quantitative restrictions and the collateral requirements of section 23A would be an overdraft in the mortgage company's checking account with an affiliate bank, which is considered an extension of credit. A line of credit by a bank to a nonbank affiliate also constitutes a covered transaction. It is important to remember that the full value of the line, not just the portion drawn down, must satisfy the quantitative and the collateral requirements of section 23A at all times. The examiner should review checking accounts and funding arrangements to ensure that the appropriate level and type of collateral is maintained. Collateral values should be monitored regularly so that depreciated or matured collateral is replaced as needed.

3070.0.7.1.3 Prohibited Transactions

In addition to the quantitative and collateral requirements, section 23A also prohibits certain affiliate transactions altogether. Most importantly, a bank and its subsidiaries may not purchase a low-quality asset (generally a classified or past-due asset) from an affiliate or accept a low-quality asset as collateral for a loan. Section 23A also requires that all covered transactions be conducted on terms that are consistent with safe and sound banking practices.

3070.0.7.1.4 Exemptions from Section 23A of the FRA

As mentioned previously, several types of intercompany transactions are exempted from the requirements of section 23A. For example, transactions between banks in which 80 percent or more of each bank's stock is owned by the same bank holding company (so-called "sister banks") are exempt from most provisions of section 23A.[25] Other transactions that are exempt include the following:

- deposits received from the affiliate during the ordinary course of business (checks in the process of collection)
- immediate credit given to an affiliate for uncollected items received in the ordinary course of business
- loans, extensions of credit, guaranties, acceptances, or letters of credit issued on behalf of the affiliate that are fully secured by obligations issued or guaranteed by the U.S. government or a segregated earmarked account in the bank
- the purchase of assets having a readily and identifiable market price at the time of purchase
- transactions that are deemed to be in the public interest and consistent with the purposes of the act

Internal controls should be in place to ensure that all transactions are adequately reviewed. Documentation should be maintained for intercompany transactions that are exempted from the requirements of section 23A.

3070.0.7.2 Section 23B of the Federal Reserve Act

The Competitive Equality Banking Act of 1987 amended the Federal Reserve Act to add a new provision, known as section 23B. In general, section 23B provides that covered transactions between a bank and its affiliates must be on terms and under circumstances, including credit standards, that are substantially the same or at least as favorable to the bank as those prevailing at the time for comparable transactions with or involving nonaffiliated companies. If no comparable transactions exist, the transaction must be on terms and under circumstances, including credit standards, that in good faith would be offered to or applied to nonaffiliated companies. A bank is also generally prohibited from purchasing as a fiduciary securities or assets from an affiliate except under specified circumstances. Finally, a bank and its affiliate may not advertise or enter into an agreement that suggests the bank is in any way responsible for the obligations of the affiliate.

Section 23B applies to any covered transaction with an affiliate, as that term is defined in section 23A. However, section 23B excludes banks from the term "affiliate." Therefore, transactions between sister banks and banks that are part of a chain banking organization are exempt from section 23B.

25. Foreign banks do not qualify as sister banks for section 23A purposes. These transactions are still subject to the prohibition against the purchase of low-quality assets and to the requirement that covered transactions be on terms and conditions that are consistent with safe and sound banking practices. It should also be noted that federal savings banks do qualify for the sister-bank exemption if all banks in the corporate chain have met their fully phased-in capital guidelines, as provided for in the Home Owner's Loan Act.

3070.0.7.3 Management and Service Fees

The Federal Reserve System's 1979 policy statement on diversion of bank income practices is intended to prevent excessive or unjustifiable management or service fees, as well as any other unwarranted payments or practices that, by diverting bank resources to the parent company or a nonbank affiliate, may have an adverse financial impact on a subsidiary (paying) bank (see section 2020.6). Diversion of income practices with respect to a mortgage banking company might potentially include, but are not limited to—

- servicing fees, or other payments assessed by the mortgage banking company and paid by the bank that bear no reasonable relationship to the fair market value, cost, volume, or quality of services rendered by the nonbank subsidiary in its role as servicer and/or seller;
- balances maintained by the bank primarily in support of mortgage banking company borrowings without appropriate compensation to the bank;
- prepayment of fees to the mortgage banking company for services not yet rendered;
- nonreimbursed origination fees, marketing costs, or other expenses incurred by the bank that primarily support the mortgage banking company's activities; and
- loan repurchase agreements between the bank and the mortgage banking company while the mortgage banking company is processing loans in the mortgage pipeline.

Purchase and funding agreements should adequately itemize and document the types of services provided and the basis for fees. Billing statements and other documentation should clearly evidence that fees actually charged and paid are reasonable and consistent with regulatory policy requirements as described.

3070.0.7.4 Tie-In Considerations of the BHC Act

Section 106 of the BHC Act Amendments of 1970 contains five restrictions intended to prohibit anticompetitive behavior by banks: two prohibit tying arrangements; two prohibit reciprocity arrangements; and one prohibits exclusive dealing arrangements.[26] The tying restrictions, which have the greatest effect on industry practices, prohibit a bank from restricting the availability or varying the consideration for one product or service (the *tying product*) on the condition that a customer purchase another product or service offered by the bank or by any of its affiliates (the *tied product*).

Section 106 was adopted in 1970 when Congress expanded the authority of the Board to approve proposals by bank holding companies to engage in nonbanking activities. The provisions of section 106 were based on congressional concern that banks' unique role in the economy, in particular their power to extend credit, would allow them to create a competitive advantage for their affiliates in the new, nonbanking markets that they were being allowed to enter.[27] Congress therefore imposed special limitations on tying by banks—restrictions beyond those imposed by the antitrust laws. Section 106 is a broader prohibition; unlike the antitrust laws, a plaintiff in action under section 106 need not show that (1) the seller has market power in the market for the tying product, (2) the tying arrangement has had an anticompetitive effect in the market for the tied product, or (3) the tying arrangement has had a substantial effect on interstate commerce.

Section 106 applies only when a *bank* offers the tying product.[28] The Board has authority to grant exceptions to section 106, which it has used to allow banking organizations to package their products when doing so would benefit the organization and its customers without anticompetitive effects.

3070.0.7.4.1 Section 225.7(d) of Regulation Y

The Board originally extended section 106, which covers tying arrangements by *banks* only, to cover nonbank affiliates and bank holding companies. The Board rescinded this extension of the statute effective April 21, 1997. Thus, unless subject to another exemption, section 106 *prohibits*—

- a bank from telling a customer that it can only receive a loan (or a discount thereon) if it purchases another product from the bank; and

26. 12 U.S.C. 1972.
27. See S. Rep. No. 1084, 91st Cong., 2d Sess. (1970).
28. See 1997 FRB 275.

- a bank from telling a customer that it can only receive a loan (or a discount thereon) if it purchases another product from an affiliate of the bank.

Section 106 and the Board's regulation allow—

- a broker-dealer affiliate to tell a customer that it can only receive placement services (or a discount thereon) if it obtains a loan from an affiliated bank; and
- a broker-dealer affiliate to tell a customer that it can only receive placement services (or a discount thereon) if it obtains a loan from a nonbank affiliate.

These distinctions make sense if one keeps in mind the concern of the statute: banks (*not* nonbanks) have special power over credit and, thus, are able to induce or coerce their customers into purchasing products that they would otherwise prefer not to purchase or to purchase from someone else.[29]

3070.0.7.4.2 Interaffiliate Tying Arrangements Treated the Same as Intrabank Arrangements

Section 106 contains an explicit exception (the *statutory traditional bank product exception*) that permits a bank to tie any product or service to a loan, discount, deposit, or trust service offered by that bank.[30] For example, a bank could condition the use of its messenger service on a customer's maintaining a deposit account at the bank. Although the statutory traditional bank product exception appears to have been effective in preserving traditional relationships between a customer and bank, the exception is limited in an important way—it does not extend to transactions involving products offered by affiliates.

The Board has adopted a *regulatory traditional bank product exception* that extends the statutory exception to transactions involving affiliates.[31] Although the Board has previously limited the scope of this extension, interaffiliate arrangements are now exempt to the same extent as intrabank arrangements.[32]

3070.0.7.4.3 Foreign Transactions Under Section 106

The Board has adopted a ''safe harbor'' from the anti-tying rules for transactions with corporate customers that are incorporated or otherwise organized and that have their principal place of business outside the United States, or with individuals who are citizens of a foreign country and are not resident in the United States. However, the safe harbor would not protect tying arrangements in which the customer is a U.S.-incorporated division of a foreign company. Furthermore, the safe harbor would not shelter a transaction from other antitrust laws if they were otherwise applicable.[33]

3070.0.7.4.4 Technical Change

The Board also has adopted a definition of ''bank'' for purposes of the anti-tying rules. The definition clarifies that any exemptions afforded to banks generally also would be applicable to credit card and other limited-purpose institutions and to U.S. branches and agencies of foreign banks.[34]

3070.0.7.5 Inspection Objective

1. To evaluate transactions between a mortgage banking company organized as a direct subsidiary of a bank holding company and affiliated banks for compliance with federal laws and regulations, and related policy guidance.

3070.0.7.6 Inspection Procedures

1. Review management's method for monitoring and identifying section 23A and 23B covered transactions and applying the quantitative limitations. Determine whether—

   a. all covered transactions have been identified;

   b. quantitative limits are calculated correctly;

   c. covered transactions, including any overdrafts and lines of credit, meet both the

29. The Board's rule also includes a limited prohibition on tying arrangements involving electronic benefit transfer services (12 C.F.R. 225.7(d)).
30. 12 U.S.C. 1972(1)(A).
31. See 12 C.F.R. 225.7(b)(1).
32. A similar action was taken for interaffiliate reciprocity arrangements, in which section 106 permits a bank to condition the availability of a product or service on the customer's providing to the bank some product or service ''related to and usually provided in connection with'' a loan, discount, deposit, or trust service (12 U.S.C. 1972(1)(C)).
33. See 12 C.F.R. 225.7(b)(3).
34. See 12 C.F.R. 225.7(e).

quantitative limits and collateral requirements of section 23A; and

d. adequate collateral values have been maintained over the life of the covered transactions (For example, collateral is maintained for the full amount of any credit lines with the bank, and any depreciated or matured collateral has been replaced as required.).

2. Review purchase and funding contracts between the mortgage banking company and the bank, as well as the substance of actual transactions, to determine that—

a. asset purchases by the bank are either within the quantitative limits of section 23A or meet the exemption requirements of C.F.R. section 250.250,

b. all purchases are at fair market value and consistent with market terms as required by section 23B,

c. no low-quality assets were transferred to the bank since the previous inspection,

d. the method of compensating the bank for balances maintained and net interest income earned on warehouse loans or lines is reasonable and based on market terms.

3. Review servicing contracts between the mortgage banking company and the bank, as well as the substance of actual transactions, to determine—

a. the capacity in which the affiliate is acting (for example, is it acting as principal on its own behalf or as an agent for the affiliate bank?);

b. the nature of all services provided; and

c. billing arrangements, the frequency of billing, the method of computation, and the basis for such fees.

4. Review the bank holding company's policy statement on the prohibition of tie-in arrangements, the adequacy of training provided to employees, and whether its respective subsidiaries are in full compliance with internal policy.

3070.0.8 REGULATION Y COMPLIANCE

During the course of the on-site inspection, the examiner is expected to conduct sufficient tests and inquiries to determine whether the company is in compliance with Regulation Y and the act. Such tests and inquiries would include a listing of company offices which can be compared with the approved offices, comparisons of credit-related insurance policies and rate schedules against stipulated public benefits cited in Board orders, and reviews of various activities for technical compliance.

While not specifically detailed in this guidance, the examiner may find it necessary to conduct a review of the company's ledgers and accounts that is sufficient to disclose possible impermissible activities and potential violations of law. The audit function, both internal and external, should not be solely relied on for this disclosure because the auditor's program may emphasize other areas of concern. As a nonbank subsidiary of a bank holding company, reference should be made to part 225 of the Code of Federal Regulations (such as section 225.28(b) of Regulation Y) and other relevant sections thereof.

Concurrent with the review of assets for credit quality, the examiner should undertake a review of asset-related activities for compliance with the subsidiary's approval orders. In mortgage banking firms, it is possible that the company is engaging unknowingly in certain impermissible activities, such as those described by 12 C.F.R. 225.126 (i.e., real estate brokerage, land development, real estate syndication, and property management) and those deemed impermissible by Board order (see sections 3000.0.4 and 3700.0 to 3700.12). The Board of Governors has ruled (1972 FRB 429) that the purchase and development of land for sale to third parties constitutes land development by a nonbank subsidiary. However, the completion of a foreclosed property to facilitate the recovery of funds advanced under the loan appears to be permissible, provided that the additional work brings the project underway at foreclosure up to a saleable condition. The Board has also ruled that property management for third parties is impermissible (1972 FRB 652). However, property management as a fiduciary, for operating premises of affiliates, or for properties acquired for debts previously contracted (DPC) is permissible. In addition to the other impermissible activities, engaging in real estate joint ventures has also been ruled impermissible. If such impermissible activities are found, they represent violations and should be appropriately treated. The servicing agreements should be reviewed to determine that no additional liabilities, real or contingent, are imposed on the company beyond its responsibilities as a servicing agent.

The usual source of growth in the servicing portfolio is the company's own origination activity. However, it is not uncommon for a company to supplement this growth with bulk purchases of serviced mortgages from other companies. Under certain circumstances, usually relating to the relative percentage of the seller's portfolio, these transactions may not comply with 12 C.F.R. 225.132. Since these transactions may represent the effective acquisition of a going concern subject to prior approval by the Federal Reserve System, "servicing portfolio" acquisitions should be reviewed for compliance.

Section 225.22(d)(1) of Regulation Y provides an exemption from required Board approval for DPC property acquired in good faith and divested within two years of acquisition. The Board may permit additional extensions that can result in the property being held by a bank holding company for a total of 10 years, if the property has value and marketability characteristics similar to real estate. In conjunction with the review of real estate owned, the examiner should determine if any subsidiary holds title to any property that should have been disposed of within the time limits of Regulation Y, the book value of which has been reduced to zero and the property is not disclosed on the balance sheet. See section 3030.0 "Acquisition of DPC Shares or Assets," for additional information on DPC property acquired.

Legal counsel representing a BHC requested an opinion as to whether certain proposed flood zone–determination activities, to be conducted through a majority-owed (50 percent) joint venture company, would be within the scope of activities related to extending credit as defined in section 225.28(b)(2) of Regulation Y. The BHC proposes to engage in a variety of lending-related activities, including providing real estate appraisals and flood zone determinations.

The Board has determined, in section 225.28(b)(2) of Regulation Y, that it is permissible for bank holding companies to engage in "[a]ny activity usual in connection with making, acquiring, brokering, or servicing loans or other extensions of credit, as determined by the Board."[35] (See 12 C.F.R. 225.28(b)(2).) The Board also determined by regulation that performing real estate appraisals is an activity that is usual in connection with making, acquiring, brokering, or servicing loans or other extensions of credit. (See 12 C.F.R. 225.28(b)(2)(i).) The Board had not specifically addressed whether providing flood zone determinations is an activity that is usual in connection with lending activities.

The proposed flood zone–determination services are considered to be a necessary aspect of mortgage lending in the United States. As noted, federal law prohibits a federally regulated lender from making, increasing, extending, or renewing a loan that is secured by improved real estate or a mobile home located in an area designated by the Federal Emergency Management Agency (FEMA) as a special flood hazard area unless the borrower obtains flood insurance.[36] (See 12 C.F.R. 208.25(c).) Further, federal law also provides that if a federally regulated lender determines, at any time during the life of a loan, that the improved real estate or mobile home securing the loan is located in a special flood hazard area and is not covered by flood insurance, the lender must instruct the borrower to obtain flood insurance and must purchase flood insurance on the borrower's behalf if the borrower fails to promptly purchase the required insurance. (See 12 C.F.R. 208.25(g).)

In addition, federal law requires the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Government National Mortgage Association (the government-sponsored enterprises or GSEs) to have procedures reasonably designed to ensure that flood insurance is in place where required at the initiation of, and during the lives of, the mortgage loans they purchase. (See 12 U.S.C. 4012a(b).) The GSEs meet this requirement by requiring lenders that sell loans to them, and companies that service loans for them, to monitor on an ongoing basis the flood zone status of any loans sold to, or serviced for, the GSEs. To comply with the requirements of federal law and the GSEs, mortgage lenders must obtain an initial flood zone determination before the origi-

35. The Gramm-Leach-Bliley Act (the GLB Act) amended the Bank Holding Company Act to limit bank holding companies that are not financial holding companies to engaging only in "activities which had been determined by the Board by regulation or order under this paragraph as of the day before the date of the enactment of the Gramm-Leach-Bliley Act on November 12, 1999, to be so closely related to banking as to be a proper incident thereto (subject to such terms and conditions contained in such regulation or order, unless modified by the Board)" (12 U.S.C. 1843(c)(8)). Before November 12, 1999, the Board had determined that "[a]ny activity usual in connection with making, acquiring, brokering, or servicing loans or other extensions of credit, as determined by the Board" was closely related to banking. Accordingly, the Board retains authority after the GLB Act to define the scope of this section 4(c)(8) activity and to modify the terms and conditions that apply to the activity.

36. Statutory authority to issue flood insurance policies under the National Flood Insurance Program (NFIP) expired on December 31, 2002, after Congress adjourned without extending the FEMA authority. On January 13, 2003, the National Flood Insurance Program Reauthorization Act was approved, extending the authorization of the NFIP to December 31, 2003; this authorization was also made retroactive to December 31, 2002.

nation of each mortgage loan and must take steps to monitor, throughout the life of the loan, the flood zone status of any improved real estate or mobile home collateral securing the loan.[37]

The joint venture company proposes to provide initial flood zone determinations to mortgage lenders and to provide mortgage lenders with ongoing flood zone–tracking services with respect to their mortgage loans. The company's activities would be limited to making determinations as to whether particular parcels of real estate are in designated flood zones, preparing the FEMA standard flood zone–determination form, and communicating flood zone determinations to customers. The company committed to not be involved in placing, underwriting, or issuing flood insurance or in the collection of flood insurance premiums. The proposed flood zone determinations would be provided in connection with providing real estate appraisals and as a separate service. In addition, the joint venture company may assist customers who wish to request that FEMA amend its flood maps to remove a property from a designated special flood hazard area.

The proposed flood zone–determination services were found to be an essential part of mortgage lending, designed to assist mortgage lenders in complying with the requirements of federal law and the GSEs. The services generally would be provided to mortgage lenders,[38] thus usual in connection with making mortgage loans. Board staff therefore issued the opinion on July 9, 2002, concluding that the proposed flood zone–determination services are within the scope of permissible activities related to extending credit under section 225.28(b)(2) of Regulation Y (12 C.F.R. 225.28(b)(2)).

3070.0.9 ON-SITE INSPECTION OF MORTGAGE BANKING SUBSIDIARIES

Scheduling of on-site inspections of mortgage banking nonbank subsidiaries of bank holding companies should be done in accordance with the Board policy for frequency and scope of inspections. (See section 5000.0.2.) After reviewing the material available at the parent company level, including the audit review, a decision whether or not to go on-site is in order. Some of the determinants of this decision would include relative size, current earnings performance, overall contribution to the corporation's condition, asset quality as indicated by nonaccrual and delinquency reports, the level of risk exposure to the organization (see section 4030.2), and the condition of the company when last inspected. From the information provided, it might be determined that the company is operating properly and is in sound condition. In such a case, an on-site inspection may not be warranted. Conversely, a deteriorating condition might be detected that would require a visit, even though a satisfactory condition had been determined during the previous inspection. Mortgage subsidiaries in unsatisfactory condition should be inspected each time the parent company is inspected. All significant mortgage banking subsidiaries should be fully inspected at least once every three years.

37. Lenders are specifically permitted to charge a reasonable fee to borrowers for flood zone determinations and life-of-the-loan tracking. For example, see 12 C.F.R. 208.25(h).

38. It was represented that the joint venture company would only market its services to mortgage lenders and that it would rarely provide services to nonlenders.

3070.0.10 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Loans to affiliates section 23A of the FRA	371c			
Restrictions on 371c transactions with affiliates	371c			
Purchase of affiliate's notes from a third party			3–1131	
Activities not closely related to banking		225.126	4–184	
Acquisition of assets		225.132	4–175.1	
Purchase by member bank of loans originated by a mortgage banking firm		250.250	3–1133	
Mortgage companies acquired under sections 4(c)(1) or 4(c)(8) of the act		225.122	4–196	
Activities closely related to banking		225.131	4–176	
Investments in community welfare projects		225.127	4–178	
Staff opinion on engaging in certain proposed flood zone–determination activities		225.28(b)(2)	4–318.4	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

3070.0.11 APPENDIX A—FIRST DAY LETTER

FEDERAL RESERVE BANK
OF BOSTON

P. O. BOX 2076
BOSTON, MASSACHUSETTS 02106-2076

June 15, 19x9

Mr. John Doe
President
XYZ Mortgage Bank Corporation
Boston, Massachusetts 02107

Dear Mr. Doe:

In conjunction with the inspection of the XYZ Bank Holding Company, we plan to begin an inspection of XYZ Mortgage Bank Corporation on July 15, 19x9. To facilitate this inspection, please provide a copy of or make available the following information relative to your organization's mortgage banking activities. Information should be as of xx/xx/xx and should be delivered to the examiner-in-charge as soon as it is available. Whenever possible, standardized management reports should be provided. Please include the name and telephone extension of the appropriate persons to contact, by department, if additional information is necessary.

Board Oversight and Management

1. Provide a listing of the mortgage banking company's board of directors that includes each individual's name, place of employment, title and position, age, management responsibilities (if any), and the length of time he or she has served on the board.
2. List significant management and board committees and have minutes from these meetings available for examiner review. Provide a copy of standardized reports that are provided before each meeting.
3. Provide an organizational chart that highlights individuals who are responsible for the following functional areas: production, warehousing and funding, marketing, servicing, finance, mortgage-servicing asset (MSA) valuations, internal audit, quality control, loan review, compliance, and legal. Include biographies and salary information.
4. Describe any organizational changes that have taken place at the mortgage banking company since xx/xx/xx, including any mergers, acquisitions, or consolidation of mortgage banking activities. Describe any management changes at or above the senior vice president level and provide details on management's new responsibilities.
5. Provide a copy of standardized management reports that are used to monitor compliance with established policies, operating procedures, and controls within each functional area.
6. Provide a copy of the mortgage banking company's most recent operating budget and its long-term strategic plan. Evaluate how interest-rate movements, competition, and other external factors have affected product mix, staffing levels, and the allocation of capital.
7. Describe the internal control environment and the internal control programs that are in place within the mortgage banking company. Have available for examiner review the following reports that were conducted since xx/xx/xx:

   a. internal and external audits

   b. loan reviews

c. internal control and compliance audits completed by or on behalf of agencies such as HUD, FHA, GNMA, FannieMae, FHLMC, state agencies, and private investors

Also have available management's response to each report and the most recent copy of any management reports that monitor the status of outstanding issues or problems.

8. Provide an organization chart for the *internal audit* department. Indicate the scope and frequency of internal audits for the mortgage banking company, highlighting any weaknesses or problem areas noted. Upon request, make internal audit workpapers available for examiner review.
9. Provide an organization chart for the *loan review* department. Indicate the scope and frequency of loan reviews for the mortgage banking company, highlighting any weaknesses or problem areas noted. Upon request, make loan review workpapers available for examiner review.
10. Provide details on the nature and scope of the quality control program for loans originated and/or serviced for investors. Include an organization chart for the unit(s) involved in such activities, details on any outsourcing programs used since the previous inspection, copies of quality control reports submitted to senior management, and management responses.
11. Describe the method for ensuring compliance with state and federal laws and regulations. Make available for examiner review the procedures manual, work programs, and workpapers compiled by the person/department responsible for compliance.
12. Describe the insurance coverage in effect for the mortgage banking company and its officers and the date it was last reviewed by the board of directors.
13. Recap all mortgage banking–related legal claims/lawsuits in excess of $1 million. Indicate the nature of any legal reserve that is maintained and the method used to assess reserve adequacy.
14. Describe the system for logging, tracking, and responding to customer complaints. The customer complaint file should be made available for examiner review while on-site.
15. Provide a copy of the disaster recovery plan and describe safeguards in place to protect loan documents and data processing input records.

Production and Correspondent Lending Data

16. Provide detailed organization charts for departments within the company which relate to the production function (i.e., retail originations, wholesale purchases, processing, underwriting, closing, shipping).
17. Provide information on the total number and dollar amount of loans generated by the following sources during the two most recent fiscal years and the interim year-to-date period. For purchased loans, please specify the method of purchase (i.e., bulk versus flow), program name, and amount subject to recourse back to either the seller or the investor):

    a. originated by the mortgage banking company

    b. purchased from affiliates

    c. purchased from nonaffiliated third parties
18. Provide written policies and procedures manuals that describe traditional and nontraditional mortgage products, underwriting standards, closing and funding procedures, exception reporting practices, management and employee compensation methods, and training programs for loan production personnel. State methods used to establish ongoing compliance with written policies and procedures and provide copies of relevant management exception reports.
19. Describe the credit approval process used for in-house originations. Include information on rate commitment options extended to the borrower, the average length of the commitment period,

controls that are in place to monitor fallout caused by processing backlogs, and procedures for expired commitments.

20. Provide details on the correspondent lending program, including a list of approved institutions and copies of the most recent loan-quality reports. Describe the credit review process before purchase and any controls that are in place to protect the mortgage banking company against future losses on loans purchased from affiliates and from correspondents.
21. Determine whether rate-locks are provided to correspondents on best effort production programs. What methods are used to verify reported loan fallout?
22. Provide information on the average income and cost per origination and compare with industry standards. Describe the method of accounting used for origination fees and other related noninterest income and expenses.
23. If the mortgage banking company is a subsidiary of a state member bank or sells loans to a bank affiliate that is subject to Regulation O, furnish a list of extensions of credit to ‘‘an executive officer, director, or principal shareholder’’ (as defined in section 215.2 of Regulation O) of—
    a. the state member bank;
    b. a bank holding company of which the state member bank is a subsidiary;
    c. any other subsidiary of that bank holding company;
    d. a company controlled by an insider, as defined by Regulation O; and
    e. a political or campaign committee that benefits or is controlled by an insider as defined by Regulation O.

    For all such extensions of credit, include the amount, date the loan(s) was originated or renewed, interest rate, collateral requirements, total amount of loans outstanding to that individual or company, and date of approval by the board of directors. Also include the aggregate amount of loans outstanding to all such insiders as of the inspection date in relation to the bank’s unimpaired capital and unimpaired surplus as defined in Regulation O. (See subsection 2050.0.3.2.)

Marketing and Hedging Data

24. Provide detailed organization charts for departments within the company that relate to the marketing and hedging functions. Describe management’s roles and responsibilities with respect to the sale of loans in the secondary market, asset securitization, funding, liquidity risk management, interest-rate risk management, and interaction with the asset/liability management function at the parent company.
25. Provide a copy of written policies and procedures used to hedge interest-rate risk associated with the pipeline and closed-loan warehouse. Describe any parameters and limits that are in place and provide a list of securities dealers with whom management is authorized to conduct business.
26. Provide management reports on pipeline and closed-loan (warehouse) inventory volume, mix, yield, age, and turnover as of the inspection date. Describe the method used to project fallout and any models that are used to determine the sensitivity of the pipeline to interest-rate fluctuations.
27. Indicate the methods used to securitize loans for sale in the secondary market, including the use of third-party guaranties and other forms of credit enhancement. Are securities generally sold or retained on the balance sheet?
28. Provide information on the number and volume of securities that lacked final pool certification as of the inspection date. State whether this volume is in compliance with investor guidelines. If

applicable, indicate whether the requirements for obtaining a letter of credit or other guaranty have been satisfied.

Servicing Data

29. Provide a detailed organization chart for the servicing department.
30. List subservicers and vendors who are employed to perform servicing functions. Briefly describe the nature of the services provided.
31. Indicate whether any contracts with subservicers and/or vendors have been terminated for cause since the prior inspection.
32. Provide the monthly servicing management reports since the prior inspection, including the number of loans serviced, dollar volume, and composition of the servicing portfolio in terms of product mix, average loan size, weighted average coupon rates, weighted average maturities, geographic location, and delinquencies and foreclosures.
33. Provide a list of investors for whom servicing was performed as of the most recent quarter-end. Identify any recourse or repurchase provisions and/or forbearance requirements.
34. State whether any investors have terminated servicing contracts with the mortgage company and/or its affiliates for cause since the prior inspection, or if any are likely to be terminated in the near future.
35. Provide a list of all major bulk purchases and sales of servicing since the prior inspection. Identify the terms of each sale and any resulting gains or losses.
36. Provide a list and aging of all outstanding advances to investors as of the date of inspection.
37. Provide access to the servicing policies and procedures manual. Indicate the frequency with which manuals are updated. How does management ensure that subservicers and vendors comply with these same policies and procedures?
38. Provide a servicing-fee schedule (in basis points) for conventional, government, and nontraditional loans serviced for third parties.
39. Provide copies of management reports used to track portfolio runoff.
40. Provide a loan delinquency report segmented into 30, 60, 90, 120, and 180 foreclosure categories. Indicate the volume and number of loans in each segment by loan type. Also include information on the number and dollar volume of delinquent loans that were purchased out of investor pools.
41. Detail the number and dollar volume of other real estate (ORE) parcels segregated by company-owned and investor-owned. Provide a list of loans in foreclosure for which action has been delayed, if applicable.
42. Provide access to the customers' complaint file so that examiners can review it while on-site.

Financial Data

43. Provide copies of the Report of Condition and Income and/or Y-series report that was filed by the mortgage banking company for the two previous fiscal years and the most recent interim period.
44. Provide an internally prepared balance sheet and income statement that reconcile with the most recent Report of Condition and Income and/or Federal Reserve Board Y-series report.

45. Provide the latest published financial statements, if applicable, including the annual report, SEC 10K, 10Qs, and any press releases.

46. Provide copies of the accounting policies pertaining to mortgage loans, securities, and other assets held for sale and held for investment. Also provide copies of management reports that monitor compliance with SFAS No. 115 (securities), the current SFAS No. 65 (loans), SFAS No. 125 (mortgage-servicing assets), and internal policies as of the close of business of the most recent quarter.

47. Provide details on all formal and informal funding mechanisms, including but not limited to repurchase agreements, commercial paper programs, and debt issuance facilities. Indicate the counterparties, where applicable; the amount uncommitted; and the amount outstanding under each facility as of the close of the most recent quarter. Provide copies of all formal and informal written agreements.

48. Provide copies of credit agreements for all funding lines from affiliated and nonaffiliated institutions. Describe methods used to monitor the credit quality of all funding sources. The following information should be included:

    a. lending bank (include copies of confirmation letters)

    b. total credit line

    c. amount in use as of the inspection date

    d. amount available for use and by whom

    e. expiration date

    f. compensating balance and/or fee arrangements

    g. purpose

    h. whether the credit lines are contractual obligations of the lenders

    i. reciprocity arrangements, if any

    j. collateral requirements

    k. legal opinions evidencing compliance with sections 23A and 23B of the Federal Reserve Act, as amended

49. Provide copies of any contingency planning documents that outline alternative courses of action should the condition of traditional funding sources deteriorate.

50. Provide a copy of any standardized financial presentations made to the executive management team and to the board of directors.

51. Provide a copy of standardized management reports used to measure and track the quality of originated, purchased, and serviced assets. Include an aging report that identifies loans that are past due 30, 60, 90, 120, and 180 or more days and indicate whether such loans are *held for sale, held for investment,* or *serviced for investors*.

52. Provide a copy of internal policies that apply to loans held for investment. Indicate the date each loan that was on the books as of the most recent quarter-end was transferred to this account, its amortized cost, market value, and any write-downs or adjustments to yield at the date of transfer. Indicate the person responsible for reviewing these loans for collectibility, the frequency of such reviews, and any adjustments or write-downs taken over the past year.

53. Provide detail pertaining to the transfer or sale of assets between the nonbank mortgage banking company and affiliated entities since the last inspection and that supports the FR Y-8 Reports. Also provide related documentation evidencing methods for asset valuation and credit-quality determination.

54. Provide detail on the allowance for loan and lease losses, contra asset valuation allowances, and

other reserve accounts as of xx/xx/xx (fiscal) and xx/xx/xx (interim). For each account in use, provide a copy of the most recent analysis and a description of the applicable loan and other losses provisions reserving methodology.

55. Provide a copy of the company's policy with respect to real estate appraisals.
56. Provide a copy of management reports that are used for liquidity, funding, and asset/liability management. If these activities are coordinated with affiliate bank or parent bank holding company personnel, provide copies of the information that is routinely provided.
57. Indicate the method for assessing capital adequacy at the mortgage company level. Provide a copy of the company's capital and dividend policies, as well as a list of dividends paid to shareholders during the two previous fiscal years and the most recent interim period. Are any changes in the level of dividends planned or anticipated?

Mortgage-Servicing Assets

58. Provide an organization chart highlighting those areas and individuals responsible for the recording, measurement, and impairment testing for originated and purchased mortgage-servicing rights (MSAs).
59. Provide an inventory listing of all MSAs as of the close of business of the most recent quarter.
60. Discuss the various loan-origination and -purchase programs that give rise to MSAs; the method for calculating and communicating the price paid to correspondents and brokers for service release premiums; whether MSAs are recorded on table-funded loans; and the details on any bulk purchases since the previous inspection, including the price paid and yield realized.
61. Discuss the various loan-sale programs that give rise to MSAs, the method for calculating and recording the initial value of MSAs.
62. Provide a copy of detailed written policies and procedures regarding the initial recording, amortization, and periodic revaluation and impairment testing for MSAs. Indicate the management and/or board committee responsible for approving such policies and the date of last approval.
63. Provide detailed information on any valuation models used for MSA revaluations and a copy of the output as of the most recent quarter-end. Indicate whether such revaluations are performed in-house or by an outside vendor and the frequency of such revaluations.
64. Reconcile fair market values of MSAs to their respective book values as of the most recent quarter-end. Provide a copy of management reports and related journal entries used to record amortization adjustments and/or write-downs.
65. Provide copies of worksheets used to calculate the amount of MSAs included in Tier 1 capital for regulatory reporting purposes as of the most recent quarter-end.
66. Furnish copies of any management reports or presentations to the board of directors or a committee thereof regarding the risk characteristics of MSAs, business risk analysis, and methods used to hedge the interest-rate and prepayment-rate risks associated with capitalized MSAs.
67. Provide an organization chart highlighting those areas and individuals responsible for hedging the interest-rate and prepayment-rate risk associated with MSAs.
68. Provide information on any financial instruments used to hedge interest-rate and prepayment-risk associated with MSAs. Include a detailed prospectus on any customized hedge products that are purchased from investment bankers and a statement from either internal or external accountants on whether such instruments qualify for hedge accounting treatment under SFAS No. 80.

69. Provide a copy of management reports that identify the number of contracts or instruments used, their current market value, and the degree of correlation between the hedge instrument and the underlying MSAs being hedged. Such reports should demonstrate the effectiveness of the hedge under varying market conditions.

70. Provide information on the number and dollar volume of servicing rights sold during the most recent fiscal year and interim period.

71. If mortgage-servicing assets are sold, provide information on the number and dollar volume sold during the most recent fiscal year and interim period.

Intercompany Transactions

72. Provide an organizational chart on a legal-entity basis that includes the bank holding company and all directly held bank and nonbank affiliates.

73. If the mortgage banking company is a direct nonbank subsidiary of the bank holding company, describe the method for identifying transactions that constitute ‘‘covered transactions’’ under sections 23A and 23B of the Federal Reserve Act, as well as the method for applying quantitative limits for section 23A and 23B purposes.

74. Provide a current listing of collateral that is maintained for covered transactions. Indicate whether collateral is maintained for the full amount of any credit lines with the bank and whether any depreciated or matured collateral has been replaced since the previous review.

75. Provide copies of any purchase and funding contracts between the mortgage banking company and affiliated bank(s). Please address whether any or all of the following conditions are met and/or provide written support, where applicable:

    a. asset purchases by the bank have been reviewed by management and are either within the quantitative limits of section 23A or meet the exemption requirements of section 250.250

    b. all purchases are at fair market value and consistent with market terms as required by section 23B

    c. no low-quality assets were transferred to a bank affiliate since the previous inspection

    d. the method of compensating bank affiliates for balances maintained by the parent company or its nonbank subsidiaries and the net interest income earned on warehouse loans or lines is reasonable and based on market terms

76. Provide copies of any servicing contracts between the mortgage banking company and affiliate bank(s). If not so stated, indicate the following information:

    a. the capacity in which the affiliate is acting (for example, is it acting as principal on its own behalf or as an agent for the affiliate bank?)

    b. the nature of all services provided

    c. billing arrangements, the frequency of billing, the method of computation and the basis for such fees

    d. the date of last review and approval by the mortgage banking company’s board of directors

77. Provide a copy of the bank holding company’s policy statement on the prohibition of tie-in arrangements, a description of training that is provided to employees in this area, and an attestation as to whether the nonbank subsidiary is in full compliance with internal policy.

78. If the mortgage banking company charges management or other fees, describe the nature of the

fees, the method of computation for such fees, and the settlement procedures. Include a listing of fees charged for the prior two fiscal years and the most recent interim period.

79. Provide a copy of the bank holding company’s intercompany tax allocation policy. Indicate the amount and timing of intercompany tax payments and credits received during the two previous fiscal years and the most recent interim period. If credits are due, please indicate the amount owed to the subsidiary and the date the intercompany receivable originated.

Sincerely yours,

Vice President,
Federal Reserve Bank of Boston

3070.0.12 APPENDIX B—ACCOUNTING LITERATURE

The following is a list of generally accepted accounting principles (GAAP) governing the mortgage banking industry that are in the form of accounting standards and interpretations. Accounting standards may change over time. Current accounting literature should be reviewed with management during each inspection.

Statements of Financial Accounting Standards (SFAS)

SFAS No. 5, ‘‘Accounting for Contingencies’’

SFAS No. 65, ‘‘Accounting for Certain Mortgage Banking Activities,’’ as amended

SFAS No. 77, ‘‘Reporting by Transferors for Transfers of Receivables with Recourse’’

SFAS No. 80, ‘‘Accounting for Futures Transactions’’

SFAS No. 91, ‘‘Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases’’

SFAS No. 115, ‘‘Accounting for Certain Investments in Debt and Equity Securities’’

SFAS No. 125, ‘‘Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities’’

FASB Technical Bulletin

Technical Bulletin No. 87-3, ‘‘Accounting for Mortgage Servicing Fees and Rights’’

Emerging Issues Task Force (EITF)

Issue No. 85-13, ‘‘Sale of Mortgage Service Rights on Mortgages Owned by Others’’

Issue No. 85-26, ‘‘Measurement of Servicing Fee under FASB Statement No. 65—When a Loan Is Sold with Servicing Retained’’

Issue No. 85-28, ‘‘Consolidation Issues Relating to Collateralized Mortgage Obligations’’

Issue No. 86-38, ‘‘Implications of Mortgage Prepayments on Amortization of Servicing Rights’’

Issue No. 86-39, ‘‘Gains from the Sale of Mortgage Loans with Servicing Rights Retained’’

Issue No. 87-25, ‘‘Sale of Convertible, Adjustable-Rate Mortgages with Contingent Repayment Agreement’’

Issue No. 87-34, ‘‘Sale of Mortgage Servicing Rights with a Subservicing Agreement’’

Issue No. 88-11, ‘‘Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold’’

Issue No. 89-4, ‘‘Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate’’

Issue No. 89-5, ‘‘Sale of Mortgage Loan Servicing Rights’’

Issue No. 90-21, ‘‘Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement’’

Issue No. 92-10, ‘‘Loan Acquisitions Involving Table Funding Arrangements’’

3070.0.13 APPENDIX C—REGULATORY GUIDANCE

The following is a list of sections in this manual that examiners may find particularly useful in the review of mortgage banking activities. Regulatory guidance also evolves over time. This list is not all inclusive.

2010.0.1	Policy Statement on the Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks
2020.0–.7	Intercompany Transactions
2050.0	Extensions of Credit to BHC Officials
2060.0–.6	Management Information Systems
2065.2	Determining an Adequate Level for the Allowance for Loan and Lease Losses
2080.05	Bank Holding Company Funding and Liquidity
2080.0–.3	BHC Funding Practices
2125.0	Trading Activities of Banking Organizations
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3073.0.1 EXPANDED STUDENT-LOAN-SERVICING ACTIVITIES

A bank holding company applied for the Board's approval under section 4(c)(8) of the Bank Holding Company Act (BHC Act) and section 225.23 of Regulation Y to expand the student-loan-servicing activities of its nonbank subsidiary. The activities would consist of—

1. providing student-loan authorities (the authority) with regular reports that include information in the aggregate and by individual lenders concerning the volume of loans being serviced for the authority and the volume of loans outstanding;
2. preparing projections for approval by the authority of student loans to be purchased and commitments to be issued in the future, based on the volume of loans being serviced and commitments outstanding, consistent with the amount of funds available to the authority as the result of its sale of bonds;
3. advising eligible lenders, borrowers, and other interested parties of the authority's student-loan-purchase program, including the criteria used by the authority in purchasing student loans and the extent to which the authority will be purchasing loans in the future based on the availability of funds; and
4. meeting regularly with the authority to advise it of the nonbank subsidiary's efforts in connection with the student-loan activities.

Under no circumstances would the nonbank subsidiary be authorized to bind the authority or its bank trustee to commit to purchase or actually to purchase student loans from eligible lenders.

The proposed activities were regarded as being equivalent to the activities of a mortgage banking subsidiary of a bank holding company, authorized under section 225.28(b)(1) of Regulation Y, with respect to acquiring and servicing mortgage loans for institutional investors or in connection with the secondary-mortgage market. The activities proposed and currently conducted by the applicant, to the extent that they were different from the services performed by any institution that services loans for others, were perceived as being different only in that they related to servicing student loans for a governmental authority. Banks and their nonbank subsidiaries generally provide comprehensive loan-acquisition and -servicing "packages" for investors in mortgage and other loans. The bank holding company's nonbank subsidiary was the nation's largest servicer of student loans, and was thus particularly well equipped to perform the proposed expanded services.

In addition to determining that the proposed activities were closely related to banking to approve the application, the Board had to conclude that the proposed activities would produce benefits to the public that would outweigh any possible adverse effects, such as unsound banking practices, unfair competition, conflicts of interests, or undue concentration of resources. The Board made that conclusion in addition to determining that the balance of public interest factors that it is required to consider under section 4(c)(8) of the BHC Act was favorable. Accordingly, the application was approved on July 1, 1985 (1985 FRB 725).

A bank holding company or its subsidiary may engage in the activity of servicing loans or other extensions of credit for either affiliated companies or for persons or institutions not affiliated with the holding company. The service will often be carried on as an additional activity of a credit-extending subsidiary, such as a mortgage company, where the loan serviced was originated by the subsidiary and subsequently sold to an investor. A servicing company provides the collection vehicle through receipt and disbursement of funds for investors who may not possess the resources to accomplish the activity. The purpose of servicing is to keep a sound loan in good standing for a passive investor. The servicing company's remuneration is usually based upon a percentage of the outstanding balance of the loan.

The traditional servicing arrangement arises from the normal business of a mortgage company. The company grants extensions of credit to qualified borrowers and subsequently packages and sells these loans, normally without recourse, to individuals or institutional investors who contract the collection of the credit to the mortgage company. The company may also purchase mortgages or other extensions of credit in the open market with the intention of reselling the credit and retaining the servicing or can simply purchase servicing portfolios (12 C.F.R. 225.132). The collection itself is basically a bookkeeping function.

Servicing loans for others is relatively risk-free to the company when the credits are sold without recourse to investors. A credit which has been sold with recourse represents an unusual circumstance and should, therefore, be reviewed in detail. The serviced loans will generally be high quality mortgages which are in turn purchased from the company by passive investors desiring a fixed rate of return on their funds. The risk to a servicing company lies in its portfolio of unsold loans, or its "warehouse." The risk is two-fold: (1) the loan may not be of high enough quality to attract an investor so that the servicing company will have to continue to carry the credit for its own account, and (2) the loan was made at an interest rate which is below current market rates. In the latter case, the servicing company must either sell the loan at a discount or continue to hold the credit for its own account. In either case, the loan is treated as an asset of the company and involves credit risk.

The inspection of a servicing company, or a servicing department of a credit-extending subsidiary, should focus on adequacy of documentation and controls, and on the quality and marketability of the warehoused loans. The examiner should obtain a past due report for the portfolio and note in the inspection report significant credits which are past due together with the period of delinquency, the type of loan, and the asset classification, if any. The nature of the servicing business is such that the number of past dues should be small because loans are only warehoused for a short period of time until they can be sold to an investor. As a rule, a past due loan or a current loan which has been warehoused for more than several months is indicative of some problem with the credit. Each loan should be evaluated to determine the reason it has not been sold.

During periods of rising long-term interest rates, the warehouse portfolio becomes subject to the risk that a loan may not be marketable, except at a discount, because of its relatively low yield. This affects both the servicer's income and liquidity.

In the case of the parent company acting as a servicer, the inspection should also determine whether the activity is being carried on under the proper exemption. A bank holding company may act as a servicer under section 4(c)(8) of the Act or under the provisions of sections 4(a)(2) and/or 4(c)(1) of the Act. If carried on under Section 4(a)(2) of the BHC Act, the holding company is limited to servicing loans only for its own account or its banking and nonbanking subsidiaries. If carried under Section 4(c)(1)(C) of the BHC Act, the bank holding company is limited to servicing loans only for its own account or its banking subsidiaries.

Finally, the income of the company should be subject to scrutiny. A servicing company should be a profitable business. The servicer receives a fee based upon a percentage of the outstanding balance of the loan. In the early years of the payback period, the fee should significantly exceed the cost of the service, and because much of the portfolio will be refinanced either prior to its maturity or prepaid, the fee income should be sufficient to cover the servicer's cost plus profit. The reason for poor earnings in this activity is generally either inefficiency in the collection area, failure to attain the breakeven point of servicing volume, or the inability to turnover the warehouse portfolio often enough to maintain new fee generation. In the event that the servicer is unprofitable, the examiner should determine the reasons and clearly set them forth in the inspection report.

The servicing arrangement is of a fiduciary nature and as such it gives rise to certain contingent liabilities. In the situation where the servicer is not fully and properly discharging its servicing responsibilities in accordance with the servicing agreement, the holder of the serviced notes might bring legal claims against the servicer. The inspection process should direct attention to this area including a review of the servicing agreement and verification that the servicer is fulfilling its obligations. Management should be reminded of the significant loss exposure which can result from improper attention to its fiduciary responsibilities.

3080.0.1 INSPECTION OBJECTIVES

1. To determine that internal controls are adequate to administer effectively the servicing of the loan portfolio.

2. To determine the level of exposure to credit risk of loans held for the firm's own account.

3. To determine if the firm's earnings are sufficient so as not to be a burden on the parent or subsidiary bank.

3080.0.2 INSPECTION PROCEDURES

1. Review the balance sheet to determine the volume of credits held for the firm's own account and evaluate their asset quality.

2. Review internal controls and evaluate their adequacy.

3. Review earnings and appraise the impact on the parent and bank subsidiaries.

4. Review servicing agreements and evaluate the potential or contingent risks to which the firm is exposed in the event of failure by a borrower to service its loan properly.

5. Determine whether mortgage servicing rights are recorded as an asset and whether they are being amortized over the average life of the loans being serviced.

A bank holding company may engage under contract with a third party in the management, servicing, and collection[1] of the types of assets that an insured depository institution may originate and own. The company cannot engage in real property management or real estate brokerage services as part of these services. See Regulation Y, section 225.28(b)(2)(vi). Provided below are some initial historical examples of Board orders that involve asset-management services related to this nonbanking activity. The commitments and conditions provided for within the Board orders should not be considered to be currently applicable.

3084.0.1 ASSET-MANAGEMENT SERVICES TO CERTAIN GOVERNMENTAL AGENCIES AND UNAFFILIATED FINANCIAL INSTITUTIONS WITH TROUBLED ASSETS

Three bank holding companies (the applicants) applied for the Board's approval under section 4(c)(8) of the BHC Act to engage de novo in providing asset-management services to the Resolution Trust Corporation and the Federal Deposit Insurance Corporation, and generally to unaffiliated financial institutions with troubled assets. The applicants committed to conduct these activities under the same terms and conditions as set out in 1988 FRB 771.

The commitments and conditions of this order required that (1) the asset-management activities would be provided to the banks and savings associations, (2) the applicant would obtain the Board's approval before providing asset-management services for pools of assets that were not originated or held by financial institutions and their affiliates, (3) the applicant would cause its asset-management subsidiary to establish procedures to preserve the confidentiality of information obtained in the course of providing asset-management services, and (4) neither the applicant nor its management subsidiary would take title to the assets managed by the asset-management subsidiary.

The applications of these holding companies were approved by a Board order on December 24, 1990 (1991 FRB 124). Two additional orders about providing asset-management services were approved on March 25, 1991 (1991 FRB 331 and 334).

3084.0.2 ASSET-MANAGEMENT SERVICES FOR ASSETS ORIGINATED BY NONFINANCIAL INSTITUTIONS

Two bank holding companies (the applicants) applied jointly for the Board's approval under section 4(c)(8) of the BHC Act to engage de novo in collection-agency activities pursuant to Regulation Y through a joint venture. The Board concluded that the collection activities were permissible.

The bank holding companies also applied for the Board's approval to engage in asset-management, asset-servicing, and collection activities through a nonbank of the joint venture located in New Jersey. The subsidiary would provide asset-management services to the Resolution Trust Corporation (RTC) and the Federal Deposit Insurance Corporation (FDIC). It would also provide these services to unaffiliated third-party investors that purchase pools of assets assembled by the RTC or the FDIC. Under the proposal, neither the applicants nor this nonbank subsidiary would acquire an ownership interest in the assets that they manage or in the institutions for which they provide the asset-management services. The applicants further committed that they would not provide real property management or real estate brokerage services as part of the proposed activities.

The Board previously determined that, within certain parameters, providing asset-management services for assets originated by financial institutions (banks, savings associations, and credit unions) and their bank holding company affiliates is an activity closely related to banking (see 1991 FRB 331, 334 and section 3600.15.3). The applicants proposed to conduct all asset-management activities subject to the same conditions as in the Board orders previously cited.

The applicants proposed to engage in asset-management activities for assets originated by nonfinancial institutions as well as by financial institutions. These assets include real estate, consumer, and other loans; equipment leases; and extensions of credit. Assets of nonfinancial institutions include pension funds, leasing com-

1. Asset-management services include acting as agent in the liquidation or sale of loans and collateral for loans, including real estate and other assets acquired through foreclosure or in satisfaction of debts previously contracted.

panies, finance companies, and investment companies formed to engage in asset-management activities. The managed assets would be limited to the types of assets that financial institutions have the authority to originate. The Board concluded that the applicants would have the expertise to engage in managing these types of assets, regardless of the originating entity. The Board also determined that the proposal was consistent with the asset-management proposals approved in its prior orders. The Board concluded that the applicants' proposed activities are closely related to banking and approved the order on December 21, 1992. (1993 FRB 131)

Section 4(c)(8) of the BHC Act (Receivables) Section 3090.0

Two nonbanking activities authorized under section 4(c)(8) of the BHC Act, per Regulation Y in section 225.28(b)(1), are the discount purchasing of a client's accounts receivables (factoring) and the establishment of a revolving credit facility secured by an assignment of accounts receivable (accounts receivable financing). These activities date back to Board orders issued in 1951. See sections 3090.1 and 3090.2.

3090.1.1 INTRODUCTION

Factoring is the discount purchasing of the client's accounts receivable invoices for goods that have been manufactured and shipped. Factoring differs from accounts receivable financing in that the factor assumes the credit risk of collecting payment from the recipient of the goods. The principal advantage of factoring is that the client is assured of the collection of the proceeds of its sales, regardless of whether the factor is paid.

A factor generally offers four basic services: (1) credit investigation and approval; (2) buying the client's accounts receivable at a discount (generally between .75 and 1.5 percent) after shipment of the goods to which there is no subsequent claim, just a claim against the invoices; (3) bookkeeping in the form of posting accounts; and (4) advancing funds in the form of an "open account" when there could be 30 days between shipment and payment. The later allows the client to replenish inventory loans for working capital or expansion.

Maturity factoring and advance factoring are the basic techniques of the industry. In maturity factoring, an average maturity due date is computed for the receivables purchased during a period and the client receives payment on that date. Advance factoring uses the same computations, however, the client has the option of taking advance payments equal to a percentage of the balance due at any time *prior* to the computed average maturity due date. The unadvanced balance, sometimes called the "client's equity," is payable on demand at the due date.

The factor's balance sheet reflects the purchases as "factored receivables" and the liabilities as "due to clients." Usually the due to clients balance will be significantly less than the factored receivables balance because of payments and advances to the clients. The income statement will show factoring commissions, which represent the discount on the receivables purchased. Interest income for advances on the due to client balances may or may not be a separate line item.

The factor is a pivoting point between the buyer and the seller. The buyer must pay or all parties lose. Also the seller must have a reputation for delivering quality merchandise. The factor must know the business well enough to account for sudden increases in returns for out-of-specification merchandise or for merchandise of low quality. If the seller does not perform adequately, payment for the goods may not be forthcoming, and if bankruptcy threatens the seller, buyers may hold back their future purchases.

3090.1.2 FUNDING

Since factors traditionally provide financing to industries with seasonal borrowing requirements, such as textiles, shoes, clothing, and other consumer goods, their own funding programs will usually reflect this volatility. It may be expected that factors generally will have greater access to short-term unsecured credit facilities than would be expected for other nonbank activities. This would hold true for factors funded solely from internal sources as well as external sources.

Because of a factor's inherent funding volatility, a major portion of a factor's liabilities will be short-term debt. For the internally funded company, this source will be predominantly commercial paper proceeds from the parent company, with perhaps some bank line proceeds intermixed. The externally funded company will probably rely on bank lines for its short-term needs, usually with the parent company's guaranty of the debt.

Longer term funding may be provided through bank term loans and subordinated debt, although the volume of this type of debt appears to be low relative to other financing industries. The terms and covenants of long-term debt appear to allow for relatively more flexibility in operations and more highly leveraged positions than similar debt for other financing industries in recognition of the volatility of factoring operations and the liquidity of factoring assets.

The principal suppliers of senior and subordinated funds to factors and accounts receivable financers appear to be limited to a few insurance companies that specialize in this field, although a few banks also provide senior term funding. These lenders have incorporated their perceptions of acceptable balance sheet ratios and earnings performance into their debt agreements as restrictive covenants. Since comparative industry data is limited, these restrictive covenants may be the examiner's primary means of evaluating leverage, loss reserves, and capital adequacy. The "due to clients" account is another significant measure of a factor's liabilities. As noted before, the account represents the accumulation of the amounts payable to the clients upon the maturity of their factored receivables. This liability is, to a large extent, self-liquidating through the collection of those receivables.

An analysis of the changes in the relative proportions of the ''due to clients'' account should provide valuable input into the analysis of a factor's earnings. Since factoring is a highly competitive industry, price cutting has reduced factoring commissions to a point where they provide minimal support to earnings; therefore, the interest margins on factoring advances have a significant impact on net income. The implication of the analysis of proportional changes is that as more clients take advances (reducing ''due to clients''), profit margins should widen, and conversely, as the ''due to clients'' proportion of total liabilities rises, profit margins may be expected to narrow.

3090.1.3 INSPECTION OBJECTIVES

1. To determine whether the company is operating within the scope of its approved activities and within the provisions of the Act and Regulation Y.
2. To determine whether transactions with affiliates, including banks, are in accordance with applicable statutes and regulations.
3. To determine the quality of the asset portfolios, and whether lending, monitoring and collection policies are adequate to maintain sound asset conditions.
4. To determine the adequacy of the reserve for loan losses and whether the asset charge-off policy is appropriate.
5. To determine the viability of the company as a going-concern, and whether its affiliate status represents a potential or actual adverse influence upon the condition of the consolidated corporation.

3090.1.4 INSPECTION PROCEDURES

The inspection procedures for a factor have been divided into two phases, preliminary and on-site, when considered necessary.

The preliminary phase entails the gathering and analysis of information at the parent company in order to determine the scope of the field work to be performed on-site. The on-site segment of the procedures expresses some of the typical practices and considerations in this form of financing.

During the preliminary phase, the following information should be reviewed:

1. System approvals for offices and activities, including stipulated public benefits;
2. Financial statements, both interim and fiscal, for a sufficient period to determine trends and operating patterns;
3. All management reports which should indicate problem loans, loan volume, new accounts and other reports regarding loan portfolio and company status;
4. External debt instruments to determine material restrictive covenants;
5. Internal audit reports and workpapers;
6. Minutes of the board of directors, executive committee and loan committee, if available at the parent company;
7. The results of a parent company loan review, if any.
8. To be requested:
   a. Schedules of past due loans, intercompany participations, and large loans;
   b. Schedules of problem accounts, liquidating accounts, and repossessed assets;
   c. General ledger trial balance;
   d. Loan trial balance, including overadvances;
   e. Statements of company lending, accrual, and other policies;
   f. Reconcilement of the loan loss reserve for the period between inspections;
   g. Listing of common borrowers between affiliates.

3090.1.4.1 On-Site Procedures

After reviewing the material available at the parent company, including the audit review, a decision whether to go on-site is in order. Some of the determinants of this decision are relative size, current earnings performance, overall contribution to the corporation's condition, asset quality as indicated by internal loan review reports and problem loan reports, and the condition of the company when last inspected. From the information provided, it might be determined that the company is operating properly and is in apparently sound condition. In such a case, an on-site inspection may not be warranted. Conversely, a deteriorating condition might be detected which would require a visit, even though a satisfactory condition had been determined during the previous inspection. Subsidiaries in unsatisfactory condition should be inspected each time the parent company is inspected.

The following comments provide a general outline of the factor's basic operation. This outline will provide a background for the comments in the inspection procedures.

While the typical factoring agreement stipulates that all accounts receivable of a client are assigned to the factor, not all are purchased without recourse. The agreement between the factor and the client will usually state that receivables subject to shipping disputes and errors, returns, and adjustments are chargeable to the client because they do not represent bona fide sales. In addition, sales made without the factor's approval are considered *client risk* receivables, with full recourse to the client if the customer fails to pay.

The usual approval process requires the client to contact the factor's credit department before filling a sales order on credit terms. The credit department will research its files, determine the credit worthiness of the customer, and approve or reject the sale. As stated before, if the credit department rejects the sale, the client may complete the sale, but at its own risk. The most common reasons for rejection are sales to affiliates, sales to known bad risks, sales to customers whose credit cannot be verified, and sales to customers whose outstanding payables exceed the factor's credit line.

Once a sale has been made and the receivable assigned to the factor, approved or not, the client's account will be credited for the net invoice amount of the sale. That is, any trade or volume discounts, early payment terms, and other adjustments are deducted from the invoice amount. The receivable then becomes part of the client's "availability" to be paid in advance or at the computed due date, depending upon the basis of the factoring arrangement.

Each month the client will receive an "accounts current" statement from the factor which details the transactions on a daily basis. This statement will reflect the daily assignments of receivables, remittances made, deductions for term loans, and interest charges and factoring commissions. Credit memos, client risk, charge backs, and other adjustments will also be shown. Client risk charge backs are the amounts deducted from the balance due to the client upon the failure of customers to pay receivables factored at client risk.

The accounts current statement and the availability sheets will be necessary for the asset analysis process. Considering the volume of transactions, the accounting system that develops this data will probably be automated, which may allow the factor to obtain comparison and monitoring data on the client. If a monitoring system is in place, the data provided will be valuable in the asset analysis process.

The evaluation of a factor includes a review of its systems and controls as well as an analysis of the quality of its assets, both of which may be accomplished by a two segment analytical approach. A major portion of a factor's assets will be factored receivables, for which the credit department has the responsibility for credit quality and collection. The other major portion of the assets will be the client loans and credit accommodations, for which the account officers are responsible. The procedures for each area will be dealt with separately.

3090.1.4.2 Credit Department

Because of its integral function in the credit and collection process, the credit department is the heart of a factor. The department maintains credit files, which are continually updated as purchases are made and paid for by the customers. These files will include financial statements, credit bureau reports, and details of purchasing volume and paying habits. Usually, each customer will have an assigned credit line, which is the credit department's estimate of the customer's credit capacity.

The evaluation of this department should take the form of a review of a sample of the customer files. The sample may be drawn from lists of large volume customers and closely monitored customers, or it may be a random sample. The examiner should have either a copy of departmental policies and procedures or a verbal understanding of them prior to the review. It should be kept in mind that the objective of the review is to critique the credit and collection process and to verify departmental effectiveness, and not to obtain classifications.

3090.1.4.3 Asset Evaluation

Prior to the review of asset quality, the examiner should receive the lists of problem clients, client over-advances, term loans, and credit accommodations; as well as the aging schedule of factored receivables including client risk receivables. These will be used as the basis for selecting the clients to be reviewed. It is recommended that the selection be made from the list of clients with term loans, largest first, in addition to the acknowledged problems. Clients with high dilution rates and those with client risk receivables equal to 20 percent or more of factored volume may also be included.

It should be noted that a factor usually collects principal and interest payments directly from the client's availability, which means that the expected delinquency rate is minimal. Past due factored volume is not an effective measure of client quality.

A maturity client's availability is the sum of all factored receivables, less trade and other discounts, factoring commissions, credit memos, and client risk charge-backs. There may also be other deductions for letters of credit and other credit accommodations. An advance client's availability would be further reduced by advances on the factored receivables, interest charges, and the reciprocal of the contractually agreed upon ''advance'' percentage. This reciprocal, 20 percent in the case of an 80 percent advance client, is sometimes referred to as the client's ''equity'' in the factored receivables. Availability may be increased by liens on additional collateral such as inventory, machinery and equipment, real estate, and other marketable assets.

The review and analysis of asset quality will be procedurally similar to that used in accounts receivable financing. However, certain aspects of the financial statements may need elaboration. The client's balance sheet will have a ''due from factor'' account instead of accounts receivable. The account balance may be somewhat lower than a normal receivables balance, which would affect turnover ratios and other short-term ratios. The difference relates to the client's ability to convert sales to cash faster with a factor than if the receivables were to be collected normally. In addition, the analysis of the statements should incorporate an assessment of the client's ability to absorb normal dilution and the potential losses associated with client risk receivables, particularly when these factors are higher than usual for the portfolio.

As a factor's systems and controls for client loans are somewhat similar to those for accounts receivable financing, the evaluation of asset quality must consider these factors before the classification of a client is made. While the typical client may have less than satisfactory financial statements, the factor's working knowledge of the client's operations and industry tends to mitigate the risk factors present.

For classification purposes, ''client risk receivables'' is the only portion of factored volume that is appropriate for use in the amount classified. Because of the recourse aspect the balance is considered as an indirect obligation rather than a direct obligation.

As a further step in the evaluation of the lending area and its controls, the evaluation of the steps taken and the results of at least one recent client liquidation should be made. By reviewing the chronology of events along with the loan and collateral balances, the effectiveness of systems and controls under extended circumstances may be assessed. The type of liquidation will have a bearing on the losses taken. Losses tend to be higher when client fraud is involved.

In the process of evaluating a factor's condition, the adequacy of systems and controls and the capability of management are considered significant measures. Asset quality, as measured by classifications, may be influenced by seasonal aspects and should be carefully analyzed to allow for such influences. Because of a lack of regular and consistent comparative data for the industry, earnings and capital adequacy are evaluated in terms of the company's own performance.

The review of the company's internal systems and controls should be continuous during the inspection. Considering the large volume of daily transactions that flows through a factor, any internal control that can be easily negated represents a potential problem and should be brought to management's attention. In the broad context, this review would include the credit controls for both clients and customers. Since credit problems can develop rapidly in factoring, credit controls and systems must be responsive to the identification of these problems. Deficiencies noted should be discussed with management and, if significant, cited in the report. The company's earnings trends may be evaluated by using a comparative yield on assets approach. By analyzing yields on asset categories from period to period the examiner will be able to make a judgment as to the efficiency of the systems. Factors are subject to the same price competition in the commercial finance market as accounts receivable financers. Declining portfolio yields may reflect the inroads made by competition and may indicate a decline in future profitability.

The subject of capital adequacy is influenced by the aforementioned seasonal characteristics. Over the period of a year, the comparisons of equity to assets and equity to liabilities will vary significantly. It is suggested that an average balance sheet be used to stabilize the variations.

In addition to balance-sheet ratio analysis, the effects of dividends and fees paid to the parent company on the capital accounts may be analyzed to determine the rate of internal capital generation. If the company is in a growth profile, or attempting to gain market share, the comparisons between fiscal periods may reflect a declining trend. Such a trend should be discussed with parent company management.

The report comments should summarize these considerations in a clear, concise presentation.

3090.1.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Loans to affiliates	23A FRA 371c			
Purchase of affiliate's notes from a third party	23A FRA 371c		3–1131	1951 FRB 960
Activities not closely related to banking	4(c)(8) BHC Act 1843(c)(8)	225.126	4–184	
Acquisition of assets	4(c)(8) BHC Act 1843(c)(8)	225.132	4–175.1	1974 FRB 725 1984 FRB 370
Real estate mortgages as eligible collateral under section 23A	23A FRA 371c			1933 FRB 566
Indebtedness of affiliate on assets acquired from member bank	23A FRA 371c		3–1125	1936 FRB 324
Marketability of collateral under section 23A	23A FRA 371c		3–1121	1935 FRB 395
Activities closely related to banking	4(c)(8) BHC Act 1843(c)(8)	225.123 225.28(b)(1)	4–176	1971 FRB 514 1975 FRB 245 1984 FRB 50 1984 FRB 370 1984 FRB 376 1984 FRB 452 1984 FRB 736 1986 FRB 143 1988 FRB 177 1988 FRB 330 1989 FRB 79 1992 FRB 74
Community development activities	4(c)(8) BHC Act 1843(c)(8)	225.127 225.28(b)(12)	4–178	1972 FRB 572

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

3090.2.1 INTRODUCTION

Accounts receivable financing is a revolving credit facility secured by an assignment of accounts receivable. As a financing technique, it allows the client (the financed company) to obtain working capital without waiting for customer payments. This form of financing is frequently used by companies with working-capital shortages, companies in seasonal industries, and companies with weak financial conditions. Typically, the funding requirements of these companies are in excess of any amounts that would be available through unsecured bank financing.

The financing process begins with a bona fide credit sale by the client and the assignment of the resulting receivable to the financer. Upon assignment, the financer advances a specific percentage of the receivable to the client. The loan is repaid by customers' direct payments or, in the case of a lockbox, by the remittance of the customer's payment to the financer, who returns the amount in excess of the loan to the client. While a simple concept for a single transaction, the operations of an accounts receivable financer become a complex process when many clients and perhaps thousands of receivables are involved.

Companies engaged in accounts receivable financing usually incorporate the full range of commercial financing activities into their operation. These activities would include inventory financing, loans secured by machinery and equipment, some forms of real estate loans, and loans secured by other assets. As a general statement, these companies will provide working-capital financing using almost any form of viable collateral to secure the loans. These additional activities are facilitated by the financer's in-depth knowledge of the borrowers' financial conditions and cash flows. This knowledge comes from the controls placed on the borrowers, such as periodic field audits, the flow of the borrower's cash through the company, and an internal staff that specializes in the financed industries.

3090.2.2 FUNDING

Accounts receivable financing companies, like factors, traditionally provide working-capital financing to seasonal industries. Consequently, the funding programs of these financing companies will reflect these variations in their increased use of short-term funds relative to other nonbanking activities.

Since many accounts receivable clients have seasonal businesses, a large portion of the financer's liabilities will be short-term debt. For internally funded financers, this debt will be predominantly commercial paper proceeds from the parent company, with perhaps some bank lines intermixed. The externally funded company will probably rely on bank lines for its short-term needs, usually with the parent company's guaranty of the debt.

Longer term funding may be provided through bank term loans and subordinated debt, although the volume of this type of debt appears to be low relative to other financing industries, another parallel to factoring. The terms and covenants of long-term debt appear to allow for more flexibility in operations and somewhat more highly leveraged positions than similar debt for other financing industries. This practice is apparently in recognition of the volatility of this form of financing and the liquidity of the assets supporting the financer's loans.

The principal suppliers of senior and subordinated funds to collateral lenders (factors and accounts receivable financers) appear to be limited to a few insurance companies that specialize in this field, although a few banks also provide senior term funding. These lenders have incorporated their perceptions of acceptable balance-sheet ratios and earnings performance into their debt agreements as restrictive covenants. Since comparative industry data are limited, these restrictive covenants may be the examiner's primary means of evaluating leverage, loss reserves, and capital adequacy.

3090.2.3 INSPECTION OBJECTIVES

1. To determine whether the company is operating within the scope of its approved activities and within the provisions of the act and Regulation Y.
2. To determine whether transactions with affiliates, including banks, are in accordance with applicable statutes and regulations.
3. To determine the quality of the asset portfolios and whether lending, monitoring, and collection policies are adequate to maintain sound asset conditions.
4. To determine the adequacy of the reserve for loan losses and whether the asset charge-off policy is appropriate.
5. To determine the viability of the company as a going concern, and whether its affiliate

status represents a potential or actual adverse influence upon the condition of the consolidated corporation.

3090.2.4 INSPECTION PROCEDURES

The inspection procedures for an accounts receivable company have been divided into two phases, preliminary and on-site.

The preliminary phase entails the gathering and analysis of information at the parent company in order to determine the scope of the field work to be performed on-site, if required. The on-site segment of the procedures expresses some of the typical practices and considerations in this form of financing.

During the preliminary phase, the following information should be reviewed:

1. system approvals for offices and activities, including stipulated public benefits
2. financial statements, both interim and fiscal, for a sufficient period to determine trends and operating patterns
3. all management reports which should indicate problem loans, loan volume, new accounts and other reports regarding loan portfolio and company status
4. external debt instruments to determine material restrictive covenants
5. internal audit reports and workpapers—
   a. internal control exception report to determine weaknesses and corrective actions,
   b. flow charts in the workpapers which will enable the examiner to become familiar with company systems, and
   c. additional internal reports may be identified which may assist the inspection on-site
6. minutes of the board of directors, executive committee and loan committee, if available at the parent company
7. the results of a parent company loan review, if completed
8. To be requested:
   a. schedules of past-due loans, intercompany participations, and large loans
   b. schedules of problem accounts, liquidating accounts, and repossessed assets
   c. general ledger trial balance
   d. loan trial balance
   e. statements of company lending, accrual, and other policies
   f. reconcilement of the loan-loss reserve for the period between inspections
   g. listing of common borrowers between affiliates

3090.2.4.1 On-Site Procedures

After reviewing the material available at the parent company level, including the audit review, a decision whether to go on-site is in order. Some of the determinants of this decision would include relative size, current earnings performance, overall contribution to the corporation's condition, asset quality as indicated by internal loan review reports and problem loan reports, and the condition of the company when last inspected. From the information provided, it might be determined that the company is operating properly and is in apparently sound condition. In such a case, an on-site inspection may not be warranted. Conversely, a deteriorating condition might be detected which would require a visit, even though a satisfactory condition had been determined during the previous inspection. Subsidiaries in unsatisfactory condition should be inspected each time the parent company is inspected.

The on-site inspection procedure will be similar to that used in a commercial department of a bank. Selection and evaluation of the assets, review of internal controls, identification of lending policies, and credit review procedures are all familiar areas to the examiner and do not need further explanation. However, the accounting and reporting systems are somewhat different and will require the examiner to become familiar with systems and policies before proceeding with the asset evaluation process.

3090.2.4.2 Accounting and Controls

There are two basic systems within the accounting and control environment of an accounts receivable company. The first system provides accounting and control for client loans and collateral balances and is frequently automated to handle the large flows of data generated in the operation. It is also common to find lockbox arrangements with banks that tie into the client system for the receipt of customer remittances. Such lockbox arrangements provide a greater degree of control over remittances.

The mechanics of the client system will be detailed in the internal audit file, which should also indicate the adequacy and efficiency of the system's controls. The audit file may also indicate the accounting techniques used and the client-monitoring reports that are generated by the system, such as dilution rates and trends, and year-to-year volume and operating comparisons. The client system provides the basic data for the company's accounting and control system. While the basic accounting considerations are outlined in the AICPA *Industry Audit Guide: Audits of Finance Companies*, there are certain accounting aspects which deserve additional treatment. In some cases where a group of related companies are clients, the financing arrangements may include cross-guarantees and cross-collateralization agreements. In these cases, the financer might utilize excess availability for some of the related entities to offset the over-advance of another entity. Another treatment that may be applied is the use of a ''reserve for liquidating accounts,'' which in some instances is a specific reserve for a problem account that reverses at least current period earnings for the account. This reserve is in addition to the allowance for bad debts and may not be an explicit balance sheet account, but an offset to gross loans outstanding.

3090.2.4.3 Definitions

While many of the following comments define certain routine accounting and control considerations for accounts receivable financing, certain of the concepts are necessary for proper evaluation of client quality (i.e., availability, dilution, over-advances, and advances on other collateral). These definitions are general in nature as is the terminology, however, the processes will be similar in almost every company.

Loans to the client are based upon a contractual percentage of the client's eligible receivables against which the financer has agreed to advance funds. Eligible receivables include all assigned receivables, less trade discounts, early payment discounts, contra-accounts (reciprocal sales between the client and customers), receivables past due beyond the eligibility period specified in the contract, and other adjustments. The advance percentage is determined by a number of factors which include the expected average dilution rate (disputed invoices, mis-shipped goods, returns and allowances, etc.) and the client's expected gross profit margin. As a general rule, lenders in this field try to finance only the cost of sales and not the client's profits.

Because this form of financing involves rapidly changing collateral balances, a high volume of customer payments, and frequent loan requests, the financer has to determine the client's ''availability'' (loanable funds) before advancing the loan. Availability is the total of eligible receivables times the advance percentage less credit memos and the current loan balance. Credit memos are adjustments to the customer's account for errors in the client's shipments (i.e., the quantity shipped was less than that ordered). It is the client's responsibility to provide this information to the financer on a daily basis. If there is sufficient availability, the requested amount is usually advanced. On occasion, the availability computation will show the client to be ''over-advanced,'' that is the loan balance exceeds the agreed percentage advance against collateral. This situation may have occurred because some receivables have become past due, or the financer may have authorized additional funds to meet some valid client requirement. As a rule, over- advance positions are usually subject to a quick paydown to reduce the loan balance to the original contractual terms.

At times, the availability computation will reflect additional collateral value in the form of inventories, machinery and equipment, and other assets, shown net of an advance percentage. These categories usually indicate term loans, secured by liens against the respective assets, which expand the collateral base and provide additional support to the client's working capital requirements. These term loans should not be confused with loans for the acquisition of such assets which might appear only in the client's monthly statement.

The accounts receivable financer charges interest on the daily cash borrowings of the client and accumulates these charges on the client's monthly statement. The total interest charge for advances on receivables and other loans is deducted directly from remittances received by the financer. Accordingly, the expected delinquency rate for an accounts receivable operation is low except for the rare loan which is paid directly by the client and other assets which formerly belonged to a defunct client.

3090.2.4.4 Over-Advances and Other Loans

It was indicated earlier that an over-advance represented funds advanced in excess of available loanable funds and that there are two basic causes for over-advances. Some over-advances occur because a portion of eligible receivables becomes past due and ineligible for advances. This condition is usually corrected by the assignment of additional receivables or receipt of customer payments, and therefore may exist only for a few days.

The other basic over-advance occurs when a client requires additional funds for valid business purposes, such as an inventory buildup at the beginning of a season. In such cases, the over-advance is set up as a very short-term loan and paid down rapidly out of the client's availability. While the policy for over-advances varies between financers, when they are permitted they are usually carefully analyzed by the internal credit committee and closely monitored until paid off.

If a client is involved only in receivables financing and has made an over-advance request, the financer generally will prefer to take a lien against inventory rather than make an unsecured over-advance. Regardless of the purpose of the inventory loan, the financer will advance only a small percentage of the inventory value (40 to 50 percent) to allow for shrinkage, spoilage and obsolescence of the collateral. While inventory liens are in effect, the field audit staff will partially verify the inventory during each audit.

While machinery and equipment may be pledged as additional collateral to support working capital loans during the business period, most client companies will also finance equipment purchases on a secured basis. In either case, the financer usually advances a percentage of the quick sale or auction value of the equipment as determined by an appraisal. During field audits, the presence of the equipment and appropriate lien tagging are verified by the field auditors.

On occasion, a lien on real estate is part of the pledged collateral. The real estate may be operating premises, land, or the property of the principal of the client. Such liens may occur when the client is acquiring new, or expanding old, operating facilities and is using the financing relationship to fund the project. However, in many cases the lien was taken to provide additional collateral for working capital loans. In either case, appropriate documentation and appraisals should be on file.

It should be noted that loans on real estate collateral are limited to those providing support to the primary business of the client. Loans to finance speculative real estate acquisitions, and unrelated commercial property are not considered to be the usual practice of this industry, and would be considered as not complying with the general activities of a commercial finance company, unless specifically approved.

3090.2.4.5 Asset Evaluation

In selecting the loans to be reviewed, the first group to be considered is the acknowledged problem accounts. The next sample should be drawn from accounts with high dilution rates, those with frequent or large over-advances, and those which constantly take down all of their availability. Participations, purchased or sold, between affiliates should also be included in the examiner's sample. While this approach may exclude some of the larger accounts, it is intended to include those accounts which are potential problems in the primary review group. Should the company have a monitoring system for potential problem accounts, the system should be used for drawing the review sample.

The principal tools for the review process should include: the credit file, the field audit file, the monthly statement for the inspection date, the availability sheet for the inspection date, and updated information for the interim period ending with the on-site inspection date. Within the credit file, the copies of the financing agreements will indicate the specific terms of the borrowing relationship: the pledged collateral; advance percentage; interest rate; guarantees; appraisals; and the required communications, such as monthly receivables agings, inventory and machinery and equipment certification, etc. The usual file information will also include management's analysis of the client's operations.

The field audit file will contain the audit reports originated by the financer's field audit staff. These reports are usually quite comprehensive, with a primary focus upon critical financial areas. As a minimum, the auditors will analyze trade payables, State and federal taxes, cash flows, inventories, and receivables. Particular attention is paid to the client's sales and shipping procedures in order to ascertain that valid invoices are being assigned to the financer. The client's accounting procedures are also analyzed to determine their effectiveness and accuracy. These reports represent a primary source of information regarding the general financial condition of the client.

The client's monthly statement and availability sheets represent spot information on the client's activity. Many clients operate in seasonal industries such as clothing and textiles. In such industries, a client will tend to use all of its availability, as well as seasonal over-advances, during its inventory buildup period, and will pay off the over-advances and may have excess availability during the sales and collection period. The examiner will have to analyze the client's current position with regard to its particular operating cycle. Over-advances granted to a client for valid reasons do not necessarily represent undue exposure or a substandard asset for the financer.

The financial statements of a client quite frequently reflect a ‘‘relatively unsatisfactory or weak’’ financial condition, with minimal working capital, high leverage, and uncertain earnings as prime ingredients. There have been cases where both deficit working capital and deficit net worth were in evidence, however, the financing relationship has continued to function properly. The financer can continue these relationships if the short-term factors (sales volume, receivables and inventory turnover, and current liabilities) are appropriate and the character of the principals warrants the exposure. Analysis of a financed client should emphasize the short-term analytical factors and the related trends in the evaluation of asset quality.

Such factors as the success of the selling season, availability of materials, and fad merchandising will have direct impact on the client's financial condition. While the loan may be adequately protected by pledged collateral, the ability of the client to continue operations may be affected by these short-term factors.

For classification purposes, the financer's controls will have to be considered in addition to weighing the degree and quality of collateral protection, short-term factors, and the client's ability to withstand any financial reverses that are evident. Clients with deficit net worth, past-due trade obligations, and delinquent taxes should be considered to be problems and appropriately classified. The ability of the financer to control the risk exposure in the portfolio will be an important consideration in determining whether to classify a specific loan.

3090.2.4.6 DPC Assets

In some companies, assets acquired from defunct clients remain in the loan account instead of being reclassified to another balance-sheet category. Usually, these assets are uncollected accounts receivable, inventory, and machinery and equipment which have not been liquidated. However, these assets may include securities, as well as business and personal real estate, which had been pledged as collateral. By retaining these assets in the loan category, effective liquidation of the respective assets may be delayed because they usually represent small dollar amounts. Apart from this consideration, classification as loans may disguise the fact that certain of the assets may be subject to provisions of Regulation Y and the act, such as control and retention considerations. Separate control of these assets is recommended.

It is common practice in the accounts receivable and factoring industry for the lender to require a pledge of client company stock by the principals, particularly in overextended situations. Additional pledges of securities owned by the principals may also provide added collateral. While such pledges are not precluded by Regulation Y and the act, once they become company assets they should be reviewed for control and retention purposes.

3090.2.4.7 Financial Condition

Secured lending relies upon the four C's of credit: the traditional Capital, Character, Capacity, and Collateral. Pragmatically, these lenders practice a fifth C, Control. In this context, control implies the continuous monitoring of the client's financial condition, continued evaluation of the collateral, constant contact with the client, and the adjusting of the credit accommodation to conform to the client's current situation. This control is the reason that the secured lender can maintain a proper and mutually profitable financing arrangement with the client.

It is to be expected that the typical portfolio may include clients with less than satisfactory financial conditions. Considering the controls imposed upon the borrowing relationships, the secured lender has compensated for some of the additional risk in the loans. The combination of field audits, collateral controls, and account officer contact can be expected to reduce the exposure to unsatisfactory clients to a minimum. However, clients do fail and losses may be taken in liquidating the account. The incidence rate of liquidations and the extent of losses taken may be an indicator of the effectiveness of company controls.

The earnings of an accounts receivable company are based upon loans carrying interest rates above prime, which means that loan volume is a major determinant of revenues. Because this industry is very competitive, loan pricing is frequently used to obtain new clients from other lenders in order to promote growth in loan volume. Increases in loan volume combined with declining interest margins may be an indicator of price competition that is yielding negative results. Analysis of client turnover may verify this possibility.

In summary, management's ability to control risk and achieve profitability is essential to the soundness of an accounts receivable operation.

The effectiveness of company policies, the expertise of the lending staff and field audit staff, and the adequacy of systems and controls are the expressions of this ability to control risk. Company profitability is a measure of management's ability to obtain satisfactory client quality and terms in a price-competitive environment. The examiner will have to balance these factors in assessing the condition of the company.

3090.2.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Loans to affiliates	23A FR Act 371c			
Purchase of affiliate's notes from a third party			3–1131	1951 FRB 960
Acquisition of assets		225.132	4–175.1	1974 FRB 725 1984 FRB 370
Activities closely related to banking		225.123	4–176	1971 FRB 514 1975 FRB 245
Investments in community welfare projects		225.127	4–178	1972 FRB 572

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

3100.0.1 INTRODUCTION

The basic activity of a consumer finance company is making installment loans to individuals and is permissible pursuant to section 225.28(b)(1) of Regulation Y and section 4(c)(8) of the BHC Act (the act). In most areas, a company may make these loans under one or more of the following licenses: consumer discount, small loan, sales finance, or second mortgage. Most of a company's activity will probably be direct cash lending, in which the borrower and the lender come into direct contact with one another in the credit-extension process. However, a significant volume of lending is done through third-party contact. This is sales finance lending in which the company purchases, or discounts, the loans originated by a durable goods dealer in daily retail sales activity. Second mortgage lending may be originated from either direct contact or through home-improvement contractors.

Most consumer finance companies offer credit-related insurance as part of their services, and may have a captive insurance subsidiary if they are large enough. Inspection considerations and procedures for reviewing credit-related insurance activities are covered in section 3170.0.

3100.0.2 FUNDING

In some holding companies, management has elected to use a conventional industry funding pattern to support its consumer finance company operations. This pattern makes use of long-term subordinated debt in a specific proportion to equity capital. The further addition of senior long-term and short-term debt is then limited by restrictive covenants incorporated into the subordinated debt agreements. These covenants also provide operating limits for management in such areas as the proportions of specific classes of assets, minimum levels of net worth to be maintained, and the maximum dividend payout allowable. Since the wording and limits of these covenants are negotiated between the borrower and the subordinated debt holder, generalizations regarding the usual terms are not practicable.

It appears that certain life insurance companies supply most of this subordinated debt to the consumer finance industry. Along with their general knowledge of the industry, these insurance companies police their loans by requiring periodic reports from the borrower and by sending teams of their people to review the borrower's operations. In a sense, this approach to funding represents regulation and control by market forces rather than by governmental intervention.

In other holding companies, management has elected to support these operations using holding company funding sources such as commercial paper and lines of credit. In using this approach, operating management is generally free from market restrictions on operations.

It is likely that most affiliated consumer finance companies will have a funding plan that falls somewhere between these two extremes. Since commercial paper generally carries a lower total cost than bank lines of credit, the examiner may find that the senior short-term debt component is almost completely supplied by the parent company. On the other hand, long-term debt may have been obtained directly, or with the parent company's guaranty, or it may have been borrowed from the parent company's sources—that is, the parent borrows from a third party and re-lends the proceeds to the subsidiary.

Since a large volume of consumer installment paper carries maturities of three years or more, the use of commercial paper proceeds with maximum maturities of 270 days warrants some comment. Securities Act Release No. 401 specifically recognizes this use of commercial paper as appropriate. Further information may be found in the Code of Federal Regulations, 17 C.F.R. 231.4412. Also see sections 2080.1 and 5010.16 for information on commercial paper.

3100.0.3 INSPECTION OBJECTIVES

1. To determine whether the company is operating within the scope of its approved activities and within the provisions of the act and Regulation Y.
2. To determine whether transactions with affiliates, including banks, are in accordance with applicable statutes and regulations.
3. To determine the quality of the asset portfolio, and whether lending, monitoring, and collection policies are adequate to maintain sound asset conditions.
4. To determine the adequacy of the reserve for loan losses and whether the asset charge-off policy is appropriate.
5. To determine the viability of the company as a going concern, and whether its affiliate

status represents a potential or actual adverse influence on the condition of the consolidated corporation or the subsidiary bank(s).

3100.0.4 INSPECTION PROCEDURES

After reviewing the material available at the parent company level, including the audit review, a decision whether or not to go on-site is in order. Some of the determinants of this decision would include relative size, current earnings performance, overall contribution to the corporation's condition, asset quality as indicated by delinquency reports and industry comparisons (detailed later in this section), and the condition of the company when last inspected. From the information provided, it might be determined that the company is operating properly and is in apparently sound condition. In such a case, an on-site inspection may not be warranted, providing that a fairly recent on-site inspection had been conducted. Conversely, a deteriorating condition might be detected which would require a visit, even though a satisfactory condition had been determined during the previous inspection. Subsidiaries in unsatisfactory condition should be inspected each time the parent company is inspected.

The inspection procedures for a consumer finance company have been divided into two phases: preliminary and on-site. The preliminary phase entails the gathering and analysis of information at the parent company to determine the scope of the field work to be performed on-site. The on-site phase establishes a minimum scope of the inspection at the main office, and includes considerations to be incorporated into a visit to field offices if the inspection scope is expanded to that degree.

During the preliminary phase, the following information should be reviewed:

1. system approvals for offices and activities, including stipulated public benefits
2. financial statements, both interim and fiscal, for a sufficient period to determine trends and operating patterns
3. all management reports which should indicate problem loans, loan volume, delinquencies, and other reports regarding loan portfolio and company status including the Robert Morris Associates' *Direct Cash Lending Questionnaire* and similar reports
4. external debt instruments to determine material restrictive covenants
5. internal audit reports and workpapers:
   a. internal control exception reports to determine weaknesses and corrective actions
   b. flow charts in the workpapers to become familiar with company systems
   c. additional internal reports may be identified which may assist the inspection on-site
6. examination reports of any state regulatory agencies having jurisdiction over the company's offices
7. minutes of the board of directors, executive committee, and any other such committee, if available at the parent company
8. the results of a parent company loan review or operations review, if conducted and available
9. the following items to be requested from management:
   a. detailed past-due schedules and intercompany participations
   b. schedule of problem accounts, liquidating accounts, and repossessed assets
   c. general-ledger trial balance
   d. loan trial balance
   e. policy statements on lending, accrual, and charge-offs
   f. reconcilement of the loan-loss reserve for the period between inspections
   g. organization chart
   h. listing of company offices with addresses and operating licenses

3100.0.4.1 On-Site Phase

The procedures of the on-site inspection are intended to evaluate management and its supervisory efforts, to determine the soundness and compliance with the company's operating policies, and to analyze the impact of these policies on the company's financial condition using ratio analysis. A thorough understanding of the policies and systems of the company is necessary for the examiner to accurately determine the company's condition.

During the initial period on-site, the examiner may obtain an overview of the company's systems by interviewing the key staff officers. These individuals can provide the examiner with the detailed reports, policy manuals, and other information necessary for the inspection.

3100.0.4.2 Policy Evaluation

Because of its large volume of transactions and the number of offices involved, the typical consumer company will maintain an extensive set of policy and procedure manuals which are intended to guide company personnel in their daily activities. During the review of these manuals, the examiner should bear in mind that liberal policies and procedures may allow the company to mask portfolio problems and reflect other than an accurate condition in its financial statements.

The principal policies to be considered cover such areas as:

1. extensions of credit;
2. treatment of delinquent accounts and partial payments;
3. loan renewals;
4. loan charge-offs;
5. provisions for loan losses;
6. bulk purchases of loans, for both credit and account purposes; and
7. treatment of deferred income.

After assessing the soundness of company policies, the next step is to test their implementation through a review of the company's supervisory structure.

3100.0.4.3 Evaluation of the Supervisory Structure

The effectiveness of the supervisory structure is a key element in the condition of a consumer finance operation. This system serves two functions: it communicates the policies to the field personnel, and it enforces those policies. Assuming that management's policies are valid, the effectiveness of this system will be partially reflected in the ratio analysis of the company. However, it may take close analysis to determine whether any poor ratios are due to inadequate policies or ineffective enforcement.

In order to evaluate the supervisory effort, the examiner may review a sample of the various supervisor's reports which are prepared after visits to the loan offices. The sample should represent a cross-section of the offices and supervisors in order to obtain a balanced view of the company.

A further evaluative step may be undertaken if there are sufficient resources available to the examiner. The on-site visits to selected loan offices may provide considerable input to the examiner in assessing supervisory effort. In selecting the offices to be visited, well-performing as well as poor-performing offices should be selected. Concentration on poor offices will result in a biased assessment of the supervisory effort and may result in an invalid evaluation of company policies. The selection of the offices may be made by using the number of policy exceptions cited, poor performance records, or local economic conditions as criteria.

3100.0.4.4 Detailed Procedures for an Office Visit

The following steps outline a general procedure for determining field compliance with company policies and assessing the effectiveness of the supervisory effort. The examiner may modify, eliminate, or expand any of these steps or may devise any procedure deemed appropriate under the circumstances present.

The review of loans on-site should be oriented toward confirming the implementation of company policies for delinquency, balance renewals, charge-offs, extensions, partial payments, collection, and loan approvals. This review is intended to be a test of compliance and not a review of specific assets for classification purposes.

1. Review the detailed delinquency report for the selected office for a short period before the inspection date, generally two or three months. Trace the well overdue loans through to resolution, pay-off, charge-off, or reinstatement. Check these loans against the loan register to determine whether new loans have been granted to these customers and if so, determine if they are in accordance with company policy.
2. Review the controls for charging off loans and determine the effectiveness of the collection and recovery effort.
3. Review the loans to present borrowers. While renewals are usually granted to the better customers, the examiner will find a volume of renewals (''under 10 percent new money advanced'' loans). In some companies, these ''under 10 percent new money'' loans represent efforts to rehabilitate borrowers with poor payment records due to ill health, unemployment, etc. However, the examiner may find that management is using this approach to adjust and control delinquency and loss rates. There should be sufficient internal controls present to prevent the continuous renewal of such loans to poor borrowers.

The examiner may find that some office personnel are circumventing these controls, for example, by advancing 11 percent new money to the borrower. If found, such circumvention raises serious questions regarding portfolio quality, the adequacy of internal controls, and the effectiveness of the supervisory effort. A high volume of "under 10 percent" loans or evidence of circumvention of controls may warrant separate treatment in the report.

4. Review partial-payment, interest-only, and extension accounts. Significant numbers of these accounts may indicate potential problems for the loan portfolio and the office.
5. Review credit-extension and loan documentation procedures, especially if the office's portfolio has a high level of losses or frequent litigation. Proper credit controls and documentation are essential for sound operations. If the office extends second mortgage financing, appraisals and lien searches should be included with the documentation.
6. Test the office's delinquency reporting. There are two methods for computing delinquencies, a contractual basis and the recency basis. On a contractual basis, principal reductions are applied to the most overdue payment under the contract and the loan is considered past due from the date of the oldest unsatisfied payment. On a recency basis, delinquency is computed from the date of last payment regardless of contract terms.

   As an example, assume a loan was granted with payments beginning the first of March. The borrower makes the first payment on time and the second payment on the first of June. On the first of April, the loan is a 30-day recency account and current contractually. On the first of May, the loan is a 60-day recency account and a 30-day contractual account. Upon receipt of payment in June, the loan is current on a recency basis and a 60-day (two-payment) contractual account. Notice the difference in computations between the banking industry and the consumer finance industry.

   The consumer finance industry has begun to institute contractual delinquency reporting standards. As these standards are developed and refined, changes in the computation of delinquent accounts may be expected.
7. Review the collection effort. The past-due accounts will be under the control of the collection manager, whose objective is to return these accounts to current status. The manager's collection efforts must begin early in the delinquency pattern if the loans are to be salvaged from charge-off. Consistent, persistent, frequent effort is expected.

The foregoing steps should provide the examiner opportunity to evaluate the company's policies, procedures, and supervisory systems.

3100.0.4.5 Additional Procedures

While field visits are a desirable aspect of the inspection procedure, the examiner may have to rely on other procedures to be satisfied with certain aspects of company operations, particularly when the company reports past-due receivables on a recency rather than a contractual basis. The additional procedures may be necessary when the examiner has other reasons to question portfolio quality or the adequacy of internal controls.

The examiner may perform an extensive review of the most recent audit of the company, including the workpapers and programs of the internal and independent auditors, when available. In this review, the examiner should be able to determine whether internal controls are adequate, and portfolio characteristics are properly reported.

3100.0.4.6 Compliance

Certain aspects of the company are subject to review for compliance with the requirements of the act and Regulation Y. These include public benefits, office activities and locations, and bulk purchases of assets.

1. Public benefits stipulated in approval orders frequently require continuing reduced interest rates or insurance charges as part of the approval to operate. It is expected that these relative public benefits continue in effect despite changes in state-mandated rates.
2. Office locations and activities are subject to approval by the Board before opening for business. The operating licenses and activities of the offices should also be reviewed for compliance with the respective approvals.
3. On occasion, a consumer finance company may make a bulk purchase of loans or other assets of another finance company. Under certain circumstances, these purchases require the prior approval of the Board (12 C.F.R. 225.132). These bulk purchases should not be confused with the bulk purchase of sales finance contracts from a retailer recently signed to a dealer agreement.

4. While most consumer finance activity relates to consumer installment loans, some companies also extend credit under the ''large loan'' provisions of the consumer lending statutes of certain states. While the limitations vary from state to state, these provisions allow loans of many times the size of normal consumer loans. A review of these large loans may indicate that there are extensions of credit to local businesses which may constitute commercial installment lending. Unless specifically approved by the System, this activity may not be permissible for the company being inspected. Review for compliance with various consumer regulations is the responsibility of the Federal Trade Commission.

3100.0.4.7 Asset Classification Policy

As previously discussed, companies use one of two different methods of delinquency computation. In general, classifications should be based on the *contractual* reporting basis whenever possible. Since much of the industry utilizes *recency* reporting, which tends to reduce classifications comparatively, the classification approach enumerated above may unduly penalize an affiliated company using the contractual basis. This is particularly true when such important measures of portfolio quality as the liquidation ratios are in line with industry averages. Therefore, formula classification may result in more severe classifications for companies using the contractual method than those reporting on a recency basis. Examiners should indicate the reporting method used when calculating classifications.

Classification information is used to evaluate the adequacy of the loss reserve. In assessing the adequacy of the loss reserves, the examiner should take into consideration the charge-off frequency, the period of delinquency which would require charge-off under company policy, and the controls regarding renewal of severely past-due accounts. A shorter charge-off cycle prevents the accumulation of poor-quality assets; in this respect, monthly charge-offs are preferable to annual charge-offs. An unlimited ''when deemed uncollectible'' charge-off policy is considered lax and inadequate. The delinquency period to required charge-offs refers to the period of time a loan is past due before it is charged to the reserve; a six-month period is understandably preferred to a nine-month or one-year period. Management should have sufficient controls in place to prevent the continued renewal of loans to avoid charge-off. Adequate controls might include special coding of such loans, with supervisory review of the renewals. Inadequate controls over these assets represent poor management practices deserving special comment.

Most subordinated debt agreements provide for an adjustment (reduction) to net worth when calculating compliance with leverage limits for any loans past due 60 days on a recency basis that exceed loss reserves. As there are some seasonal characteristics to the loan portfolio, it may be of benefit to compare the delinquency statistics on inspection date to the company's seasonal pattern as revealed in both the subordinated debt calculations and monthly past-due reports. It is possible that a currently adverse portfolio condition may be due to local economic conditions which correct themselves over a period of time. Such conditions may relate to a tourist economy, an agricultural community, or a strike at a major local employer's plant. Consumer finance companies are very sensitive to these local factors; therefore, these factors may temper the examiner's evaluation of the loss reserves.

3100.0.4.8 Ratio Analysis

In order to assess the condition of a company using ratio analysis, the examiner will have to be familiar with the company's accounting policies and systems. It will become obvious from the data used in the ratios that, under certain accounting treatments, the data can be misinterpreted. The following analysis has been structured around the *Direct Cash Lending Questionnaire,* published by the Robert Morris Associates and endorsed by the National Consumer Finance Association, in an effort to provide both a format for developing the information and a means of minimizing the possibility of misinterpretation. While some consumer companies do not prepare the questionnaire, much of the information is required for management purposes and should be available from company systems.

The analytical factors presented have been derived from two principal sources: *A Lender's Approach to a Realistic Analysis of Consumer Finance Companies* by Richard E. Edwards (Philadelphia: The Philadelphia National Bank, 1970) and the *Industry Audit Guide: Audits of Finance Companies* by the Committee on Finance Companies (New York: American Institute of

Certified Public Accountants, 1988). These sources provide basic information on certain accounting and management policies and are recommended as references for the examiner. While the Federal Reserve System stipulates no specific accounting policies, the examiner may choose to criticize those policies which result in a misleading presentation of the company's financial condition.

Each year the *Annual Statement Studies*, published by Robert Morris Associates, includes sets of consumer finance company operating ratios. This information will provide a background against which the performance of the company under inspection can be measured. Such compiled ratios should be used only as background as they represent the ''average company'' in the respective sample. Attention should be directed toward the company's trends as they compare to the industry's trends and the changes in the company that are indicated by those trends.

3100.0.4.9 Delinquency

As shown in the *Annual Statement Studies*, the delinquency rates are on a recency-of-payment basis. *While past-due statistics based on contractual payments are preferred*, companies continue to report on a recency basis. It is important to have full knowledge of the company's reporting, lending, and renewal policies in order to fully understand the implications of this data. The trends for ''interest-only'' accounts and ''partial-payment'' accounts will provide some measure of the adherence of the operating personnel to company policy regarding these loan categories.

3100.0.4.10 Liquidation

Liquidation ratios provide two types of information. First, they indicate the amount of principal cash flowing back to the company for liquidity purposes. Secondly, they indicate the amount required to pay senior debt and the period of time required to do so. Several ratios follow:

1. Average monthly cash principal collection to average net monthly outstanding.

   The higher this percentage, the more liquid the portfolio. A company following conservative policies such as requiring full payments and a contractual aging of receivables will tend to show a higher principal collection percentage and, accordingly, a higher liquidity. This ratio can be used to estimate near term collections as compared to current outstandings.

   Monthly cash collections should not include loan renewals or rebates during the period. On an industry-wide basis, there appears to be a pattern of increased loan renewals during November and December, which would be reflected in a seasonal decrease in principal cash collections. Lower than expected collections may be indications of changes in local economic patterns or of increased market effort by a competitor which has resulted in loan payoff. In any event, adverse change in the collection pattern should be reviewed for the underlying causes.
2. The ratio of unsubordinated liabilities less cash and near cash to estimated monthly principal collections results in the number of months it would take to pay senior debt.
3. The ratio of senior debt to gross receivables reflects the proportion of gross receivables which would have to be liquidated to repay senior debt. The higher the percentage, the more senior lenders are relying on the assets for protection.

3100.0.4.11 Loss Reserves

Analysis of the loss reserve for a specific entity has to include company policy regarding loan charge-offs, delinquencies, payments, and charge-off frequency. In addition, if charge-offs are made gross of deferred income, the reserve account may be slightly larger than if charge-offs were net of deferred income. Ratios used to evaluate loss reserves include—

1. Reserve for loan losses to total receivables, net of deferred income,
2. Loans charged off less recoveries to average outstandings (net or gross of deferred income, depending on policy).

   Unless the company's charge-off and delinquency policies are realistic, this ratio will not depict true losses over the periods, and
3. Recoveries to loans charged off tends to be higher in companies with conservative charge-off policies than those with liberal policies. This ratio is indicative of the effectiveness of a company's collection and follow-up policy.

3100.0.4.12 Volume

Analyzing aspects of a company's loan volume can provide the examiner with some information regarding the company's renewal and credit policies.

Lengthening of loan maturities during the current period will be reflected in the future average monthly principal collections and in the company's liquidity. While loans of longer maturity are not necessarily indicative of an adverse trend, the reasons behind a longer maturity portfolio should be analyzed. Ratios used to evaluate loan volume include:

1. *New money advanced to present borrowers to total loan volume.*

   This ratio is somewhat indicative of whether the company's renewal policy is conservative or liberal. A high percentage may indicate that a volume of new money is being advanced along with the renewal of the previous balance.

2. *Loans to present borrowers with less than 10 percent new money advanced to loan volume.*

   A high ratio can indicate the possibility of disguised delinquencies and potential charge-offs. The examiner may take a random sample of loans in the new money advanced to present borrowers category and review them to determine whether or not the company's ''balance renewal'' policy is being followed.

The preceding ratios were presented because they represent a means of measuring the effect of certain company policies. The analysis of company operations may be expanded to include other ratios such as return on equity, return on assets, interest margins, and other conventional measurements. The particular format utilized will, of course, vary to some degree between companies, however, the analysis should be broad enough in scope to determine the company's trends and the causes of those trends.

3100.0.4.13 Evaluation of the Company's Condition

Ratio analysis of a consumer finance company is a feasible technique for evaluating its condition because of the ''portfolio effect'' of its assets. However, the examiner must look beyond the ratios and analyze the effects of company policies on the elements of the ratios. As an example, if a company only charges off loans once a year, the losses determined by a formula classification would be less just after the charge-off date than just before.

In comparing classifications from one inspection to another, there might be a difference in the loss classifications which may be interpreted as an apparent improvement or decline in asset quality should the inspections bracket the charge-off date. Similar misinterpretations can occur from a change in charge-off frequency, a change to an automatic charge-off policy, or a shortening in the past-due period required for charge-off.

Certain accounting and reporting techniques may also be misleading in ratio analysis. For example, an artificial improvement in earnings would be reported when a company changes from a collection basis to an accrual basis of income recognition, if the collection and follow-up policy had been poor or deteriorating. Only a thorough review of the accounting policies and an understanding of their interplay with operating policies will prevent this type of misinterpretation. In some cases, the company's accounting system may yield results that inadvertently distort the ratios. A company recognizing income on a straight-line basis would, during a period of low loan volume, reflect improving gross interest income as a percentage of loans outstanding. While the importance of realistic accounting policies cannot be overstated, neither can the proper interpretation of reported results be overstressed.

One of the key elements in the evaluation of the company's performance is reflected in the ratios, but not quantified by the analysis. The company's internal controls and management information systems are the primary means of controlling asset quality and communicating management's policies. The supervisory effort is not only reflected by the ratios, but also in such areas as personnel turnover, citations in state supervisory reports, audit exceptions, and litigation. The systems relied on by management should be responsive not only to the changing needs of the company, but also to the changing climate of consumer regulations.

In the inspection report commentary, the examiner should maintain an objective view of the company under inspection. Management's corrective actions for exceptions and plans to reverse adverse trends are a necessary ingredient in the commentary. Report comments should give the reader an accurate picture of the condition of the company and its relationship with, and impact on, the financial condition of the consolidated corporation and the subsidiary bank(s).

3100.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Activities not closely related to banking		225.126	4–184	
Marketability of collateral under section 23A			3–1121	1935 FRB 395
Activities closely related to banking		225.123	4–176	1971 FRB 514 1975 FRB 245
Expansion of activities of a trust company, or acquisition of a de novo bank, to include consumer lending		225.28(b)(1)		1984 FRB 371 1985 FRB 51 1985 FRB 55 1985 FRB 61 1985 FRB 253

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

The Board amended Regulation Y, effective April 21, 1997, to include the acquiring of debt in default as an authorized nonbanking activity for bank holding companies (see Regulation Y, section 225.28(b)(2)(vii)). A bank holding may acquire debt that is in default at the time of acquisition if the company—

1. divests shares or assets securing debt in default that are not permissible investments for bank holding companies, within the time period required for divestiture of property acquired in satisfaction of a debt previously contracted under section 225.12(b) of Regulation Y;
2. stands only in the position of a creditor and does not purchase equity of obligors of debt in default (other than equity that may be collateral for such debt); and
3. does not acquire debt in default secured by shares of a bank or bank holding company.

The Board held that these restrictions were necessary to define the scope of the activity and to ensure that the activity remains the acquisition of debt instead of an impermissible nonbanking activity involving the acquisition of securities or other assets. As for calculating the time period for disposing of the underlying shares or assets, the time period is the same as that applied under the BHC Act to disposing of shares or assets acquired in satisfaction of a debt previously contracted. During this period, a bank holding company can divest the property or, in the case of any debt that has been previously contracted, restructure the debt.

The initial Board order that was issued to permit the acquisition of defaulted debt is summarized here as a historical example of the nonbanking activity. Provisions or commitments made in the Board order should not be relied upon. The current requirements are found in section 225.28(b)(2)(vii) of Regulation Y.

3104.0.1 ACQUISITION OF DEFAULTED DEBT—BOARD ORDER

A bank holding company (the applicant) within the meaning of the BHC Act gave notice under section 4(c)(8) of the BHC Act (12 U.S.C. 1843(c)(8)) and the Board's Regulation Y that it proposed to acquire a company (the company) and engage nationwide in asset-based commercial lending and management of assets.

The applicant proposed to engage through the company in managing certain assets as the corporate general partner in two limited partnerships (the partnerships).[1] The applicant committed to conduct the activities, which the Board previously determined to be permissible, through the partnerships, subject to the limitations previously established by the Board.[2]

One nonbanking activity proposed by the partnerships, acquisition of defaulted debt, was an activity that the Board had not previously approved. The partnerships are engaged primarily in making, servicing, and investing in discounted bank loans and other debt securities.[3] The partnerships acquire debt that has been or is in the process of being restructured, including secured and unsecured debt in the form of bank loans, privately placed and publicly traded debt instruments, bonds, notes, debentures, and discounted receivables.[4] The applicant stated that the partnerships will take an active role in the restructuring of the defaulted debt they acquire, including participating on creditors' committees. The applicant indicates that such discounted debt would be acquired for the purpose of restructuring the debt to achieve a higher yield and greater collateral protection.

Some of the debt the partnerships would acquire may be in default at the time of acquisition and may be secured by voting shares or

1. The first partnership group (in which the company owned more than a 50 percent interest) was to terminate by December 31, 1995. The company owned less than 50 percent of the second partnership group, which would terminate by December 31, 1999.

2. See 1994 FRB 736. The partnerships, together with the applicant and its affiliates, would hold not more than 5 percent of any class of voting securities of any issuer and not more than 25 percent of the total equity, including subordinated debt, of any issuer. In addition, the applicant committed that no directors, officers, or employees of the applicant or its affiliates will serve as directors, officers, or employees of any issuer of which the applicant and its affiliates hold more than 10 percent of the total equity. The applicant also committed that future limited partnerships would be structured in the same manner as the current partnerships.

3. The partnerships are not leveraged, and the applicant stated that the partnerships will not be leveraged. The applicant has committed that neither the applicant nor any of its subsidiaries would be permitted to make loans to the partnerships.

4. The debt investments may include investments in companies that may be contemplating, be involved in, or recently have completed a negotiated restructuring of their outstanding debt or a reorganization under chapter 11 of the Federal Bankruptcy Code.

other assets that would be impermissible for a bank holding company to hold without Board approval.[5] Because the partnerships would have the right in some cases to take title immediately to shares or assets securing defaulted debt that they acquire, the applicant committed that the partnerships would treat this collateral, as well as any other assets acquired in renegotiating this debt, as assets acquired in satisfaction of a debt previously contracted (DPC). Under the BHC Act, a bank holding company must divest any shares or assets acquired as DPC within two years from the date the asset is acquired. For this purpose, the applicant has committed that it will consider shares or assets acquired in satisfaction of defaulted debt to have been acquired on the date the defaulted debt is acquired.[6]

The Board stated that the acquisition of defaulted debt under the circumstances and conditions proposed by the applicant is an activity that is closely related to banking. The applicant stated that it will only purchase debt, not equity, and will stand in the position of a creditor.

Based on all the facts of record, the Board concluded that the proposed activities are closely related to banking. The Board approved the notice on October 17, 1995 (see 1995 FRB 1128). Approval was specifically conditioned on the applicant's compliance with the commitments made in connection with the notice.

5. The applicant has committed that the partnerships will not acquire debt in default that is secured by shares of banks or bank holding companies.

6. The applicant could apply for up to a three-year extension. See 12 C.F.R. 225.22(d)(1). The Board notes that the divestiture requirement would be satisfied if, during the divestiture period, the partnerships renegotiate the debt into a performing obligation and release the collateral to the borrower as part of the renegotiation. To the extent that defaulted debt acquired by the partnerships is secured by assets or shares that would be permissible investments for a bank holding company, this divestiture commitment would not apply.

Section 4(c)(8) of the BHC Act (Credit Card Authorization and Lost/Stolen Credit Card Reporting Services) Section 3105.0

A bank holding company applied for the Board's approval, pursuant to section 4(c)(8) of the BHC Act, to engage de novo, through its existing nonbank subsidiary, in credit card authorization services and lost/stolen credit card reporting services. The credit card authorization activity would consist of providing, for a fee, a service to issuers of credit cards that would enable merchants to determine the validity and credit limits of cards tendered to them. In addition, the applicant was to provide, for a fee, a reporting service to credit card holders, that would enable them to report the loss or theft of any of their credit cards via a single toll-free telephone call to the nonbank subsidiary.

A number of banks indirectly offer the service of reporting lost cards that are issued by other institutions by arranging with independent companies to provide the service under a trade name associated with the bank. With respect to credit card authorization services, banks have a financial interest in the security of the credit cards and the availability of credit. Based on the foregoing, the Board believed that banks generally have, in fact, provided the services proposed by the applicant and are particularly well suited to provide the proposed services. On that basis, the Board concluded that the proposed services were closely related to banking.

Since the proposed credit card reporting service would create more competition and provide greater conveniences by allowing an individual who loses more than one card to report all lost cards at once to one source rather than having to make separate notifications to each card issuer, and there was no evidence of adverse effects as a result of the proposal, the application was approved by the Board on January 5, 1985 (1985 FRB 648). See Regulation Y, section 225.28(b)(2).

A domestic bank holding company (the applicant) applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.23(a)(3) of the Board's Regulation Y to engage de novo, through a wholly owned subsidiary, in the following services to customers who make loans secured by inventory:

1. identifying inventory and deciding its general condition, level of protection, and amount of use, as appropriate
2. identifying inventory subject to a purchase-money security interest under the Uniform Commercial Code
3. identifying missing inventory and any credit exposure that could result
4. supporting the proper allocation of loan payments that are related to the aging or sale of inventory[1]

The applicant would provide the above inventory-inspection services only in connection with an extension of credit either by the BHC (applicant) or a third pary. The service would be provided throughout the United States, but only in connection with inventory pledged as collateral for a loan.

Bank holding companies currently inspect and survey collateral for loans made or services provided by them. Banks inspect collateral for loans originated in direct lending activities. The applicant suggested that its proposed collateral-inspection services to third-party lenders are identical to the collateral-inspection services performed for its own extensions of credit.

In accordance with section 225.28(b)(1) of Regulation Y, the Board authorized bank holding companies to make, acquire, and service loans for the company's own account or for the account of others. The Board believes that these activities include collateral-inspection services provided to third parties in connection with third-party extensions of credit. The Board also believes that bank holding companies have the necessary expertise to provide this service for other lenders (on a stand-alone basis).

The Board found that public benefits would result from a potential increase in the availability of inventory financing. It noted that there was no evidence suggesting that the proposal would result in significant adverse effects. The financial and managerial resources of the applicant were believed to be consistent with previous approvals. The Board, based on the facts of record, and the commitments and conditions made by the applicant, approved the request on September 13, 1993 (1993 FRB 1053).

1. For example, a loan may be secured by a pool of inventory collateral, but there may be an agreement to apply loan proceeds to specific items of collateral in a specified order. Equipment used beyond a stated number of hours might be of limited value, and the lender might agree to release its security interest in such items. The inspection of inventory collateral would verify the equipment's proceeds to pay off the oldest (or the youngest) items of collateral first (or last), rather than applying the proceeds pro rata to all items.

A bank holding company may acquire or retain an industrial bank to the extent authorized by state law, under section 225.28(b)(4) of Regulation Y only if the industrial bank acquired by the holding company is not a ‘‘bank’’ within the meaning of the Bank Holding Company Act. Industrial loan companies, industrial banks, and Morris Plan banks are state-chartered financial institutions which engage primarily in the business of furnishing consumer loans and small-business loans. The distinction between these institutional forms and consumer finance companies lies in the ability to generate funds through the acceptance of deposits or issuance of certificates of indebtedness (thrift notes). Although some of these institutions have the same charters as banks (in some states), they traditionally have not been considered to be banks for purposes of the Bank Holding Company Act as they cannot both make commercial loans and accept demand deposits, although in some states they have been empowered to offer NOW accounts. Under a decision of the Supreme Court, NOW accounts are not demand deposits for the purposes of defining what a bank is. Thus, industrial loan companies and similar institutions may offer NOW accounts and make commercial loans without being treated as banks for purposes of the Bank Holding Company Act. These institutions may be insured by the Federal Deposit Insurance Corporation and are eligible for membership in the Federal Reserve System. Many of the companies are ‘‘self-insured’’ (by a consortium of similar institutions in the form of a guaranty corporation) or are uninsured.

3110.0.1 NONBANKING ACQUISITIONS NOT REQUIRING PRIOR BOARD APPROVAL

In accordance with 12 C.F.R. 225.22(d)(8) of Regulation Y, the Board’s prior approval is not required for certain asset acquisitions by a lending company or industrial bank. This refers to the assets of an office(s) of a company of which all, or substantially all, the assets relate to making, acquiring, or servicing loans for personal, family, or household purposes, if—

- the acquiring company has previously received Board approval to engage in lending or industrial banking activities under Regulation Y;
- the assets acquired during any 12-month period do not represent more than 50 percent of the risk-weighted assets (on a consolidated basis) of the acquiring lending company or industrial bank, or more than $100 million, whichever amount is less;
- the assets acquired do not represent more than 50 percent of the selling company’s consolidated assets that are devoted to lending activities or industrial banking business;
- the acquiring company notifies the Reserve Bank of the acquisition within 30 days after the acquisition; and
- the acquiring company, after giving effect to the transaction, meets the Board’s capital adequacy guidelines and the Board has not previously notified the acquiring company that it may not acquire the assets under the exemption.

3110.0.2 INSPECTION OBJECTIVES

1. To determine the quality of the loan portfolio and the overall condition of the company.
2. To determine what exposure the subsidiary presents to the holding company and subsidiary bank(s).
3. To determine compliance with applicable laws and regulations.

3110.0.3 INSPECTION PROCEDURES

1. Contact the applicable state regulatory agency to determine the legal parameters within which the company operates and to assess the degree to which the company is supervised. Each of the institutional structures under this exemption is state chartered, and the laws and regulations vary widely from state to state. The company may be directly supervised by its state department of banking or may be subject to virtually no supervision or regulation. If the company is insured by the Federal Deposit Insurance Corporation or is a member of the Federal Reserve System, the company is primarily subject to the primary supervision and regulation of that agency. In cases in which the company is supervised by a banking agency, that agency’s report of examination will generally suffice. However, when the company is not supervised or examined, or when the Reserve Bank finds the supervis-

ing agency's report inadequate, an on-site inspection is necessary.

2. Focus on an evaluation of the loan portfolio and securities account, a determination of the volatility of the deposits, an appraisal of the adequacy of the audit program, and a review of the company's internal policies.
3. Review the receivables representing lending activities. The company should provide a schedule of the aging of the consumer receivables. It is preferable that the aging be done on a contractual method. Classification of the consumer paper may be done on a formula basis. The larger credits must be given a complete evaluation.
4. Review the adequacy of the allowance for loan and lease losses in conjunction with the asset evaluation.
5. Price the securities portfolio, with particular emphasis placed upon determining its liquidity. Since the deposits of these institutions are not always insured, they are more susceptible to a deposit run off; therefore, the requirement of adequate liquidity is of paramount importance.

   The deposits may be insured by a guaranty corporation up to a certain limit in some states. These guaranty corporations have provided some stability to the industry. The guaranty corporations are independent of any government agency or municipality and therefore are limited in the amount of protection which can be offered depositors.
6. Review back-up lines of credit available to ensure secondary liquidity to the company.
7. Review the deposit accounts of the company. The deposits are evidenced by certificates of indebtedness, or thrift notes. Information regarding the number of deposits, the size of accounts, and maturity distribution should be obtained to assess the stability of the funding base.
8. Determine that the institution makes proper disclosure to the public as to the type of instrument the certificate represents. Some states require that a disclosure statement, or a prospectus, be filed with the public yearly, which sets forth the uses to which the funds are being put and states that the funds are not insured. This prospectus should be reviewed for proper disclosure of the required information to ensure against possible suits.
9. Check the company's policy concerning withdrawals, giving recognition to state law requirements, to ascertain whether funds are generally not allowed to be withdrawn without prior notice.
10. Review the scope of the internal or external audits.

3110.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations*	*Orders*
Reference for authorized nonbanking activity—activity closely related to banking		225.28(b)(4)		1982 FRB 253 1983 FRB 921 1984 FRB 231 1984 FRB 234 1984 FRB 371 1984 FRB 469 1984 FRB 741 1985 FRB 476
Nonbanking acquisition not requiring Board approval (conditions specified)		225.22 (d)(8)		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Before 1989, the Board had determined that the operation of a savings association is closely related to banking but concluded, as a general matter, that the operation of a savings and loan association is not a proper incident to banking because the potential adverse affects of generally allowing the affiliations of banks and thrift institutions were not outweighed by the potential public benefits (1977 FRB 280). In other individual cases, the Board found that the adverse effects of the affiliation would be outweighed by the public benefits of preserving the failing thrift institution as a competitor in its market and ensuring public confidence (see 1985 FRB 462). The 1982 Garn–St Germain Act recognized the Board's authority under section 4(c)(8) of the BHC Act to approve such acquisitions by authorizing the Board to dispense with the usual notice and hearing requirements of this section under appropriate emergency circumstances.

Provisions of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) amended section 4 of the Bank Holding Company Act to give bank holding companies the authority, effective August 9, 1989, to acquire any savings association. The legislation lifted the previously existing ‘‘tandem operations’’ restrictions as they apply to savings associations that are owned by bank holding companies (see 1989 FRB 716, appendix I). These restrictions provided that savings associations acquired by a bank holding company could not be operated in tandem with any other subsidiary of the bank holding company, and required approval by the appropriate Federal Reserve Bank before the savings association engaged in any transactions with the bank holding company or its other subsidiaries. The Board is now prohibited from imposing such restrictions on such transactions in the future, except for those required by sections 23A and 23B of the Federal Reserve Act. With respect to previous Board approvals of the acquisition of problem thrifts by BHCs, FIRREA required the Board to modify those approvals by limiting any restrictions on transactions between the savings association and its holding company affiliates to those required under sections 23A and 23B of the Federal Reserve Act. In 1989 FRB 716, the Board removed the tandem restrictions imposed on the operations of savings association subsidiaries of a bank holding company.

The Board amended Regulation Y pursuant to FIRREA, effective October 10, 1989 (see 12 C.F.R. 225.28(b)(4)(ii)). The regulation allows bank holding companies to acquire healthy as well as failed or failing savings and loan associations in accordance with FIRREA. The regulation permits bank holding companies to acquire savings and loan associations in any state, regardless of whether the holding company may operate a bank in that state. It does not impose any operational or branching conditions on the operations of savings and loan associations. The regulation authorizes, as a permissible activity under section 4(c)(8) of the BHC Act, the owning, controlling, or operating of a savings association, if the savings association engages only in deposit taking, lending, and other activities that are permissible for BHCs.[1] The Board has permitted a short divestiture period for impermissible investments and other activities (see 1992 FRB 707).

FIRREA established a five-year moratorium on any aquisition that involved the transfer of deposits from one federally insured deposit fund to another, with limited exceptions. As a general matter, the moratorium prevented an institution whose deposits are insured by the Savings Association Insurance Fund (SAIF) from converting to an institution whose deposits are insured by the Bank Insurance Fund (BIF). A provision of FIRREA provided that this moratorium does not apply to the merger of a SAIF-insured savings association owned by a bank holding company into a BIF-insured bank subsidiary of the same holding company. This provision, known as the Oakar Amendment,[2] authorized bank holding companies to merge troubled savings associations into bank subsidiaries during the moratorium period, as well as avoid the payment of

1. Section 225.2(m) of Regulation Y defines a savings association as (a) any federal savings association or federal savings bank; (b) any building and loan association, savings and loan association, homestead association, or cooperative bank if such association or cooperative bank is a member of the Savings Association Insurance Fund (SAIF); and (c) any savings bank or cooperative which is deemed by the director of the Office of Thrift Supervision to be a savings association under section 10(l) of the Home Owners' Loan Act.

2. The Federal Deposit Insurance Corporation Act of 1991 amended the Oakar provision (commonly referred to as ‘‘Oakar II Amendment’’) to authorize a bank that is not a subsidiary of a bank holding company to merge directly with a thrift. The Riegle Community Development and Regulatory Improvement Act further amended the Oakar provisions to eliminate the requirement for prior Federal Reserve Board approval of Oakar transactions when the bank involved (in an acquisition of a thrift) is a BIF member subsidiary bank of a bank holding company.

exit and entrance fees to the deposit insurance funds required under FIRREA for other savings association conversion transactions.

One provision that has a significant bearing on BHCs is a FIRREA provision (12 U.S.C. 1815(e)) addressing the liability of commonly controlled institutions. Any insured depository institution is liable for any loss incurred by the FDIC in connection with a commonly controlled insured depository institution in default or in danger of default. (See section 2090.8 for a discussion of this provision as well as section 2020.1 with regard to the sister-bank exemption from section 23B of the Federal Reserve Act.)

3111.0.1 LAWS, REGULATIONS, INTERPRETATIONS, ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Activity approval	1843(4)(i)	225.28(b)(4)(ii)		1997 FRB 275
Determination that the operation of a thrift institution is closely related to banking				1989 FRB 86 1986 FRB 724 1986 FRB 342 1985 FRB 340 1983 FRB 812 1982 FRB 660 1982 FRB 316 1977 FRB 280 1974 FRB 868
Acquisition of stock savings and loan associations				1985 FRB 462
Removal of tandem restrictions				1989 FRB 716
Establishing branches on an interstate basis after acquisition				1993 FRB 890
Minority investment (interest) in a savings bank				1995 FRB 509

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

The performance of trust services by a trust company subsidiary that is neither a ‘‘bank’’ nor a nonbank bank encompasses virtually any kind of fiduciary, agency, or custodial service commonly performed by a trust company so long as the subsidiary does not accept demand deposits or make loans, except as expressly permitted by section 225.28(b)(5) of Regulation Y. Generally, under Regulation Y, a trust company may only accept deposits arising out of trust funds not currently invested; perform escrow services, such as receiving, holding, and disbursing downpayments and other funds deposited by purchasers in real estate transactions; and act as an agent for an issuer of, or broker or dealer in, securities in a capacity of a paying agent, dividend-disbursing agent, or securities clearing agent, so long as the funds are not used by the customer as a general-purpose checking account and do not bear interest. The subsidiary's lending activities are restricted to making call loans to securities dealers and to purchasing money market instruments; however, such loans may not be used to provide funding for nonbank subsidiaries of the holding company.

Trust companies may be either state chartered or nationally chartered. Some nationally chartered trust companies have national bank charters but have agreed through limitations in their bylaws to engage only in those activities permitted for trust departments of national banks. To prevent the use of a trust company as a vehicle for evasion of section 3(d) of the Bank Holding Company Act, the Board has conditioned its approval of certain interstate acquisitions by requiring that (1) the trust company's demand deposit–taking activities not be operated in tandem with any other subsidiary, (2) demand deposit and commercial lending services of affiliates will not be linked in any way, and (3) the trust company will not engage in any transactions with affiliates, other than the payment of dividends or the infusion of capital, without the Board's approval (for example, see U.S. Trust Corporation, 1984 FRB 371). The scope of these conditions may be reviewed by the Board in connection with nonbank bank applications.

As part of normal administration of its trust accounts, a trust company will from time to time engage in an activity, such as property management or land development, that has been determined to be *not* closely related to banking by the Board. Any such service may only be performed incidentally to fiduciary-account administration and may not be offered or marketed as a separate service.

The board of directors and senior management of financial holding companies (FHCs) and bank holding companies (BHCs) are responsible for overseeing the operations of their fiduciary activities in a safe and sound manner. Such oversight (particularly for those BHCs and FHCs engaged in a broad range of financial activities) at the consolidated level is important because the risks associated with financial activities as well as fiduciary activities can cut across legal entities and business lines. Federal Reserve examiners review and assess the internal policies, reports, and procedures and effectiveness of the BHC/FHC consolidated risk-management process.

The appropriate regulator of trust activities (including activities of a fiduciary, agency, or custodial nature) has the primary responsibility for evaluating risks, hedging, and risk management at the legal-entity level for any subsidiary or subsidiaries that the regulator supervises. Federal Reserve examiners should seek to use the examination findings of the appropriate regulators. (See SR-00-13.)

To determine the complete scope of fiduciary assets within an FHC/BHC, examiners should reference the Uniform Bank Performance Report (UBPR), which reflects the information gathered on Schedule RC-T. To further understand the scope of fiduciary assets within an FHC/BHC, an examiner should also look at information reported on Schedules Y-11 and Y-9C with respect to income derived from trust, fiduciary, and asset-management activities. (See also page 4 of the Bank Holding Company Performance Report (BHCPR) for the amount and percentages of income from fiduciary activities to adjusted operating income (tax-equivalent), including the BHC's corresponding peer-group ratios.)

Peer analysis is also available at the bank level. Examiners should refer to pages Trust 1 and Trust 1A of the UBPR. General comparison information is also available on a lagged basis in the FFIEC's electronic report ‘‘Trust Assets of Financial Institutions’’ (www2.fdic.gov/structur/trust/index.asp). Aggregate data are listed by year back to 1996.

3120.0.1 ON-SITE INSPECTIONS

Trust companies are normally engaged in activities such as management of funds for individuals. These activities are significant to the integrity of the banking system and involve significant potential liability to the bank holding company if not properly conducted. Therefore, periodic on-site inspections should be performed. If the trust company is examined by a state banking department, then alternate-year examination procedures may apply. If nationally chartered, a review of the periodic on-site examinations of the Comptroller of the Currency will generally suffice. If the trust company is not subject to a regular examination by another federal banking agency (i.e., if it is an uninsured, state-chartered nonmember trust company), the Reserve Bank should perform regular on-site inspections to include, at a minimum, full-scope reviews of the trust activity. The inspections would use procedures such as those used in the examinations of trust activities of state member banks. This portion of the inspection should be performed by examiners specially trained in trust examinations. Holding company inspectors should specifically review trust activities for compliance with any conditions imposed by the Board in connection with the approval of an application.

The main sections that follow (sections 3130.1 through 3130.9) address all financial and investment advisory activities under section 4(c)(8) of the BHC Act and section 225.28(b)(6) of Regulation Y that have been authorized by the Board. This section provides general inspection objectives and procedures that relate to such financial and investment advisory activities. These objectives and procedures can be applied to the BHC inspection of every advisory activity when advisory activities are not listed separately in any of this manual's individual advisory sections.

Any commitments that were made by the bank holding company or its nonbank subsidiaries to the Federal Reserve System pertaining to its financial and investment advisory nonbanking activities should be reviewed by the examiner for compliance and applicability, in accordance with the current statutory and regulatory provisions. Any existing commitments or conditions that relate to the financial resources of a bank holding company or its subsidiaries or to commitments or conditions that relate to the risk-management policies of the organization should remain intact and should be reviewed by an examiner for compliance during each inspection.

The Board's Regulation Y, effective April 1997, resulted in a structural reorganization of financial and investment advisory nonbanking activities. The provision of discretionary investment advice is no longer limited to institutional customers. Bank holding companies and their subsidiaries may engage in financial and investment advisory activities without restriction. Bank holding companies can manage retail customer accounts outside of the trust department of an affiliated bank (to the extent permitted by law). Further, bank holding companies may engage in any combination of permissible nonbanking activities listed in Regulation Y. Accordingly, bank holding companies may provide financial and investment advice jointly with permissible agency transactional service, investment or trading transactions as principal, or any other listed nonbanking activity.

The rules in Regulation Y provide examples of financial and investment advisory activities that are illustrative rather than exclusive. With regard to the examples, a bank holding company may act as an investment or financial adviser without restriction to any person, including

1. serving as an investment adviser (as defined in section 2(a)(20) of the Investment Company Act of 1940) to an investment company registered under that act, including sponsoring, organizing, and managing a closed-end investment company;
2. furnishing general economic information and advice, general economical statistical forecasting services, and industry studies;
3. providing advice in connection with mergers, acquisitions, divestitures, investments, joint ventures, leveraged buyouts, recapitalizations, capital structurings, financing transactions and similar instruments, and conducting financial-feasibility studies;
4. providing information, statistical forecasting, and advice with respect to any transaction in foreign exchange, swaps, and similar transactions, commodities, and any forward contract, option, future, option on a future, and similar instrument;
5. providing educational courses and instructional materials to consumers on individual financial-management matters; and
6. providing tax-planning and tax-preparation services to any person.

Sections 3130.1 through 3130.9 include many historical examples of various financial and investment advisory activities that have been approved by the Board. These examples are to be viewed as historical references. They should be considered as to their applicability to current statutory and regulatory provisions. Some examples include, but are not limited to, providing financial advice in rendering fairness opinions and providing valuation services in connection with mergers, acquisitions, divestitures, investments, joint ventures, leveraged buyouts, recapitalizations, and capital structurings. Other examples include providing advice on financing and similar transactions with respect to private and public financings and loan syndications; conducting financial-feasibility studies; and providing financial advice to state and local governments with respect to the issuance of their securities.

3130.0.1 INSPECTION OBJECTIVES

1. To review the adviser's organizational structure and the qualifications of its management to conduct business, and to determine whether they are satisfactory.

2. To determine the status of the adviser's financial condition and the adequacy of internal controls, general accounting policies, and reporting procedures, and to determine if they reflect the guidelines established by management.
3. To determine whether fee income is accurately computed and reported on a consistent basis.
4. To determine what financial effect the activity has on the parent holding company and the bank subsidiaries.
5. To review and evaluate investment practices considering the adviser's investment responsibilities for the selection and allocation of investments for various types of accounts to determine whether they are appropriate.
6. To evaluate funding sources, including indebtedness, and their management with respect to maturities and interest rates.
7. To determine the adequacy of internal and external audits.
8. To determine whether the adviser company has adequate policies and procedures to prevent self-dealing and similar improper conflicts.
9. To determine whether operating practices provide for adequate legal documents and agreements such that the account activities, in general, are consistent with the contractual responsibilities and authorities.
10. To determine if any litigation is pending against the company and the possible impact of an unfavorable court decision.
11. To evaluate compliance with applicable bank holding company laws, regulations, and interpretations, including compliance with the standards of care and conduct applicable to fiduciaries as required by Regulation Y.

3130.0.2 INSPECTION PROCEDURES

1. Review System approval and activities for conformance with any limitations. Determine if the activity is conducted through a separately incorporated subsidiary of the bank holding company that—
   a. refrains from taking positions for its own account;
   b. observes the standards of care and conduct applicable to fiduciaries with respect to its advisory and transactional services; and
   c. avoids executing customer transactions when acting in an advisory capacity.
2. Prepare financial statements for the last two fiscal years, plus interim if appropriate. Analyze for adverse trends and evaluate for negative effects on affiliates.
3. Evaluate asset quality when warranted, documenting the scope and detailing asset review. Compile classification data, write up classifications if appropriate, and evaluate reserve adequacy.
4. Obtain documentation for all indebtedness. Evaluate funding sources for maturity mismatch, dependence on affiliates' concentrations, and dependability. Review borrowings from affiliate banks for compliance with section 23A of the Federal Reserve Act.
5. Review income and expense accounts and transactions with affiliates for compliance with section 23B of the Federal Reserve Act.
6. Review the company's revenue sources to determine that it has not taken positions and does not, itself, execute transactions when acting in an advisory capacity.
7. Evaluate contracts and service agreements with affiliates. Identify whether the company receives or provides services or products. Determine that the services or products are needed and received or provided, and that the contract or agreement terms represent market rates.
8. Review the company's fee schedule for providing advice and the fees charged by affiliated banks to conduct transactions for the company's customers. Determine whether the bank is being adequately compensated for executing trades, or whether these profits are accruing largely to the benefit of the company.
9. Review checking-account statements for all accounts at affiliate banks for overdrafts since the previous inspection.
10. Evaluate whether the nonbank activities are being performed by affiliate bank personnel or are using bank assets. If so, is the bank adequately compensated?
11. Identify off-balance-sheet activities and contingent liabilities, and assess the risk to the company and any affiliate.
12. Obtain a listing of litigation against the company or any individuals who represent the company from the company's legal counsel, and evaluate potential effects on the financial condition.
13. Obtain and review internal and external audit reports and workpapers.

14. Obtain and review internal and external asset-review reports.
15. Obtain and review copies of the board of directors' and senior management's policies and procedures.
16. Review a sample of recommendations to determine that a reasonable basis exists for the company's recommendations.
17. Review the advisory contracts to determine if there are any conflicts of interests involving the parent company or affiliates, as well as the officers, directors, or principal shareholders and their related interests of the holding company and its affiliates.
18. Evaluate insurance for adequacy.
19. Obtain or verify that workpapers contain the following permanent documentation:
    a. System approval letters
    b. date of incorporation or date acquired
    c. date activity commenced
    d. articles of incorporation and by-laws
    e. commitments
    f. supervisory actions
    g. other pertinent correspondence
20. Obtain and review a listing of shareholders for each class of stock outstanding, and a schedule of officers, directors, and their related interests.

A bank holding company or its nonbank subsidiary that engages in investment or financial adviser activities is subject to section 225.28(b)(6) of Regulation Y. The purpose of an inspection of a company providing investment or financial advice is to determine that it is operating according to applicable laws, regulations, and interpretations, and to determine that the company is subject to an adequate audit program. Regulation Y allows a bank holding company to serve as an investment adviser as defined in section 2(a)(20) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(20)), which defines an ‘‘investment adviser’’ of an investment company as ‘‘…any person who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company…’’

The Board has issued an interpretive rule regarding the investment adviser activities of bank holding companies under Regulation Y (12 C.F.R. 225.125). The following is a list of some of its provisions:

1. Bank holding companies, including their bank and nonbank subsidiaries, may act as investment advisers to various types of investment companies such as mutual funds and closed-end investment companies. Mutual funds and closed-end investment companies are described in the interpretation.
2. Bank holding company investment adviser activities are limited by the Glass-Steagall Act (Banking Act of 1933 (12 U.S.C. 24, 78, 377, 378)). This act generally prohibits member banks from engaging in the purchase or sale of equity securities other than in an agency capacity.
3. A bank holding company may not sponsor, organize, or control a mutual fund. This does not apply to closed-end investment companies so long as they are not primarily or frequently engaged in the issuance, sale, or distribution of securities.
4. A bank holding company should not act as investment adviser to an investment company which has a name similar to the bank holding company or any of its subsidiary banks, unless the prospectus of the investment company contains certain required disclosures. In no case should a bank holding company act as investment adviser to an investment company that has either the same name as the name of the bank holding company or any of its subsidiary banks, or that has a name that contains the word ‘‘bank.’’
5. Since investment adviser activities may create potential conflicts of interest, the Board determined that a bank holding company and its subsidiaries should not purchase in their sole discretion, in a fiduciary capacity (including as managing agent), securities of any investment company for which the bank holding company acts as investment adviser, unless the purchase is specifically authorized by (1) the terms of the instrument creating the fiduciary relationship, (2) court order, or (3) the law of the jurisdiction under which the trust is administered.
6. A bank holding company may not engage, directly or indirectly, in the underwriting, public sale, or distribution of securities of any investment company for which it or any nonbank subsidiary acts as investment adviser, except in compliance with section 20 of the Glass-Steagall Act. The Board has determined, however, that the conduct of securities brokerage activities by a bank holding company or its nonbank subsidiaries, when conducted individually or in combination with investment advisory activities, is not deemed to be the underwriting, public sale, or distribution of securities prohibited by the Glass-Steagall Act.
7. A bank holding company or any of its nonbank subsidiaries that have been authorized by the Board under the Bank Holding Company Act to conduct securities brokerage activities (either separately or in combination with investment advisory activities) may act as agent, upon the order and for the account of customers of the holding company or its nonbank subsidiary, to purchase or sell shares of an investment company for which the bank holding company or its subsidiaries act as an investment adviser.
8. A bank holding company or any of its nonbank subsidiaries that have been authorized by the Board under the Bank Holding Company Act to provide investment advice to third parties generally (either separately or in combination with securities brokerage services) may provide investment advice to customers with respect to the purchase or sale of shares of an investment company for

which the holding company or any of its subsidiaries acts as an investment adviser.

9. A bank holding company or its subsidiary bank, at the time a service is provided, must caution customers to read the prospectus of the investment company before investing. Customers must be advised in writing that the investment company's shares are not insured by the Federal Deposit Insurance Corporation and are not deposits, obligations, or endorsed or guaranteed in any way by any bank (unless that is the case). The role of the company or affiliate as adviser to the investment company must be disclosed in writing. Such disclosures may be done orally, but the cusotomer must be given such disclosures in writing immediately thereafter.
10. Because of potential conflicts of interest, a bank holding company which acts both as custodian (pursuant to section 225.25(b)(3) of Regulation Y) and investment adviser for an investment company should exercise care to maintain at a minimum level demand deposit accounts of the investment company which are placed with a bank affiliate, and should not invest cash funds of the investment company in time deposit accounts (including certificates of deposit) of any bank affiliate.

3130.1.1 REAL ESTATE DEVELOPMENT ADVISERS FOR STATE AND LOCAL GOVERNMENTS

Advising state and local governments about methods available to finance real estate development projects, and evaluating projected income to determine if debt resulting from proposed development projects can be adequately serviced is permissible if the activities are authorized under section 225.28(b)(6) of Regulation Y.

Before this activity was incorporated into Regulation Y, in 1980, the Board had received certain comments noting that certain aspects of these advisory services may be within the scope of the activity of ‘‘management consulting.’’ The Board had found that it was not permissible for bank holding companies to offer management consulting services to nonaffiliated companies. Certain management consulting advice could be provided to unaffiliated depository institutions, however. In view of the relationship that had traditionally existed between banks and state and local governments, and the net public benefits that would result from provision of advice to such governments by bank holding companies, the Board indicated that it would be more flexible in determining what particular services constitute ‘‘providing financial advice’’ rather than ‘‘management consulting’’ when the services are solely for state and local governments rather than other nonbank organizations. With the Board's April 1997 revision of Regulation Y, investment and financial advisory activities were grouped together and a bank holding company could act as an investment or financial adviser without restriction.

The Board also allowed the provision of management consulting services regarding any financial, economic, accounting, or audit matter to any company. These financial activities are directly related to the activities and expertise of bank holding companies. Management consulting services are subject to a revenue limitation, however. They may be provided to any customer on any matter, provided that the total annual revenue derived from the management consulting services does not exceed 30 percent of the company's total annual revenue derived from management consulting activities. Thus, any services provided to state and local governments that are deemed management consulting services are subject to this revenue limitation.

3130.1.2 INSPECTION OBJECTIVES

1. To review the adviser's organizational structure and the qualifications of management to conduct business, and to determine whether they are satisfactory.
2. To determine the status of the adviser's financial condition and the adequacy of internal controls, general accounting policies, and reporting procedures, and to determine if they reflect the guidelines established by management.
3. To determine whether fee income is accurately computed and reported on a consistent basis.
4. To determine what financial effect the activity has on the parent holding company and the bank subsidiaries.
5. To review and evaluate investment practices considering the adviser's investment responsibilities for the selection and allocation of investments for various types of accounts, and to determine whether they are appropriate.

6. To evaluate funding sources, including indebtedness, and their management based on maturities and interest rates.
7. To determine the adequacy of internal and external audits.
8. To determine whether the adviser company has adequate policies and procedures to prevent self-dealing and similar improper conflicts.
9. To determine whether operating practices provide for adequate legal documents and agreements such that the account activities, in general, are consistent with the contractual responsibilities and authorities.
10. To determine if any litigation is pending against the company and the possible impact of an unfavorable court decision.
11. To evaluate compliance with applicable bank holding company laws, regulations, and interpretations, including compliance with the standards of care and conduct applicable to fiduciaries as required by Regulation Y.

3130.1.3 INSPECTION PROCEDURES

1. Obtain the company's policy and procedure manuals, and distribute relevant portions to the examiners for review and compliance evaluation.
2. Review the minutes of meetings of the board of directors, audit committees, and any officer-level committees. Ensure that examiners performing other portions of the inspection review relevant minutes or summaries thereof.
3. Obtain, review, and evaluate the adequacy of internal and external audit procedures, reports, and workpapers.
4. Prepare financial statements for the last two fiscal years, plus the interim period, if appropriate. Analyze and evaluate the information for adverse trends and for negative effects on affiliates.
5. Obtain, review, and evaluate internal and external asset-review reports.
6. Evaluate asset quality where warranted, documenting the scope and detailing asset review. Compile classification data, write up classifications if appropriate, and evaluate the adequacy of contra asset allowances.
7. Obtain documentation for all indebtedness. Evaluate funding sources for maturity mismatch, dependence on affiliates, concentrations, and dependability. Review borrowings from affiliate banks for compliance with section 23A of the Federal Reserve Act.
8. Review checking-account statements for all accounts at affiliate banks, checking for overdrafts since the previous inspection.
9. Complete the inspection checklist (see the sections beginning at 3130.1.3.2) based on the guidance provided in section 3130.1.3.1.
10. Identify off-balance-sheet activities and contingent liabilities, and assess the risk to the company and any affiliate.
11. Obtain a listing of litigation against the company or any individuals who represent the company from the company's legal counsel, and summarize the matters in litigation (or in threatened litigation) and any compromise actions. Evaluate the potential effects on the company's financial condition.
12. Evaluate contracts and service agreements with affiliates. Identify whether the company receives or provides services or products. Determine that the services or products are needed and received or provided, and that the contract or agreement terms represent market rates.
13. Review income and expense accounts and transactions with affiliates for compliance with section 23B of the Federal Reserve Act.
14. Evaluate whether the nonbank activities are being performed by affiliate bank personnel or whether bank assets are being used. If so, is the bank adequately compensated?
15. Review FR System approvals, and check conformance with any specified limitations or commitments.
16. Review a sample of recommendations to determine that a reasonable basis exists for the company's recommendations.
17. Review the advisory contracts to determine if there are any conflicts of interests involving the parent company or affiliates, as well as the officers, directors, or principal shareholders and their related interests of the holding company and its affiliates.
18. Evaluate insurance, including bond coverage, for adequacy. Determine the extent of current liability insurance relating to the adviser function, and evaluate the adequacy of such coverage—particularly the extent to which possible significant surcharges would be covered by such insurance.
19. Obtain a listing of shareholders for each class of stock outstanding and a schedule of officers, directors, and their related interests.

20. Obtain or update biographical and experience information for key management personnel, together with overall staffing and salary levels as appropriate for full evaluation.
21. Determine whether operating practices provide for adequate legal documents and agreements such that the account activities, in general, are consistent with contractual responsibilities.
22. Ascertain if senior management is aware, or has adopted the procedures necessary to become aware, of its current and potential responsibilities in connection with any regulatory-reporting and/or regulatory-compliance requirements.
23. Obtain or verify that workpapers contain the following permanent documentation:
    a. System approval letters
    b. date of incorporation or date acquired
    c. date activity commenced
    d. articles of incorporation and by-laws
    e. commitments
    f. supervisory actions
    g. other pertinent correspondence

3130.1.3.1 Scope of Inspection

It is expected that inspections of investment adviser subsidiaries will generally be conducted as part of regularly scheduled bank holding company inspections. If, however, the investment adviser subsidiary provides portfolio management services for a significant portion of trust assets held by a state member bank, the Reserve Bank should inspect the investment adviser subsidiary at the same time it examines the trust operations of the bank subsidiary. The scope of the inspection should be based on a review of the nature and complexity of the financial services provided to customers. An adviser which merely provides investment advice and does not provide any additional financial services, such as portfolio management, safekeeping, recordkeeping, or trading services, may not require an inspection. However, an adviser which provides portfolio management, safekeeping, or other services will require an inspection. To determine the scope of the inspection, it is essential to identify what types of services are being offered to customers and to assess the risks associated with those services.

The examiner needs to understand the adviser's operations, including how it represents itself to clients and whether the adviser has any vested interests in the financial services which it offers. As indicated in SR-88-11 (April 28, 1988), examiners should use their discretion to schedule inspections based on the size and complexity of the adviser's operations. Most section 4(c)(8) BHC subsidiaries will be subject to SEC registration requirements. (See SR-91-4 (SA).) Appropriate checklist questions should be completed for registered investment advisers which provide investment advice to affiliated banks or trust companies and for investment advisers which engage in activities which could have a significant impact on the bank holding company's financial safety and soundness. The checklist should also be completed for all advisers that manage investment portfolios for their customers. The checklist is only a guideline and some of the sections in the checklist may not be applicable. Conversely, the scope of such examinations is not limited to the items included in this checklist.

3130.1.3.2 Inspection Checklist

The questions in this checklist will assist the examiner in evaluating various areas of supervisory concerns.

3130.1.3.2.1 Review of Fundamental Policies and Procedures

The investment adviser's policies and procedures should be reviewed using the following checklist to ensure that fundamental policies and procedures have been established and implemented.

1. Are adequate minutes of the board and board committee meetings prepared?
2. Is the adviser properly chartered and registered?
3. Does the adviser have sufficient blanket bond or other fidelity or liability coverage in place?
4. Is corporate and regulatory reporting performed on a timely basis?
5. Does the above reporting fairly present the accounting and supplemental data reflected by the corporate records?
6. Are internal accounting controls, provided by a segregation of duties or a need for administrative approvals, adequate?
7. Are duties properly segregated in the receiving, disbursing, and recording of cash and cash transactions?
8. Are fee calculations and billing procedures adequate to ensure accuracy and propriety?

9. Are all security transactions authorized or approved by the appropriate management level, and is there documented evidence of the authorization or approval?

3130.1.3.2.2 Supervision and Organization

Supervision refers to the conduct of an adviser's board of directors and senior management in establishing, communicating, and enforcing a system of policies, procedures, and practices suitable to its business objectives and legal requirements. Organization may be characterized as the framework of committees and the assigned responsibilities through which supervision functions. The examiner should (1) review the structure of the organization for adequacy of management information systems and (2) the organization framework as both relate to meeting the entity's stated responsibilities as well as generally accepted standards of conduct. The examiner should review the supervisory function by first identifying the duties and responsibilities of the board of directors. The directors owe the duty of reasonable supervision, including appropriate attention to areas in which the adviser is assuming sensitive and complex fiduciary responsibilities. The next level of review is the committee and officer positions to which certain authority has been delegated. In reviewing this level of supervision, the examiner should keep in mind that certain functions cannot be delegated; for example, approval of significant new services or lines of business, approval of formal policies designed to ensure that the adviser operates in basic compliance with laws and regulations, and the selection and supervision of senior management cannot ordinarily be delegated. Informal delegations and operating practices represent the last level of review. In reviewing both formal and informal delegations, consideration should be given to the institution's size and complexity. A final determination of the adequacy of supervision and organization must be based on findings of the entire inspection of the bank holding company or its nonbank subsidiaries. While topics that have direct or indirect impact on the adequacy of director supervision and management competence are of particular sensitivity, examiners nevertheless have a responsibility to carefully address and comment upon such issues. During the course of the inspection, the examiner should review the supervisory and organizational structure of the bank holding company, with particular reference to investment-related activities. The examiner should determine whether the board of directors has developed adequate objectives and policies.

3130.1.3.2.2.1 Supervision and Organization Checklist

1. If the board of directors does not directly supervise investment adviser activities—
   a. has a responsible board committee(s) been named to exercise this function?
   b. are any delegations consistent with by-law provisions and other appropriate principles?
   c. do the board's minutes nevertheless reflect periodic but timely review of the conduct and operating results of the function?
2. Do minutes of the board, or its committee(s), reflect that members—
   a. attend meetings with reasonable frequency?
   b. require and approve, where necessary, appropriate written policies, strategic plans, and management reports relating thereto?
   c. review audit and regulatory reports (and management proposals and corrective measures in response thereto), litigation developments, earnings and expense reports, and changes to fee schedules?
3. Through adoption of formal policies and provisions for auditing, does the board adequately seek to ensure the integrity of the organization's records and operational systems?
4. Are policies and procedures adequately communicated to officers and staff?
5. Does the board or a board committee consider, periodically review, and provide for insurance protection?
6. Does the bank holding company maintain access to competent legal counsel and, where appropriate, obtain written opinions on significant legal questions such as—
   a. pending or threatened litigation?
   b. account agreements whose terms are unclear or ambiguous or raise complicated points of law?
   c. proposed actions or policies involving matters such as conflicts of interest, restricted securities, ERISA, and other matters involving possible legal exposure?
7. If an account's securities are registered in a nominee name(s)—

   a. is the nominee agreement current?
   b. is the nominee registered with the American Society of Corporate Secretaries (to guard against duplication of the nominee name) and state authorities (where required by local law)?
8. Is staffing adequate, in terms of both numbers and qualifications, to handle the current volume of business?
9. Is there adequate provision for management succession, or for continuing operations in case of the loss of key personnel?
10. Is senior management aware of its responsibilities in connection with, and has it established written policies and procedures to ensure compliance with, any applicable regulatory-reporting requirements?
11. Are significant functions of the investment adviser subject to either internal or external audit? If not, ascertain whether an audit program should either be developed or expanded.
12. When appropriate in light of the size and complexity of the adviser's operations, has management had an audit of financial statements performed by certified public accountants?
13. Have all significant exceptions and recommendations in audits or examinations or inspection reports been corrected, implemented, or otherwise satisfactorily resolved?

3130.1.3.2.3 Portfolio Management

Investment selection is the process whereby the adviser evaluates, selects, and reevaluates those securities or other financial assets it will buy or sell for its clients, or for which it will make recommendations. It includes the process of researching and selecting recommended individual stocks and bonds, and setting objectives or strategies for diversifications by types and classes of securities into general or specialized portfolios, as well as the process of communicating and executing overall strategies for particular accounts.

When an adviser holds itself out as a professional, the adviser will be held to a high standard of prudence and expertise in the investment-selection and -review process. Therefore, advisers must carefully consider policies and procedures in this area in accordance with the size and character of the investment-selection responsibilities undertaken. In furnishing portfolio investment advice, particularly to retail clients, an investment adviser should observe the standards of care and conduct applicable to fiduciaries.[1]

3130.1.3.2.3.1 Investment Standards and Research

1. Are the general investment standards and review and selection responsibilities defined and approved by the board of directors?
2. Does management or senior investment personnel review overall investment policy and potential investment problems at least annually?
3. Is portfolio management policy adequately communicated to appropriate personnel (for example, by including it in committee minutes, directives, or memoranda circulated to such personnel)?
4. Does the institution, where appropriate, diversify investments according to—
   a. types of assets, such as common stocks, fixed-income securities, and real estate?
   b. types of securities by characteristics such as income, growth, and size of company?
   c. types of securities by industry and specific companies within industries?
   d. maturities of debt securities?
   e. geographic location of companies of issue, such as utilities?
   f. tax-exempt income?
5. If the institution has a list of securities approved for purchase, retention, and/or sale—
   a. are recommendations for additions to or deletions from such list(s) approved by a committee or group with appropriate authority and expertise?
   b. are periodic reviews made of the lists of securities approved for purchase, retention, or sale to assess the current appropriateness of the investments listed?
6. If the institution uses any research or analysis in its general investment-review and -selection process—
   a. are appropriate factors taken into account?
   b. is appropriate documentation obtained and filed to reflect consideration of such factors?
7. If the size and character of the entity's discretionary investment responsibilities are such that the type of detailed research consider-

1. The term ''portfolio investment'' is intended to refer generally to the investment of funds in a ''security'' as defined in section 2(1) of the Securities Act of 1933 (15 U.S.C. 77b) or in real property interests, except when the real property is to be used in the trade or business of the person being advised. In furnishing portfolio investment advice, bank holding companies and their subsidiaries shall observe the standards of care and conduct applicable to fiduciaries.

ations and files envisioned in the previous question are not relied on, does it use ratings by acceptable financial-rating agencies, such as Moody's or Standard and Poor's, together with evaluation of basic relevant factors pertaining to the type of security under consideration?
8. Where appropriate, does the organization differentiate its investment-selection process as to the type of account in question, such as those for which the need for growth or income is paramount, or for taxable versus tax-free trusts or retail versus institutional accounts?
9. Do personnel possess sufficient expertise and experience to properly implement the firm's investment-selection systems and responsibilities?

3130.1.3.2.3.2 Account Administration

Special consideration has to be given to accounts subject to the Employee Retirement Income Security Act of 1974 (ERISA), which imposes fiduciary responsibilities upon any person who has any power of control, management, or disposition over the funds or other property of any employee benefit fund. When an adviser exercises investment discretion over such plans, the extensive fiduciary responsibility and prohibited transaction rules of ERISA will apply.

1. Does the adviser have portfolio management procedures which provide for—
   a. consideration of the needs and objectives of particular types of accounts, such as the need for income versus growth or taxable versus tax-free income?
   b. conformity with investment provisions of governing instruments?
   c. consideration of the liquidity needs of the account for anticipated distributions?
   d. appropriate diversification, including avoidance or elimination of concentrations in individual securities and by type and subclass of securities?
2. When assets in discretionary accounts are considered unsuitable, is a program of prudent and timely sale of such assets followed unless retention is required?
3. In order to determine the advisability of retaining or changing assets, does the adviser have procedures for periodic reviews?
4. Do minute books or other records—
   a. identify reviewed accounts?
   b. report written conclusions on the advisability of retaining or disposing of assets in the accounts?
5. As appropriate to the size and character of business, are account synopses and historical data used in the review of account assets?
6. Does the investment-review information include—
   a. amount and description of investment?
   b. categories of investment, such as bonds and stocks?
   c. types of investments within each category, such as industry groups for stocks?
   d. cost?
   e. market or appraised value at review date?
   f. annual income?
   g. yield at market?
   h. rating of recognized financial service?
7. For accounts in which the adviser makes investments at the direction of the client, does the adviser—
   a. review the account to detect illegal, nonconforming, substandard, or otherwise unsuitable investments?
   b. advise the power holder of any improper investments?
   c. inform parties at interest in the account if any improper investment is not disposed of, and seek legal relief, if necessary?
   d. resign from the account if corrective action is not taken concerning improper investments?
8. Have proxy voting policies and procedures as listed below been established for ERISA accounts that are suitable in relation to assumed responsibilities?
   a. voting of routine proxies?
   b. identification and handling of proxy or tender determinations when sensitive social issues, conflicts of interest, significant increases in management power or perquisites, or merger or buy-out proposals are involved?

      NOTE: For requirements relating to proxy processing and the Shareholder Communications Act of 1985, see Operations and Internal Controls in the *Trust Examination Manual*. For questions relating to the voting of affiliate stock, see Conflicts of Interest in the *Trust Examination Manual*.

   When an adviser invests accounts in options and/or futures, the following checklist questions (numbers 9 through 13) should be completed. For additional information as to appropriate uses of options and futures contracts, see SR-83-2(SA) and SR-83-39(SA).

9. When an adviser uses options and/or futures, has the board of directors or a directors'-level committee approved a policy and strategy for their use? Does the policy address—
   a. the investment objectives to be accomplished by the use of these contracts?
   b. the specific types of contracts to be used?
   c. the types of accounts authorized to use these contracts?
   d. restrictions and/or conditions upon use of contracts, such as selection of brokerage houses, position limits, time frames, leveraging, etc.?
10. Was adequate disclosure made and adequate authorization obtained to execute contract transactions for various types of participating accounts?
11. Are adequate systems and controls in effect to ensure—
    a. proper tax treatment?
    b. proper segregation of securities and/or monies?
    c. conformance with account objectives?
    d. adherence to adopted strategy, position limits, and related program parameters?
    e. periodic management evaluation and reporting systems with respect to—
       - results of contract activities upon overall investment performance?
       - market developments, including current liquidity of relevant futures and options contracts in which positions are taken?
       - financial condition, fee competitiveness, and performance of involved broker-dealers?
12. Does the accounting system accurately reflect contract activities with respect to—
    a. transaction details?
    b. current gains or losses on open contract positions?
    c. necessary tax information?
13. Do operating personnel appear sufficiently knowledgeable relative to the level of contract-transactions activity?

3130.1.3.2.4 Conflicts of Interests

The inspection of an investment adviser subsidiary which provides services to an affiliated trust company or bank with a trust department requires expanded inspection procedures. Often the investment adviser subsidiary was organized for the purpose of providing investment advice and services for the trust accounts held at one or more of its affiliates. These subsidiaries often employ the same individuals who worked in the banks or trust company which they advise.

Conflict-of-interest problems may arise when the adviser exercises any ''discretion'' when there are mutually opposing interests. The most serious conflict of interest is self-dealing, which could include transactions such as an investment in affiliated banks or the purchase of securities from or through an affiliate. To resolve conflicts of interest, such transactions and the fees associated with them must be fully disclosed and authorized by the appropriate parties.

Potential conflict-of-interest situations are not limited to transactions between affiliates, but can be between the adviser and any of its directors, officers, or employees individually. Due to the complexity, sensitivity, and exposure involved in conflicts of interest, it is particularly important that an adviser develop the awareness and policies and procedures to identify and deal with conflicts situations. Therefore, it is considered highly desirable, even when not specifically required by regulation, that written policies be adopted and periodically revised as necessary.

3130.1.3.2.4.1 Self-Dealing

1. Has the adviser—
   a. acquired any assets from itself or its affiliates?
   b. acquired any assets from directors, officers, or employees of the organization or its affiliates, or from any other individuals with whom a connection exists that might affect their best judgment?
2. Has the adviser sold or transferred any account assets, by loan or otherwise, to—
   a. any affiliates?
   b. directors, officers, or employees of any affiliates?
   c. other individuals or corporations with whom such a connection exists or other organizations in which such an interest exists that might affect the exercise of its best judgment?
3. Has the company purchased any securities for a customer account from any member of an undivided syndicate for which the adviser or any of its affiliates are participating, or from a private placement which the adviser assisted?

4. Does the company have satisfactory policies and procedures, in terms of its size and character of business, to address the preceding situations?
5. If the company directs extra fee-producing business to itself or an affiliate (for example, brokerage services or options-trading services), or if it charges separate fees to accounts for securities transactions or other services commonly provided as part of general account administration (for example, fees for cash management or investments in mutual funds when management or administration fees are received by the company or an affiliate)—
   a. has it identified those accounts which may properly participate in such services in accordance with adopted policy, legal opinion, a Department of Labor ruling, and/or other necessary determinations?
   b. has it made appropriate prior disclosures and obtained adequate specific authorizations for those accounts identified as entitled to the services?
6. Have any assets held by the company in one account been sold to another account? NOTE: The transaction may be permissible if appropriate disclosure is made, authorization is received, and the law or the governing instrument do not prohibit it. However, an interaccount transaction for ERISA accounts may be a prohibited transaction. In addition, difficult problems can arise in establishing or documenting a ‘‘fair’’ price for the transaction, particularly if the asset is a thinly traded security or is a unique asset.
7. Does the company have appropriate policies and procedures to ensure—
   a. its discretionary accounts are not left in uninvested cash positions beyond a minimum period of time?
   b. its accounts are invested in affiliate interest-bearing deposits only for appropriate temporary or other purposes? NOTE: To the extent the company has long-term affiliate deposits or significant aggregate holdings, a special review should be made of the company’s documentation evidencing the suitability of such investments in view of available alternate vehicles.
8. Are securities of affiliates only purchased upon proper direction or specific authorization in account instruments?
9. When the adviser purchases securities which are underwritten by an affiliate, does the adviser do so only upon proper direction and specific authorization of the customer?
10. Does the company act as investment adviser to an open-end or closed-end investment company that is registered under the Investment Company Act of 1940? If so, do its activities conform with the Board’s interpretation at 12 C.F.R. 225.125, which defines the scope of permissible activities?

3130.1.3.2.4.2 Broker Selection

1. When volume of activity warrants, is allocation of brokerage business controlled through an approved list which is periodically reviewed and approved by the company’s board or a senior-officer-level committee?
2. Does management attempt to obtain the best service for customers, including periodic evaluations of broker qualifications such as—
   a. financial condition?
   b. past record of good and timely delivery and payment on trades?
   c. quality of execution and ability to handle specialized transactions?
   d. quality of research received, if applicable?
3. Are there procedures to monitor or periodically survey available negotiated commission prices in order to ascertain reasonable costs for the execution requirements of its accounts?
4. If commissions higher than the ‘‘lowest’’ available negotiated commissions are being paid for executions in order to receive goods and/or services—
   a. have such goods and/or services been determined to reasonably qualify as ‘‘brokerage and research services’’ as defined in section 28(e)(3) of the Securities Exchange Act of 1934?
   b. does an appropriate committee periodically (at least annually) review and determine that the value of the goods and services justifies the payment of the higher brokerage commissions?
5. Does the entity periodically review and maintain records of all goods and/or services received from brokers or third parties in return for brokerage and/or dealer business allocated to particular firms?
6. Do policies and procedures preclude—
   a. selection of broker-dealers on the basis of deposit balances?
   b. agreements or understandings for allocation of specific amounts of business to a

broker-dealer such that the adviser company would not be able to cease allocating business to the firm if it were no longer providing acceptable execution?

7. Are auditing and other monitoring controls and reporting procedures in effect to verify the compliance of traders with policies regarding broker selection and payment of commissions? NOTE: Under section 28(e) of the Securities Exchange Act of 1934, the adviser may also legitimately pay more than the lowest-available commission for reasons of execution, financial soundness, and efficiency of delivery and payment.
8. In addition to advisory services, are brokerage services provided for customers pursuant to section 225.28(b)(7)(i) of Regulation Y? If so, the examiner should refer to the discount brokerage examination procedures in SR-85-29 (FIS), which contains guidelines and checklist questions for the inspection of brokerage activities.

3130.1.3.2.4.3 Trading Policies and Practices

1. When trading specialists are employed, are there adequate written or unwritten standards of competence, education, and training for such individuals?
2. When specialists are not employed, are the individuals responsible for trading reasonably trained and informed in relation to the volume and character of trading activity they are required to perform?
3. When transactions are permitted to be crossed between accounts, are procedures adequate to ensure fair pricing of the transactions? If it is not clear the transactions are permitted, has the company determined through counsel that crossing is permissible under applicable law?
4. When specialists are employed and volume of activity permits, are block trades considered in order to obtain more favorable trade prices and execution prices for accounts?
5. If applicable, do procedures, including establishment of time frames in advance of such trading, require special authorization and attention for large or block trades which are to be executed in a number of transactions?
6. If procedures permit the combining of purchase or sale orders of the same security—
   a. are resulting benefits in price and/or execution costs applied on a pro rata or average basis to the participating accounts?
   b. are allocable shares similarly pro-rated to participating accounts when a combined trade is not executed at once, but in a number of transactions over a period of time?
7. Does the adviser maintain policies ‘‘reasonably designed to prevent the misuse of material non-public information?’’

3130.1.3.2.5 Recordkeeping

Registered investment advisers are subject to extensive recordkeeping requirements. SEC Rule 204-2 imposes recordkeeping standards and requires that registered investment advisers keep accurate records. In addition to this recordkeeping, the adviser is subject to the ‘‘brochure rule’’ (Rule 204-3). This rule requires an investment adviser to deliver a specified disclosure statement with respect to its background and business practices to every client or prospective client. In addition to an initial disclosure, the adviser must offer annually to deliver a current disclosure statement upon request. Those advisers which have custody or possession of securities of any client must maintain certain additional records, including separate ledger accounts for each client, copies of confirmations, and a position record showing the interest of each client and the location of the securities.

1. Does the investment adviser make and keep current appropriate books and records including—
   a. journals or summary journals?
   b. a memorandum of each order given by the firm or instructions received, showing terms and conditions of the orders?
   c. all checkbooks, bank statements, canceled checks, and cash reconciliations?
   d. all bills or statements, paid or unpaid?
   e. trial balances, financial statements, and internal audit papers?
   f. written communications received or sent by the firm?
   g. list of discretionary accounts?
   h. powers of attorney and discretionary powers?
   i. written agreements?
   j. copies of each notice, circular, advertisement, newspaper article, investment letter, bulletin, or other communication recommending the purchase or sale of a security?
2. Does the adviser maintain a record of every transaction in which the adviser or any

"advisory representative" has a direct or indirect beneficial interest?
3. Are partnership articles, articles of incorporation, charter, minute books, and stock certificate books maintained at the adviser's principal office?
4. If required books and records are photocopied or microfilmed, or if they are produced or reproduced on computer storage media—
   a. are such media indexed and arranged to permit immediate location of any particular record?
   b. were any copies or printouts of such records promptly provided on request?
   c. is at least one copy of the original records that are now on such media stored in a separate location from the original for the time required?
   d. does the adviser maintain procedures for the maintenance and preservation of, and access to, records so as to reasonably safeguard them from loss, alteration, or destruction?
   e. does the adviser have facilities for the immediate, easily readable projection of microfilmed records and for producing easily readable facsimile enlargements?
5. Do the entries in the general ledger and journals properly reflect payments or receipts of monies or other goods or services?
6. Do the financial statements, canceled checks, deposit slips, and check register properly reflect payments or receipts of monies or other goods or services?
7. When the adviser's financial records indicate that it is capitalized with client funds (through either loans or equity), have adequate disclosures been made to clients about the risks and conflicts of interest involved?

3130.1.3.2.6 Security Storage and Processing

Investment advisers generally do not take possession and control of client funds and securities. However, in those cases in which such responsibilities are assumed, the inspection must evaluate those internal controls which are in place for the safeguarding of client funds and securities. Controls and related processing procedures must be appropriately designed and implemented by the adviser to efficiently and safely facilitate such operations.

1. Does the adviser have custody of client funds or securities?
2. Does the adviser gain effective access to client assets through practices, arrangements, or relationships with clients, such as trustee, executor, or account signator?
3. When the adviser has custody of client funds or securities, does the adviser maintain the following records:
   a. a record reflecting all purchases, sales, receipts, and deliveries of securities, and all debits and credits to such accounts?
   b. a separate ledger account for each client, showing purchases, sales receipts, and deliveries of securities?
   c. copies of confirmations of all transactions for such clients?
   d. a record for each security in which any client has a position, reflecting the name of the client, amount of interest, and location of security?
4. When the adviser renders investment-management services, are the following records maintained:
   a. for each client, a record of securities purchased and sold, containing the date, amount, and price of each transaction?
   b. a record for each security in which any client has a current position, showing the name of each client and current interest or number of shares owned by each client?
5. Are client assets physically segregated from the adviser's own assets?
6. For the vault and other related security-processing areas, are adequate controls/safeguards in effect which include the following:
   a. Are assets maintained under a system of joint custody or dual control?
   b. Is access to these areas restricted to designated/authorized personnel?
   c. As appropriate, are other controls/safeguards systems in place (for example, rotation of assignments, key/lock combinations, or vault or area entrance log(s))?
   d. Is a security-ticket system used as a vault and asset-movement control system?
7. If a security-ticket system is used, are adequate controls/safeguards in effect which include the following:
   a. Are security tickets prenumbered?
   b. Does each copy of the security ticket clearly indicate its destination to ensure prompt and accurate delivery?

c. Does the security ticket provide the necessary information to ensure proper processing and recording of the transaction?
d. Does the security ticket contain sufficient copies to ensure that sound internal control is maintained over the physical security-movement process by providing the following with a copy (or copies):
   - portfolio managers who initiated the transactions?
   - appropriate vault/operations personnel?
   - the audit/asset control function?
e. Are unissued security tickets properly safeguarded and subject to adequate numeric controls?

8. Does the control of security ticket/transaction cancellation and replacement include—
   a. restricting the ability to initiate such action to supervisory personnel?
   b. reporting such activity to the audit/asset control function and other function(s) affected by such action?
   c. procedures to ensure that securities are returned to the vault or that funds charged from an account are redeposited, or that the securities or funds are immediately placed under the control of a new security ticket/transaction?
   d. identifying a replacement security ticket by recording such information on the replacement ticket?
   e. requiring all copies of the replaced security ticket to be forwarded to the audit/asset control function?
9. For assets received, are adequate controls/safeguards in effect which include the following:
   a. Are all assets received promptly placed under joint custody or control?
   b. Is appropriate documentation required and on file for all assets received, and is it compared to actual assets received and posted to control ledgers?
   c. As applicable, are procedures in place for controlling and properly handling assets received by other means, including delivery by mail or messenger?
   d. If assets are not to be physically held or issued (for example, mutual fund shares), is a receipt, statement, or acknowledgment obtained from the issuer or holder and processed by receipt ticket or other means to ensure proper accountability?
   e. If securities received are not properly registered in the company's nominee name, are procedures in place to ensure prompt re-registration, control, and follow-up until re-registration?
10. For the delivery of assets, are adequate control/safeguards in place which include the following:
    a. Are appropriate receipts obtained and on file for securities delivered?
    b. Are procedures in place to ensure that bearer securities are not mailed in amounts in excess of the company's insurance limits?
11. Do vault custodians—
    a. compare securities received/withdrawn to the security ticket?
    b. for withdrawals, verify that the security ticket is signed (initialed) by authorized personnel?
    c. for securities temporarily withdrawn from the vault (for example, for transfer, re-registration, or account/portfolio manager review), is a copy of the security ticket retained by vault personnel pending the return of the security to the vault?
12. For pending security transactions, are adequate controls in effect which include the following:
    a. Are pending items periodically reviewed by operations personnel?
    b. Do procedures provide for prompt follow-up on items which have not been completed within established time periods?
    c. Are exceptions promptly reported and resolved by appropriate personnel (for example, management, supervisors, and/or the audit/asset control function)?
    d. Are current pending security items in compliance with established procedures for reporting exceptions, and are those transactions which have not been completed within established time periods been followed up satisfactorily?
    NOTE: Examiner judgment should be used in determining the scope of this review. However, at a minimum, the review should include procedures for handling security transactions pending 30 days or more.
13. Does the security-processing system—
    a. contain a sufficient number of controls/safeguards to properly reflect the current status of and limit an individual's control over a security transaction?

   b. contain sufficient information to identify, locate, and trace the movement of each asset?
   c. provide for adequate segregation of duties and responsibilities?
14. Has individual accountability or responsibility been properly assigned for the physical protection of the securities and related cash flow, if applicable, throughout the security-processing system?
15. Do procedures require that orders for trades originate with account or portfolio managers, with the signature or initials of the authorizing party shown on the order form or purchase/sale ticket?
16. Are transactions made on a first-in, first-out basis (that is, executed in order of receipt), except when combined in blocks for execution pursuant to appropriate written procedures?
17. Do operations personnel perform independently of account or portfolio managers to—
   a. reconcile trade tickets to brokers' confirmations?
   b. monitor and promptly follow up on any outstanding transactions, such as confirmations not received within specified time periods or purchases/sales which have not settled on settlement date?
   c. promptly post payments for purchases/sales to the recordkeeping system and promptly record/remove assets?

3130.1.3.2.7 Other Matters

1. Is the adviser or any of its principals involved in litigation or arbitration which will have an impact on its ability to fulfill its contract with clients?
2. Were any matters of a material nature found in the adviser's correspondence, such as significant client complaints?
3. Did a review of customer-complaint files reveal any possible areas for special inspection focus?
4. Did a review of the adviser's current financial condition raise concerns as to the adviser's solvency or its ability to otherwise continue to provide advisory services?
5. Are there any other aspects of the adviser's operations, or the operations of an affiliate, which raise concerns?

3130.1.4 INSPECTION FINDINGS

A written summary of the subsidiary's activities should be presented to the examiner in charge of the bank holding company inspection and should be included in the inspection report or its supporting workpapers. Material exceptions should be noted with management's responses under an appropriate caption in the open section of the report. Any comments in the report regarding the scope of the investment advisory inspections should note that such inspections are primarily focused on safety-and-soundness considerations and not on compliance with securities laws.

In those cases in which a separate Report of Bank Holding Company Inspection on Investment Advisory Activities is prepared, examiners may use the Uniform Interagency Trust Rating System (see SR-98-37 FRB, revised October 13, 1998, and effective January 1, 1999), which provides a basis for the evaluation of critical areas of supervisory concern. The rating system is generally used by federal supervisory agencies to assess the condition of trust companies. However, the system can be adopted to report on advisory operations as well. When the inspection uncovers significant deficiencies which require corrective action, and the inspection was not done in conjunction with a concurrent bank holding company inspection, a separate report should be prepared and delivered to the inspected nonbank adviser. Send a copy of the summary and any report comments to the Trust Activities Program, Washington, DC 20551.

3130.1.5 ON-SITE INSPECTION BY TRUST EXAMINERS

An investment advisory subsidiary of a bank holding company will normally be registered as an investment adviser under the federal securities laws, and will be subject to examinations of its advisory activities by the Securities and Exchange Commission (SEC). Nevertheless, because investment responsibility is involved in any investment adviser's activities, and since the SEC's routine examinations may be infrequent, periodic on-site inspections should be conducted as an integral part of BHC inspections.

Consideration should be given to using trust examiners to conduct, or at least participate in, on-site inspections of financial and investment advisory nonbank subsidiaries, especially when the subsidiary provides services to an affiliate bank trust department examined by the Board of Governors of the Federal Reserve System. If the bank holding company has to ''spin off'' the investment research and selection process of its banks' trust departments into an investment advisory subsidiary, there may be a need to review the activities of the trust departments together with those of the advisory subsidiary through an on-site inspection.

The companies being advised on a contractual basis and which were sponsored by the holding company or any affiliate are also defined as affiliates in sections 23A and 23B of the Federal Reserve Act. The examiner should therefore be alert to any intercompany transactions between a bank subsidiary and the advised company. A review of financial statements of such companies is warranted.

3130.1.6 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Limitations and activity approval	15 U.S.C. 80; section 23A FRA 371c	225.28(b)(6) 225.125	4–177	1997 FRB 275 1971 FRB 512 1972 FRB 149, 571
Activity approval—real estate development advisers for state and local governments		225.28(b)(6)		1997 FRB 275 1980 FRB 962 and 984

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

This section renders inspection guidance on financial and investment advisory activities that are provided in connection with mergers, acquisitions, divestitures, investments, joint ventures, leveraged buyouts, recapitalizations, capital structurings, and financing transactions and similar transactions, and on conducting financial-feasibility studies.[1] This section also provides historical examples of financial and investment advice previously approved by Board order. The examples consist of various kinds of advice with regard to mergers and similar corporate transactions under the current Regulation Y, section 225.28(b)(6)(iii). Some of the examples of advisory nonbank activities were approved for inclusion into Regulation Y long before the revision of Regulation Y that was effective April 21, 1997. The reader of these examples must only take into consideration the current provisions of Regulation Y. There should be no reliance on Board order commitments, old regulatory provisions, supervisory policies, and interpretations made before April 21, 1997, unless they were not revised. Certain former provisions or commitments may no longer be applicable. The historical examples discussed in this section have been revised according to the new regulatory provisions.

If inspection objectives and procedures are stated in a specific section, the examiner should use this specialized guidance. In addition, the examiner should use the generalized inspection objectives and procedures in section 3130.0, which are generally applicable to all advisory activities.

3130.3.1 ADVISER TO A MORTGAGE OR REAL ESTATE INVESTMENT TRUST

An adviser to a mortgage or real estate investment trust (REIT) furnishes expertise in the areas of funds acquisition, lending, investing, and servicing that is similar to the role of adviser to a mutual fund. The contracted service is performed on a fee basis that is generally based on a percentage of the trust's total assets. The intention of the exemption, found in section 225.28(b)(iii) of Regulation Y, is to allow the relationship to be advisory in nature as opposed to controlling. However, in some instances, the relationship between trusts and their advisers has gone beyond the parameters of advice and resulted in legal entanglements, conflicts of interest, and financial exposure for the bank holding company. Because of the potential risk exposures which may result when a bank holding company or its subsidiary engages in this activity, the overall relationship must be subject to particular scrutiny during an inspection.

REITs were established by the U.S. Congress in 1960, effective January 1, 1961. A REIT is a hybrid form of an investment vehicle which is essentially a financial intermediary specializing in real estate lending and investment. A REIT obtains funds by borrowing from financial institutions or other lenders or by issuing shares (equity capital). It invests the funds in real estate, either as a lender or equity owner. REITs are usually owned by passive owners, not operators. REITs are designed to take advantage of benefits within the federal Internal Revenue Code.

There are generally four types of REITs: equity, mortgage, hybrid, and ''finite-life.'' An equity REIT acquires income-producing properties, deriving its earnings mostly from rents. A mortgage REIT provides financing to real estate projects that are owned by others, deriving its earnings from interest charged on the loans. A hybrid REIT combines the equity REIT and the mortgage REIT. The finite-life REIT is structured to self-liquidate within an established time frame.

By meeting certain prescribed requirements during a taxable year, a REIT may function as a conduit with respect to income distributed to its beneficiaries. If at least 95 percent of the trust's income is distributed to the beneficiaries (excluding capital gains), the trust pays no taxes on the distributed income, thus avoiding the double taxation associated with corporations. Therefore, this investment vehicle has the tax advantage of a partnership but offers the limited liability and perpetuity of a corporation.

A REIT must be a corporation (other than an insurance company or bank), an association, or a trust, or it must be managed by at least one trustee, with transferable shares of beneficial interest as form and evidence of ownership. There must be at least 100 beneficial owners, and the trust must elect to be treated as a REIT for tax purposes. A REIT must meet the following threefold gross income test. At least 95 per-

1. Feasibility studies do not include assisting management with the planning or marketing for a given product or providing general operational or management advice.

cent of the trust's income must come from real property rentals, dividends, abatements and refunds of real property taxes, interest on loans, or gains from the sale of securities or real estate, with the further stipulation that no less than 75 percent of the trust's income must be directly related to real property. Also, less than 30 percent of the trust's income can be derived from the sale of any securities held for less than six months and from foreclosure property and real property held for less than four years that is not involuntarily converted.

In addition to the threefold gross income test, there is a twofold investment test which must be met. First, at least 75 percent of the value of the trust's total assets must be real estate assets, government securities, and cash. Second, 25 percent of the trust's total assets may be securities, but the trust cannot hold securities from one issuer which amount to greater than 5 percent of the trust's total assets and more than 10 percent of the outstanding voting securities of the issuer.

3130.3.1.1 Evaluating Advisory Activities for a REIT

A bank holding company may have an insignificant amount of capital invested in the advisory company. However, if the bank holding company or its subsidiaries have extensions of credit or unfunded commitments outstanding, an evaluation of the credit may be needed using normal classification criteria as to their collectibility, particularly if there is substantial risk exposure. Examination/inspection reports of subsidiaries should be reviewed to determine the consolidated exposure. The holding company or its banking subsidiaries may be participating in exchanges or swaps with the advised REIT, whereby trust assets are exchanged for forgiveness of bank debt. Such pending asset swaps should be considered in conjunction with the credit evaluations. The swaps may be for the purpose of reducing the REIT's liabilities, which can involve an exchange of assets with the lender. The lender's balance sheet reflects an exchange of one asset for another together with, possibly, a lump-sum payment of cash to the trust. If a swap is pending, review the criteria that the holding company used to (1) determine the benefit of the swap to the company and (2) select which of the REIT's assets would be considered for the swap. Also, determine the amount of any cash or earning assets that will be given to the trust.

A holding company and a trust have separate and distinct shareholders but common management. The potential exposure in such cases may be pronounced. Such relationships should be reviewed for conflicts of interest. Loans may be booked by the holding company or its subsidiary and subsequently sold to the trust. The credit decision may have been made by the subsidiary, and the REIT's purchase of the loans may have been approved by the affiliated adviser. The benefits to the holding company may include receiving the origination fee and selling the loan to the trust, thereby increasing the REIT's assets, upon which the holding company's advisory fee is based. Following receipt of the sale's proceeds, the process may be repeated. If the holding company has participated in this type of process, there is potential for a conflict of interest. The holding company or its subsidiary may have to repurchase the credit.

Theatened or pending litigation may result from loans that were originated by the holding company or its subsidiaries or that were recommended by the adviser. The number of such loans together with the current payment status of the credit should be determined. If there are numerous loans on a nonaccrual status, the holding company may have accumulated a significant loss. Finally, any suit involving the adviser which pertains to services it performed should be explored as to its validity and potential financial exposure.

3130.3.2 INSPECTION OBJECTIVES

1. To determine the level of risk involved when the bank holding company or its subsidiaries have extensions of credit and unfunded commitments outstanding to the advised trust.
2. To review for conflicts of interests in cases when a holding company and a trust have separate and distinct shareholders but common management.
3. To review all threatened or pending litigation involving loans originated by the holding company or its subsidiaries that were recommended by the adviser.
4. To review all covered transactions between a bank holding company's subsidiary bank and a REIT, if the REIT is sponsored and advised on a contractual basis by the bank or any subsidiary or affiliate of the bank, to ensure that transactions are permitted pursuant to sections 23A and 23B of the Federal Reserve Act.

5. To determine whether the REIT has been advised to sell real estate in the ordinary course of business and, if so, whether the appropriate liability account for corporate federal and state taxes has been established by the advised subsidiary.
6. To determine whether the REIT adviser is providing the appropriate advice to the REIT to generate nonspeculative high yields; adequate liquidity; portfolio diversification; sufficient cash flow to pay dividends; continuous repricing; and adequate public disclosure, including the extent of risk involved.
7. To determine the adequacy and quality of professional management and the level of management's equity stake in the REIT.
8. To determine the effect on net earnings from floating interest rates on asset yields that may have been caused by prepayment risk.

3130.3.3 INSPECTION PROCEDURES

1. Determine if there are any significant extensions of credit or unfunded commitments outstanding. If so—
   a. evaluate the credit using normal classification criteria as to collectibility;
   b. review examination or inspection reports of the holding company's subsidiaries and determine the consolidated exposure; and
   c. review any pending asset swaps in conjunction with the credit evaluations, if the holding company or its banking subsidiaries are participating in exchanges or swaps with the advised REIT whereby trust assets are exchanged for forgiveness of bank debt.
      - Review the lender's balance sheet to make certain that it reflects an exchange of one asset for another, as well as any lump-sum payment of cash to the trust.
      - Review the criteria the holding company used to (1) determine the benefit of the swap to the company and (2) select which of the REIT's assets would be considered for the swap.
      - Determine the amount of any cash or earning assets that will be given to the trust.
2. Determine and evaluate any significant conflicts of interests in cases when a holding company and a trust have separate and distinct shareholders but common management.
   a. Determine if there are any loans booked by the holding company or its subsidiary and subsequently sold to the trust, if the credit decision was made by the subsidiary, and if the REIT's purchase of the loans was approved by the affiliated adviser.
   b. If significant conflicts of interest exist, determine whether the holding company or its subsidiary must repurchase any associated credit.
3. Review all threatened or pending litigation involving loans originated by the holding company or its subsidiaries that were recommended by the adviser.
   a. Determine the number and amount of such loans together with the current payment status of the credit and whether any loans are on a nonaccrual status.
   b. Evaluate any suit involving the adviser that pertains to services it performed as to the suit's validity and potential financial exposure.
4. Evaluate the effect on net earnings and dividends that declining rates (floating-rate assets) have on the prices of floating-rate mortgage assets. Determine the results and the nature of any hedging strategies that are used to offset a decline in net earnings.

See also the inspection procedures in sections 3130.0 and 3130.1.

3130.3.4 FINANCIAL ADVICE ON ISSUING SECURITIES OF FOREIGN GOVERNMENTS IN THE UNITED STATES

3130.3.4.1 Financial Advice to the Canadian Federal, Provincial, and Municipal Governments

An example of providing financial and investment advisory activities is a Board order that was previously approved (now authorized under section 225.28(b)(6)(iii) of Regulation Y). The order specifically authorized the providing of financial advice to the Canadian federal and provincial governments for issuing their securities in the United States. Also, the Board's Regulation K authorizes the provision of such investment, financial, or economic advisory services to foreign governmental entities (see section 211.10(a)(8)). The Board approved the proposed activity on February 12, 1988 (1988 FRB 249).

Another Board order authorized a foreign bank, subject to the BHC Act, to acquire a securities firm to engage in this activity, but to expand the activity to include the providing of such advice to the Canadian municipal governments in addition to the federal and provincial governments. The Board concluded that the slight modification would not alter the activity to render it less closely related to banking. The Board approved the order on March 28, 1988 (1988 FRB 334). Other approved Board orders for this activity are 1988 FRB 500 and 1988 FRB 571.

3130.3.4.2 Providing Financial Advice to the Japanese National and Municipal Governments and Their Agencies

Another example of providing advice to foreign governments is a bank holding company that applied for the Board's approval to engage, through its wholly owned securities subsidiary, in certain securities-related, foreign-exchange, and investment and financial advisory activities. The activity, which consisted of providing financial advice to the Japanese national and municipal governments, had not previously been authorized for bank holding companies. When making its decision, the Board referred to similar orders as well as to the facts provided. It approved these advisory services by order on June 4, 1990. (See 1990 FRB 654.)

The Board, effective September 10, 1992, added the providing of financial advice to foreign governments, such as advice with respect to the issuance of their securities, to the activities permissible by Regulation Y, currently authorized by section 225.28(b)(iii).

3130.3.5 PROVIDING FINANCIAL-FEASIBILITY STUDIES AND VALUATION SERVICES

The following provides an example of a bank holding company that was authorized to provide financial-feasibility studies and valuation services, including expert-witness testimony in connection with the valuation services. A bank holding company (the applicant) had requested the Board's approval to acquire 100 percent of the voting shares of a company (the company) that engaged in investment advisory, investment management, and financial advisory services. The company engaged in providing (1) financial-feasibility studies for specific projects of private corporations, (2) valuations of companies and of large blocks of utility stock for a variety of purposes, and (3) expert-witness testimony on behalf of utility companies in rate cases.

In providing financial-feasibility studies, all financial aspects of the particular project were evaluated, including economic conditions, sales and earnings statements, balance sheets, and cash-flow data. Each engagement involved analyzing and projecting the income to be generated by a particular project. The Board believed that this activity was functionally similar to the financial advice traditionally offered by banks to their commercial lending customers. The applicant provided evidence revealing that certain major banks perform similar financial-feasibility analysis services for their customers. The Board thus approved the provision of such financial-feasibility studies for corporations. Certain commitments were made to guard against any possible conflicts of interests and related adverse effects between the applicant's credit-extending subsidiaries and the company, acting as an adviser regarding the financial-feasibility studies. Included was the condition that the company's financial advisory activities would not encompass the performance of routine tasks or operations for a customer on a daily or continuous basis.

Upon consideration of the above, the Board also determined the activity of providing valuations of companies, as well as the expert-witness testimony incidental to such valuations, to be permissible. The commercial lending and trust departments of banks commonly make valuations of a broad range of tangible and intangible property, including the securities of closely held companies. The applicant provided evidence that numerous banks compete directly with the company in offering corporate valuations for a fee.

The Board, effective September 10, 1992, added the providing of financial-feasibility studies to the list of nonbanking activities permitted by Regulation Y (see section 225.28(b)(6)(iii)). With the Regulation Y revisions, effective April 1997, the Board specifically determined that feasibility studies do not include assisting management with the planning or marketing for a given project or providing general operational or management advice. The 1992 amendment to this regulation permitted bank holding companies to conduct feasibility studies for high net worth individuals, as well as corporations, and financial and nonfinancial institutions. With the April 1997 amendment, such services could be provided to any person.

3130.3.5.1 Valuation Services

The valuation services included the following activities:

1. the valuation of a company for purposes of acquisitions, mergers, and divestitures
2. tender-offer evaluations
3. advice for management or for a bankruptcy court on the viability and capital adequacy of financially troubled companies and on the fairness of bankruptcy reorganizations
4. valuation opinions on transactions in publicly held securities
5. valuations on the fair market value of employee stock ownership trusts
6. periodic valuation of stock of privately owned companies held in pension or profit-sharing plans, charitable trusts, or venture-capital funds
7. the valuation of a privately owned company or of a large block of publicly owned securities for estate-tax purposes
8. for estate-tax purposes, valuations of a company's common stock and other securities for recapitalization of a privately held company

3130.3.5.2 Utility-Rate Testimony in Support of Utility-Company Valuations

The company frequently provided expert witness testimony on behalf of utility firms in rate cases. The company's personnel were retained to give expert testimony on financial matters such as the cost of capital, economic conditions, and the rate of return expected by investors in utility securities. The Board believed that to a large degree the activity may be considered incidental to the company's general provision of economic information and advice which is permissible under section 225.28(b)(6)(ii) of Regulation Y. Also, banks routinely calculate the cost of capital for customers to advise them regarding financial alternatives.

3130.3.6 EDUCATION-FINANCING ADVISORY SERVICES

Four bank holding companies (collectively, the notificants) gave notice pursuant to section 4(c)(8) of the Bank Holding Company Act (BHC Act) (12 U.S.C. 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) of their intention to each acquire more than 5 percent of a company (the company) that would provide education-financing advisory services.[2] The company would enable state governments to assist parents in financing the higher education of their children.

The company will (1) develop and manage an educational savings and lending program on behalf of the state, (2) design and provide necessary computer software for the program, (3) provide marketing and program materials, and (4) train state personnel to implement the program. The notificants would eventually provide the services to various state governments nationwide.

As part of developing the education savings and lending program, the company would assist in formulating and defining its overall scope; provide the research necessary to begin operations; design the program's operations; and organize the program in cooperation with all interested parties, including coordinating participation among the state authorities. The company would also coordinate key functions of a college-funding program, such as marketing, public relations, training, investment, lending, legal documentation, financial recordkeeping, and ongoing program evaluation. In addition, the company would design, install, and maintain the computer software necessary to implement the program's services. The company's compensation would be based on application fees received by a state educational assistance authority and the amount of investment and loan balances held by the program.

All of the intended services are integrally related to advising and administering student-loan and college-savings programs. Banks offering their own student-loan and college-savings programs engage in many of the planned activities and are uniquely suited to advise and assist other potential providers, including state governments, in structuring and implementing student-loan and college-savings programs.[3] The Board previously concluded that bank holding companies may provide similar advisory and support services to state authorities that are engaged in making student loans.[4] Accordingly,

2. The notificants would have varying ownership interests in excess of 5 percent. Other individual ownership interests of less than 5 percent would be held by various banks and savings institutions located in one state. Each notificant committed that the company would be treated as a subsidiary within the meaning of the BHC Act (12 U.S.C. 1841(d)).
3. See 12 C.F.R. 225.28(b)(1) and (6).
4. See 1985 FRB 725.

based on all the facts of record, the Board concluded that the proposed activities are closely related to banking under section 4(c)(8) of the BHC Act. The Board approved the notice on September 25, 1995 (1995 FRB 1042). Approval of this proposal is specifically conditioned on the notificants' compliance with the commitments made in connection with this notice.

3130.3.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Providing financial-feasibility studies, valuation services, utility-rate testimony, but not "public" credit ratings		225.28(b)(6)(iii)		1985 FRB 118, 120
Financial-feasibility studies for issues of tax-exempt revenue bonds and private corporations				1987 FRB 59
Advice in connection with merger, acquisition/ divestiture, and financing transactions and advice regarding loan syndications, interest-rate swaps, and interest-rate-cap transactions		225.28(b)(6)(iii)		1987 FRB 59
Providing financial advice to the Canadian federal, municipal, and provincial governments, such as with respect to the issuance of their securities in the United States		225.28(b)(6)(iii)		1988 FRB 249 1988 FRB 334
Financial advice to the Japanese national and municipal governments		225.28(b)(6)(iii)		1990 FRB 654
Financial advice to state and local governments		225.28(b)(6)(iii)		1973 FRB 701
Financial advice vs. management consulting				1972 FRB 674, 676
Investment advice pertaining to income-producing real property				1983 FRB 564
Investment advisory activities and joint ventures with securities firms		225.28(b)(6)(iii)		1994 FRB 638
Education-Financing Advisory Services				1995 FRB 1042
Regulation Y revision		62 *Federal Register* 9290 to 9307 (February 28, 1997)		1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

3130.4.1 INFORMATIONAL, STATISTICAL FORECASTING, AND ADVICE ON SUCH TRANSACTIONS AS FOREIGN EXCHANGE, SWAPS, COMMODITIES, AND DERIVATIVES

Providing financial and investment advisory activities may consist of a bank holding company's providing information, statistical forecasting, and advice with respect to any transaction in foreign exchange, swaps, caps, and similar transactions, commodities, and any forward contract, option, future, option on a future, and similar instruments.[1] The Board has found financial advice regarding interest-rate swap and cap transactions to be permissible. The Board has also found that providing advice in connection with currency swaps is permissible,[2] as well as providing advice regarding loan syndications.[3] This section provides an example of a February 16, 1983, Board order permitting a bank holding company to establish a de novo subsidiary to offer certain informational, advisory, and transactional services including the provision of the following:

1. General economic information and statistical forecasting with respect to foreign exchange and money markets through time-sharing networks. The services included the analysis of foreign-exchange and money market trends in the context of economic and political developments and the provision of information with respect to foreign exchange.
2. Advisory services designed to assist customers in monitoring, evaluating, and managing their foreign-exchange exposure, including making recommendations regarding policies and procedures to enhance a customer's ability to identify, measure, and manage financial risks in a multicurrency environment. The newly formed subsidiary would also provide advice on the timing of purchases and sales of foreign exchange in both spot and forward markets.
3. Transactional services with respect to foreign-exchange exposures. The subsidiary would arrange foreign-exchange transactions by an affiliated bank holding company and other commercial banks.

As a condition for approval, the applicants were required to seek the Board's authorization if they engaged in any additional activities within the United States. (See 1983 FRB 221.)

Effective February 6, 1984, the Board amended Regulation Y to allow bank holding companies to offer foreign-exchange advisory and transactional services that include providing general information and statistical forecasting with respect to foreign-exchange markets. The activity included arranging for ''swaps'' among customers with complementary foreign-exchange exposures and the execution of foreign-exchange transactions, provided the activity would be conducted through a separately incorporated subsidiary of the bank holding company that will observe the standards of care and conduct applicable to fiduciaries with respect to its foreign-exchange advisory and transactional services.

3130.4.1.1 Inspection Objectives

1. To determine the financial effect of the activity on the parent BHC and its bank subsidiary (or subsidiaries).
2. To determine that the specific activities provided by the company are permissible.
3. To determine that the company is not exposing itself to conflicts of interest between its own role of recommending foreign-exchange positions to its customers and any role its affiliates may have in executing foreign-exchange transactions.

3130.4.1.2 Inspection Procedures

1. Review the company's financial statements for accuracy, and determine if there are any factors or trends that could have an adverse impact on the parent holding company or the bank subsidiary (or subsidiaries).
2. Review the company's policies and procedures to determine that the following are present:
   a. adequate minutes of the board and board committee meetings
   b. adequate blanket bond coverage
3. Review a sample of recommendations to determine that a reasonable basis exists for the company's recommendations.

1. See 62 Federal Register 9,290 (February 28, 1997) (12 C.F.R. 225.28 (b)(6)) or 1997 FRB 275.
2. See 1989 FRB 308.
3. See 1987 FRB 220.

4. Review the company's fee schedule for providing advice and the fees charged by affiliated banks to conduct foreign-exchange transactions for the company's customers. Determine whether bank subsidiaries are being adequately compensated for executing trades, or whether these profits are accruing largely to the benefit of the bank holding company or its nonbank subsidiaries.
5. Review the company's revenue sources to determine that it has not taken foreign-exchange positions and does not execute foreign-exchange transactions.

3130.4.2 FINANCIAL ADVICE AS TO THE STRUCTURING OF AND ARRANGING FOR LOAN SYNDICATIONS, INTEREST-RATE SWAPS, CAPS, AND SIMILAR TRANSACTIONS

A bank holding company may provide information, statistical forecasting, and advice with respect to any transaction in swaps, caps, and similar transactions; commodities; and any forward contract, option, future, option on a future, and similar instruments.[4] The Board has found financial advice regarding interest-rate swap and cap transactions to be permissible.[5] The Board has also found the provision of advice regarding loan syndications to be permissible.[6]

An example of a Board order regarding providing financial advice is one in which a bank holding company (BHC) applied for the Board's approval to establish its company de novo as a financial advisory firm. The Board had not previously approved the structuring of and arranging for loan syndications (see section 225.25(b)(6)(ii) of Regulation Y) or arranging for interest-rate "swaps" and interest-rate caps, and similar transactions (see section 225.28 (b)(6)(iv) of Regulation Y). Interest-rate caps are contractual agreements wherein the seller of a cap agrees to make payment to the purchaser of a cap if a particular interest-rate index (prime) exceeds a predetermined level, with payments calculated on an assumed principal amount for a deferred time period. The caps and swaps are typically used to manage or hedge outstanding positions in the financial markets.

The Board's authorization included the following conditions:

1. The advice rendered by the company on an explicit fee basis will be rendered without regard to correspondent balances maintained by the customers of the company at any depository institution subsidiary of the BHC.
2. Company's financial advisory activities shall not encompass the performance of routine tasks or operations for a customer on a daily or continuous basis. The Board, on November 28, 1986, approved the activity by order (1987 FRB 59). (See 1990 FRB 756.) The Board subsequently, effective September 10, 1992, added this nonbanking activity to the list of activities permitted by Regulation Y. (See section 225.28(b)(6)(iii) for loan syndications and 225.28(b)(6)(iv) for interest-rate swaps and caps.)

Reference can also be made to another Board order (1991 FRB 184) relating to providing advice on joint ventures, leveraged buyouts, restructurings, recapitalizations, and other corporate transactions (see 225.28 (b)(6)(iii) of Regulation Y), as well as to providing advice regarding the structuring and arranging of swaps, caps, and similar transactions relating to interest rates, currency and exchange rates and prices, and economic and financial indexes (see 225.28(b)(6)(iv) of Regulation Y).

3130.4.3 ADVICE RELATING TO THE STRUCTURING OF AND ARRANGING FOR CURRENCY SWAPS

A foreign bank subject to the BHC Act applied for the Board's approval to acquire a company engaged in certain securities, foreign-exchange, and financial advisory activities. The Board previously determined the activities proposed by the BHC, except for providing advice relating to the structuring of and arranging for currency swaps, to be closely related to banking. As for advice on currency swaps, it was noted that most banks that provide advice relating to interest-rate swaps also provide advice relating to currency swaps. Providing advice as to currency swaps was deemed to be functionally and operationally similar to providing advice relating to the structuring of and arranging for interest-

4. See 62 Federal Register 9,290 (February 28, 1997) (12 C.F.R. 225.28 (b)(6)) or 1997 FRB 275.
5. See 1989 FRB 308.
6. See 1987 FRB 220.

rate swaps. Both transactions have the common objectives of securing low-cost funds and converting one type of risk to another, and both transactions require similar documentation. The Board approved the activity by order on February 13, 1989 (1989 FRB 308). The Board, effective September 10, 1992, added providing advice as to currency swaps to the nonbanking activities permitted by regulation. See section 225.28(b)(iv) of Regulation Y.

3130.4.4 ADVICE WITH RESPECT TO FUTURES CONTRACTS

3130.4.4.1 Limited Advisory Services with Respect to Futures Contracts on Stock Indexes and Options on Such Futures Contracts

The following is an example of a bank holding company that applied to the Board to engage de novo, through a wholly owned subsidiary, in the provision of advisory services with respect to futures contracts on stock indexes and options thereon. The advisory services to be provided consisted of general research and advice on market conditions and hedging strategies, client-account information and reconciliation of trades, and communication linkage between clients and exchange floors in connection with the subsidiary's futures commission merchant activities. The services offered to customers were provided either as part of an integrated package of services or for a separate fee.

The futures advisory services were essentially identical to the advisory services previously approved by the Board by regulation and order with respect to other financially related futures contracts. The Board concluded the applicant's provision of advisory services for futures contracts on stock indexes and for options thereon to be permissible (1987 FRB 220 and section 225.28(b)(6)(iv) of Regulation Y).

Previously, the Board had approved the execution and clearance of futures contracts on stock indexes and options thereon (1985 FRB 251). At that time, however, the Board had not approved a proposal to provide investment advisory services in connection with the execution and clearance of such instruments.

3130.4.4.2 Advice on Certain Futures and Options on Futures

This section is a historical example of a bank holding company that requested the Board's approval to provide de novo investment advice concerning futures and options on futures contracts on foreign exchange, government securities, and bullion and money market instruments. In addition, the company would provide portfolio investment advice, for which applicant had previously received authorization pursuant to Regulation Y (the authorization is currently included in section 225.28(b)(6)(iv)).

Previously, the Board had approved the provision of investment advice as a futures commission merchant (FCM) (section 225.28(b)(7)(iv)(A)) or as a commodity trading adviser (CTA) registered with the Commodity Futures Trading Commission (CFTC). The provision by an FCM or CTA of such advice could include providing counsel, publications, written analyses, and reports relating to the purchase and sale of futures contracts and options on futures contracts that bank holding company futures commission merchant subsidiaries are permitted to execute and clear. Such advisory services could also consist of providing written or oral presentations on the historical relationship between the cash and futures markets or the functions of futures as hedging devices, demonstrating examples of financial futures uses for hedging, and assisting in structuring a hedging strategy for a cash position. FCMs and CTAs are subject to registration with and regulation by the Commodity Futures Trading Commission pursuant to the Commodity Exchange Act, as amended. (7 U.S.C. 1).

Before incorporation of the advisory activity into Regulation Y (see 1986 FRB 369), the Board had determined by order that the provision of futures and options advice by FCMs is permissible and closely related to banking (see 1985 FRB 168 and 111, 1984 FRB 780, and 1984 FRB 369). A CTA could provide such advice even though it is not acting as an FCM.

The issue presented by this latter proposal was whether the conduct of this activity by company would be a proper incident to banking if company, serving as an adviser, did not meet the *former* Regulation Y requirement of registering with the CFTC as a CTA or FCM. The applicant expected to qualify for a statutory exemption (7 U.S.C.6m) from the registration under section 4m of the Commodity Exchange Act. This exemption provides that any person who, during the previous 12 months, has not furnished commodity advisory services to more than 15 persons and has not represented himself or herself to the public as a CTA is exempt from the registration requirements for CTAs under the act. The applicant's proposal permitted company to provide commodity trading advice without those safeguards. The Board held that it expects the adviser to disclose to its customers substantially the same information required for registered CTAs, including the CTA's performance record, conflicts of interest, possible trading risks, and civil and criminal actions against the CTA.

The Board concluded that the possible adverse effects would be further minimized by the following conditions:

1. Company will remain subject to the antifraud provisions of the Commodity Exchange Act as well as other restrictions in the act.
2. The adviser will not trade for its own account (except to hedge), will limit its advice to instruments that banks deal in extensively (foreign exchange, bullion, government securities, and money market instruments), and will only serve customers that are financially sophisticated and have significant dealings or holdings in the underlying commodities or instruments. The Board approved the application by order on October 18, 1988 (1988 FRB 820).

3130.4.5 PROVIDING DISCRETIONARY PORTFOLIO MANAGEMENT SERVICES ON FUTURES AND OPTIONS ON FUTURES ON NONFINANCIAL COMMODITIES

With respect to the Regulation Y provisions effective April 21, 1997, discretionary portfolio management advice is not separately listed in section 225.28(b)(6)(iv). Discretionary investment advice is discussed, however, within the preamble to the final rule. The preamble emphasizes that such advice may be provided to any person (such advice is no longer limited to institutional investors) regarding contracts relating to financial and nonfinancial assets.

Foreign banking organizations (applicants) subject to the BHC Act provided notice to engage through their subsidiary (company) in providing investment advisory services with respect to futures and options on futures on financial and nonfinancial commodities, including discretionary portfolio management services.[7] The Board previously determined that the proposed activities, with the exception of providing discretionary portfolio management services with respect to futures and options on futures on nonfinancial commodities, are closely related to banking.

The Board had permitted bank holding companies to provide investment advice with respect to futures and options on futures on both financial and nonfinancial commodities. (See section 225.28(b)(6)(iv) of Regulation Y.) The Board also previously approved providing discretionary portfolio management services with respect to futures and options on futures on financial commodities. (See 1995 FRB 386.) In addition, the Office of the Comptroller of the Currency permits national banks to engage in discretionary funds management with respect to futures and options on futures on nonfinancial commodities. (See OCC Interpretive Letter No. 494 (December 20, 1989).)

In this regard, applicants committed that company would provide the proposed discretionary portfolio management services only at the request of the customer. Applicants also committed that company would comply with applicable law, including fiduciary principles. In addition, applicants proposed that company exercise its discretionary portfolio management authority only in purchasing and selling exchange-traded futures and options on futures contracts previously approved by the Board. (See SR-93-27.) The Board gave its approval on June 30, 1995 (1995 FRB 803).

3130.4.6 COMBINATION OF PROVIDING ADVICE WITH OTHER NONBANKING ACTIVITIES

3130.4.6.1 Providing Nonfinancial Futures Advice and the Combining of Foreign-Exchange, Government Securities Advisory, and Execution Services

A BHC applicant requested the Board's permission to engage in trading options on foreign exchange and offering investment advice on financial and nonfinancial options and futures contracts, securities, and interest-rate and currency swaps. The applicant applied to provide these advisory services through a partnership, of which it would own 80 percent of its equity.

7. Company does not trade futures or options on futures for its own account or provide futures commission merchant execution or clearance services.

This partnership would provide these advisory services only to the applicant, its affiliates, and the applicant's partner, a commodity trading organization. The partnership would provide execution services only to the applicant and its affiliates, not to the applicant's partner.

The Board had not previously approved the provision of nonfinancial futures advice for bank holding companies. The Board noted that the Office of the Comptroller of the Currency (OCC), by OCC Interpretive Letter 494 (December 20, 1989), determined that a national bank could provide execution, clearing, and advisory services for customer transactions in standardized, exchange-traded ''nonfinancial'' futures contracts and options, such as futures on oil and agricultural products. The OCC determined that the contracts are financial products and that the provision of investment advice was essentially the same as the advice given with respect to financial futures contracts. The OCC contends that investment advice is incidental to the bank's authority to purchase and sell the instruments on behalf of its customers.

The Board has permitted bank holding companies to provide advice with respect to futures and options on futures relating to bank-eligible securities, bullion, and foreign exchange (12 C.F.R. 225.28(b)(6)(iv)). The Board also has permitted bank holding companies to provide investment advice with respect to options and futures contracts based on broad-based indexes of stock and bonds (1990 FRB 770). The Board thus determined that the provision of investment advice with respect to investing in options and futures, based on nonfinancial instruments, to be the functional equivalent of providing advice on options and futures based on financial instruments. In each case, the bank holding company subsidiary is furnishing advice with respect to trading of a financial instrument. The partnership would not provide advice to third parties without Federal Reserve approval. The Board thus approved the providing of investment advice on nonfinancial futures, options, and options on futures.

The applicant also proposed that the partnership provide execution services to the applicant's wholly owned subsidiary and to the applicant's U.S. branches with respect to—

1. over-the-counter options on foreign exchange, U.S. government securities, and other money market instruments, and indexes on such securities and instruments;
2. exchange-traded transactions in futures, options, and options on futures on foreign exchange, U.S. government securities, and other money market instruments, and indexes on such securities and instruments; and
3. spot and forward transactions in foreign exchange.

The Board previously approved the combination of advice and execution for—

1. foreign-exchange transactions (1990 FRB 649),
2. transactions on derivative instruments based on U.S. government securities and other money market instruments (1990 FRB 664), and
3. securities brokerage (1989 FRB 396).

The Board approved by order the providing of the combination of foreign-exchange and government securities advisory and execution services on December 21, 1990 (1991 FRB 126).

For these reasons, the Board approved the providing of discretionary portfolio management services with respect to futures and options on futures on nonfinancial commodities on June 30, 1995. (See 1995 FRB 803).

3130.4.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Provide information and advice on foreign operations and arrange foreign-exchange transactions				1983 FRB 221
Foreign-exchange and advisory and transactional services added to Regulation Y		225.28(b)(6)(iv)		
Financial advice as to the structuring of, and arranging for loan syndications, interest-rate swap, caps, and similar transactions		225.28(b)(6)(iii) and (iv)		1987 FRB 59 1990 FRB 756
Advisory services with respect to futures contracts on stock indexes and options on such futures contracts		225.28(b)(6)(iv)		1987 FRB 220
Providing discretionary portfolio management services on futures and options on futures on nonfinancial commodities		225.28(b)(6)(iv)		1995 FRB 803
Providing nonfinancial futures advice and the combining of foreign-exchange, government securities advisory, and execution services		225.28(b)(6)(iv)		1995 FRB 803
Advice in connection with currency swaps		225.28(b)(6)(iv)		1989 FRB 309

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The financial and investment advisory nonbanking activity of consumer financial counseling may consist of providing advice, educational courses, and instructional materials to individuals on consumer-oriented financial-management matters, including debt consolidation, applying for a mortgage, bankruptcy, budget management, real estate tax shelters, tax planning, retirement and estate planning, insurance, and general investment management. The authority for this advisory activity is currently derived from section 225.28(b)(6)(v) of Regulation Y.

This nonbanking activity was added to the Regulation Y ''laundry list'' in 1986. Previously, the Board authorized the provision of consumer financial counseling services by order. (See 1979 FRB 65, 1979 FRB 265, 1985 FRB 253, and 1985 FRB 662. These references are only historical examples.) A bank holding company may provide information, statistical forecasting, and advice with respect to any transaction in foreign exchange, swaps, caps, and similar transactions, commodities, and any forward contract, option, future, option on a future, and similar instruments.[1] The Board has found financial advice regarding interest-rate swap and cap transactions to be permissible. The Board has also found that providing advice in connection with currency swaps is permissible,[2] as well as providing advice regarding loan syndications.[3] The revised Regulation Y, effective April 1997, deleted restrictions on consumer-counseling services that prohibited bank holding companies from promoting specific products and services, and from obtaining or disclosing confidential customer information without the customer's consent. These restrictions do not apply to banks that engage in the above activities.

Prudent management should take into consideration certain actions to prevent potential conflicts from arising. When considering these orders, the Board was concerned that the provision of consumer financial counseling activities could potentially result in unfair competition, conflicts of interest, and other adverse effects. (See 1979 FRB 267.) Examiners should be alert to problems that may arise from such conflicts as they review this nonbanking activity. Further, the examiner should determine whether counselors, as a general practice, are advising each customer that they are not required to purchase any services from affiliates, and determine whether customers have the option to exclude themselves from service and product offerings provided by affiliates.

1. See 62 *Federal Register* 9,290 (February 28, 1997) (12 C.F.R. 225.28 (b)(6)) or 1997 FRB 275.

2. See 1989 FRB 308.

3. See 1987 FRB 220.

3130.5.1 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Providing financial-management courses, counseling, and related instructional materials				1979 FRB 265
Engaging, through an acquired bank, in consumer financial counseling				1985 FRB 253
Providing consumer financial counseling services as a permissible nonbanking activity		225.28(b)(6)(v)		1986 FRB 833 1985 FRB 662

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Financial and investment advisory services include tax-planning and tax-preparation services. Tax planning involves providing advice and strategies designed to minimize tax liabilities. For individuals, this includes analysis of the tax implications of retirement plans, estate planning, and family trusts; for corporations, it includes analysis of the tax implications of mergers and acquisitions, the portfolio mix, specific investments, previous tax payments, and year-end tax planning. Tax preparation involves the preparation of tax forms and advice concerning liability based on records and receipts supplied by the client. This nonbanking activity was included in the Regulation Y ‘‘laundry list’’ in 1986. (See section 225.28(b)(6)(vi).) Such services may be provided to any person. Effective April 21, 1997, certain restrictions were removed. These Regulation Y revisions deleted restrictions in the area of tax-planning and tax-preparation services that prohibited bank holding companies from promoting specific products or services and from obtaining or disclosing confidential customer information without the customer's consent. These restrictions do not apply to banks. This fact needs to be considered when referring to the historical examples that follow.

The Board had previously approved, by order (1985 FRB 168), the activity of tax-preparation services for individuals. Since tax-preparation services for corporations is functionally or operationally similar to the tax-preparation services that banks already provide to individuals as well as to their affiliates and other financial institutions, the Board approved the providing of corporate tax-preparation services. When the nonbanking activity was incorporated into Regulation Y in 1986, tax-planning and tax-preparation services were authorized, not only for individuals and corporations, but for noncorporate businesses, such as partnerships and sole proprietorships and tax-exempt nonprofit organizations. Tax-planning and tax-preparation services must be conducted in accordance with applicable jurisdictional law.

3130.6.1 INSPECTION OBJECTIVES

1. To ascertain whether the customer has the option to be excluded from promotions of other specific products and services.
2. To determine what financial effect the activity has on the parent company and its subsidiaries.
3. To determine whether the company has formal written policies and procedures to ensure accurate, timely, and confidential preparation and maintenance of customers' tax returns.
4. To determine whether the tax-return preparers are appropriately qualified to provide such tax services, and to determine the extent of management's involvement in the activity.
6. To identify the potential and extent of off-balance-sheet risk associated with the activity.

3130.6.2 INSPECTION PROCEDURES

1. Review the company's financial statements for accuracy, and determine if there are any factors or trends that could have an adverse impact on the parent company or the bank subsidiaries.
2. Determine whether bonding and other insurance coverage is adequate in relation to the risks associated with the activity.
3. Review pertinent contracts, client lists, public advertising and information, correspondence, and other documentation representing the services provided, and determine if charges for the tax-preparation service are on an explicit fee basis that is not dependent on the amount of tax savings achieved.
4. Determine if the client has a written legal opinion on file certifying that the activity is not considered the practice of law.
5. Review pertinent correspondence and the minutes of board of directors and board committee meetings, and determine if any significant law suits, Internal Revenue Service adverse actions, or other potential or contingency losses are pending and probable because of inaccurate tax-return preparation. Analyze their probable effect in relation to the financial condition of the company.
6. Review the company's formal written policies and procedures for assurance of professional competence in providing sound tax-planning advice and the accurate, timely, and confidential preparation and maintenance of customer's tax returns. The policies and procedures should require that tax-planning advice be clearly communicated by persons who are adequately supervised and who possess the necessary professional technical training and experience needed to provide tax-planning advice.

3130.6.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Preparation of tax returns in a non-fiduciary capacity is closely related to banking				1985 FRB 168
Permissible nonbanking activity		225.28(b)(6)(vi)		1986 FRB 833

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

3140.0.1 LEASING AUTHORIZATIONS WITHIN REGULATION Y

Leasing is a form of financing which provides a lessee (the customer) the right to use land or depreciable assets without tying up working capital, and provides the lessor (the owner of the property) with a generally higher rate of return than just lending as a result of the tax benefits that can arise from the ownership of the equipment, real property, or tangible personal property. In 1971, ''leasing personal property or acting as agent, broker, or adviser in leasing such property'' was added to the list of permissible nonbanking activities for bank holding companies under Regulation Y. In 1974, the authority to engage in this activity was expanded to include leasing of real property.

In 1997, restrictions on leasing activities were removed to permit greater flexibility to acquire leaseable property in quantity and to sell or re-lease property upon the lease's expiration. Removed restrictions consisted of the maximum lease term, maximum holding period for leased property, limit on acquisitions of property to specific leasing transactions, restriction on leases to those that served as the functional equivalent of extensions of credit, and 100 percent limit on the amount of reliance that could be placed on the value of leased property. Added clarifications consisted of more details on the requirements for a nonoperating lease, particularly those for automobile rentals.

3140.0.2 PERMISSIBLE LEASING ACTIVITIES

Two types of leasing activities are permissible for bank holding companies: full-payout leasing and high residual value leasing. A *full payout lease* is the functional equivalent of an extension of credit that relies primarily on rental payments and tax benefits to recover the cost of the leased property and related financing costs. *High residual value leasing* may involve significant reliance on the expected residual value of the leased property—on average, under 50 percent. However, this value can extend up to the full original cost of the property (that is, to recover the full acquisition cost of the leased property plus related financing costs).

When leasing personal or real property, or acting as agent, broker, or advisor, only those leasing transactions meeting the following criteria are considered permissible:

1. The lease must be on a nonoperating basis.
2. The initial lease term must be at least 90 days.
3. For leasing involving real property—
   a. at the inception of the initial lease, the effect of the transaction must yield a return that will compensate the bank holding company, as lessor, for its full investment in the property plus the estimated total cost of financing the property over the term of the lease (This includes rental payments, estimated tax benefits, and the estimated residual value of the property at the expiration of the initial lease.) and
   b. the estimated residual value (yield) of the property at the expiration of the initial term of the lease may not exceed 25 percent of the acquisition cost of the property to the bank holding company (lessor).

With respect to leasing personal or real property on a nonoperating basis, this means that the bank holding company or its subsidiary may not engage in operating, servicing, maintaining, or repairing leased property during the lease term. A bank holding company, however, can arrange for a third party to provide the services or products.

As for automobiles, this means that a bank holding company may not (1) provide servicing, repair, or maintenance of the leased vehicle during the lease term; (2) purchase parts and accessories either in bulk or for an individual vehicle after its delivery to the lessee; (3) provide the loan of an automobile during the vehicle's servicing; (4) purchase insurance for the lessee; or (5) provide for the renewal of the vehicle's license (registration) without authorization from the lessor.

3140.0.3 ACCOUNTING FOR LEASES

Leasing has become a prominent financing vehicle. Lessors have employed a number of different methods in structuring and accounting for leases. Statement No. 13 of the Financial Accounting Standards Board (FASB),[1] ''Account-

1. Other FASB releases dealing with leasing are FASB Statements 22, 23, 27, 28, 29, 76, 77, 92, 94, 98, and 109; FASB Interpretations 19, 21, 23, 24, 26, and 27; and FASB Technical Bulletins 79-10, 79-12, 79-13, 79-14, 79-15, 79-16, 85-3, 86-2, and 88-1.

ing for Leases,'' has become the uniform standard in accounting for leases.

The accounting for leases must be viewed from the perspective of the parties involved in the leasing transaction, the lessee and the lessor. Negotiations and closing costs incurred with respect to the lease should be written off over the life of the lease.

In applying FASB Statement No. 13, certain terminology is used. Basic terms that should be considered are described below.

Inception of a lease. The inception of a lease refers to the date the lease contract was signed or the date that the construction was completed, or if earlier, the date of the written commitment stating the significant terms.

Term of the lease. The lease term consists of the noncancelable term and the period comprising the bargain renewal option.

Fair value of lease property. The fair value of a lease consists of the price that the property could be sold in an arms-length transaction.

Economic life of the leased property. The economic life of the leased property represents the period over which the property is expected to be economically beneficial to one or more users for its intended purpose.

Estimated residual value of the leased property (ERV). The residual value is the estimated fair value of the leased property at the expiration of the lease term.

Interest rate implicit in the lease. The implicit interest rate is the discount rate that causes the sum of the minimum lease payments and the unguaranteed residual value at the end of the lease term to be equal to the fair value of the property at the beginning of the lease term.

Lessee's incremental borrowing rate. The incremental borrowing rate is the interest rate at which the lessee could borrow the funds to purchase the leased property.

3140.0.3.1 Accounting for Leases by a Lessee

There are two methods for accounting for leasing transactions by a lessee. These are the operating method and the capitalized lease method.

3140.0.3.1.1 Operating Method of Accounting for Leases

The operating accounting method merely records the cost of the rental payments as an expense when it is required to be paid in accordance with the terms of the lease agreement.

Example: Assume that equipment is leased for $100,000 per year for three years. Under this method, the annual cost would be recorded as a rental expense on the Income Statement:

Dr. Rent	$100,000	
Cr. Cash		$100,000

To record an annual payment of rent based on an operating lease agreement.

3140.0.3.1.2 Capitalized Lease Method of Accounting for Leases

3140.0.3.1.2.1 When a Lessee Is to Use the Capitalized Lease Method

If *any one* of the following conditions exist, the lessee must capitalize the lease:

1. The asset is owned by the lessee at the end of the lease term.

*2. The lease term is equal to or more than 75 percent of the estimated economic life of the asset.

3. The lessee can purchase the asset below its fair market value before or at the end of the lease term (bargain purchase option).
*4. The present value of the minimum lease payments at the beginning of the least term is equal to or more than 90 percent of the fair market value of the property.

*If the lease begins in the remaining 25 percent of the asset's estimated economic life, these items do not apply; such leases are considered operating leases.

Using this method, the lease is recorded as an asset at the lesser of the present value of the rental and other minimum lease payments or the fair value of the leased property as though the lease obligation was being purchased on credit. The payment made is treated as a payment made on an installment debt. At the same time, the asset is being amortized over the lease term. The lease obligation is treated as a long-term debt. The discount rate that is used to capitalize the lease is the lessee's incremental borrowing rate or the interest rate implicit in the lease agreement.

Example #1: This example illustrates the capitalized lease method using the same example as above with the added fact that the lease agreement contains an interest rate of 10 percent. Assume that the interest rate of the lease agreement is the same as the lessee's marginal borrowing rate.

Dr. Capitalized Lease	$248,685	
Cr. Lease Obligation		$248,685

To record an equipment lease obligation under a capitalized lease agreement.

(Present value of $100,000 per year for three years at a 10 percent interest rate)

1st Year

Interest Expense	$ 24,869	
Lease Obligation	75,131	
Cash		$100,000

To record the first year's payment on an equipment lease obligation.

($248,685 × .10 = $24,869)

Dr. Equipment Lease Amortization	$ 82,895	
Cr. Capitalized Lease		$ 82,895

To record the annual amortization of a capitalized equipment lease.

($248,685/3 years)

2nd Year

Dr. Interest Expense	$ 17,355	
Dr. Lease Obligation	82,645	
Cr. Cash		$100,000

To record the second annual lease payment under a three-year capitalized lease agreement.

(Interest = $248,685 + 24,869 – $100,000 = $173,554 × .10 = $17,355)

Dr. Lease Amortization	$ 82,895	
Cr. Capitalized Lease		$ 82,895

To record the second year's lease amortization under a three-year capitalized lease.

3rd Year

Dr. Interest Expense	$ 9,091	
Dr. Lease Obligation	90,909	
Cr. Cash		$100,000

To record the third year's lease payment under a three-year capitalized lease obligation.

(Interest = $173,554 + $17,355 = $190,909 – $100,000 = $90,909 × .10 = $9,091)

The financial statements are to include footnotes that disclose the present value of noncancelable lease commitments where the lessor either recovers more than 75 percent of the economic life of the asset leased or the investment plus a reasonable return.

3140.0.3.2 Accounting for Leases by a Lessor

3140.0.3.2.1 Operating Lease (Lessor)

A lessor would have the following accounting entries for an operating lease:

Dr. Cash	$xxx,xxx	
Cr. Rent Income on Leased Assets[2]		$xxx,xxx
Dr. Depreciation Expense	$xxx,xxx	
Cr. Accumulated Depreciation—Leased Assets		$xxx,xxx

In order for the *lessor* to be able to capitalize a direct financing lease, any one of the same four criteria for a lessee must apply along with two additional criteria:

2. Any rent received in advance would be initially credited to "unearned rent revenue."

1. Collectibility of the minimum lease payments must be reasonably predictable.
2. No important uncertainties exist as the amount of unreimbursable costs incurred.

In accounting for the lessor's capitalized lease transactions, there are some common accounts that are used. These are described below.

Unearned income from lease financing receivables. Unearned income represents the unearned interest liability account that is netted against the total of lease payments receivable which includes the estimated residual value for balance-sheet presentation. It represents the ''interest'' income equal to the excess of rentals receivable over the fair value of the property at the inception of the lease.

Lease financing receivables. This asset account is established in the amount of total lease payments to be received from the lessee. The amount by which the rentals receivable exceeds the cost of the property is the functional equivalent of interest and represents a portion of the income to be recognized over the life of the lease. In the example below, the cost of the property is temporarily charged to a fixed asset account, then transferred to lease payments receivable.

Throughout the lease term, the rentals receivable account is periodically reduced by the full amount of each rental payment received.

3140.0.3.2.2 Direct Financing Capitalized Lease

In this situation, a finance company purchases equipment from a manufacturer (recorded as equipment [asset] when purchased). The finance company (lease financing nonbanking subsidiary) then leases that equipment and records it as a normal financing lease. There is *no* dealer profit from the sale of the asset. Unearned interest income is recognized over the life of the lease using the effective interest method. Since the lessor has ''sold'' the asset, no depreciation is recorded.

Example #1: Lease with No Guaranteed Residual Value by the Lessee

Assume that the finance company purchases equipment costing $100,000. It then leases the equipment to a lessee under a five-year lease agreement that requires annual payments of $25,000 per year. At the end of the lease term, the lessee will own the equipment. The implied interest rate is 7.931 percent (comparison of the present value of the equipment of $100,000 against the $25,000 annual payment for five years).

Dr. Equipment	$100,000	
Cr. Cash		$100,000

To record the purchase of equipment to be leased

Dr. Lease Financing Receivables	$125,000	
Cr. Equipment		$100,000
Cr. Unearned Income from Lease Financing Receivables		25,000

To record the initial lease

Year 1

Dr. Cash	$ 25,000	
Cr. Lease Financing Receivables		$ 25,000
Dr. Unearned Income from Lease Financing Receivables	$ 7,931	
Cr. Income from Lease Financing Receivables		7,931

To record the receipt of the first equipment lease payment.

Lease Payments Receivable	$125,000
Unearned Interest Revenue	–25,000
	$100,000 × .07931 = $7,931

Year 2

Dr. Cash	$ 25,000	
Cr. Lease Financing Receivables		$ 25,000
Dr. Unearned Income from Lease Financing Receivables	$ 6,577	
Cr. Income from Lease Financing Receivables		$ 6,577

To record the receipt of the second equipment lease payment.

Lease Payments Receivable	$100,000	
Unearned Interest	–17,069	($25,000 – 7,931)
(Present Value of Remaining Receivable	$ 82,931)	× .07931 = $6,577

Year 3

Dr. Cash	$ 25,000	
Cr. Lease Financing Receivables		$ 25,000
Dr. Unearned Income from Lease Financing Receivables	$ 5,116	
Cr. Income from Lease Financing Receivables		$ 5,116

To record the receipt of the third equipment lease payment.

Lease Payments Receivable	$ 75,000	
Unearned Interest	–10,492	($17,069 – $6,577)
(Present Value of Remaining Receivable	$ 64,508)	× .07931 = $5,116

Year 4

Dr. Cash	$ 25,000	
Cr. Lease Financing Receivables		$25,000
Dr. Unearned Income from Lease Financing Receivables	$ 3,539	
Cr. Income from Lease Financing Receivables		$ 3,539

To record the receipt of the fourth equipment lease payment.

Lease Payments Receivable	$ 50,000	
Unearned Interest	–5,376	($10,492 – $5,116)
(Present Value of Remaining Receivable	$ 44,624)	× .07931 = $3,539

Year 5

Dr. Cash	$ 25,000	
Cr. Leases Financing Receivables		$ 25,000
Dr. Unearned Income from Lease Financing Receivables	$ 1,837	
Cr. Income from Lease Financing Receivables		$ 1,837

To record the receipt of the fifth equipment lease payment.

Lease Payments Receivable	$ 25,000	
Unearned Interest	–1,837	($5,376 – $3,539)
(Present Value of Remaining Receivable	$ 23,163)	× .07931 = $1,837

Example #2: Lease with a Residual Value (Guaranteed by the Lessee)

A lessor acquires property to be leased for $14,000 (its fair value at the inception of the lease). The estimated economic life of the property is five years. The lease has a noncancelable lease term of four years with a rental payment due of $3,649 at the end of each year. The lessee guarantees the residual value at the end of the four-year lease term in the amount of $4,000. The lessor's implied rate of interest in the lease is 10.8695 percent. The present value of the minimum lease payments at this interest rate and monthly payments exceeds 90 percent of the fair value of the property at the inception of the lease (.90 × $14,000 = $12,600).

Year 1

January 1, 19x1

Dr. Equipment	$ 14,000	
Cash		$ 14,000

To record purchase of equipment for the purpose of a financing lease.

Dr. Lease Financing Receivables	$ 18,596	
Cr. Equipment		$ 14,000
Cr. Unearned Income from Lease Financing Receivables		4,596

To record investment in direct-financing lease

December 31, 19x1

Dr. Unearned Income from Lease Financing Receivables	$ 1,521	
Cr. Income from Lease Financing Receivables		$ 1,521

To recognize the portion of unearned income that is earned at the end of the first year of investment.

(Fair value of property at inception of the lease of $14,000 × 10.8695% = $1,521)

Dr. Cash	$ 3,649	
Cr. Lease Financing Receivables		$ 3,649

To record receipt of the first year's rental

Year 2

Dr. Unearned Income from Lease Financing Receivables	$ 1,290	
Cr. Interest Income from Lease Financing Receivables		$ 1,290

To recognize the portion of unearned income that is earned at the end of the second year of investment

($14,000 + 1,521 – 3,649 = $11,872 × 10.8695% = $1,290)

Dr. Cash	$ 3,649	
Cr. Lease Financing Receivables		$ 3,649

To record the receipt of the second year's rental

Year 3

Dr. Unearned Income from Lease Financing Receivables	$ 1,034	
Cr. Income from Lease Financing Receivables		$ 1,034

($11,872 + 1,290 – 3,649 = $9,513 × 10.8695% = $1,034)

To recognize the portion of unearned income that is earned at the end of the third year of investment

Dr. Cash	$ 3,649	
Cr. Lease Financing Receivables		$ 3,649

To record the receipt of the third year's rental.

Year 4

Dr. Unearned Income from Lease Financing Receivables	$ 751	
Cr. Income Lease Financing Receivables		$ 751

To recognize the portion of unearned income that is earned at the end of the fourth year of investment.

($9,513 + 1,034 – $3,649 = $6,898 × 10.8695% = $751)

Dr. Cash	$ 3,649	
Cr. Lease Financing Receivable		$ 3,649

To record the receipt of the fourth year's rental.

Dr. Cash	$4,000	
Cr. Lease Financing Receivables		$ 4,000

To record the receipt of the lessor's guaranteed residual value (guaranteed by the lessee) at the end of the lease term.

($6,898 + 751 – $3,649 = $4,000)

3140.0.3.2.3 Balance-Sheet Presentation

The lease payments receivable would be reported on the balance sheet as a single amount "net investment" (Lease Financing Receivables less the balance of the Unearned Income from Lease Financing Receivables). If the lessor has established an allowance for possible lease losses, this amount is shown separately as a deduction from the net investment. The net investment in the direct financing lease is $18,000 for example #2 above. It consists of the gross investment of $18,596 ($3,649 × 4 annual rental payments) plus the $4,000 residual value less the unearned income of $4,596.

3140.0.3.2.4 Classification

If it is deemed appropriate to classify a lease, the amount to be classified (in example #2 above) would be the net investment. For illustration, assume that two of the four payments had been received on the lease, that income has been recognized monthly according to the effective interest rate method, and that the lease is now considered a loss. Further assume that the third payment should have been received eight months ago. It is determined during the inspection that the lease should be classified as doubtful of collection. The balance to be classified is the net investment of $7,728. This consists of the balance of Lease Financings Receivable of $9,513 (includes the $4,000 estimated guaranteed residual value) less the balance of Unearned Income from Lease Financings Receivable of $1,785 ($1,034 + $751 = amount due on regular payment intervals) or a net investment of $7,728.

3140.0.3.2.5 Delinquency

It is considered appropriate to state in the inspection report the percentage of delinquency in the lease portfolio. The percentage is calculated by deviding the aggregate rentals receivable on delinquent leases (less unearned income on the delinquent leases) by the total of rentals receivable on all leases (less their unearned income). Estimated realizable values would not be included in the delinquent amounts unless they were guaranteed by the lessee.

3140.0.4 LEVERAGED LEASES

The lessor can ‘‘leverage’’ a lease transaction by borrowing a substantial portion of the acquisition cost from a long-term lender, with the rentals and the property pledged as collateral for the loan. The lessor borrows in order to finance a leasing transaction with a small, or perhaps, a negative equity in the property to be leased.

The initial step in accounting for this type of lease involves calculating the cash flows over the term of the lease. The cash flows include the income tax effects of tax deductions to the lessor, the lessor’s initial investment in the property, the rental receipts net of debt service, and the proceeds expected to be received from the sale of any residual. The next step in accounting for a leverage lease involves determining the applied interest rate that, when applied to the net investment in the years that the net investment will be positive, would precisely allocate the net income to the positive years. See appendix E of SFAS 13 for an example as to how to account for a leveraged lease.

3140.0.5 INSPECTION OBJECTIVES

1. To determine the effect of the investment in the leasing subsidiary upon consolidated operations, and indirectly upon the bank subsidiaries’ safety and soundness.
2. To determine if the company is operating in compliance with applicable laws and regulations, and to ensure that corrective action is initiated if warranted.
3. To determine if policies, procedures, and controls are adequate to protect the company from mismanagement, unnecessary risk, and loss.
4. To assess the management’s ability to operate the company in a safe and sound manner.
5. To determine that accounting practices do not overstate income.

3140.0.6 INSPECTION PROCEDURES

The decision whether the operations of a leasing subsidiary will be inspected ‘‘on-site’’ is based on the availability and adequacy of leasing company data at the offices of the parent company. Item 1 below provides a listing of information necessary to the inspection process. If this and any other information necessary to assess the overall condition of the subsidiary is available at the parent’s office or can be obtained through a written request to the subsidiary, an on-site inspection may not be necessary. The inspection frequency requirements, found in section 5000.0.4, should be reviewed in making such a determination.

1. The following information should be available at the start of the inspection:
   a. trial balance of all leases and outstanding credits,
   b. listing of accounts on which payments are delinquent 30 days or more, or on which payments are otherwise not being made according to schedule,
   c. comparative interim and fiscal financial statements of the leasing company,
   d. listing of unbooked assets and contingent liabilities,
   e. cash-flow projections for the current fiscal year and the next fiscal year,
   f. listing of available lines of credit,
   g. copies of the most recent internal and external audit reports, and
   h. minutes of board and executive committee meetings since the date of the previous inspection.
2. Establish a ‘‘credit line’’ above which all leases will be reviewed. The line can be set at an amount that will cause a certain percentage of the dollar volume of the lease portfolio to be reviewed (e.g., between 70 percent and 80 percent), or at an amount that will cause the review of each lease exceeding a certain percentage of gross capital. Leases on which payments are delinquent are to be reviewed regardless of amount.
3. Analyze the creditworthiness of the lessees. Consideration is given to the figures derived from the lessee’s financial statements, as well as cash flow, trends and projections of growth in sales and income, and the qualifications of management.

   Delinquency on a lease obligation is potentially more serious than delinquency on a conventional loan. If the property under lease is necessary for the lessee’s continued production of income, as is frequently the case, the lessee’s financial condition will be seriously deteriorated before the lessee is willing to risk losing the property by default.
4. For those leases which might result in loss to the lessor, or for which financial information was not adequate to make such a determination, transcribe the following information to line sheets:
   a. name and line of business of lessee

b. name of guarantor(s)
c. original date of the lease contract
d. original amount of the rentals receivable
e. ERV of the property
g. book value of the investment in the lease as of the inspection date
h. cost of the property
i. description and location of the property
j. amount and frequency of rental payments
k. original amount, term, rate, and schedule of amortization of any nonrecourse debt associated with the lease
l. lessor's percentage of equity participation in the lease obligation, if applicable
m. summary financial data indicating the creditworthiness of the lessee, and guarantors, if applicable

5. Before the conclusion of the inspection, discuss with management all classified leases. Inadequate or negative cash flow and unfavorable trends reflected in financial statements of the lessee are usually indicative of a substandard lease. Leases classified doubtful typically include those on which payments are delinquent for an extended period and those on which the lessor's recovery of investment is dependent upon an event of unknown probability, such as a pending lawsuit or insurance claim.

   A loss classification results from the lessee's inability or refusal to continue making payments.
6. Prepare a write-up to support the classifications. The write-up should include the lessee's type of business, present financial status, circumstances which led to the classification, the probability that the terms of the lease can be met, and the amount of protection afforded by sale or re-lease of the underlying property.
7. Review a sample of the lessor's computations of lease yields to determine whether the lessor will recover not less than the full investment in the property plus the estimated total cost of financing the property over the term of the lease. This includes rental payments, estimated tax benefits, and the estimated residual value of the property at the expiration of the initial lease.

   With respect to the full-payout lease, governmental entities may be prohibited from entering into leases for periods exceeding one year. In that case, the bank holding company or its subsidiary (as lessor) should demonstrate that the lease is expected to be continually renewed until the cost is fully recovered.
8. Ascertain whether title to the property rests with the lessor, and that the lessor has taken steps to protect its ownership rights. Evidence of filing under the Uniform Commercial Code, where appropriate, should be found in the documentation file. Aircraft should be registered with the FAA, interstate vehicles with the ICC, and ships with the Coast Guard.
9. Check for cancellation or other provisions in the contract which could jeopardize the full-payout status of the lease. There is no need to take exception to a cancellation provision which provides for payment by the lessee of an amount which allows the lessor to recover fully its investment in the property.
10. Check that insurance coverage is effective on leased property and is provided by the lessee in compliance with all insurance provisions of the contract in an amount sufficient to protect against loss from property damage. Public liability insurance should also be provided to protect against loss from lawsuits which could arise from situations such as the crash of leased aircraft.
11. Review the lessee's duties under the contract with respect to repairs and taxes. Determine whether the lessor has instituted procedures to check that the lessee's required duties are being performed.
12. Review the status of all property acquired for lease purposes but which is not now under lease. Determine the reason for the "off-lease" status of the property, ascertain the realizable value of the property, and investigate whether the off-lease property will be sold or re-leased within the required two-year period.
13. Investigate the lessor's procedures for periodic review of the reasonableness of the estimated residual value. The estimate should be reviewed at least annually and reduced in amount on the books if the value has declined on a presumably permanent basis.
14. Review past operations of the lease company to determine if projections of income and ERV have been realistic in light of actual experience.
15. Review the minutes of the meetings of the board and executive committees to determine whether purchases of property and delinquent leases are reported to the board.
16. Determine if the company has entered into leases with companies owned or controlled by any director, officer, or 10 percent share-

holder of the leasing company or holding company. Compare the rates and terms on such leases to the rates and terms offered on leases to companies of similar credit standing.

17. Check for lease concentrations to any one lessee or industry and prepare a comment for the inspection report if any concentration is considered unwarranted.
18. Determine whether the company has established limits for the maximum amount of ''credit'' to be extended to a single lessee. If such limits have been established, investigate whether the company adheres to them. If they have not been established, inquire as to the company's policy on this matter.
19. Provide the examiner-in-charge with information to be included in the inspection report, including:
    a. scope of the inspection (on- or off-premises)
    b. comments concerning any policies or conditions having an adverse effect on the leasing company or parent company
    c. brief history of the company and a description of its activities
    d. summary analysis of financial factors of the company, including trends in the volume and classification of receivables, adequacy of capital and reserves, return on assets, and contribution to consolidated income and consolidated assets
    e. statutory authority under which the company operates
    f. details of all borrowings of the company from within the holding company system and from external sources
    g. details of any litigation in which the company is a defendant
    h. scope and frequency of audit of the company by both internal and external auditors
20. Compare current earnings performance and balance-sheet ratios of the company with past performance and industry composites.
21. Determine whether cash flows of the company are adequate to service all debts.
22. Assess the adequacy of internal controls over the company's operations.
23. Check for action taken on matters criticized in the most recent audit reports and the previous inspection report. Determine if leases classified ''loss'' were removed from the books.
24. Investigate whether any affiliated banks maintain compensating balances for lines of credit of the leasing company, and if so, whether the leasing company compensates the bank for maintenance of the balances. If ''loss'' leases have not been removed from the books, discuss with management the reasons why the charge-offs were not made. Determine whether the financial statements and reports submitted to the Board of Governors were misstated as a result of the ''no charge-off'' decision.
25. For higher residual value leasing, determine that—
    a. the residual values have been estimated accurately;
    b. residual values are reviewed and adjusted annually;
    c. the initial terms of the lease are at least 90 days;
    d. the lessor relies on a residual value of the leased property that will recoup the acquisition cost of the property and any related financing or other associated costs;
    e. the aggregate book value of all tangible personal property held for such a lease, having an estimated residual value in excess of 25 percent of the acquisition cost of the property, does not exceed 10 percent of the BHC's consolidated domestic and foreign assets;
    f. the BHC maintains separately identifiable records of the leasing transactions and activities; and
    g. each company maintains capitalization fully adequate to meet its obligations and support its activities, and that its capital levels are commensurate with industry standards for companies engaged in comparable leasing activities.

3140.0.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Automobile leasing				1976 FRB 930
Consumer leasing	15 U.S.C. 1667			
Higher residual value leasing				1991 FRB 490,187 1990 FRB 462, 960
Personal or real property leasing activities of bank holding companies		225.28(b)(3)		
Special-purpose leasing corporation			3–712	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

The Board considers the making of equity and debt investments in corporations or projects designed ‘‘primarily to promote’’ community welfare as an activity closely related to banking. The Board includes such investments in the list of permissible nonbanking activities in Regulation Y; however, bank holding companies must obtain prior approval to engage in these activities. The Board, effective April 21, 1997, included the provision of advisory and related services for programs designed primarily to promote community welfare into Regulation Y. Such advisory activities had previously been permitted only by Board order. For examples of advisory services approved for community development projects, see 1990 FRB 671, 1989 FRB 576, and 1988 FRB 140.

3150.0.1 INVESTMENTS IN CORPORATIONS OR PROJECTS TO PROMOTE COMMUNITY WELFARE—BOARD INTERPRETATION

The Board also provides guidance with regard to investments in community welfare projects through its interpretation (see section 225.127 of Regulation Y (12 C.F.R. 225.127)). This interpretation describes projects that the Board has considered as promoting community welfare as their primary intent. These include but are not limited to—

1. projects to construct or rehabilitate housing for low- or moderate-income persons,
2. projects for construction or rehabilitation of ancillary local commercial facilities necessary to provide goods or services principally to persons residing in low- or moderate-income housing, and
3. projects designed explicitly to create improved job opportunities for low- or moderate-income groups.

Because the Board believes that bank holding companies should take an active role in the quest for solutions to the nation’s social problems, it has not defined other types of investments designed primarily to promote the community welfare in order to give bank holding companies greater flexibility in developing new and creative approaches to resolving community problems. Accordingly, the Board has maintained the flexibility to determine whether an activity is primarily designed to promote the community welfare. Factors that the Board might consider include whether the activity benefits low- and moderate-income individuals in areas such as housing and employment and the need for specialized community development activities in different localities. The Board will consider a range of different activities, but will probably not approve a proposal that does not in some way either benefit low- or moderate-income individuals or benefit the specialized needs of local communities.

Once a bank holding company has obtained Board approval to engage in community development activities pursuant to Regulation Y, the holding company may, without further System approval, engage either directly or through a subsidiary in certain community development activities, so long as such activities do not exceed 5 percent of the bank holding company’s total consolidated capital stock and surplus.

A bank holding company may invest and provide financing—

1. to a corporation or project or class of corporations or projects that the Board previously has determined is a public welfare project pursuant to paragraph 23 of section 9 of the Federal Reserve Act (12 U.S.C. 338a);
2. to a corporation or project that the Office of the Comptroller of the Currency previously has determined, by order or regulation, is a public welfare investment pursuant to section 5136 of the Revised Statutes (12 U.S.C. 24 (Eleventh));
3. to a community development financial institution (other than a bank or bank holding company) pursuant to section 103(5) of the Community Development Banking and Financial Institutions Act of 1994 (12 U.S.C. 4702(5));
4. for the development, rehabilitation, management, sale, and rental of residential property if a majority of the units will be occupied by low- and moderate-income persons or if the property is a ‘‘qualified low-income building’’ as defined in section 42(c)(2) of the Internal Revenue Code (26 U.S.C. 42(c)(2));
5. for the development, rehabilitation, management, sale, and rental of nonresidential real property or other assets located in a low- or moderate-income area provided the property

is used primarily for low- and moderate-income persons;
6. to one or more small businesses located in a low- or moderate-income area to stimulate economic development;
7. for the development of, and to otherwise assist with, job training or placement facilities or to foster programs designed primarily for low- and moderate-income persons;
8. to an entity located in a low- or moderate-income area if that entity creates long-term employment opportunities, a majority of which (based on full-time equivalent positions) will be held by low- and moderate-income persons; and
9. for providing technical assistance, credit counseling, research, and program development assistance to low- and moderate-income persons, small businesses, or nonprofit corporations to help achieve community development.

3150.0.2 EXAMPLES OF BOARD-APPROVED ACTIVITIES DESIGNED TO PROMOTE COMMUNITY WELFARE

With its primary thrust to promote community welfare rather than creating a focus on a collateral effect, economic rehabilitation and development should focus on providing housing, services, or jobs for low- or moderate-income residents or groups. Examples of projects previously approved by the Board include an investment in—

1. an agricultural test farm (testing crops, equipment, alternative farming methods and chemicals, and providing student agricultural research opportunities and financial planning workshops for farmers (see 1990 FRB 671);
2. an entity that provides education to young persons (see 1991 FRB 70) through a nonprofit, tax-exempt bank holding company (educational programs consisted of the American economic system, how to start a business, college financial planning, and career opportunities in banking);
3. the acquisition and redevelopment of a sole medical clinic in a small rural town without public transportation that was located 30 miles from another facility and was needed to attract new physicians to replace those retiring (see 1991 FRB 63); and
4. a limited partnership to develop a nearly vacant office building into a hotel complex within a major city, located adjacent to a public housing project. Commitments included providing training to welfare recipients residing in public housing projects and employing low- and moderate-income individuals at the hotel complex, and donating a portion of the profits to a nonprofit corporation designated to provide low-cost housing, employment, and business opportunities for disadvantaged residents. (See 1996 FRB 679.)

3150.0.3 EXAMPLES OF INVESTMENTS VIEWED AS NOT PROMOTING COMMUNITY WELFARE

The Board has indicated that some investments are not designed primarily to promote community welfare unless there is substantial evidence to the contrary, even though the investment may benefit the community to some extent. Examples include investments to build or rehabilitate high-income housing or commercial, office, or industrial facilities which are not designed explicitly to create job opportunities for low-income persons, even though the investment may benefit the community to some extent. This latter point was made in an order (see 1996 FRB 679) whereby the Board denied an application by a bank holding company to acquire an investment in an industrial development corporation involved in the construction of a shopping and office complex in an urban renewal area. The Board identified the critical issue as whether the project was devised primarily to promote the community welfare or primarily designed as a profit-making venture in which the benefits to the community were merely a collateral effect.

In another case, the Board denied a proposal intended to acquire a company that indirectly acted as a managing general partner of a private development venture. The venture was a large-scale, urban redevelopment initiative, jointly sponsored by government and private entities, that was intended to revitalize a geographic area that was largely abandoned within a working middle-class community. (See 1990 FRB 672.)

3150.0.4 INSPECTION OBJECTIVES

1. To determine that new investments and financing in community development and other corporations and projects are designed primarily to promote community welfare.
2. To determine that previous investments and financings continue to meet the standards

imposed by section 225.28(b)(12) of Regulation Y.

3. To determine that the activity remains within the scope of regulatory approval when such approval involves specific rather than general investments.
4. To determine that advisory and related services for programs designed primarily to promote community welfare are being conducted within the scope of their regulatory approval.

3150.0.5 INSPECTION PROCEDURES

As is standard practice in the examination of other subsidiaries engaged in nonbanking activities, a thorough review of pertinent books, records, contracts, and financial statements should be undertaken by the examiner. To fulfill the inspection objectives concerning this activity, the examiner may have to go beyond routine investigative practices. Since this activity encompasses a wide variety of programs, procedures will have to be developed on an ad hoc basis. When federal or state approval of the program is required, the examiner may wish to review applications and other materials submitted to such authorities. The terms or conditions imposed by such bodies as well as the subsidiary's continued eligibility may also be of importance. Contact with responsible federal or state officials may be deemed appropriate in certain cases. Such contacts, however, should be initiated only in accordance with respective Reserve Bank procedures. When a community welfare project or financing does not include the involvement of another governmental body, the examiner will need to verify directly whether goals essential to the nature of the activity, such as providing housing for the elderly or jobs for low- or moderate-income people, are being met. In this regard, the burden should be on the holding company to provide such data. In some instances, an on-site visit to the project may be appropriate.

3150.0.6 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Permissible investments described	1701	225.28(b)(12) 225.127	4–178	1972 FRB 495 1978 FRB 45 1984 FRB 452
Provision of community development advice on a fee-for-service basis				1988 FRB 140 1989 FRB 576
Purchase of land for agricultural testing activities				1990 FRB 672
Nonprofit, tax-exempt BHC—educational programs in economics, starting businesses, financial planning, career opportunities in banking				1991 FRB 70
Projects to create improved job opportunities for low- or moderate-income groups				1992 FRB 619
Approval of community development converting an office building into a hotel complex, located next to a public housing project designated as ‘‘difficult to develop’’				1996 FRB 679
Denial of a bank holding company formation by a community development corporation				1976 FRB 639
Denial of a venture that would revitalize an abandoned area in a middle-class community				1994 FRB 733

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

3160.0.1 PROVISION OF DATA PROCESSING AND TRANSMISSION SERVICES

Under section 4(c)(8) of the BHC Act, the permissibility of bank holding company data processing activities is generally predicated upon the type of data processed or transmitted. Subsidiaries formed under this section may engage in business directly with outside customers, unlike section 4(c)(1) subsidiaries, which can act only as servicers for affiliates[1] and cannot deal directly with outside customers.

The intent of section 4(c)(8) is to permit bank holding companies and their nonbank subsidiaries to directly provide to customers financially or economically oriented services (or those that are similar to these services) that banks have traditionally used in their own internal operations and provided to their customers. Such services (with prior approval) are unrestricted as to location and may be provided from out-of-state locations.

3160.0.2 INCIDENTAL ACTIVITIES

The Board regards the following as incidental activities necessary to carrying on permissible data processing activities:

1. Making excess computer time available to anyone as long as the only involvement by the bank holding company system is furnishing the facility and the necessary operating personnel. This stipulation applies when—
   a. the equipment is not purchased solely for the purpose of creating excess capacity to sell;
   b. hardware is not offered in conjunction with excess capacity; and
   c. the facilities for the use of the excess capacity do not include providing any software other than systems software (including language), network communications support, and the operating personnel and documentation necessary for maintaining and using these facilities.
2. Selling byproducts of permissible data processing and data transmission activities where they are not designed, or appreciably enhanced, for the purpose of marketability.
3. Furnishing any data processing service upon request of a customer if the service is not otherwise reasonably available in the relevant market area.

3160.0.3 SECTION 4(c)(8) vs. SECTION 4(c)(1)

Section 4(c)(1) data processing subsidiaries, which do not require prior approval, are limited as follows:

1. They can furnish computer services *only* for the internal operations of the bank holding company and its bank affiliates.[1]
2. Direct computer services to nonaffiliated customers are not permitted. Any contract to furnish services to nonaffiliated customers must be between the affiliate bank and its customer, with the data processing subsidiary acting as a servicer for its affiliate bank. In addition, the kinds of services furnished are limited to those that a bank can normally provide.

Section 4(c)(8) data processing subsidiaries may deal directly with the customer. In accordance with section 4(c)(8) of the BHC Act and section 225.28(b)(14) of Regulation Y, the kinds of services nonbank subsidiaries of bank holding companies may provide to others are—

1. data processing and transmission services, facilities (including hardware, software, documentation, or operating personnel), databases, advice, and access to such services, facilities, or databases by any technological means, if—
   a. the data to be processed or furnished are financial, banking, or economic data and
   b. the hardware provided in connection with the data processing and transmission services is offered only in conjunction with software designed and marketed for the processing and transmission of financial, banking, or economic data, and the general-purpose hardware does not constitute more than 30 percent of the cost of any packaged offering.
2. data processing, data storage, and data transmission services for a third party that are not financial, banking, or economic related if the

1. In this context, ''affiliates'' is limited to other organizations that have subsidiaries of the same parent bank holding company as the servicer.

subsidiary's total annual revenue derived from those activities does not exceed 30 percent (49 percent effective January 8, 2004) of its total annual revenues derived from data processing, data storage, and data transmission activities. See 1993 FRB 1158 and section 3160.2.

3160.0.4 MINI-COMPUTER ACTIVITIES

Some data processing subsidiaries are actively engaged in placing mini-computers with some of their customers. However, if the subsidiary acts as sales agent for the manufacturer and receives a commission, it is in violation of section 225.28(b)(14) of Regulation Y and should be advised to cease the practice.

3160.0.5 HARDWARE AND SOFTWARE AS AN INTEGRATED PACKAGE

Customers of data processing services require that suppliers provide them with hardware and software as an integrated package. Providing general-purpose hardware is permissible only if the cost of the hardware does not exceed 30 percent of the cost of the packaged offering, and only in conjuction with permissible software. When hardware is provided in a specialized form (such as ATMs), its provision meets the *National Courier* test and is closely related to banking and therefore not subject to the 30 percent limitation.

3160.0.6 PACKAGED FINANCIAL SYSTEMS

The Board found that providing packaged financial systems, including data processing hardware and software, to be installed on the premises of the customer is closely related to banking if conducted within the limits of Regulation Y.

3160.0.7 EXCESS CAPACITY

The sale of excess computer time is currently treated in a Board interpretation as a permissible incidental activity. The interpretation (12 C.F.R. 225.123(e)(1)) currently permits a bank holding company to make excess computer time available to anyone so long as the only involvement of the holding company is furnishing the facility and the necessary operating personnel. Data processors that process time-sensitive data must maintain sufficient capacity to meet peak demand and provide backup in case of equipment failure. Excess capacity necessarily results from such needs and thus the sale of excess capacity is necessary to reduce costs and to remain competitive. Bank holding companies are limited in the sale of excess capacity as follows:

1. A bank holding company may not purchase data processing equipment solely for the purpose of creating excess capacity.
2. A bank holding company may not sell hardware in conjunction with excess capacity.
3. A bank holding company may provide only limited types of software in connection with its sale of excess capacity. This includes systems software (that is, software designed only to control and operate the hardware and not to perform substantive operations), network communications support, and the operating personnel and documentation necessary for maintaining and using these facilities.

3160.0.8 BYPRODUCTS

The sale of byproducts for the development of a program for a permissible data processing activity is treated in a Board interpretation (12 C.F.R. 225.123(e)) as a permissible incidental activity. Byproducts may be data, software, or data processing techniques or information developed by the bank holding company. Byproducts *may not* be designed or appreciably enhanced for the purpose of marketability.

3160.0.9 REQUIREMENT OF SEPARATE RECORDKEEPING

The Board's data processing interpretation is designed to minimize any possibility of unfair competition. A bank holding company subsidiary or related entity that provides permissible data processing and data transmission activities (services, facilities, byproducts, or excess capacity) must keep separate books and records and provide the documents to any new or renewal customer upon request.

3160.0.10 SUMMARY

Holding company EDP proposals are evaluated from the standpoint of whether the proposed data processing activities involve banking, financial, or related economic data within the meaning of the Board's Regulation Y. Processing, storing, and transmitting data for third parties, when the data are not financial, banking, or economic, is permissible if the revenues derived from those activities do not exceed 49 percent of the subsidiary's total annual revenues derived from data processing, data storage, and data transmission activities. For examples of previous Board authorizations for data processing and transmission services in accordance with Regulation Y, see sections 3160.1 through 3160.3.

The data processing that is permissible under Regulation Y encompasses various data processing services, including sales analysis, inventory analysis, freight payment, municipal tax billing, credit union accounting, and savings and mortgage company bookkeeping and payroll processing.

3160.0.11 INSPECTION OBJECTIVES

1. To determine that the full range of EDP services performed are permissible financially oriented activities in compliance with applicable laws and regulations.
2. To review the relationship between the data processing subsidiary and its affiliates and the effect of those relationships on the affairs and soundness of the bank affiliate.
3. To determine if operating policies are adequate and if management is operating in conformance with the established policies.
4. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulation have been noted.

NOTE: All bank-related EDP servicers receive EDP examinations conducted by the primary bank regulator, which cover detailed operations, audit, proper backup, and overall computer operations. The bank holding company–related inspection should focus on the types and permissibility of services performed, the revenue limitations of section 225.28(b)(14) of Regulation Y, the types of customers serviced, and transactions between affiliates, and should provide an overall financial evaluation.

3160.0.12 INSPECTION PROCEDURES

3160.0.12.1 Pre-Inspection

1. Where available, review the EDP examination report in conjunction with the lead bank examination for details of the subsidiary's operations and management.
2. Review correspondence files and the application memo for the history of the subsidiary.

3160.0.12.2 On-Site

1. Have a brief meeting with the chief executive officer of the subsidiary to establish contact and present a brief indication of the scope of the inspection.
2. Ask the controller of the company for the schedules and other information requested in the entry letter.
3. Request the following information and schedules in addition to what was requested in the entry letter:
   a. complete list of the computer applications the subsidiary performs
   b. list of customers
   c. policy and procedure manual, if any
   d. copy of the latest internal and external financial and operational audits and internal control reviews
   e. copy of the types of management reports the subsidiary submits to the parent company and directors
   f. internal management organization chart
   g. copy of the agreement executed with the affiliates concerning the services provided and the fees collected
4. Review the board of directors' minutes and the executive committee's minutes to determine the broad types of operations of the company.
5. Determine the scope of the inspection based on evaluations of—
   a. corporate minutes,
   b. schedules,
   c. accounting records,
   d. internal controls, and
   e. the scope of the work performed by the internal auditor.
6. Review the trial balances and compare them against the respective general ledger control accounts.
7. Where necessary, interview pertinent division heads.
8. Determine if there are adequate management information systems and regular periodic reports made available that provide

sufficient segregated details on the annual revenues earned from (1) financial-, banking-, or econimic-related data processing and data transmission services and (2) third-party nonfinancial data processing and data transmission services. Ascertain whether the information will allow verification of compliance with the revenue limitations found in section 225.28(b)(14) of the Board's Regulation Y.

9. Verify that the subsidiary of the bank holding company is complying with the revenue limitations found in section 225.28(b)(14) of Regulation Y.
10. Review the data processing and transmission services provided to customers for violations of the Board's regulations and interpretations and obtain sufficient documentation for the workpapers.
11. Prepare a statement of condition with a minimum two-year comparison. More than two years may be prepared if the information is available and meaningful.
12. Prepare a statement of income using the same procedures outlined above.
13. Review all significant internal policies. Determine if the policies were developed internally or by the parent company.
14. Review the subsidiary's management reports to the parent company. Is the reporting complete and frequent (at least quarterly)? Is the parent company fully aware of the subsidiary's operations or problems?
15. Review the adequacy of internal and external financial and operational audits and internal control reviews. Interview the EDP auditor and review the audit reports and CPA management letters (for the period of the inspection) and conduct interviews with the auditors, including the EDP auditor (if one was engaged).
16. Review the condition of the company's records, that is, their availability, completeness, and accuracy. Deficiencies should be discussed in detail with recommendations for improvement.
17. Review all intercompany transactions. Be consistently alert for any transactions with affiliate bank(s) that would be a violation of section 23A and section 23B of the Federal Reserve Act and Regulation W.
18. Review significant litigation and other contingent liabilities.

3160.0.13 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
EDP auditing		225.28(b)(14)		
Types of activities—incidental activities		225.123 and 225.123(a)	4–176	1975 FRB 215
Data processing as an activity closely related to banking		225.123(e)		1974 FRB 58
Section 4(c)(1) type of EDP services		225.118	4–195	
		225.28(b)(14)		1986 FRB 497
Retention of data subsidiary				1972 FRB 318
Order authorizing a bank holding company to engage in expanded data processing and data transmission activities				1982 FRB 505
Amendment of Regulation Y for expanded activities		225.28(b)(14)		1982 FRB 552 1997 FRB 275

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Order authorizing a BHC to offer financial-office service and the service of designing and assembling data processing hardware. Receipt of hotel information and the ability to make airline and hotel reservations is not related to the provision of banking, financial, and economic data.		225.28(b)(14)		1986 FRB 497
Order authorizing engaging in electronic benefit services, stored-value card services, and electronic data interchange services				1993 FRB 1158
Order authorizing the provision of a network for the processing and transmission of medical payment data				1994 FRB 139
Order authorizing the provision of traveler's checks and postage stamps via an ATM card and terminal				1994 FRB 1107
Order allowing a BHC to process certain non-financial data—personnel information for financial institutions for use in their internal operations				1995 FRB 295
Order authorizing optical scanning and database preparation				1995 FRB 1049
Order authorizing engaging in the development, production, and provision of customer home banking—personal financial management using personal computers				1996 FRB 363

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Order allowing a BHC to engage in— (1) providing data processing and data transmission services to nonaffiliated financial institutions and				1996 FRB 674
(2) assisting the institutions in offering their customers banking and financial services over the Internet				1996 FRB 680
Order approving limited nonfinancial data processing and transmission services, including customer identification, account, and information or verification files for detecting fraudulent use.				1996 FRB 348

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

A bank holding company applied for the Board's approval to acquire all the shares of a nonbank data processing company to engage in the processing and transmission of certain medical-payment data. The nonbank subsidiary plans to engage in activities that specialize in a range of medical-payment electronic funds transfer services, including the development of software products related to the processing of medical-claims payments.

Basic network services. The Board determined by order that a nonbank subsidiary of a bank holding company may provide a network for the processing and transmission of medical-payment data between health-care providers (such as physicians, hospitals, and pharmacies) and entities responsible for paying medical benefits (such as health insurers, health maintenance organizations, and preferred provider organizations). These nonbanking activities are permissible under the Bank Holding Company Act and the Board's Regulation Y (12 C.F.R. 225.28(b)(14)). The information on the patient's medical-benefits card (made available by paying organizations) would be used to access the system (similar to a debit or credit card). In general, health-care providers would enter claims information into the network with a request for payment, and the payers would authorize electronic fund transfers for full or partial payment of the claims.

The bank holding company's nonbank subsidiary would also process and transmit medical-treatment data necessary for the processing of claims, and would furnish providers with access to a coverage-information database. The database would transmit information about the terms of a particular payer's medical coverage contract, such as the extent to which specific medical treatments are covered by the patient's insurance policy. While such medical and coverage data are not financial data, the processing and transmission of these data are essential to the transmission and processing of the medical payments and financial information in the network. Also, these data processing services allow the electronic transfer of funds. The Board found that the processing and transmission of the medical and coverage data, in connection with the nonbank subsidiary's operation of a payments network, are permissible as incidental activities. The Board further determined that the nonbank subsidiary's operation of a medical-payments network would constitute permissible data processing and data transmission activities under the BHC Act.

Adjudication software. The Board also authorized the bank holding company's nonbank subsidiary to furnish claims-adjudication software to payers. The software is designed for the processing of routine claims and would include the basic rules of a payer's coverage contract. Claims-adjudication processing would involve the interaction of financial and banking data and medical and coverage data as a necessary prelude to electronic funds transfer. The Board found that the processing of medical and coverage data involved in claims adjudication is an integral and necessary part of the processing of related financial and banking information, and the nonbank subsidiary's processing of underlying payment transactions. The Board concluded that the nonbank subsidiary's provision of claims-adjudication software is permissible as an activity incidental to its provision of software for the processing of banking and financial data and to its operation of a medical-payments network.

Electronic data interchange. The bank holding company's nonbank subsidiary also plans to provide medical–payments system participants with statistical and other data derived from the information in its database. Each participant would have on-line access to all of the data it places into the system, and third parties designated by a payer or provider could also receive access to the data owned by that customer. The Board has previously stated that bank holding companies may provide byproducts of permissible data processing and data transmission activities as long as the byproducts are not designed, or appreciably enhanced, for the purpose of marketability (12 C.F.R. 225.123(e)(2)). The Board has also indicated that byproducts include data, software, or data processing techniques that may be applicable to the data processing requirements of other industries.

The nonbank subsidiary may perform limited selection, combination, and similar functions on raw data so that the data can be transmitted to the customer in a reorganized and more usable form. It may also design software that would enable customers to perform similar reorganization functions on raw data. The Board concluded that the proposed electronic data interchange services would constitute permissible byproducts of the nonbank subsidiary's primary data processing activities, and are therefore permissible as an incidental activity.

The Board's approval of the application on December 22, 1993, is based on the facts of record and is subject to the commitments and representations that were made by the applicant and the conditions referred to in the order. (See 1994 FRB 139.)

Four bank holding companies (the applicants) applied for the Board's approval under section 4(c)(8) of the Bank Holding Company Act to engage de novo, through their joint venture corporation (the company), in nonbanking activities consisting of engaging in electronic benefit transfer services, stored-value card services, and electronic data interchange services. The applicants proposed to engage in the activities throughout the United States. The applicants provide data processing and transmission services through the company to retail merchants using point-of-sale (POS) terminals and to banks who are members of the company's automated teller machine (ATM) network.

3160.2.1 ELECTRONIC BENEFIT TRANSFER SERVICES

The electronic benefit transfer services would involve data processing and transmission services required to permit the delivery of governmental program benefits (such as welfare payments and food stamps) through the ATM and POS terminals of participating merchants and banks. Under a benefits services system, a benefit recipient would be issued a magnetically encoded card, similar to an ATM card, which could be used to obtain access to a government benefit account maintained on behalf of the recipient. The Board concluded that such activities are financial activities that are operationally and functionally similar to the electronic payment and data processing services provided by banks and bank holding companies in the operation of ATM and POS networks. In particular, the proposed benefit services involve the processing of access and authorization requests submitted to, and electronic payments originating from, financial accounts on the same basis as transactions initiated with traditional credit and debit cards. The Board thus concluded that such electronic benefit transfer activities are closely related to banking, permissible for bank holding companies under the BHC Act.

3160.2.2 STORED-VALUE CARD SERVICES

Stored-value card services would involve data processing and transmission services and electronic payment services related to stored-value cards. These cards are similar to credit or debit cards in which authorized funds can be transferred and credited using magnetic stripe or computer chip technology. The services would be provided in connection with both ''closed'' and ''open'' stored-value card systems. Closed systems include both single-vendor stored-value card systems and systems designed for single-use sites. An open system, by contrast, refers to multiple-vender, multiple-site stored-value card systems.

3160.2.2.1 Stored-Value Card Closed Systems

In most current closed systems, cash must be deposited in a particular vendor's card-dispensing terminal, and the card received from the terminal may be used only for purchases from that specific vendor. The card itself is disposable, and the only account reconciliation that may be required would involve the vendor's own cash receipts, the amount of funds debited from the cards at turnstiles or other points of sale, and the amount of the vendor's liabilities stored on outstanding cards. The company intended to play a role in the operation of this basic type of closed system, as well as to help develop and operate more complex closed systems. These systems would use a plastic card containing electronic technology, such as a computer chip or magnetic stripe, to which funds could be credited and from which funds could be debited, for an indefinite period of time. The company proposed performing accounting functions in customer accounts and accounting for the level of the vendor's stored liabilities. In such a capacity, the company would be responsible for the settlement and reconciliation of these customer and vendor accounts. The company would also perform other functions, such as embossing and issuing cards and arranging for funds collection.

3160.2.2.2 Stored-Value Card Open Systems

The applicants anticipate that stored-value cards eventually will operate in an open system similar to a POS network, which allows value stored on a card to be used with a wide range of participating vendors. The applicants expect that the company's principal stored-value card activities would involve the development and operation of such open systems.

In an open system, customers' debit cards would hold an integrated computer chip or some type of comparable technology capable of storing value for use in stored-value card transactions. Value could be placed on the card at an ATM adapted to read and place value on the chip, at a limited purpose ATM-type machine whose only functions would be to add value to the chip and to transfer stored value back to the customer's account, or at a cash-to-card machine or other value transfer device (collectively, value terminals). These value terminals would be operated, in at least some cases, by the company. Once value is placed on a card, equivalent funds could be transferred to the company, which would hold the funds for payment of stored-value card transactions. Stored value would leave the chip when the customer purchases goods or services either at a POS terminal (which may be operated by the company) or at a vending machine, telephone booth, mass transit turnstile, or other unmanned delivery location (collectively, reader terminals), or when the customer transfers funds back to an account at a value terminal. Reader terminals generally would be off-line devices, not connected to the company's ATM or POS networks. Instead of a direct electronic connection, a reader terminal would retain, for a period of time, value representing the amount of customer purchases at the terminal. Then, at the vendor's convenience, the company, the vendor, or a third party would collect value from the reader terminals using specially designed collection cards issued by the company. The collection cards would then be submitted to the company so that funds can be properly credited. Once these transactions occur, the company would be responsible for making settlement by transferring funds to the accounts of participating merchants and other appropriate parties.

The Board concluded that the company's activities in providing stored-value card services, in both closed and open systems, are closely related to banking. The activities involve processing debits and credits to the stored-value cards and performing related accounting and settlement functions, and are thus a data processing activity. Financial balances are maintained and adjusted at POS and other terminals as the customer purchases various items or adds value to the card, and the activity constitutes the processing of banking, financial, or economic data within the meaning of Regulation Y. In addition, aspects of the company's stored-value card services are functionally similar to the issuance and sale of consumer payment instruments such as travelers' checks, which are activities that banks conduct and that the Board has previously determined to be closely related to banking within the meaning of the BHC Act. The Board concluded that the company's proposed services in connection with stored-value cards, in either an open system or a closed system, are closely related to banking.

3160.2.3 ELECTRONIC DATA INTERCHANGE SERVICES

The company also proposes to furnish retail merchants with data collected from sales transactions consummated at the merchant's place of business (data services). The data collected and furnished would relate to specific items and quantities of products purchased by the customer, as well as customer purchasing patterns over a period of time. The data would be formatted so that it could be used by the merchant for inventory control, targeted marketing, and other purposes. The company's data services generally would be furnished to merchants as an adjunct to its POS transaction processing services and would be rendered through a retail merchant's POS terminals. The company does not intend to offer data services independently. In addition, the data that are collected by the company would be furnished only to the merchant that is a party to the underlying sales transaction; that is, the company does not intend to provide such information to third parties.

The company's data services would be limited to capturing, formatting, and furnishing data collected from sales transactions consummated at a particular merchant's place of business. In addition, the data collected would be furnished only to that merchant and only in accordance with the merchant's specific instructions. The company does not intend to provide software, render advice, or provide other services associated with the marketing or other uses of the data. The applicants do anticipate, however, that the company could provide additional related functions, such as issuing store coupons or credits related to a merchant's marketing programs at POS terminals. Based on the facts presented, the Board determined that the sales data that would be processed under the proposed data services are financial and economic data within the meaning of Regulation Y.

3160.2.4 BOARD APPROVAL

Based on all the facts of record, the Board approved the applications. The Board's approval is specifically conditioned on compliance with the commitments made in connection with the applications and with the conditions referred to in the order. (See 1993 FRB 1158.)

Regulation Y has been revised to clarify that a bank holding company may render advice to anyone on processing and transmitting banking, financial, and economic data (see 12 C.F.R. 225.28(b)(14)). The following two restrictions on permissible data processing activities have been deleted: (1) All data processing services must be provided pursuant to a written agreement with the third party that describes and limits the services; and (2) data processing facilities must be designed, marketed, and operated for processing and transmitting financial, banking, or economic data. The data processing activity has also been revised to permit bank holding companies to derive up to 30 percent of their data processing revenues from processing and transmitting data that are *not* financial, banking, or economic.

Eleven bank holding companies (the applicants) applied for the Board's approval to engage through a joint venture corporation (the company) in certain nonbanking activities related to the operation of a retail electronic funds transfer network, including data processing and data transmission activities related to automated teller machine (ATM) and point-of-sale (POS) transactions, as well as electronic benefit transfer, stored-value card, and electronic data capture and interchange services. (A complete list of the proposed activities is found at 1994 FRB 1110–1111.)

The applicants also proposed to offer through the company certain data processing and data transmission services not previously considered by the Board. Those services consisted of allowing customers to use their ATM cards at an ATM terminal to withdraw funds from a bank account in the form of travelers' checks or postage stamps. Payment for the transactions would be accomplished by a debit to a cardholder's deposit account.

The transactions would occur at terminals that would not be owned and operated by the company. Cardholders buying postage stamps or travelers' checks at an ATM terminal would purchase those products from the bank owning the ATM. The decision on which travelers' checks to issue would remain with the bank that owns the ATM terminal, and the company would not be the issuer of the travelers' checks.

The company's primary activities would be processing and transmitting access requests and payment authorizations. The company would also provide terminal-driving services, load ATM terminals with postage stamps and travelers' checks, and market the products through the network.

The Board determined that the proposed activities involved the processing of access and authorization requests submitted to deposit accounts on the same basis as other transactions initiated with a traditional debit card. The activity is operationally and functionally similar to the data processing services provided by banks and bank holding companies in their operation of ATM and POS networks. Traditionally, banks have been permissibly engaged in the sale of travelers' checks and postage stamps. The Board thus found the company's proposed data processing and transmission activities, with respect to these transactions, to be closely related to banking. (See 1994 FRB 1107.)

Five bank holding companies (the applicants) applied for the Board's approval to engage, through a joint venture subsidiary (the company), in certain data processing activities pursuant to Regulation Y. The applicants, through the company, would provide data processing and related services to banks and other automated teller machine (ATM) owners in connection with the distribution through ATMs of tickets, gift certificates, prepaid telephone cards, and other documents evidencing a prepayment for goods or services.[1]

The company would provide the software and telecommunications channels necessary to transmit cardholder requests, card-issuer authorizations, and related switching and account reconciliation services. Specifically, the company would provide terminal driving services that include—

- establishing and maintaining an electronic link between an ATM and a telecommunications switch to transmit cardholder requests and card-issuer authorizations; and
- operating the feature and functions displays on an ATM screen using computer software to permit an ATM to dispense various products in addition to currency.

The company would also provide switching services and transaction processing to transmit account debiting, transaction authorization, and settlement data between the ATM owner, or its bank, and the cardholder's bank.

A typical transaction would consist of an ATM cardholder selecting a particular product, such as a concert ticket, from a menu displayed on the ATM screen. The electronic commands transmitted by the company would verify that the deposit account or line of credit designated by the cardholder had sufficient funds to effect the purchase. Following authorization, the ATM would dispense the product and issue a receipt. The card-issuing bank would then debit an amount equal to the cost of the purchase from the cardholder's designated account and transfer the funds to the account of the merchant or ATM owner, using settlement procedures established by the company's ATM network.

The Board previously determined that a bank holding company could provide data processing and related services necessary to permit customers to use an ATM card to debit a deposit account or line of credit at an ATM terminal for cash and credit transactions, and for the purchase of travelers' checks, money orders, and postage stamps. The Board has further determined that a bank holding company may provide data processing services that support the use of credit cards by consumers in the direct purchase of goods and services from a merchant. (See 1995 FRB 492, 1990 FRB 549, and 1985 FRB 113.)

The data processing proposed in this case involves the same type of data processing support as the Board has previously approved for credit card transactions and other more traditional types of ATM transactions. The Board thus concluded that the activities proposed by the applicants are permissible, consisting of data processing and transmission services encompassed within the Board's Regulation Y, and are thus closely related to banking within the meaning of section 4(c)(8) of the Bank Holding Company Act. (See 1996 FRB 848.)

1. The tickets would include public transportation tickets and tickets to entertainment events. Gift certificates and prepaid telephone cards would be issued in fixed denominations for a specific merchant or group of merchants, and they would evidence prepayment of the purchase price of merchandise or services to be selected by the bearer at some time in the future. The ATM owners would also sell products that could be offered for sale directly by a financial institution, such as mutual fund shares or insurance policies, where permitted by applicable law.

3160.5.1 ENGAGE IN TRANSMITTING MONEY IN THE UNITED STATES

A bank holding company gave notice under section 4(c)(8) of the Bank Holding Company Act (BHC Act) (12 U.S.C. 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) to engage de novo through two companies (the companies) in the activity of transmitting money for customers within the United States and its territories (''domestic money transmission services'') to third parties located in foreign countries.[1] The activity was to be conducted at first through a network of approximately 1,200 ''outside representative offices'' located in California, Florida, Illinois, and Texas that are under contract with the companies to provide money transmission services.[2] The bank holding company proposes to engage in the planned activity nationwide. The companies are corporations that currently engage in the business of money transmission to Mexico through representatives in California, Florida, Illinois, and Texas.

Domestic money transmission services would be provided in the following manner: A customer would contact the companies directly by means of a dedicated telephone located in the outside representative office to request that the companies transmit funds to a third party for a fee. The outside representative would collect cash and a fee from the customer, issue a receipt, and deposit funds in an account maintained by the outside representative solely for the purpose of receiving funds in trust to be transmitted to a third party. The outside representative may maintain this account at any bank, including a subsidiary bank, but would have no agreement with any bank to accept deposits on its behalf. Neither the outside representatives nor the companies would be FDIC-insured institutions.

The companies would collect funds deposited in an outside representative's account daily through an automated clearinghouse (ACH) or similar transaction and deposit an amount equal to the amount to be transmitted into an account they maintain at a bank, which may include one of its subsidiary banks, located near the third party receiving the funds. The third party would be notified that money is available at a local disbursement site, which could include a bank subsidiary of the bank holding company or consumer finance office or an unaffiliated check-cashing, finance, or other type of office. Funds would be made available to the third party by a check drawn on the companies' account almost immediately after the transmission order is placed by the customer.[3]

A customer would not transmit funds to any bank account maintained by the customer or any third party. Thus, the bank holding company would not use this service to collect deposits for customers of its subsidiary banks or any other bank.

There was no agreement between a customer and a bank to accept money in an account for use by the bank in connection with the proposed domestic money transmission services. The companies and their outside representative would accept money from a customer for the sole purpose of transmitting funds to a third party. A customer would not give funds to the companies with the expectation that the companies would permit the customer to reclaim the funds on demand or after a period of time. Moreover, the companies would not maintain balances or pay interest on the money they receive, and they would only hold funds long enough to transmit them to the designated third party.[4]

The Board previously determined that money transmission abroad is closely related to banking.[5] The Office of the Comptroller of the Currency (OCC) also has concluded that it is permissible for a national bank to accept money from nonbank affiliates for the purpose of transmitting the funds to a foreign country and that a

1. The Board previously approved the bank holding company's acquisition of a company to engage in the activity of transmitting funds to third parties in Mexico by using an unaffiliated foreign bank to make the cash payments. See 1995 FRB 974.

2. Outside representative offices would be expanded to include consumer finance offices in addition to existing grocery stores, travel agencies, pharmacies, and insurance agencies.

3. The domestic money transmission services do not involve lending money because only funds provided by the customer would be transmitted to a third party. The plan does not involve the paying of checks. Although the third party receives money by means of a check drawn on an account maintained by the companies, the receipt of funds in check form is not the payment of a check (see *Independent Bankers Ass'n of America v. Smith*, 534 F.2d 921, 943–45 (D.C. Cir. 1976)).

4. Many states permit companies that are not chartered as banks to transmit money without deeming this activity to involve the taking of deposits. The bank holding company is required to conduct the proposed activities in compliance with licensing and other requirements of relevant state law.

5. See 1990 FRB 270.

nonbank affiliate that participates with the national bank in transmitting money abroad would not become a branch of the bank.[6] Based on all the facts of record and for the reasons discussed in this and the Board's previous orders, the Board concludes that domestic money transmission services are closely related to banking. The Board has relied on the fact that the companies are subject to licensing and examination by state authorities.[7] The companies have committed to comply with all applicable reporting requirements, including reporting all transactions over $10,000 to the Internal Revenue Service. The bank holding company committed to apply the internal controls currently in place at the financial services company to ensure compliance with the Bank Secrecy Act.[8]

Based on the foregoing and all the facts of record, the Board approved the notice on October 17, 1995 (see 1995 FRB 1130). The Board's decision was specifically conditioned on the bank holding company's complying with all the commitments made in connection with the notice and obtaining all necessary approvals from state regulators.

6. The OCC has reasoned that nonbank offices that transmit funds through a national bank to a third party do not constitute ''branches'' under federal law.

7. This order was specifically conditioned on requiring the bank holding company to obtain all necessary state licenses.

8. These procedures include a weekly review of all transactions over $10,000. In addition, the companies will require customer identification, including the customer's current address and occupation, for all transmissions above $3,000. The companies also will run a computer match of all remitters and recipients by name and Social Security number so that reporting requirements cannot be evaded by means of a series of transactions.

Support Services—Printing and Selling MICR-encoded items Section 3165.1

The Board has included within Regulation Y (section 225.28(b)(10)(ii)(B)) the authority for bank holding companies to engage in the printing and selling of magnetic ink character recognition (MICR)-encoded items as part of support services. This activity includes this primary activity and also the printing and selling of corporate image checks, cash tickets, voucher checks, deposit slips, savings withdrawal packages, and other forms that require MICR encoding. The activity was initially authorized as a permissible activity by Board order, whereby such documents were to be printed for and sold exclusively to depository institutions. The applicant associated with that Board order proposed to acquire a controlling interest in a printing company that prints and sells checks and related documents. It planned to engage in a joint venture with another company that engages in check printing and other printing activities. The Board concluded for that application that checks and other MICR-encoded documents used in the payments process are provided in specialized form and that they are an integral part of a fundamental banking service, and thus the activity is deemed closely related to banking. See 1986 FRB 794. The Board included the nonbanking activity in the Regulation Y ‘‘laundry list,’’ effective April 1997.

3170.0.1 INSURANCE ACTIVITIES PERMISSIBLE FOR BANK HOLDING COMPANIES

Before the enactment of the 1970 amendments to the Bank Holding Company Act, the Board by order authorized certain bank holding companies to engage in insurance activities. The specific type of permissible insurance activity for each bank holding company was described in its Board order. These few bank holding-companies that commenced insurance agency activities before January 1, 1971, have grandfather rights under the current statutes and regulations (section 4(c)(8)), exemption G and 12 (CFR 225.28(b)(11)(vii)). These bank holding companies may, with the prior approval of the Board, engage in general insurance agency activities without restriction as to location or to type of insurance sold. (See section 3170.0.3.7)

The 1970 amendments to the Bank Holding Company Act authorized the Board to determine permissible nonbanking activities under section 4(c)(8). Subsequently, on September 1, 1971, the Board amended Regulation Y to permit bank holding companies to engage in certain insurance agency activities.

The Board further amended the section of Regulation Y concerning permissible insurance agency activities on September 1, 1981. The 1981 amendments limited permissible insurance activities previously authorized by Regulation Y. The first amendment deleted from the Board's regulations the authority for bank holding companies to act under section 4(c)(8) of the Bank Holding Company as agent for the sale of insurance for themselves and their subsidiaries. This amendment reflected a court decision of the United States Court of Appeals for the Fifth Circuit that acting as agent for the sale of insurance for the bank holding company and its nonbanking subsidiaries was impermissible (permissible for banks, however). Such insurance is permissible, however, if conducted pursuant to section 4(c)(1)(C) of the BHC Act.[1] The second 1981 amendment deleted from the Board's regulations the authority to act as agent for insurance sold as a matter of convenience to the public. The opinion also found that the part of the Board's regulation relating to the sale of ''convenience insurance''[2] exceeded the scope of the provisions of section 4(c)(8) of the Bank Holding Company Act. The sale of this other insurance was considered impermissible.

On October 15, 1982, Congress enacted the Garn–St Germain Depository Institutions Act (Public Law 97-320). Title VI of that act amended section 4(c)(8) of the Bank Holding Company Act. This amendment stated that insurance agency, brokerage, and underwriting activities are *not* ''closely related'' to banking within the meaning of section 4(c)(8) of the Bank Holding Company Act. However, the amendment provided for seven exceptions to the general prohibition of bank holding companies engaging in insurance activities. One of the seven exceptions contains grandfather exemptions for insurance agency activities conducted on May 1, 1982, or for those insurance activities approved by the Board on or before May 1, 1982. As a result, bank holding companies receiving Board approval on or before May 1, 1982, may continue to engage in their insurance agency activities. (See section 3170.0.3.4)

The seven types of insurance activities allowed as permissible for bank holding companies are as follows:

1. Acting as agent, broker, or principal (i.e., underwriter) for credit-related life, accident and health, or unemployment insurance.
2. For bank holding company finance subsidiaries, acting as agent or broker for credit-related property insurance in connection with loans not exceeding $10,000 ($25,000 in the case of a mobile home loan) made by finance company subsidiaries of bank holding companies. (The Board interpreted this provision as permitting only the sale of insurance that does not exceed the outstanding balance of the loan—vendor's single interest insurance rather than general property insurance that covers the borrower's equity interest.)

1. The Board's Regulation Y was amended as of December 1983 to include the sale of insurance for a holding company based on the services provision of section 4(c)(1)(C) of the BHC Act, which did not require any prior Board approval. Included in the regulation were the services of selling, purchasing, or underwriting such insurance as blanket bond insurance, group insurance for employees, and property and casualty insurance for the bank holding company or its subsidiaries.

2. ''Convenience insurance'' consisted of insurance that was sold as a matter of convenience to the purchaser. The premium income from the sale of this insurance was expected to constitute less than 5 percent of the aggregate insurance premium income of the holding company. The sale of this insurance was not designed to permit entry into the general insurance-agency business.

3. Acting as agent for the sale of any type of insurance in a place with a population not exceeding 5,000, or with insurance agency facilities that the bank holding company demonstrates to be inadequate.
4. Any insurance agency activity engaged in by a bank holding company or its subsidiaries on May 1, 1982 (or approved as of May 1, 1982), including (i) insurance sales at new locations of the same bank holding company or subsidiaries in the state of the bank holding company's principal place of business or adjacent states or any state or states in which insurance activities were conducted by the bank holding company or any of its subsidiaries on May 1, 1982, or, (ii) insurance coverage functionally equivalent to those engaged in or approved by the Board as of May 1, 1982.
5. Acting, on behalf of insurance underwriters, as supervisor of retail agents who sell fidelity insurance and property and casualty insurance on holding company assets or group insurance for the employees of a bank holding company or its subsidiaries.
6. Any insurance agency activities engaged in by a bank holding company having total consolidated assets of $50,000,000 or less. Life insurance and annuities sold under this provision, however, must be authorized by (1), (2), or (3) above.
7. Any insurance agency activity that is performed by a registered bank holding company, which was engaged in some insurance activity before January 1, 1971, pursuant to the approval of the Board.

These seven types of insurance allowed by the amendment to section 4(c)(8) of the Garn–St Germain Act are generally consistent with the types of insurance activities previously authorized by the Board. The one general exception related to the prohibition of the sale of property and casualty insurance.

3170.0.2 INSURANCE AGENCY ACTIVITIES

Insurance agency activities are among the most widely practiced nonbank activities engaged in by bank holding companies. Many bank holding companies are involved in the sale of insurance at some level in the organization; however, the inspection focuses on these activities only when performed by the parent company or by a nonbank subsidiary (excluding bank-owned subsidiaries). Many of the smaller bank holding companies engage directly in these activities rather than through insurance agency subsidiaries. In either arrangement, however, sales are usually conducted on the premises of the subsidiary bank by personnel who most often serve as officers or employees of the bank or parent company.

Performance of insurance agency activities has been profitable for most bank holding companies with many of the smaller companies relying heavily on the commissions generated to service acquisition or other related indebtedness. In most cases, little or no expenditures for fixed assets are required since the premises of the subsidiary banks or parent company are utilized. Likewise, little or no liabilities are incurred since there are minimal assets to be financed.

3170.0.3 PERMISSIBLE TYPES OF COVERAGE INCLUDING GRANDFATHER PRIVILEGES

As noted above, the Board, effective November 7, 1986, approved a revision of specific insurance agency and underwriting activities permissible for bank holding companies under section 4(c)(8) of the BHC Act (section 225.28(b)(11) of Regulation Y). In clarifying the scope of insurance activities that are closely related to banking and permissible for bank holding companies under the Garn–St Germain Act, the Board included in its revised Regulation Y the seven specific exemptions contained in that statute.

3170.0.3.1 Insurance Activities Permissible for Bank Holding Companies per Section 225.28(b)(11)(i) of the Board's Regulation Y

Permissible insurance agency activities include the sale of life, accident and health, and involuntary unemployment insurance that is directly related to an extension of credit by a bank holding company with respect to its own extensions of credit and those of its subsidiaries. For the purpose of determining what activities are permissible, the Board interpreted the term ''extension of credit'' to include direct loans to borrowers, loans purchased from other lenders, and leases of real or personal property so long as the leases meet all the criteria contained in section 225.28(b)(3) of Regulation Y, which defines leases as the functional equivalent of an extension of credit. (See the discussion of leasing in section 3140.0.)

The regulation requires that insurance coverage be limited to the ''outstanding balance due'' on an extension of credit. The ''outstanding balance due'' is calculated as follows:

1. Include:
    a. principal and interest
    b. reasonable administrative fees outstanding on the loan
    c. the balance of payments due in a lease transaction
2. Exclude:
    a. the residual value of the leased item (since the lessor owns the leased item and the lessee is not obligated to purchase the item by paying the residual value)

The insurance may provide for total repayment of the extension of credit in the event of the death of the borrower or for periodic payments on the extension of credit when the borrower is temporarily disabled or unemployed. Such single or periodic payments may not exceed the balance on the loan and thus provide for additional general life or accident coverage.

While ordinarily such credit-related insurance coverage would be declining term as payments reduce the balance due on an extension of credit (loans in connection with first mortgages), a bank holding company may write or sell a level term policy on nonamortizing loans. Policies written or sold pursuant to this paragraph, moreover, may be individual rather than group policies, and the premiums on such policies may be age-related. The Board continues to require that insurance policies sold or written to cover the ''outstanding balance due'' insure only named borrowers or lessees of a particular bank holding company. Accordingly, such policies could cover both spouses jointly only if both spouses were actual borrowers or lessees under the terms of the agreement with the bank holding company.

The Board permits, with regard to an extension of credit, the sale and underwriting of credit-related life, accident and health, and involuntary unemployment insurance (1) with respect to lease transactions, as previously discussed, when such lease transactions are the equivalent of loans; (2) in connection with loans secured by residential first mortgages; and (3) in connection with the servicing of loans originated or purchased by the applicant bank holding company and subsequently sold.

The regulation explicitly permits the sale of life, disability, and involuntary unemployment insurance with respect to a lease transaction, provided the lease is the type of nonoperating, full payout lease described as permissible for bank holding companies in section 225.28(b)(3) of Regulation Y. The Board has determined that such leases are the ''functional equivalent of an extension of credit.'' It believes that this type of lease is encompassed in the term ''extension of credit'' as it is used in exemption A of the Garn–St Germain Act.

As discussed previously, the first exemption of the Garn–St Germain Act permits the sale of any type of life, disability, and involuntary unemployment insurance relating to an extension of credit, including home mortgage redemption insurance. Home mortgage insurance insures the repayment of the unpaid balance of a residential first mortgage loan in the event of the death or disability of the mortgagor. The Board has determined that home mortgage redemption insurance is closely related to banking because it supports the lending function (1986 FRB 339 and 671) by providing for repayment of residential mortgage loans at a time when the death or disability of the borrower may delay or disrupt the scheduled repayment of such loans. Home mortgage redemption insurance in connection with residential mortgage loans is considered as fulfilling the same function as credit life and credit accident and health insurance with respect to other types of loans. The Board recognized that such insurance functions as credit insurance in supporting a bank's lending function (see the Board's approval for the *sale* of such insurance by bank holding companies within 1975 FRB 45).

In approving the activity of home mortgage redemption insurance by order, the Board previously relied on commitments by applicants to inform, in writing, borrowers who are prospective purchasers of such insurance that home mortgage redemption insurance is not required and that, if desired, it may be purchased from other sources. The Board has also relied on a commitment for written notice to borrowers that the insurance contract may be rescinded at any time after the loan commitment is made and before closing. The Board continues to require that such notices be provided to borrowers. In addition, the Board continues to rely on the fact that premiums for such insurance are payable periodically during the term of the extension of credit, so as to increase the borrowers' ability to rescind the insurance and to limit premium financing as an incentive to sell such insurance.

The Board considers an ‘‘extension of credit’’ as covering loans that are made or purchased by the bank holding company or its subsidiaries. Credit-related insurance may be continued on the loans that were sold, and are now only being serviced, provided that they were made or purchased by the bank holding company or its subsidiaries. The Board permits bank holding companies to sell credit-related life, accident and health, and involuntary unemployment insurance where the bank holding company previously placed funds at risk. In this situation, the bank holding company must continue to limit its insurance coverage to the outstanding balance due on the extension of credit by the borrower.

A bank holding company may not sell or underwrite insurance when merely servicing a loan and *it has never placed its funds at risk* either by originating or purchasing the loan; the bank holding company is permitted to collect and transmit insurance premiums, act as intermediary in renewing existing policies or adjusting coverages, and engage in other activities which are incidental to the servicing of loans. The bank holding company may collect a fee for such services, providing that the fee is based on the provision of the service and is not a premium for insurance sold. In that case, the bank holding company would be engaging in loan servicing rather than insurance activities.

3170.0.3.2 Section 225.28(b)(11)(ii) of Regulation Y—Sale of Credit-Related Property Insurance by Finance Company Subsidiaries of a BHC

The Garn–St Germain Act restricts the authority of bank holding companies to engage in property and casualty insurance activities. Before 1982, the Board approved the sale of property and casualty insurance that was directly related to an extension of credit by a bank or bank-related firm in the bank holding company system. The sale of property insurance is now limited to an extension of credit made by a finance company that is a subsidiary of a bank holding company, acting as agent or broker. A finance company subsidiary may only engage in the sale of such property insurance if—

1. the insurance is limited to assuring repayment of the outstanding balance on such extension of credit in the event of loss or damage to any property used as collateral for the extension of credit;
2. the extension of credit is not more than $10,000, or $25,000 if it is to finance the purchase of a residential manufactured home[3] and the credit is secured by the home; and
3. the applicant commits to notify borrowers in writing that—
   a. they are not required to purchase such insurance from the applicant;
   b. such insurance does not insure any interest of the borrower in the collateral; and
   c. the applicant will accept more comprehensive property insurance in place of such single interest insurance.

3170.0.3.2.1 Definition of a Finance Company

A ‘‘finance company’’ for purposes of the sale of property insurance includes all non-deposit-taking financial institutions that engage in a significant degree of consumer lending (excluding lending secured by first mortgages) and all financial institutions specifically defined by individual states as finance companies that engage in a significant degree of consumer lending. Finance companies, under this provision, include those entities that may be authorized to accept limited types of time or savings deposits under state law but which a state has defined to be a finance company. Since exemption B of the Garn–St Germain Act is directed to consumer loans, the regulation requires that a qualifying company be engaged in that type of lending to a significant degree as measured by either number of loans, percentage of loans, percentage of loan amounts outstanding, or some similar measure. The Board will evaluate the amount of the consumer lending on a case-by-case basis.

3170.0.3.2.2 Property Insurance a Finance Company May Sell

Section 225.28(b)(11)(ii) of Regulation Y permits finance company subsidiaries of bank holding companies to engage in the sale of single-interest property insurance that insures against damage or loss only to the extent of the lender’s interest in the property that serves as collateral-for a loan. The Garn–St Germain Act limits the permissible insurance coverage to ‘‘the out-

3. These limitations increase at the end of each year, beginning with 1982, by the percentage increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers published by the Bureau of Labor Statistics.

standing balance due on an extension of credit.'' It does not contemplate general property insurance that covers the entire value of the property, including the balance due the lender and the equity interest of the borrower/owner. Generally such insurance is declining balance and the only interest in the collateral property that may be insured is that of the lender.

The sale of single-interest insurance is permitted provided that the BHC finance company subsidiary does not require such insurance of borrowers who have adequate property insurance on the loan collateral. In addition, the finance company subsidiary is required to disclose in writing that such insurance, if required, need not be purchased from the lender and that such insurance does not cover the borrower's interest in the property. The requirement is also imposed by the Board's Regulation Z, section 226.4(d)(2), if the premium is excluded from the finance charge.

3170.0.3.3 Section 225.28(b)(11)(iii) of Regulation Y—Insurance in Small Towns

Engaging in any insurance activity is permitted in a place where the bank holding company or a subsidiary of the bank holding company has a lending office in a community that—

1. has a population not exceeding 5,000 (as shown by the last preceding decennial census) or
2. has inadequate insurance-agency facilities, as determined by the Board, after notice and opportunity for hearing.

In order to provide insurance agency activities in a town with a population not exceeding 5,000, or in a community that has inadequate insurance agency facilities, the bank holding company must have a lending office that serves the public in the small town. The regulation specifically requires that the office be a lending office in order to provide the bank holding company with a link to the town, to avoid remote operation from a central location of a network of small-town insurance agencies, and generally to maintain insurance as a fee-generating activity to help sustain a small-town lending office as an independent, viable profit center.

The *current* requirement does not limit the sale of insurance to a ''principal place of banking business'' located in a community not exceeding a population of 5,000. Also, a bank holding company insurance agency is not precluded from selling insurance to those residing outside the community who initiate the transaction at the agency's place of business in the town of less than 5,000. Advertising in the community newspaper or a telephone book that may serve an area larger than the community of 5,000 is also not prohibited. The current regulation requires that the bank holding company or a subsidiary thereof establish or have a lending office in the community that has a population not exceeding 5,000.

3170.0.3.4 Section 225.28(b)(11)(iv) of Regulation Y—Insurance Agency Activities Conducted on May 1, 1982

This provision of the regulation includes engaging in any specific insurance agency activity[4] if the bank holding company, or subsidiary conducting the specific insurance agency activity, conducted the insurance agency activity on May 1, 1982, or received Board approval to conduct the insurance agency activity on or before May 1, 1982. Activities engaged in on May 1, 1982, include activities carried on subsequently as the result of an application to engage in such activities pending before the Board on May 1, 1982, and approved subsequently by the Board or as the result of an acquisition by such company pursuant to a binding written contract entered into on or before May 1, 1982, of another company engaged in such activities at the time of the acquisition.

A bank holding company or subsidiary engaging in a specific insurance-agency activity under section 225.28(b)(11)(iv) of Regulation Y may—

1. engage in such specific insurance-agency activity only at locations—
    a. in the state in which the bank holding company has its principal place of business (as defined in 12 U.S.C. 1842(d));
    b. in any state or states immediately adjacent to such state; and
    c. in any state in which the specific insurance-agency activity was conducted (or was

4. Nothing in paragraph (iv) precludes a BHC subsidiary that is authorized to engage in a specific insurance-agency activity under this clause from continuing to engage in the particular activity after merger with an affiliate, if the merger was for legitimate business purposes and prior notice has been provided to the Board.

approved to be conducted) by such bank holding company or subsidiary thereof or by any other subsidiary of such bank holding company on May 1, 1982; and

2. provide other insurance coverages that may become available after May 1, 1982, so long as those coverages insure against the types of risks as (or are otherwise functionally equivalent to) coverages sold or approved to be sold on May 1, 1982, by such bank holding company or subsidiary.

This provision of the regulation parallels exemption D of the Garn–St Germain Act and grandfathers those insurance agency activities in which individual bank holding companies were engaged on May 1, 1982. Under this provision, a bank holding company or subsidiary thereof may continue to engage in particular types of insurance agency activities that were permissible before the passage of the Garn–St Germain Act but which are now prohibited by that act. A qualifying bank holding company may engage, for example, in the sale of property and casualty insurance on property serving as collateral for loans made by a lending subsidiary of the holding company.

A qualifying bank holding company may also engage in grandfathered insurance related to the provision of ‘‘other financial services’’ previously authorized under section 225.28(b)(11)(i)(B) of Regulation Y. This type of insurance is not considered to be related to an extension of credit under the Garn–St Germain Act. As a result, the Board *no longer permits* the sale of insurance related to the provision of the general financial services offered by a bank or bank-related firm. Such insurance included, for example, insurance on the contents of safe deposit boxes, or savings completion insurance on certificates of deposit, Christmas club accounts, individual retirement accounts, tuition completion plans, or credit-related insurance for serviced loans. Prior to the Garn–St Germain Act, insurance related to the provision of general financial services was permitted to be sold to borrowers whose loans were neither purchased nor originated, but may have been serviced by the bank holding company. Insurance with respect to loan servicing was the primary type of insurance previously permitted by the Board as related to such financial services. Now, the Garn–St Germain Act limits the sale of insurance by bank holding companies in general to insurance related to an extension of credit.

3170.0.3.4.1 Limitations on Expansion of Grandfather Rights

Exemption D provides for limited expansion of grandfathered insurance agency activities in order to permit qualifying bank holding companies to remain effective insurance agent competitors. The exemption presented three issues that the Board resolved in paragraph (iv) of the regulation: (1) defining which subsidiaries of a bank holding company may engage in otherwise impermissible insurance agency activities under exemption D; (2) the scope of permissible geographic expansion; and (3) the scope of product-line expansion.

Specific Subsidiaries That May Engage in Grandfathered Activities

Grandfather rights do not inure to the benefit of the entire holding company system by virtue of the fact that a particular subsidiary was engaged in insurance agency activities before May 1, 1982. Only the subsidiary of the bank holding company that was engaged in insurance activities on May 1, 1982, or received Board approval to engage in insurance activities before May 1, 1982, has grandfather status.

The Board believes that the emphasis in the legislative history on the transfer of grandfather rights shows the intent of Congress to prohibit not only the transfer of such rights from ‘‘grandfathered’’ subsidiaries to those affiliates wholly without grandfather rights, but also to prohibit the transfer of grandfather rights with respect to particular kinds of insurance from one ‘‘grandfathered’’ subsidiary to another. Thus, a subsidiary that sold only credit life insurance before the grandfather date should not acquire grandfather rights to sell property and casualty insurance solely because an affiliate sold property and casualty insurance before the grandfather date. The grandfather rights of a particular subsidiary are limited to the precise activities (or their functional equivalent) engaged in before May 1, 1982. This requirement does not preclude the transfer of grandfather rights in the case of a bona fide merger (1983 FRB 554, 555).

Section 225.28(b)(11) of the Board’s Regulation Y is only intended to clarify the exemptions in title VI of the Garn–St Germain Act. It does not authorize any bank holding company to commence any insurance activity, or to acquire a company with insurance activities, without compliance with the notice and application requirements of section 4(c)(8) of the BHC Act.

Geographic Expansion by a Grandfathered Subsidiary of a Bank Holding Company.

The language of exemption D of the Garn–St Germain Act, while limiting the grandfathered activities to those agency activities conducted by the specific grandfathered subsidiary, *does allow* expansion into states where such specific types of agency activities "were conducted by the bank holding company or any of its subsidiaries on May 1, 1982 . . ." If a bank holding company subsidiary is selling a particular type of insurance in a given state, the Board does not believe there is any regulatory or business purpose served by restricting another grandfathered subsidiary from engaging in the same activity in the same location.

Product-Line Expansion

The Board's regulation provides for product-line expansion. A grandfathered subsidiary of a bank holding company may seek approval from the Board to engage in the sale of new types of insurance that protect against the same types of risks as, or are otherwise functionally equivalent to, insurance sold on the grandfather date.

3170.0.3.4.2 Transfer of Grandfather Rights among Subsidiaries

A grandfathered subsidiary of a bank holding company (or its successor) may retain its grandfather rights after merger with an affiliate, if such merger is based on legitimate business concerns, for example, centralized management or increased efficiency, rather than as a means of extending insurance powers. The regulation further provides that bank holding companies must advise the Board before any such merger for legitimate business purposes in order to confirm the transfer of grandfather rights.

3170.0.3.5 Section 225.28(b)(11)(v) of Regulation Y—Bank Holding Company's Insurance Coverage for Internal Operations

The Garn–St Germain Act approved, and the revised Regulation Y included, insurance agency activities where the activities are solely limited to supervising on behalf of insurance underwriters the activities of retail insurance agents who sell—

1. fidelity insurance and property and casualty insurance on the real and personal property used in the operations of the bank holding company or its subsidiaries and
2. group insurance that protects the employees of the bank holding company or any of its subsidiaries.

This provision of Regulation Y is reflective of an intent on the part of Congress to avoid preempting certain practices permissible under Texas law. This insurance relates to a particular situation that may have little applicability elsewhere.

3170.0.3.6 Section 225.28(b)(11)(vi) of Regulation Y—Small Bank Holding Companies

The Board has determined in section 225.28(b)(11)(vi) of its Regulation Y that engaging in any insurance agency activity is permissible if the bank holding company has total consolidated assets of $50 million or less. A bank holding company performing insurance agency activities under this paragraph *may not* engage in the sale of life insurance or annuities except as provided in section 225.28(b)(11)(i) and (iii) of Regulation Y, and it may not continue to engage in insurance agency activities pursuant to that provision more than 90 days after the end of the quarterly reporting period in which total assets of the holding company and its subsidiaries exceed $50 million.

A bank holding company is required to cease general insurance-agency activities pursuant to this provision within 90 days after the end of the quarterly reporting period in which the bank holding company's total assets exceed $50 million. Thereafter, the bank holding company may continue to engage in the sale of insurance pursuant to other exemptions.

3170.0.3.7 Section 225.28(b)(11)(vii) of Regulation Y—Insurance Agency Activities Conducted before 1971

The Board has determined in section 225.28(b)(11)(vii) of its Regulation Y that any insurance agency activity performed at any location in the United States directly or indirectly by a bank holding company that was engaged in insurance agency activities before January 1, 1971, as a consequence of approval by the Board before January 1, 1971, is permissible.

3170.0.3.7.1 Agency Activities

The Board adopted a position in section 225.28(b)(11)(vii) permitting any qualifying bank holding company to engage in general insurance-agency activities without restriction as to location or to type of insurance sold (1985 FRB 171 and 1984 FRB 235, 470). A company qualifies under this provision if it was engaged in insurance agency activities as a consequence of Board approval before January 1, 1971. A very limited number of active bank holding companies received such Board approval in the period from passage of the BHC Act in 1956 until January 1, 1971.

The regulation does not limit the insurance agency activities of a qualifying company by requiring that the company engage only in the sale of such types of insurance as it sold before 1971 from such locations as it conducted insurance agency activities before 1971. The Board's regulation permits the limited number of qualifying companies to engage in general insurance-agency activities pursuant to exemption G regardless of their precise insurance agency activities before 1971 (1985 FRB 171 and 1984 FRB 470).

3170.0.4 INCOME FROM THE SALE OF CREDIT LIFE INSURANCE

3170.0.4.1 Policy Statement on Income from Sale of Credit Life Insurance

Effective May 1, 1981, the Board adopted a policy statement (1981 FRB 431) generally prohibiting employees, officers, directors, or others associated with a state member bank from profiting personally from the sale of life insurance in connection with loans made by the bank. The bank may, however, allow their employees and officers to participate in the income under a bonus or incentive plan not to exceed 5 percent of the recipient's annual salary. Income from the sale of credit-related life insurance should most appropriately be credited to the bank, or alternately to a bank holding company or other affiliate of the bank so long as the bank receives reasonable compensation for its role in selling the insurance. As a general rule, ''reasonable compensation'' means an amount equivalent to at least 20 percent of the affiliate's net income attributable to the bank's credit life insurance sales. (Insurance agency activities engaged in directly by a bank subsidiary are regulated by the chartering authority. However, intercompany transactions should be reviewed by BHC inspection personnel.)

3170.0.4.2 Disposition of Credit Life Insurance Income

The Comptroller of the Currency has issued a regulation dealing with sales of credit life, health, and accident insurance by national banks which prohibits transfer of insurance commissions to an affiliate of the bank unless commission income in proportion to the shares held by the bank's minority shareholders is placed in trust and paid to them periodically. Where the subsidiary bank is wholly owned by a bank holding company, however, the regulation allows the commissions to be credited to the holding company or to its wholly owned subsidiaries (12 C.F.R. 2).

3170.0.5 INSPECTION OBJECTIVES

1. To determine the extent of insurance operations and the overall condition of subsidiaries engaged in insurance agency and underwriting activities.
2. To determine whether the types of insurance sold are in accordance with the provisions of section 225.28(b)(11) of Regulation Y.
3. To determine the impact of the performance of the activities on the parent bank holding company and its subsidiaries.
4. To suggest corrective action when necessary in the areas of policies, procedures, or laws and regulations.

3170.0.6 INSPECTION PROCEDURES

Where the insurance activities are performed through an insurance agency or underwriting subsidiary, perform the following activities:

1. Compare the company's general ledgers with statements prepared for the latest FR Y-6 and the annual report to the state insurance department.

2. Review minutes of the board of directors meetings.
3. Review the activity's compliance with the Board's policy statement on income from the sale of credit life insurance (See section 3170.0.4.1) and the Comptroller of the Currency's regulation dealing with the sales of credit life, health, and accident insurance by national banks (12 C.F.R. 2).
4. Review any agreements, guarantees, or pledges between the subsidiary and its parent holding company or affiliates.

Where the insurance activities are performed through an insurance agency or underwriting subsidiary or directly by the parent company, perform the following procedures:

1. Obtain copies of insurance policies issued to determine that the types and terms of insurance coverage sold are within the scope of those permitted by the Board under section 225.28(b)(11) of Regulation Y.
2. Check for compliance with section 106(b) of the 1970 Amendments to the BHC Act (prohibition against tie-in arrangements).

3170.0.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
General description of permissible insurance agency and underwriting activities		225.28(b)(11)	4–050.1	1986 FRB 829
Garn–St Germain Depository Institutions Act, title VI amending section 4(c)(8) of the BHC Act	1843(c)(8)			
Insurance agency activities permitted for national banks	Section 13, paragraph 11 of the Federal Reserve Act			
Permissibility of some types of mortgage insurance				40 *Federal Register* 2766 40 *Federal Register* 13042 1975 FRB 45 1975 FRB 678
Impermissibility of mortgage guarantee insurance				40 *Federal Register* 44624
Court review of activity				533 F. 2d 224 (5th Circuit, 1976) 558 F. 2d 729 (5th Circuit, 1977)

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Level term credit life insurance				39 *Federal Register* 26318 39 *Federal Register* 32796 40 *Federal Register* 11647
Permissible insurance coverage limited to actual debtors				39 *Federal Register* 7493
Sale of home mortgage redemption insurance				1986 FRB 339, 671 1975 FRB 45
Joint credit life insurance				39 *Federal Register* 38942 1974 FRB 138
Tie-in arrangements	Section 106(b) of the Bank Holding Company Act Amendments of 1970	225.7		38 *Federal Register* 6441 1975 FRB 693, 678, 686
Permissibility of selling insurance in small communities				44 *Federal Register* 65051
Policy statement on income from sale of credit life insurance			3–1556	1981 FRB 431
Transfer of insurance agency grandfather rights in the case of a bona fide merger				1983 FRB 554, 555
Permissibility of credit-related property and casualty insurance activities				1984 FRB 452
Insurance agency activities conducted before 1971—BHCs permitted to engage in insurance agency activities without restriction as to location or to type of insurance sold				1985 FRB 171 1984 FRB 235, 470
General insurance-agency subsidiary qualifies for grandfather privileges under exemption D of the Garn–St Germain Act; grandfather privileges do not terminate upon its acquisition by a nongrandfathered BHC				1987 FRB 276, 672

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

3180.0.1 INSURANCE UNDERWRITING ACTIVITIES

On December 11, 1972, after consideration of a public hearing held on March 24, 1972, the Board amended Regulation Y to add the activity of underwriting credit life insurance and credit accident and health insurance to the list of activities in which a bank holding company may engage, provided that such insurance is directly related to an extension of credit by the holding company system. Such insurance ensures a bank or bank-related firm of repayment of a credit extension in the event of death or disability while at the same time providing the borrower with financial security in either event. In approving this activity, the Board set forth, in a footnote to Regulation Y, requirements to ensure that performance of the activity would result in demonstrable benefits to the public. The Board stated that applications to engage in underwriting activities would be approved only in cases in which the applicant demonstrates that such approval would benefit the consumer or result in other public benefits and that normally such a showing would be made by a projected reduction in rates charged the public for the insurance or an increase in other public benefits resulting from bank holding company performance of this service.

On October 3, 1986, the Board adopted a revision of the provisions of Regulation Y that deals with permissible insurance agency and underwriting activities for bank holding companies. The general revision of the insurance provisions of Regulation Y combined both the insurance agency and insurance underwriting activities reflects amendments to the Bank Holding Company Act by the Garn–St Germain Depository Institutions Act of 1982. The revision of the provisions relating to insurance underwriting eliminated the rate-reduction requirement that previously applied to those companies engaged in the underwriting of credit life, credit accident and health, and involuntary unemployment insurance. Accordingly, bank holding companies engaging in this activity may charge premiums as permitted by the states.

In order for insurance underwriting (including home mortgage redemption insurance) to be permissible in accordance with section 225.28(b)(11) of the Board's revised Regulation Y, the insurance must—

1. be directly related to an extension of credit[1] by the bank holding company or any of its subsidiaries and
2. be limited to ensuring the repayment of the outstanding principal balance due on the extension of credit in the event of the death, disability, or involuntary unemployment of the debtor.

3180.0.1.1 Insurance Underwriting Activities Permissible for Bank Holding Companies per Section 225.28(b)(11)(i) of the Board's Regulation Y—Credit Insurance

The Board permits the insurance underwriting activities described above as well as the insurance agency activities described in section 3170.0.

In section 225.28(b)(11)(i) of Regulation Y, the Board issued three significant interpretations of the term ''extension of credit'' as contained in the Garn–St Germain Act. It permits the underwriting of credit-related life, accident and health, and involuntary unemployment insurance (1) with respect to lease transactions where such lease transactions are the equivalent of loans (leasing is addressed in section 3140.0), (2) in connection with loans secured by residential first mortgages, and (3) in connection with the servicing of loans originated or purchased by the applicant bank holding company and subsequently sold.

Permissible insurance underwriting requires that the credit insurance must be directly related to an extension of credit by the bank holding company or any of its subsidiaries. An ''extension of credit'' includes direct loans to borrowers, and the lease of real or personal property, and loans purchased from other lenders. The first significant interpretation, noted above, allows the inclusion of leasing personal or real property, provided the lease is a nonoperating and full-payout lease, the insurance ensuring the payment of the remaining lease payments that are due in the event of the death, disability, or involuntary unemployment of the lessee.

1. ''Extension of credit'' includes direct loans to borrowers, loans purchased from other lenders, and leases of real or personal property so long as the leases are nonoperating and full-payout leases.

The interpretation thus defines leases as the functional equivalent of an extension of credit.

The second interpretation in paragraph (i) of the regulation involving the definition of ‘‘extension of credit’’ is the permissibility of underwriting home mortgage insurance, which ensures the repayment of the unpaid balance of a residential first mortgage loan in the event of the death or disability of the mortgagor. Exemption A of the Garn–St Germain Act permits the underwriting of any type of life, disability, and involuntary unemployment insurance related to an extension of credit by a bank holding company as long as the face value of the insurance policy does not exceed the ‘‘outstanding balance due’’ on the extension of credit. The Board continues to require that insurance policies written insure only named borrowers or lessees of a particular bank holding company. Such policies could cover both spouses jointly, but only if both spouses were actual borrowers or lessees under the terms of the agreement with the bank holding company (see 1974 FRB 138).

The Board had previously held that the underwriting of home mortgage insurance is not closely related to banking in part because it is more like general life insurance than credit life insurance and in part because banks have not generally underwritten such insurance (see 1980 FRB 660 and 1982 FRB 318). Recently, however, the Board permitted bank holding companies to underwrite such insurance (see 1986 FRB 339 and 1986 FRB 671). In permitting this activity by order, the Board provided detailed findings that the underwriting of home mortgage redemption insurance is permitted by exemption A of the Garn–St Germain Act, is closely related to banking, and does not present the possibility of such significant adverse effects that it should not be added to the list of activities permissible for bank holding companies. The Board also found that home mortgage insurance supports the lending function. The Board thus believes, for the reasons cited in the above-cited orders, that the underwriting of home mortgage redemption insurance is permissible for bank holding companies.

In approving the underwriting of home mortgage insurance by order, the Board relied on commitments by applicants to inform, in writing, borrowers who are prospective purchasers of such insurance that home mortgage redemption insurance is not required and that, if desired, it may be purchased from other sources. The Board has also relied on a commitment for written notice to borrowers that the insurance contract may be rescinded at any time after the loan commitment is made and before closing. In processing applications to engage in the underwriting of home mortgage redemption insurance pursuant to the current regulation, the Board, and the Reserve Banks acting pursuant to delegated authority, will continue to require that such notices be provided to borrowers. In addition, the Board will continue to rely on the fact that premiums for such insurance are payable periodically during the term of the extension of credit, so as to increase the borrower's ability to rescind the insurance and to limit premium financing as an incentive to sell and underwrite such insurance.

A third significant interpretation of the term ‘‘extension of credit’’ found in exemption A of the Garn–St Germain Act involves the underwriting of insurance in connection with the serviced loans (see section 3170.0.3.1) The Garn–St Germain Act limits bank holding companies in general to insurance related to an extension of credit. The term ‘‘extension of credit’’ is used in exemption A to describe transactions in which the funds of the bank holding company or its subsidiaries have been placed at risk, including direct loans or leases or loans that have been purchased. Loans that are merely being serviced by the bank holding company generally would not be covered by this definition.

The underwriting of insurance on loans being serviced is necessary only when the term of the insurance was originally shorter than that of the loan. The bank holding company that is selling and underwriting insurance on the loan that it originated and is servicing is, in effect, only extending the term of its original insurance policy to be coterminous with the duration of the loan. It is providing insurance that it could have provided previously. A bank holding company may not underwrite insurance in the case where it is merely servicing a loan and it has never placed its funds at risk either by originating or purchasing the loan.

3180.0.2 LIMITED PROPERTY INSURANCE RELATED TO AN EXTENSION OF CREDIT (FINANCE COMPANY SUBSIDIARY OF A BANK HOLDING COMPANY)

The Board's revised regulation does not permit the underwriting of this type of insurance. See section 225.28(b)(11)(ii) of Regulation Y and section 3170.0.3.1 for information on authorized insurance agency activities.

3180.0.3 INSURANCE ACTIVITIES BEFORE 1971

The Board's revised regulation (section 225.28(b)(11)(vii)), as it relates to exemption G of the Garn–St Germain Act, does not authorize underwriting activities for bank holding companies. See section 3170.0.3.7 for information on the respective authorized insurance-agency activities under exemption G.

3180.0.4 UNDERWRITING AS REINSURER

The majority of bank holding company subsidiaries engaged in insurance underwriting are reinsurers rather than direct underwriters. As reinsurer, these companies engage a direct insurer to issue the policies, collect the premiums, pay claims, maintain accounting books and records, prepare federal and state tax returns, and perform other services necessary to conduct the insurance activities. Usually, such reinsurance companies will have executed a reinsurance agreement and a service agreement with the direct underwriter which spell out all services to be performed and set the fees to be paid for such services. The above arrangement involves a minimum of activity by the reinsurer and is probably most often chosen by bank holding companies since it does not place additional burdens on management and precludes hiring actuaries and other professional personnel to manage the insurance company.

There are many ratios or measures used to evaluate the condition of insurance underwriters. The National Association of Insurance Commissioners has developed a system consisting of nine ratios that measure various aspects of life and health insurance companies' financial condition and stability *(The Early Warning System for Life and Health Insurance Companies)*. These tests establish benchmarks which are likely to distinguish between troubled and sound companies. The examiner may wish to compare the subject company's ratios to these benchmarks. When making comparisons, however, the examiner should recognize that one insurer may require a somewhat better ratio than another due to greater underwriting and investment risks. Smaller companies will generally maintain a proportionately larger surplus account since loss experience on a small volume of business tends to fluctuate more widely.

Another possible source of information available to help determine a company's condition is *Best's Insurance Reports*. The report is published annually and provides pertinent financial and historical data for legal reserve life insurance companies operating in the United States and Canada. It assigns a rating for each company in the report. Information presented in the report is taken from annual statements filed with the state insurance departments. It should be noted that reports filed with the insurance departments are prepared using the statutory method of financial accounting and presentation rather than generally accepted accounting principles. Beginning in 1973, insurance companies were required to adhere to generally accepted accounting principles for certification of financial statements (see *Audits of Stock Life Insurance Companies,* American Institute of Certified Public Accountants), however, they continue to report under the statutory method to the state insurance departments. The statutory method is basically a cash-basis accounting presentation which generally depicts a more conservative position. Certain assets are "not admitted" by regulatory authorities in the financial presentation because they are not readily convertible into cash for the payment of claims and expenses.

Policy reserves represent the primary liability portion of underwriters' balance sheets. There are several acceptable methods permitted by state authorities for calculating these reserves. Most of these methods are rather complicated and a description of their calculation is beyond the scope of this manual. However, insurance companies are generally closely regulated by state authorities, which place primary importance on determining the adequacy of the policy reserves. A review of the latest available insurance examination report should give an evaluation of the adequacy of the reserves.

Reinsurance arrangements may distribute the insurance and losses in many different ways between the direct insurer and the reinsurer. An understanding of such arrangements is essential in determining the extent of risk incurred by the company being inspected.

3180.0.5 INSPECTION OBJECTIVES

1. To determine the extent of underwriting activities and the overall condition of subsidiaries engaged in underwriting.
2. To determine whether the activities performed are within the scope of those permitted under section 225.28(b)(11) of Regulation Y.

3. To determine the impact of the underwriting operations on the parent bank holding company and its subsidiaries.
4. To suggest corrective action where necessary in the areas of policies, procedures, or laws and regulations.

3180.0.6 INSPECTION PROCEDURES

Where the insurance underwriting activities are performed through an underwriting subsidiary, perform the following procedures:

1. Compare the company's general ledgers with statements prepared for the latest FR Y-6. (Generally, records are maintained on the statutory accounting basis and are more easily tied to the financial statements in the annual report to the state insurance department).
2. Review minutes of the board of directors meetings.
3. Review the quality and liquidity of the subsidiary company's investments in CDs, stocks, bonds, or other marketable securities.
4. Review intercompany transactions, including balances maintained with or assets purchased from affiliated banks.
5. Review any agreements, guarantees, or pledges between the company and its parent holding company or affiliates.

Where the insurance activities are performed either directly or through an underwriting subsidiary, perform the following procedures:

1. Review copies of any reinsurance and/or service agreements executed with other insurance companies.
2. Review the latest annual report submitted to the state insurance department.
3. Review the latest report of examination prepared by the state insurance department.
4. Check calculation of premium charges by a random sample of policies for adherence to the state rate structure.
5. Obtain copies of insurance policies issued to customers to determine that the types of insurance coverage and terms offered are within the scope of those permitted under section 225.28(b)(11) of Regulation Y.

3180.0.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Permissible underwriting activities	12 U.S.C. 1843(c)(A)–(G)	225.28(b)(11)	4–050.1	
Underwriting of permissible credit-related home mortgage insurance				1986 FRB 671, 339
Nonpermissibility of mortgage guarantee insurance				1974 FRB 727
Underwriting of joint credit life insurance			4–337	39 Federal Register 7493 1974 FRB 138

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Courier activities are permissible for bank holding companies if the items being transported by the courier are themselves related to bank operations. Examples of such items are drafts, money orders, travelers' checks, commercial papers, written instruments, and data processing material. Currency and bearer-type negotiable instruments which require more than normal security measures may not be transported by the company.

If the courier company operates under the exemptive provision of section 4(c)(8) of the Bank Holding Company Act, the following restrictions are placed on its operations to ensure competition:

1. The company must be a separate, independent corporate entity.
2. The company must be profit-oriented and not subsidized by the holding company system.
3. Services of the company must be performed on a specific-fee basis with direct payment from the customer. Payment may not be made indirectly such as through maintenance by the customer of deposit balances at an affiliated bank.
4. Upon request, the company must furnish comparable services at comparable rates to firms which compete with banking or data processing subsidiaries of its parent company, unless compliance with the request would be beyond the practical capacity of the company.

The last restriction was intended to prevent use of bank-affiliated courier services for the purpose of gaining an advantage over competitors to whom courier services were not otherwise available.

3190.0.1 INSPECTION OBJECTIVES

1. To determine if the company is operating in compliance with applicable laws and regulations, and ensure that corrective action will be taken, if appropriate.
2. To determine if courier services are provided to competing institutions upon their request if courier services are not otherwise available.

3190.0.2 INSPECTION PROCEDURES

1. Determine whether the company makes known to its customers its minimum rate schedule for services and its general pricing policies.
2. Determine whether the company maintains for a period of two years or more the records of each request for service which it has denied to firms competing with the banking and data processing subsidiaries of its parent company. The reasons for the denial must also be recorded and maintained for a like period.
3. Review income statements of the company to ascertain whether the company is operating profitably, without a subsidy in any manner from any entity within the holding company system. Any operating losses sustained over an extended period of time are inconsistent with continued authority to engage in courier services.
4. Determine whether the materials transported by the company are restricted to those which would normally be exchanged among banks and banking institutions, including audit and accounting media of a banking or financial nature, and other business records or documents used in processing such media.

3190.0.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Courier activities of bank holding companies		225.28(b)(10)		1973 *Fed. Reg.* 32136 1975 *Fed. Reg.* 36309
Conditions of entry into courier activities		225.129	4–180	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

On February 26, 1974, the Board amended Regulation Y to permit bank holding companies to engage in the activity of providing bank management consulting services to nonaffiliated commercial banks. The advisee institution must be a ‘‘bank’’ as that term is defined by section 2(c) of the BHC Act or an operations subsidiary of such an institution. (See 12 C.F.R. 250.141.) Effective April 20, 1982, the Board expanded this activity by permitting holding companies to provide management consulting advice to nonbank depository institutions. When expanding the activity to include management consulting advice to nonbank depository institutions, the Board indicated that the advisory services provided to nonbank institutions should generally be the services that were then being provided to banks.

Effective April 21, 1997, management consulting was expanded in Regulation Y (section 225.28(b)(9) to allow bank holding companies to provide management consulting services regarding financial, economic, accounting, or audit matters to any company on any matter. The total annual revenue derived from third-party management consulting services by a nonbank subsidiary of the bank holding company cannot exceed 30 percent of the subsidiary’s total annual revenues derived from all management consulting activities. The Board continues to view ‘‘management consulting’’ as including, but not limited to, providing analysis or advice as to a firm’s—

1. purchasing operations, such as inventory control, sources of supply, and cost minimization subject to constraints;
2. production operations, such as quality control, work measurement, product methods, scheduling shifts, time and motion studies, and safety standards;
3. market operations, such as market testing, advertising programs, market development, packaging, and brand development;
4. planning operations, such as demand and cost projections, plant location, program planning, corporate acquisitions and mergers, and determination of long-term and short-term goals;
5. personnel operations, such as recruitment, training, incentive programs, employee compensation, and management-personnel relations;
6. internal operations, such as taxes, corporate organization, budgeting systems, budgeting control, evaluation of data processing systems, and efficiency evaluations; and
7. research operations, such as product development, basic research, and product design and innovation.

By interpretation, the Board previously determined that it considers bank management consulting advice to include, but not be limited to, advice concerning (1) bank operations, systems, and procedures; (2) computer operations and mechanization; (3) implementation of electronic funds transfer systems; (4) site planning and evaluation; (5) bank mergers and the establishment of new branches; (6) operation and management of a trust department; (7) international banking and foreign-exchange transactions; (8) purchasing policies and practices; (9) cost analysis, capital adequacy, and planning; (10) auditing; (11) accounting procedures; (12) tax planning; (13) investment advice as authorized in section 225.28(b)(6) of Regulation Y; (14) credit policies and administration, including credit documentation, evaluation, and debt collection; (15) product development, including specialized lending provisions; (16) marketing operations, including research, market development, and advertising programs; (17) personnel operations including recruiting, training, evaluation, and compensation; and (18) security measures and procedures. Providing management consulting advice on compliance with laws and regulations may be accomplished only when these activities are incidental to a primary consulting activity and when such advice would not constitute the rendering of legal advice.

In general, those consulting services which correspondent banks traditionally have provided to their respondents (both bank and nonbank depository institutions) are considered to be included within the scope of Regulation Y as permissible services to be provided by nonbank holding company subsidiaries to nonaffiliated bank and nonbank depository institutions.

3200.0.1 MANAGEMENT CONSULTING LIMITATIONS

Recognizing the potential for conflict-of-interest situations, such as the possibility for anticompetitive cooperative arrangements, improper use of confidential information, and similar abuses that this activity could entail, the Board incorporated in Regulation Y a few restrictions on a bank holding company. With regard to affiliation status, neither the bank holding company nor any of its subsidiaries may own or control directly or indirectly more than 5 percent of the voting securities in the client institution. The prohibition would not apply when the shares were acquired in satisfaction of a debt previously contracted or to shares acquired in a fiduciary capacity without sole discretionary voting authority. A bank holding company may offer consulting advice to a client institution whose shares it holds in a fiduciary capacity with sole discretionary voting rights if said holding company does not hold more than 5 percent of the voting shares of that institution. Bank holding companies are permitted to have common management officials with the client institution to which they provide management consulting services if such interlocks would be permissible under exceptions found in the Board's Regulation L (Management Official Interlocks) that apply to such institutions in need of management or operating expertise (12 C.F.R. 212.4(b)).

Management consulting services may not be provided to a client on a daily or continuing basis except where necessary to instruct the client on how to perform the services for itself. The Board has informed bank holding companies that their management consulting subsidiaries should refrain from entering relationships on a daily or continuing basis even when the client institution may be experiencing financial or managerial difficulties. Particular caution should be exercised when a bank holding company contemplates the subsequent acquisition of the client institution. However, when a bank holding company is attempting to acquire a troubled depository institution, limited management consulting services may be offered via an on-premises bank holding company employee. Nevertheless, the representative should not have the authority to lend or make personnel decisions. Failure to heed these guidelines not only would cause the bank holding company to exceed the permissible bounds of the activity, but also could cause it to acquire control of the client institution that might constitute an acquisition of a subsidiary within the meaning of section 3(a) of the BHC Act. Section 225.31(d)(2)(i) of Regulation Y indicates that a rebuttable presumption of control shall exist when a company enters into an agreement, such as a management contract, with a bank or other company pursuant to which the first company or any of its subsidiaries exercises significant influence over the general management or overall operations of the bank or other companies. Reserve Bank personnel are encouraged to contact the Board's applications section to discuss the restrictions on this activity whenever a BHC proposes to have its personnel assist a troubled or problem institution.

When evaluating a BHC's application to engage in management consulting, it is important to note whether the applicant bank holding company has exhibited the necessary expertise in the operation of its own subsidiaries—and whether this qualifies it to offer advice to others.

3200.0.2 INSPECTION OBJECTIVES

1. To verify that the bank holding company is performing only those types of management consulting services at those locations for which it received prior regulatory approval.
2. To verify that the advice being provided is within the scope of the approval and consistent with the activities of the interpretation (12 C.F.R. 225.131) and section 225.28(b)(9) of Regulation Y.
3. To determine that the bank holding company does not own or control, directly or indirectly, securities of its client depository institutions except for shares acquired as the result of a default on a debt previously contracted or shares held in a fiduciary capacity (within certain limits), provided the holding company does not have sole discretionary authority to vote more than 5 percent of the client's shares. (See 12 C.F.R. 225.131.)
4. To determine that the bank holding company does not control the activities of a client institution by virtue of nonexempt interlocking directors.
5. To determine that services rendered to the client institutions are not being provided on a daily or continuing basis.
6. To determine that disclosure is made to each client of (1) the names of all depository institutions that are affiliates of the consulting company and (2) the names of all existing client institutions located in the same county (or counties) or standard metropolitan statistical area(s) (SMSA) as the client institution.

3200.0.3 INSPECTION PROCEDURES

A thorough review of pertinent records, contracts, lists of clients, and documentation of the services being provided to clients should be undertaken to determine that adequate management information systems and detailed revenue and other reports are available to verify the BHC's compliance with the Board's rule on the revenue limitations in section 225.28(b)(9) of Regulation Y. Determine that services are being provided to the appropriate customer base and within the scope of the Board's approval. Further, the examiner should ascertain the existence of procedures to inform each potential client of the names of all depository and client institutions that are affiliates of the consulting company and of the names of all existing clients located in the same market area as the prospective client.

For management consulting services that do not involve any financial, economic, accounting, and auditing matters, verify that the revenues earned are within the limits permitted by the Board's regulations and interpretations. The basis for any fee structure should be determined to ascertain that the advice is being rendered on an explicit-fee basis, such as an hourly or daily rate. Such fees should not be affected by factors not directly related to the service, such as balances maintained by the client at any subsidiary depository institution of the bank holding company. The extent of the consultant company's involvement in the day-to-day affairs and operation of the client should also be reviewed.

The absence of parent company control, direct or indirect, over the clients of the management consulting subsidiary should be established. The examiner should compare listings of directors and principal officers of the bank holding company, its various affiliates, and the clients with due regard to exempt interlocks. The examiner should determine the extent of ownership or control by the bank holding company and its affiliates of any equity securities in its clients by requesting a listing of all shares owned in outside organizations. Overall conclusions, including recommendations concerning the operation, apparent violations, and any possible control of client institutions and conflicts of interest, should be discussed with parent company management and detailed in the inspection report.

3200.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Orders, interpretation preceding permissibility of bank management consulting	225.131 225.113		4–194	1972 FRB 676 1972 FRB 674
Bank management consulting authorized as permissible nonbank activity		225.28(b)(9)	4–181	1974 FRB 226 1974 FRB 675
Presumption of control		225.31(d)		
Exemption from section 8 of Clayton Act for banks in low-income areas			3–830	
Bank management consulting as possible rendering of legal advice				39 *Fed. Reg.* 41586
Other approvals				39 *Fed. Reg.* 39106 39 *Fed. Reg.* 36508 1976 FRB 725

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Justice Department concern over possible conflicts of interest				1977 FRB 950
Limitations on activity when acquisition of bank is involved				1976 FRB 699 1977 FRB 1088
Permissible interlocking directors		212.4(a)(1)		1979 FRB 654
Deferral of decision to consider offering of management consulting advice to unaffiliated savings banks as a permissible activity				42 *Fed. Reg.* 22560
Expanding activity to include non-bank depository institutions				1982 FRB 237 and 238
Management consulting to failed savings associations				1988 FRB 771
Expansion of the activity to include— 1. services regarding financial, economic, accounting, or audit matters to any company; 2. the ability of the BHC's non-bank subsidiary to provide limited management consulting services to any third-party customer on any matter.		225.28(b)(9)(i)		1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Within Regulation Y (section 225.28(b)(9)(ii)), management consulting and counseling activities include employee benefits consulting services. Employee benefits consulting services include providing consulting services to employee benefit, compensation, and insurance plans, including designing plans, assisting in their implementation of plans, providing administrative services thereto, and developing employee communication programs for such plans. A bank holding company nonbank subsidiary's total annual revenue derived from third-party management consulting services to any customer on any matter (including third-party employee benefits consulting and career counseling services) may not exceed 30 percent of its total annual revenue derived from management consulting activities.

The initial Board orders that were issued to permit employee benefit consulting services are summarized here as historical examples of the nonbanking activity. Commitments made in those Board orders should not be relied upon. Refer only to the provisions within the current Regulation Y, as cited above.

3202.0.1 BOARD ORDERS INVOLVING EMPLOYEE BENEFITS CONSULTING

A bank holding company (the applicant) applied for the Board's approval under section 4(c)(8) of the BHC Act and Regulation Y to acquire 100 percent of the voting shares of a company that provides a full range of services involving employee benefits plans. The services are divided into four basic types of activities:

1. *Plan design.* Designing employee benefit plans, including determining actuarial funding levels and cost estimates.
2. *Plan implementation.* Providing assistance in implementing plans, including assistance in the preparation of plan documents and in the implementation of employee benefit administration systems.
3. *Administrative services.* Providing administrative services with respect to plans, including recordkeeping services, calculating and certifying employment reports and government filings pursuant to ERISA, and providing information to a client's legal counsel in labor relations and negotiations.
4. *Employee communications.* Developing employee communication programs with respect to plans for the benefit of the client.

The applicant represented that all of the proposed activities were included in trust company or financial or investment advisory service activities permissible under Regulation Y. Although certain employee benefits consulting activities (as conducted by the company being acquired, particularly activities involving plan administration) are conducted by trust companies or trust departments of banks in their capacities as trustees or custodians of employee benefit plans and investment managers of plan assets, it was not apparent that the *complete range* of employee benefits consulting services were generally conducted by trust companies or authorized by the Board as permissible trust company activities under Regulation Y.

The Board believed that employee benefits consulting was essentially a financial planning activity involving preparing and conveying financial data to a client, which it had previously determined to be closely related to banking and permissible under Regulation Y in the areas of investment advisory services, data processing services, and courier services. The record did not indicate, however, that employee benefits consulting is wholly encompassed within *any or all* of those activities. The Board, therefore, did not agree with the applicant that *all* of the proposed activities were currently authorized for bank holding companies under existing provisions of Regulation Y.

A review of the four basic types of activities revealed that many of the proposed employee benefits consulting activities either were already specifically engaged in by banks and trust companies, or were functionally related to activities in which banks and trust companies were regularly engaged. The Board recognized, however, that the actuarial aspect of the employee benefits consulting activities is not generally included in trust company or bank activities. Such activities are limited in scope and purpose in that they are conducted primarily as a means to ensure adequate funding of defined benefits plans. In this case, they were performed solely as a means for the applicant to provide a full range of benefits-planning activities for its clients. The acquired company's actuarial services would not be conducted as an independent activity, but only as a necessary and integrally related component of employee benefits consulting.[1]

In *Association of Data Processing Organizations, Inc. v. Board of Governors,* 745 F.2d 277 (D.C. Cir. 1984), the court of appeals held that the Board may permit those activities that are ''a part of'' the overall permissible activity where, as here, ''in both market contemplation and technological reality, the service is a unitary one.'' Based on this ruling, the Board concluded that the applicant's proposed activities are permissible as closely related to banking, and were approved on June 19, 1985 (1985 FRB 656).

Another Board order permitting the provision of employee benefits consulting services, which is slightly different from the order cited above, is found in 1986 FRB 337. See also 1986 FRB 729 and 1987 FRB 158, 681.

1. As part of its acquisition, the bank holding company proposed to assist firms in IRS audits of plans; inform clients of developments in employee benefit programs through newsletters and other correspondence and through participation in seminars, public programs, and other forums; and engage in professional actuarial activities and other activities incidental to the actuarial profession. The activities are generally related to the type of actuarial activities performed for purposes of engaging in employee benefits consulting and that would not generate any significant income. Such activities were, therefore, permissible as incidental to the bank holding company's approved activities. The applicant also proposed to provide expert actuarial opinions of a general nature for purposes such as divorce actions and personal injury litigation. The Board believed that such activities were beyond the scope of incidental activities and were not permissible.

Career counseling services may be provided to—

1. a financial organization[1] and individuals currently employed by, or recently displaced from, a financial organization;
2. individuals who are seeking employment at a financial organization; and
3. individuals who are currently employed in or who seek positions in the finance, accounting, and audit departments of any company.

The initial Board order that was issued to permit the provision of career counseling services is summarized below as a historical example on the origination of this nonbanking activity. Commitments made in the Board order should not be relied upon. See the current provisions of Regulation Y (section 225.28(b)(9)(iii)) for that purpose.

3204.0.1 CAREER COUNSELING—INITIAL BOARD ORDER

A bank holding company (the applicant) applied for the Board's approval under section 4(c)(8) of the BHC Act and the Board's Regulation Y to provide career counseling services to unaffiliated parties through its wholly owned nonbank subsidiary. The applicant proposed to expand its employee benefits consulting services to include career counseling activities. The nonbank subsidiary currently provides these services to the applicant and its affiliates under section 4(c)(1)(C) of the BHC Act. It plans to expand the provision of these services nationwide to unaffiliated companies and individuals in a wide array of industries. The services would provide assistance to individuals who are employed and seeking advancement in their careers and to unemployed individuals who are seeking new employment. The nonbank subsidiary plans to provide these services directly to companies and advise these companies on effective methods of providing career counseling services to their employees.

The nonbank subsidiary will advise unaffiliated organizations on the advantages of including career counseling services as part of a comprehensive employee benefits plan. It will assist these organizations in establishing their own facilities to implement career counseling services for their current or former employees. If the organization does not want to operate its own counseling facility, the nonbank subsidiary will provide the services directly to the organization's current or former employees at the nonbank subsidiary's career assistance center.

The proposed career counseling services include (1) assessing an individual's education, prior business experience, salary history, interests, and skills to aid in finding employment or evaluating opportunities for career development; (2) assisting in the preparation of résumés and cover letters; (3) contacting employers regarding employment opportunities and making this information available to clients; (4) conducting general workshops on the financial aspects of unemployment, current economic trends, the process of finding a job, and alternative career options; and (5) providing individual counseling on setting and obtaining employment goals.

The issue presented to the Board was whether the proposed activities are closely related to banking. The Board had not previously determined whether providing career counseling services to unaffiliated parties is closely related to banking under section 4 of the BHC Act and permissible for bank holding companies. The Board viewed the applicant's proposal in four parts: (1) career counseling services for financial organizations (that is, banks, bank holding companies and their subsidiaries, thrift institutions, and thrift holding companies and their subsidiaries) and employees of financial organizations; (2) career counseling services for individuals who are unemployed or employed outside the banking industry and who seek employment at banks and other financial institutions; (3) career counseling for individuals seeking financial positions (such as chief financial officer, cash management positions, and accounting and auditing personnel); and (4) career counseling services generally for any individual seeking any type of employment at any type of company.

The Board determined that career counseling services are closely related to banking when they are provided for (1) financial organizations and individuals currently employed at, or recently displaced from, a financial organization; (2) individuals who seek employment at a financial organization; and (3) individuals who

1. Financial organization means insured depository institution holding companies and their subsidiaries, other than nonbanking affiliates of diversified savings and loan holding companies that engage in activities not permissible under section 4 (c)(8) of the BHC Act.

are currently employed in, or who seek, financially related positions at any company. The Board concluded that the record does not presently support a finding that general career counseling services are otherwise closely related to banking.[2]

The applicant will provide career counseling services on a fee basis with no guarantee of employment. The Board approved the order on November 8, 1993. As a condition to its approval, the applicant must comply with all commitments made in connection with the application, as well as with other conditions stated within Regulation Y and the Board's order. (1994 FRB 51)

2. When providing career counseling for an individual within one of the three proposed categories, the applicant was permitted to provide limited career counseling services regarding positions outside of these categories as ''incidental'' to the proposed career counseling services. However, the applicant is not permitted to hold itself out as a provider of general career counseling services for individuals seeking career opportunities outside the banking or financial industries. Regulation Y and judicial decisions construe ''incidental activities'' as activities that must be necessary to the provision of a closely related activity in order to be considered incidental. (See 12 C.F.R. 225.21(a)(2) and *National Courier Association v. Board of Governors*, 516 F.2d 1229, 1240–41 (D.C. Cir. 1975).)

The Board has included in Regulation Y (see section 225.28(b)(13)) the authority to issue and sell at retail money orders and similar consumer-type payment instruments; the sale of U.S. savings bonds; and the issuance and sale of travelers' checks. Previously, the Board, through various orders, had authorized over time various nonbanking activities in this regard. Initially, it permitted by order and then the Board had included in the list of permissible activities the sale and issuance at retail of money orders having a face value of not more than $1,000, the sale of U.S. savings bonds, and the issuance and sale of travelers' checks. In its original order, effective February 26, 1979, the Board did not include the issuance of travelers' checks. However, after overwhelmingly favorable responses to its proposal to include the issuance of travelers' checks to the list of permissible activities, the Board included this activity effective December 21, 1981. As part of the Board's regulatory review of Regulation Y, and its subsequent overhaul, which was finalized and made effective February 4, 1984, the *issuance* of money orders was listed as a permissible activity. On March 16, 1984, the Board, by order, increased the face value of the payment instruments that the bank holding company could issue to $10,000, if the bank holding company agreed to meet certain weekly reporting requirements (1984 FRB 364). Also, by order dated December 16, 1985, the Board allowed the sale of official checks with no maximum limitation as long as the proceeds of checks in excess of $10,000 were deposited in a demand account and the bank holding company made weekly reports of these checks as well as money orders that had a face value of up to $10,000 (1986 FRB 148). The Board later authorized the issuance and selling of variably denominated payment instruments without limitation as to face value. (See 1993 FRB 42.) As part of the comprehensive revision of Regulation Y, effective April 21, 1997, the Board removed the limitation of the face amount of payment instruments. (See section 225.28(b)(13) of Regulation Y.)

3210.0.1 INSPECTION OBJECTIVES

1. To determine that the scope of the activity is within the parameters established by the Board.
2. To determine if there is any loss exposure due to the lack of systems and controls.

3210.0.2 INSPECTION PROCEDURES

In determining whether a significant degree of risk exposure to the BHC exists, the examiner should address the following questions to management, when considered appropriate:

1. Are there written agreements between the bank and its parent concerning the obligations of each for the sale of money orders and U.S. savings bonds and for the issuance and sale of travelers' checks? Do the agreements provide information on the fees, reimburseable expenses, sharing of overhead expenses, and taxes?
2. Who prints the travelers' checks and money orders?
3. Is the printer bonded or covered by insurance?
4. Is the newly printed inventory of travelers' checks and money orders received in dual custody?
5. If check inventory sent to outlets is on a consignment basis, does the consignee acknowledge receipt on a "trust receipt"?
6. Does the consignment "inventory invoice" describe, in complete detail, the number of checks, serial numbers, and denominations?
7. How are inventories and sales monitored at the outlet level?
8. What are the maximum dollar shipments for the day, per outlet and per package?
9. Does the subsidiary bank maintain the settlement account?
10. What procedures are in effect to establish the checks that have been sold?
11. What are the remittance requirements for the agents for checks sold?
12. If losses and redemptions exceed proceeds from sales, who makes up the deficiency?
13. Does the parent invest the settlement account's float, generated by the excess of proceeds received over checks redeemed, in long-term investments?
14. If a nonbank subsidiary acts as agent on behalf of its parent, what fee is paid by the parent other than commissions on the sale of checks?
15. Is the subsidiary reimbursed for its expenses?
16. What has been the history of losses?
17. How long are losses carried in suspense accounts before being charged off?
18. Does the subsidiary bank maintain compensating balances in financial institutions as

an inducement for the financial institutions to carry the holding company's travelers' checks? If so, does the parent compensate the bank for lost income?

19. What internal audit procedures are in place? Discuss frequency, scope, and follow-up.

3210.0.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Adding activity to permissible list (excluding issuance of travelers' checks)		225.28(b)(13)		1979 FRB 265
Adding the issuance of travelers' checks to permissible list		225.28(b)(13)		1981 FRB 912
Increased face value or payment instruments to $10,000, if weekly reports provided				1984 FRB 364
Sale of official checks with no maximum amount, if checks in excess of $10,000 deposited in demand deposit account, if weekly reports of checks made as well as money orders with face value up to $10,000				1984 FRB 148
Sale of official checks with no maximum limitation provided the proceeds of checks in excess of $10,000 were deposited in a demand account and that weekly reports of the official checks were made as well as the total value of official checks with face values exceeding $10,000				1986 FRB 148
Issuing and selling drafts and wire transfers in foreign currencies				1988 FRB 252
Issuing and selling variably denominated payment instruments without limitation as to face value				1993 FRB 42
Removal of the limitation on the face amount of payment instruments		225.28(b)(13)		1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

As noted in section 3210.0, the Board has authorized the issuance and sale of various payment instruments. This section provides brief historical summaries of the initial Board orders that led to the incorporation of the activity into the Regulation Y ‘‘laundry list.’’ Provisions within the Board orders, including commitments and any regulatory references, should not be relied upon as provisions that are currently authorized. For the current regulatory authorization, see section 225.28(b)(13) of Regulation Y, effective April 1997.

3210.1.1 ISSUING CONSUMER-TYPE PAYMENT INSTRUMENTS HAVING A FACE VALUE OF NOT MORE THAN $10,000

A bank holding company applied for the Board’s approval under section 4(c)(8) of the BHC Act and section 225.23 of the Board’s Regulation Y to engage de novo in the issuance and sale of variably denominated payment instruments with a maximum face value of $10,000. The instruments would be sold in U.S. dollars and foreign currency by the holding company’s subsidiaries and unaffiliated financial institutions and would consist of domestic and international money orders and official checks. They would also be used for certain internal transactions, such as payroll. The Board had recently amended Regulation Y to include on the list of permissible nonbanking activities the issuance or sale of money orders and other similar consumer-type instruments with a face value not exceeding $1,000. The Board concluded that an increase in the denomination of such instruments would not affect their fundamental nature.

As a condition to its approval, the Board required the bank holding company to file with the Board weekly reports of daily data on the activity. The issuance of such instruments with a face value of more than $1,000 could have an adverse effect on the bank holding company’s reserve base. Because reserve requirements serve as an essential monetary policy tool, the Board was concerned that the proposal might result in adverse effects resulting from an erosion of reservable deposits within the banking system (1984 FRB 364).

3210.1.2 ISSUING AND SELLING OFFICIAL CHECKS WITH NO MAXIMUM FACE VALUE

Effective December 16, 1985, the Board approved by order a bank holding company’s application to sell official checks with no maximum limitation on the face value, so long as the proceeds of checks in excess of $10,000 were deposited in a demand account at its subsidiary until the respective payment instrument was paid. To address the Board’s monetary policy concerns about the activity potentially causing a significant reduction in the reserve base or resulting in other adverse effects on the conduct of monetary policy, the bank holding company agreed to make weekly reports of all outstanding instruments (including money orders and official checks) with face values of up to $10,000, and also the aggregate value of all official checks with face values exceeding $10,000 (1986 FRB 148).

3210.1.3 ISSUING AND SELLING DRAFTS AND WIRE TRANSFERS PAYABLE IN FOREIGN CURRENCIES

A foreign bank subject to the BHC Act applied for the Board’s approval under section 4(c)(8) of the act and section 225.23(a)(3) of Regulation Y to engage de novo through a wholly owned subsidiary in the issuance and sale of foreign drafts and wire transfers with unlimited face amounts that are payable in foreign currencies. The applicant proposed to conduct these activities through the subsidiary as well as through a nationwide network of unaffiliated selling agents, including commercial banks, thrift institutions, and others.

The Board previously determined that the issuance and sale of money orders and similar payment instruments with a maximum face value of $1,000 is closely related to banking. (See former section 12 C.F.R. 225.25(b)(12).)[1] The Board also approved by order a limited number of applications to engage in the issuance and sale of (1) payment instruments with a $10,000 maximum face amount (see 1987 FRB 727) and

1. Effective April 21, 1997, the $1,000 limit was eliminated. The revised Regulation Y (see section 225.28(b)(13)) authorizes the issuance of payment instruments of any amount.

(2) payment instruments with unlimited face amounts, subject to certain operational and reporting requirements (see 1986 FRB 148).

In considering the previous applications, the Board expressed concern that the issuance of payment instruments in denominations larger than $1,000[2] would have an adverse effect on the reserve base because such instruments are not subject to the transaction reserve account requirements of the Board's Regulation D. The Board noted that because reserve requirements serve as an essential monetary policy tool, the conduct of monetary policy could be adversely affected by the erosion of reservable deposits in the banking system.

To address the concerns expressed in previous Board orders, the applicant committed that the proceeds of all sales of foreign-currency-denominated instruments will be held in demand deposit accounts at U.S. commercial banks. Deposits stemming from the sale of instruments with denominations of $10,000 or less are to be swept daily into nonreservable instruments. The total proceeds of the sale of any payment instruments with denominations greater than $10,000 will be deposited in a demand deposit account at a U.S. depository institution, to be used to purchase foreign currency for each particular payment instrument at the time of the transaction. The Board determined that these commitments and other procedures outlined in the order adequately addressed its concerns about the potential adverse effects on the reserve base. The Board approved the application on February 3, 1988, subject to the continued evaluation of its potential for adverse effects on the conduct of monetary policy (1988 FRB 252).

3210.1.4 ISSUING AND SELLING VARIABLY DENOMINATED PAYMENT INSTRUMENTS WITHOUT LIMITATION AS TO FACE VALUE

A bank holding company applied for the Board's approval under section 4(c)(8) of the BHC Act to engage both directly and indirectly through a bank holding company nonbank subsidiary in the issuance and sale of variably denominated payment instruments without limitation as to face value and without the reporting and reservable deposit requirement previously imposed by the Board on issuers of such instruments.

The Board previously determined by regulation that the issuance and sale of money orders and other similar consumer-type payment instruments with a face value not exceeding $1,000[3] is an activity that is closely related to banking and is therefore permissible for bank holding companies (see former section 225.25(b)(12) of Regulation Y (12 C.F.R. 225.25(b)(12))).

Effective December 22, 1992, the Board amended Regulation D to impose reserve requirements on teller's checks. The Board's notice amending Regulation D stated that bank holding companies that had received prior approval under section 4(c)(8) of the BHC Act to issue and sell variably denominated payment instruments—subject to the demand deposit requirement, reporting requirement, or limits on the denomination of payment instruments—could request relief by letter from those conditions. The Board believes that the adverse effect of erosion of the reserve base is addressed in the Regulation D revisions, and special reporting and demand deposit requirements previously imposed by the Board in connection with approvals to engage in the issuance and sale of variably denominated payment instruments in amounts over $10,000 are no longer needed. As a result, the Board determined not to impose those requirements on the applicant and to grant the applicant's request for relief from the reporting requirement to which it was subject. The Board approved the application on November 12, 1992, subject to the Regulation D effective date of December 22, 1992, and the conditions and commitments stated in the order (1993 FRB 42).

2. See footnote 1.

3. See footnote 1.

Section 4(c)(8) of the BHC Act (Arranging Commercial Real Estate Equity Financing) Section 3220.0

Effective September 1, 1982, the Board approved an application of a bank holding company to engage in, through a nonbank subsidiary, the activity of arranging equity financing for certain types of income-producing properties (1982 FRB 647). The Board limited the activity by requiring that the holding company act only as an intermediary between developers and investors to arrange financing, and imposed certain other conditions to prevent the holding company from engaging in real estate development or syndication. At that time, however, the Board did not expand the Regulation Y list of permissible activities for bank holding companies to include this activity.

In February 1984, the Board added the arranging of commercial real estate equity financing to the list of permissible nonbanking activities in Regulation Y (section 225.28(b)(2)(ii)). Regulation Y incorporated the limitations placed on the activity by the Board's 1982 order, which is discussed below.

Equity financing involves arranging for the financing of commercial or industrial income-producing real estate through the transfer of the title, control, and risk of the project from the owner or developer to one or more investors. In performing the equity-financing activity for commercial or industrial income-producing real estate, consultations should be made with the owner or developer to determine the nature, objectives, and financing arrangements for the property or project. The project's concept, architectural design, building layout, suitability for its purpose and prospects, traffic flow, as well as competing projects, source(s) of customers, nature of the market, projected rentals and income flows, timetables for completion, and the availability of construction and long-term financing for the property, have to be carefully reviewed. Financing alternatives, including equity financing, should be predetermined.

The Board has found that the particular expertise and analysis required to provide equity financing for large commercial or industrial income-producing properties is functionally and operationally similar to the analysis and expertise that is required when a bank provides traditional mortgage financing services for such properties. This finding is supported by the fact that equity financing can be viewed as an economic substitute for long-term mortgage financing. The Board's view is that equity financing, subject to the limitations described below, bears a functional relationship to investment advisory services that are traditionally and lawfully performed by commercial banks with respect to commercial and industrial real estate.

The Board therefore, in 1984, approved adding the arranging of commercial real estate equity financing to the list of permissible nonbanking activities in Regulation Y. On April 21, 1997, the comprehensive revision of Regulation Y removed certain restrictions from this nonbanking activity. The activity currently consists of acting as an intermediary for the financing of commercial or industrial income-producing real estate by arranging for the transfer of title, control, and risk of such a real estate project to one or more investors, if the bank holding company and its affiliates do not have an interest in, or participate in, managing or developing a real estate project for which it arranges equity financing, and do not promote or sponsor the development of the property.

3220.0.1 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Application to engage in equity-financing activities				1982 FRB 647 1983 FRB 817 1984 FRB 50
Adding activity to permissible list		225.28(b)(2)(ii)		1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

3230.0.1 OVERVIEW OF SECURITIES BROKERAGE AS A NONBANKING ACTIVITY

In addition to providing a full panoply of financial services to their customers, banks and bank holding companies seek ''off-balance-sheet'' or non-asset-building sources of revenue. Securities brokerage is one type of endeavor perceived to have growth and profit potential.The main reasons for this are easy market entry, low start-up costs, and maximum use of a branch system and customer base.

After the deregulation of brokerage commissions in 1975, certain brokers began to compete for securities business by drastically reducing their commissions. In order to reduce operating expenses, yet still remain profitable at reduced commission rates, these firms ceased investment research and offered their customers a reduced level of service by ''unbundling'' brokerage services and offering only the execution of securities transactions. Brokers who offer this reduced level of service have come to be known as ''discount brokers.''

The Board, in 1983, added ''securities brokerage'' to the list of permissible activities for bank holding companies shortly after it approved the application of BankAmerica Corporation to acquire Charles Schwab & Co., as discussed below. In 1984, the U.S. Supreme Court sustained the Board's approval order and ruled that it is not a violation of the Glass-Steagall Act for banks and bank-affiliated brokers to buy and sell securities as agent for customers (SIA v. Board of Governors, 104 S. Ct. 3003). For additional historical information regarding the expansion of securities brokerage nonbank activities by Board order or by incorporation into Regulation Y, see sections 3230.1 through 3230.3.

Before April 21, 1997, Regulation Y differentiated between securities brokerage services provided alone (that is, discount brokerage services) and securities brokerage services provided in combination with investment advisory services (that is, full-service brokerage activities). Regulation Y no longer distinguishes between discount and full-service brokerage activities.

Regulation Y currently authorizes securities brokerage services (including securities clearing and/or securities execution services on an exchange), whether alone or in combination with investment advisory services and incidental activities (including such related activities as securities credit, custodial services, individual retirement accounts, and cash-management services), if the services are restricted to buying and selling securities solely as agent for the account of customers and do not include securities underwriting or dealing. In addition to the information and examiner guidance provided in this section, see the American Institute of Certified Public Accountants' *Audit and Accounting Guide—Brokers and Dealers in Securities.*[1] The guide includes detailed information about the securities industry, broker-dealer functions, activities and operations, books and records, accounting and auditing standards and considerations, and other topics such as internal controls and regulatory considerations.

3230.0.2 INITIAL BOARD ORDER APPROVAL FOR SECURITIES BROKERAGE

On January 7, 1983, the Board approved the application of BankAmerica Corporation to acquire Charles Schwab & Co., which engaged in retail discount securities brokerage, securities credit lending, and certain incidental activities (1983 FRB 105). None of the proposed activities was among those the Board had previously designated in Regulation Y as being closely related to banking.

In its order approving the application, the Board found that the brokerage and securities credit activities were closely related to banking for purposes of section 4(c)(8) of the Bank Holding Company Act (''BHC Act''). That decision was based on the fact that many banks provide various types of securities brokerage services as an accommodation to customers and as an agent for trusts and other accounts managed by banks.

Banks also administer employee stock purchases, dividend reinvestment, and automatic investment service plans, which involve the periodic purchase of a particular security or securities from a fixed list of securities, on behalf of the customer. Banks often execute orders involving securities not listed on an exchange by dealing directly with dealers making a market in a particular security or with other third parties. In performing these services,

1. Issued as of April 1, 1997.

banks exercise the same type of discretion and judgment with respect to the best method of execution as brokers do with respect to similar types of orders. Further, national banks are expressly authorized by statute to purchase and sell securities without recourse, solely upon the order, and for the account of, customers (12 U.S.C. 24 (Seventh)).

The Board, in summary, noted that banks in fact had generally provided securities brokerage to some extent. The company that was acquired, pursuant to the January 1983 order, provided several other services incidental to its discount brokerage activities.

3230.0.2.1 Margin Lending

Historically, banks have had a significant amount outstanding in loans to borrowers for the purpose of purchasing or carrying securities. The extension of such credit secured by stock and other collateral, or margin lending, has long been an important bank activity. The Board, therefore, ruled that this activity was closely related to banking and incidental to the securities brokerage activities of the company being acquired.

3230.0.2.2 Maintenance of Customer Securities Accounts

Charles Schwab & Co. offered various services to its brokerage customers. These services included individual retirement accounts for which an unaffiliated savings and loan association served as a trustee; a ‘‘sweep’’ arrangement, pursuant to which idle customer balances exceeding a certain minimum were automatically invested in an unaffiliated money market mutual fund; the payment of interest on net free balances awaiting investment; and a specially named account which combined the payment of interest on free credit balances with customer access to such balances through a debit card and checking account offered under an arrangement with an unaffiliated commercial bank. Increasingly, these types of services were being offered by other brokerage firms. The Board found that each of these services was identical, or functionally and operationally equivalent to, services generally offered by banks to customers directly or through bank trust departments. Based on that finding, the Board found that the provision of those accounts was closely related to banking as well as an incidental activity in connection with securities brokerage and margin lending activities.

3230.0.2.3 Custodial Services

The brokerage firm also provided various types of securities custodial services, involving the safekeeping of customers’ securities, accounting for dividends or interest received on such securities, and other ancillary services. Banks generally offer securities custodial services in connection with their trust departments and other securities transaction services. Furthermore, in extending margin credit, a lender is required to maintain custody of the securities pledged to the lender as collateral to secure the loan. Accordingly, the Board found that the provision of securities custodial services was closely related to banking and that it was a necessary incident to permissible margin lending activities.

3230.0.3 MARGIN CREDIT ACTIVITIES AND SECURITIES BROKERAGE

When securities brokerage was added to the permissible activities within Regulation Y, it was contemplated that a bank holding company, or its nonbank subsidiary performing the permitted securities brokerage activities, would be required to register as a broker-dealer with the Securities and Exchange Commission and that its margin credit activities would therefore be subject to the Board’s Regulation T. Regulation T governs securities credit by broker-dealers (12 C.F.R. 220).

3230.0.4 FINAL RULE ADOPTION—ACTIVITY INITIALLY ADDED TO REGULATION Y

On August 10, 1983, the Board adopted a final rule deeming securities brokerage and margin lending ‘‘closely related’’ to banking, consistent with the Glass-Steagall Act, and are, therefore, generally permissible for bank holding companies. To clarify that services incidental to brokerage services are permissible, the Board did include a list of permissible incidental services. The list included services such as offering custodial services, furnishing individual retirement accounts, and cash-management services, provided that the securities brokerage services are restricted to buying and selling securities solely as agent for the account of customers and do not include securities underwriting.

As for cash-management services, such services are intended to include customer- account-related functions, such as paying interest on net free balances awaiting investment, providing arrangements under which free credit balances are automatically invested in money market mutual funds, and establishing arrangements under which access to such balances is provided by debit card or checking accounts.

The list of incidental activities in the regulation is not intended to be exhaustive. The Board believes that to compete effectively with other brokers, bank holding companies should have the flexibility to provide a full range of customer-account and custodial services, provided such services meet the test for permissible incidental activities under section 4(c)(8) of the BHC Act and are consistent with the Glass-Steagall Act.

As previously noted, Regulation Y, effective April 21, 1997, permits securities brokerage without distinguishing between discount and full-service brokerage activities. The previous regulatory requirement for certain disclosures has been eliminated. Those disclosure requirements are in an interagency policy statement that governs the sale of securities and other nondeposit investment products on bank premises (see sections 2010.6.1.3.1 and 2010.6.2.9), as well as in SEC rules. Similar disclosure requirements are required by the Board's policy statement that governs a bank holding company's sale of shares of mutual funds and other investment companies that it advises (see section 225.125 of Regulation Y).

3230.0.5 MARKET ENTRY INTO SECURITIES BROKERAGE

There are three general methods of market entry available to bank holding companies or nonbank subsidiaries of bank holding companies wishing to offer securities brokerage services: (1) become associated with a brokerage firm, (2) purchase an existing firm, or (3) establish their own brokerage operations. The most common mode is broker association, which is less costly and the most rapid form of entry. The following broker relationships are presently established:

1. *Introducing broker*. The first level of involvement occurs when a BHC or a nonbank subsidiary of a BHC serves as an ''introducing broker'' in effecting securities transactions by accepting the customers' orders and transmitting the orders to the executing broker.[2] Order tickets and records of original entry are prepared by the BHC or nonbank subsidiary. In this situation, the executing broker generally produces customer confirmations and account statements. These documents often prominently display the BHC or the bank holding company's nonbank subsidiary's name and logo. The executing broker, the bank holding company, and/or its nonbank subsidiaries may offer safekeeping services and margin credit.
2. *Omnibus account*. A higher level of bank holding company nonbank subsidiary involvement occurs when the broker ''carries'' customer accounts by accepting and transmitting orders for execution, producing the customer confirmation, and maintaining all customer records. When carrying customers' accounts, the bank holding company's nonbank subsidiary may maintain a single customer account, called an omnibus account, with the executing broker. Safekeeping and margin credit services may be offered.
3. *Separately incorporated broker-dealer subsidiary affiliate*. The highest level of involvement occurs when a bank holding company organizes or acquires a separately incorporated broker-dealer subsidiary or affiliate, which transacts business like any other broker-dealer. This would include its own customer lists, both retail and wholesale; possible exchange membership; and executing and clearing its own transaction.

3230.0.6 PURPOSE OF INSPECTION OF SECURITIES BROKERAGE ACTIVITIES

The purpose of the inspection is to evaluate any potential liability due to wrongful or negligent performance of responsibilities, to assess the level of management expertise, and to determine the degree of compliance with legal and policy parameters necessary to protect investors.

2. There is a lower level of involvement wherein the BHC or nonbank subsidiary is responsible for making the brokerage services available to customers by advertising the distributing customer account applications. Account acceptances are generally made by the unaffiliated broker who will receive orders directly from customers.

3230.0.7 INSPECTION OBJECTIVES

1. To determine the scope and nature of services provided.
2. To evaluate operations, audits, and controls.
3. To review the sufficiency of administrative policies and procedures.
4. To determine the level of responsibility.
5. To appraise the quality of management and staff.
6. To ascertain earnings, volume of business, and prospects.
7. To review compliance with applicable laws, regulations, and policies.

3230.0.8 SCOPE OF INSPECTION

The scope of inspection will vary depending on the nature of the brokerage operation. In defining the scope of inspection, it is first necessary to determine the extent of activities performed and the corporate structure. Any bank holding company subsidiary (that is not a bank), which functions as a securities broker, is required to register as a broker-dealer with the Securities and Exchange Commission (SEC).[3]

In developing the scope of inspection, it is emphasized that Reserve Bank examiners can rely on the applicable self-regulatory organization's examination with respect to investor protection, compliance with SEC and SRO rules, and Regulation T. The self-regulatory organizations do not furnish an examination report, but instead furnish a registered broker-dealer with a letter pertaining to examination findings. Hence, the scope of inspection for a registered broker-dealer will commence with a review of a self-regulatory organization's most recent letter dealing with its examination of brokerage activities. A broker-dealer belonging to more than one self-regulatory organization will be examined only once in each examination cycle. Serious violations that could endanger a banking organization (for example, fraudulent activities that could subject the organization to losses or lawsuits) or significant violations that have not yet been corrected, should be noted in the bank holding company inspection report. Reserve Bank staff are responsible for evaluating all other aspects of securities brokerage activities.

The actual scope of this portion of the inspection will range from a brief visit for a limited service ‘‘arranger’’ relationship to extensive review for an omnibus relationship or registered broker-dealer.

3. A broker-dealer registered with the SEC (registered broker-dealer) is subject to SEC recordkeeping and confirmation rules, fair practice rules, professional qualification rules for individuals associated with securities firms, and the uniform net capital rule. Registered broker-dealers are also required to pay for insurance coverage on customers' assets by the Securities Investor Protection Corporation (SIPC) and are required to be members and subject to the rules of the National Association of Securities Dealers, Inc. (NASD), or other self-regulatory organizations, such as the New York Stock Exchange. These self-regulatory organizations (SROs) also test for broker compliance with Regulation T (12 C.F.R. 220).

3230.0.9 MATERIALS REQUIRED FOR INSPECTION

When commencing the securities brokerage portion of a bank holding company or its nonbank subsidiary inspection, the following material should be obtained:

1. contractual agreement with the executing and/or clearing broker
2. recent activity report (for at least six months)
3. income and expense reports
4. written policies and procedures regarding—
   a. order processing,
   b. settlements,
   c. account reconciliations,
   d. audit coverage, and
   e. trust department relationship
5. account application forms
6. customer disclosure documents
7. organization chart
8. fee schedule
9. internal and external audit reports
10. a copy of the contingency plan for continuance in emergencies
11. the most recent SRO letter pertaining to the last brokerage examination

3230.0.10 INSPECTION PROCEDURES

If applicable, the following areas should be covered during the inspection.

3230.0.10.1 Organization and Management

Review carefully the contractual agreement with the executing and/or clearing broker and list all duties and obligations of the respective parties. Determine that the agreement contains an indemnification clause insulating against broker error. Once the review is completed, the examiner can identify the type of relationship and plan the scope of the inspection.

Review the organization chart and match responsibilities and operational functions to the appropriate section. Evaluate management and staff based upon their education, experience, performance, and the profitability and efficiency of operations and any other relevant factors.

3230.0.10.2 Operations

A securities brokerage operation is organized along functional lines including—

1. execution,
2. settlement,
3. delivery,
4. custody,
5. recordkeeping, and
6. audits and controls.

Before review, prepare a flow chart of the operation to quickly overview the operational areas and to locate control points and identify potential weaknesses.

3230.0.10.2.1 Execution

This area processes client orders. The orders may be received by telephone at the nonbank subsidiary or directly by the executing broker. When the nonbank subsidiary accepts customer orders, they can be transmitted by direct wire to the executing broker. Completed transactions initiated by the nonbank subsidiary are confirmed back to the nonbank subsidiary, which in turn sends a confirmation to the client. Examiners should determine that proper safeguards are in place to ensure valid orders are received, pending orders are controlled, and completed orders are reported for customer notification and record update. The examiner should also determine that the following are in place:

1. use of code numbers, names, or other verification devices when accepting orders
2. maintenance and reconcilement of a trade log (orders received) and execution report (orders completed)
3. taping of telephone orders
4. confirmation of completed orders are confirmed to clients in a timely fashion
5. preparation and transmittal of input media for record update

3230.0.10.2.2 Settlement

This area receives payments and proceeds, collects dividends and interest, and, in some instances, effects margin calls on broker instruction. Settlements are effected in two stages:

1. *Broker vs. customer*. Before settlement date, the customer must send cash or securities to the broker as requested in the broker's customer confirmation. Cash or securities are required to effect payment against delivery or delivery against payment in accordance with industry securities settlement procedures.
2. *Broker vs. broker*. When physical delivery of securities is required, it is generally done on a firm-to-firm basis or to a firm's safekeeping agent. Major equity securities, and an ever-increasing number of debt securities, are eligible for net settlement and securities immobilization with depositories. Usually, a net settlement account is used for cash and securities transactions; these accounts should be reconciled daily. The settlement process should include a procedure which verifies execution price and fees.

3230.0.10.2.3 Delivery

Securities are delivered to the executing broker and purchased securities to clients. The examiner should determine that safeguards provide adequate control over certificates in process. Proper fail-to-deliver/receive and completed transaction records should be maintained.

The securities broker that accepts customer orders generally is exposed to *delivery risk* by customers. Basically, customers can take advantage of the broker by placing an order to buy securities when the customer has no funds available to purchase securities or by placing an order to sell securities which are not owned by the customer. Either type of transaction is permissible in a *margin account*, provided that the customer has the resources available to properly margin the transaction. If the customer does not have a margin account, the broker should not purchase a security for the customer unless (1) there are sufficient funds in the customer's account or (2) the customer represents and the broker ascertains that the customer will promptly make full cash payment for the security before selling it, and that the customer does not contemplate selling it before making payment.

Alternatively, the broker should not sell a security for a customer unless (1) the security is held in the customer's account, or (2) the broker accepts in good faith the customer's statement that the security is owned by the customer and that it will be promptly deposited into the account.

By not executing a purchase or sale until the customer has deposited cash or securities, customer-default risks can be avoided on cash transactions. However, for competitive reasons, many brokers would not wish to place such stringent restrictions upon their customers—especially with respect to the purchase of securities. Lack of proper account supervision can lead to the fraudulent customer practice of ''free riding,'' wherein the customer will buy securities in anticipation of a price rise. Before settlement date, the customer will sell the securities to take the profits. If the market price of the securities declines, the customer will dishonor the trade, and thus attempt to leave the broker holding the depreciated securities. Securities brokerage procedures should be designed to look for generally abusive practices by customers.

3230.0.10.2.4 Recordkeeping

Any records which must be prepared by the broker under inspection are subject to the Securities and Exchange Commission's recordkeeping and confirmation rules 17a-3 and 17a-4. Compliance with those recordkeeping rules will be verified by stock exchange or NASD examiners during their routine compliance inspections.

3230.0.10.2.5 Audits and Controls

Complete the ''Securities Brokerage/Internal Controls Checklist'' to determine whether operations are satisfactorily controlled and audited by the bank holding company's or nonbank subsidiary's audit staff. All significant administrative and operational aspects should be covered. Management should receive reports of audit findings and respond in writing as to actions taken.

3230.0.10.3 Conflicts of Interest

Determine that policies have been effectively implemented covering relationships with affiliated trust departments, self-dealing, fee-splitting or rebate arrangements, and officer/employee transactions.

3230.0.10.3.1 Relationship with Affiliated Trust Departments

Questions may arise concerning the permissibility of a securities broker's executing securities transactions for an affiliated trust department. In general, the receipt of commission income for securities brokerage transactions entered into on behalf of a trust account (in addition to the fee received for account administration) raises conflict-of-interest considerations to which traditional prohibitions of fiduciary law are directed. When a securities broker affiliate is used, the trust institution may be considered to share indirectly in the commission income of the affiliate even when there is no direct remittance of the fee to the bank. The staff letter at 3—447.11 of the Federal Reserve Regulatory Service provides guidance in determining whether and in what circumstances use of affiliated discount brokerage services may or may not be permissible. If questionable trust department use of affiliated broker services is disclosed, appropriate trust examiner(s) should be notified.

3230.0.10.4 Earnings, Volume Trends, and Prospects

Determine the present and future impact that the securities brokerage activities may have on the bank holding company and its subsidiaries. If possible, a separate profit center should be established, thus providing a useful management tool which facilitates analysis of current profitability, business volume, fixed and variable costs, and degree of goal actualization. Periodic review of these factors will enable management to direct available resources, aid in the budget process, and provide a basis for business planning. Prospects for profitable growth should be assessed by noting changes in aggregate account levels and trade activity. The local competitive environment should be gauged and market-share information noted. In considering these factors, the examiner should attempt to determine what level of activity must be maintained or attained in order for the securities brokerage function to break even. Present a summary statement expressing an overall view on the current state and future viability of the operation.

3230.0.10.5 Compliance

The examiner should determine whether any additional state regulations must be complied with. Also determine that staff is aware of and complying with applicable regulations and laws, which may be outside the scope of an examination conducted by a self-regulatory organization.

3230.0.10.6 Presentation of Findings

The Scope of Inspection in the report should note that securities brokerage activities were reviewed. It should be noted that in order to avoid duplication of examination procedures, the inspection did not focus upon securities laws compliance (as verified by the NASD, Inc., or stock-exchange examiners), but instead focused upon financial and safety-and-soundness considerations. Appropriate nonbank subsidiary pages should be completed. Present a summary comment in the confidential section reflecting an overall appraisal of the operation. The self-regulatory organization responsible for examining the securities brokerage operation should be identified. Identify also the associated broker, if any, with whom the organization conducts business. Any material exceptions should be noted with management's responses under an appropriate caption within the open section. Matters of importance should be brought forward to the Examiner's Comments and Matters Requiring Special Board Attention page. In addition, any other significant problems, detrimental practices, or potential liabilities which could have a negative impact on the organization should be commented upon.

3230.0.11 EXAMINATION CHECKLISTS

Two checklists are provided for use by the examiner to aid in evaluating securities brokerage activities:

1. Securities Brokerage Inspections
2. Securities Brokerage/Internal Controls

All questions are not applicable for each brokerage subsidiary. The nature and scope of brokerage activities determine the applicability of specific questions. The term ‘‘banking organization’’ refers to a bank holding company and any of its nonbank subsidiaries.

3230.0.11.1 Securities Brokerage Inspection Checklist

	Yes	*No*
1. Is a contractual agreement between the banking organization and the executing and/or clearing broker on file?	______	______*
2. Does the agreement indemnify the banking organization against broker error?	______	______*
3. Does the agreement clearly define respective responsibilities of the banking organization and broker?	______	______*
4. Was the agreement reviewed by the banking organization's counsel?	______	______*
5. Was the agreement approved by the board of directors? If not, by whom? _________	______	______*
6. Are written procedures covering brokerage activities in effect?	______	______*

*Response may require report comment.

	Yes	No
7. Have job descriptions been prepared?	______	______*
8. Have specific policies been developed regarding—		
• relationships with affiliated bank trust depts?	______	______*
• conflicts of interest?	______	______*
• investment advice?	______	______*
9. Are investment advice or research services being offered?	______*	______
10. Are income and expense records separately maintained?	______	______*
11. Are brokerage activities included in the audit program?	______	______*
12. Are customer orders placed with banking organization personnel?	______	______
If so, is customer authorization on file?	______	______*
Are telephone conversations tape recorded?	______	______*
Are transaction records maintained by traders?	______	______*

13. How are payments effected? (check one)

direct charge to customer account	______
payment through the mail	______
other ____	

14. What is the timeframe of payment?

prior to execution	______
upon verbal notification of execution	______
upon customer's receipt of confirmation	______
after settlement date	______*

15. What is the frequency of settlement-account reconcilements?

daily	______
biweekly	______
weekly	______
other	______*

*Response may require report comment

	Yes	*No*
16. Does an affiliated trust department use the discount brokerage service?	______	______*
If yes, what type account? ________________________		
discretionary trust ______**		
discretionary agency ______**		
custody ______		
employee benefit ______**		
17. Is sufficient insurance coverage in effect?	______	______*
Describe types and limits.		
______________________________________		
______________________________________		
18. Does a review of records confirm that the broker functions solely as an agent, i.e., does not engage in underwriting or taking positions for its own account?	______	______*
19. Do monitoring and internal reporting procedures adequately track profitability and operating impact for management consideration?	______	______*

*Response may require report comment.

**If available documentation reveals that affiliated trust departments use brokerage services to execute transactions for this type of account, the appropriate federal regulator of trust activities should be notified.

3230.0.11.2 Securities Brokerage/Internal Control Checklist

The following questions should be answered, to the extent applicable, in reviewing a securities brokerage operation. Few brokers will perform all of the activities discussed below.

	Yes	*No*
1. Do internal audit procedures include the securities brokerage function?	______	______*
2. Has the banking organization adopted procedures for the periodic review of insurance coverage relating to securities brokerage activities (e.g., errors and omissions, fidelity bonding, and securities in transit)?	______	______*
3. Has the banking organization adopted procedures with respect to the accounts of directors, officers, or employees or their immediate families?	______	______*
4. Are procedures in place to prevent internally generated credits to the securities brokerage customers' accounts from being automatically recorded as collected funds?	______	______*

*Response may require report comment.

	Yes	*No*
5. Are procedures in place to ensure that acceptance of a relatively large order will not be effected unless the order taker verifies that the customer placing the order has internal authorization to engage in large trades?	______	______*
6. Has the banking organization adopted written procedures prohibiting employees from furnishing investment advice?	______	______*
7. Are customer telephone orders tape recorded?	______	______*
8. Are tape recordings of telephone orders reviewed periodically to verify that employees have *not* made securities recommendations or furnished investment advice?	______	______*
9. Are persons responsible for taking and transmitting orders precluded from preparing accounting entries?	______	______*
10. Is there adequate separation of duties between persons responsible for making initial accounting entries and those responsible for making subsequent adjusting entries to prevent a concealment of theft or fraud?	______	______*
11. Does the securities brokerage function monitor and reconcile safekeeping, clearing, payment, and income expense accounts on a regular basis?	______	______*
12. Has management developed a contingency plan to ensure continued brokerage operations of the securities brokerage operation in the event of fire, flood, power failure, or some other unforeseen event?	______	______*
13. With respect to termination of brokerage accounts, does the securities brokerage operation have procedures in place to prevent an account from being closed while an open securities order is outstanding?	______	______*
14. Does the credit-approval process require a credit decision to be made by someone who routinely makes credit decisions—as opposed to a manager of a securities brokerage operation?	______	______*
15. If securities received from customers are registered in the name of a third party, are procedures in place to ensure that such securities are accepted only upon satisfactory proof of ownership?	______	______*
16. Are procedures in place to ensure that customers delivering securities registered in a ‘‘street name’’ have title to such securities (i.e., they are not lost or stolen securities)?	______	______*
17. Is only a limited number of responsible employees authorized to execute or guarantee security assignments?	______	______*
18. Is the use of facsimile signature devices adequately controlled?	______	______*

*Response may require report comment.

	Yes	*No*
19. Are procedures in place to control cash, securities, and documents pertaining to securities shipped for ‘‘delivery against payment’’?	______	______*
20. Are adequate physical controls maintained over securities on hand (e.g., restricted access to the ‘‘cage area’’)?	______	______*
21. Are detail records pertaining to securities in transfer and those pledged as collateral to borrowings agreed periodically (at least quarterly) with the securities record?	______	______*
22. Are security positions (and related general-ledger amounts) in suspense accounts investigated and resolved on a timely basis?	______	______*
23. Are fails to receive and fails to deliver periodically reviewed and reconciled?	______	______*

*Response may require report comment.

3230.0.12 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Board's authority for rulemaking and jurisdiction over BHCs	1843(c)(8), 1844(b)			
Order approving the application of a BHC to acquire a retail discount securities broker				1983 FRB 105
Order approving acquisition of retail discount broker by a BHC				1983 FRB 565
Securities brokerage as a permissible activity		225.28(b)(7)(i)		
Credit by brokers and dealers—Regulation T	220			
Order approving the provision of combined securities brokerage, investment advisory, and research services				1986 FRB 584
Securities brokerage subsidiary can exchange customer lists with affiliates and confidential customer information (with customer approval)				1988 FRB 571
Securities brokerage with discretionary investment managment and investment advisory services				1988 FRB 700 1987 FRB 930 1987 FRB 810
Full-service brokerage for institutional and retail customers—bank-ineligible securities				1989 FRB 396 1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

4(c)(8)—Securities Brokerage (Board Decisions)

Section 3230.05

This section serves as a prelude to the securities brokerage sections that follow. Sections 3230.1 through 3230.3 provide brief historical summaries of Board decisions on securities brokerage; these authorizations are now incorporated into Regulation Y for this activity. The summaries provide the reader with some historical perspective as to how and why the current provisions of Regulation Y evolved. The conditions and commitments within these orders may no longer apply to the current provisions of Regulation Y. Therefore, reference must be made to Regulation Y, section 225.28(b)(7)(i).

Before the 1997 revisions of the Board's Regulation Y (12 C.F.R. 225), the Board's rules differentiated between securities brokerage services provided alone (that is, discount brokerage services) and securities brokerage services provided in combination with investment advisory services (that is, full-service brokerage activities). The revisions to Regulation Y that became effective in April 1997 permit securities brokerage without distinguishing between discount and full-service brokerage activities.

Another major change for securities brokerage activities concerns the types of disclosures required of bank holding companies. Before the 1997 revisions, bank holding companies providing full-service brokerage services were required to make certain disclosures to customers regarding the uninsured nature of securities and were not permitted to disclose confidential customer information without the customer's consent. Effective in April 1997, these disclosure requirements were eliminated. The disclosure requirements—along with a number of other requirements that specifically address the potential for customer confusion, training requirements, suitability requirements, and other matters—are already contained in an interagency policy statement that governs the sale of securities and other nondeposit investment products on bank premises, as well as in rules adopted by the SEC. In addition, similar disclosure requirements are required by the Board's policy statement governing the sale by bank holding companies of shares of mutual funds and other investment companies that the bank holding company advises.

Banking organizations and their affiliates, in general, are becoming more effective in implementing the regulatory disclosure requirements. Customers are also becoming increasingly aware that such investment products purchased at banking organizations and their affiliates are not federally insured. Moreover, the Board and the SEC have adequate supervisory authority to ensure that bank holding companies comply with the applicable regulatory disclosure requirements. To the extent that disclosures to customers are appropriate in areas not covered by the regulatory policy statements or SEC regulations, the Board will consider whether to develop supervisory guidance.

Two bank holding companies jointly applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.23(a)(3) of Regulation Y to form a de novo subsidiary that would engage in the following nonbanking activities:

1. providing portfolio investment advice to ''institutional customers''
2. providing securities execution (brokerage) services, related securities credit activities pursuant to the Board's Regulation T, and incidental activities
3. furnishing general economic information and advice, general economical statistical forecasting services, and industry studies to institutional customers
4. serving as an investment adviser (as defined in section 2(a)(20) of the Investment Company Act of 1940) to investment companies registered under that act

Separate fees are to be charged for the advisory services and the securities brokerage services. The company would also provide incidental services such as custodial and cash-management services and acting as a registered investment adviser. The services are to be provided throughout the United States. The providing of advisory services to retail clients was not authorized by the Board. The applicant committed to create a ''Chinese Wall'' between the affiliated bank and the securities affiliate.

The Board determined that the activities would not violate Glass-Steagall Act prohibitions. Board approval was conditioned with the requirement that the standards of care and conduct applicable to fiduciaries would be observed. The applicant would not allow the exchange of confidential information between the de novo subsidiary and its affiliates. The applicant further committed that employees of the de novo subsidiary would not be given customer lists and other confidential information obtained by its affiliates in connection with commercial banking operations. Transmission of advisory research and recommendations to the commercial lending department of any of the bank holding company's affiliates was not permitted.

The proposal represented the combination of activities, previously determined to be closely related to banking, in such a way that the functional nature and scope of the combined activities conducted would not be altered. By Board order, the applicants' application was approved on June 13, 1986 (see 1986 FRB 584), subject to the conditions stated therein. Other orders were approved by the Board on August 5, 1987 (1987 FRB 810), and October 1, 1987 (1987 FRB 930), which also authorized a bank holding company to engage in combined investment advisory and securities brokerage activities. In this order, the Board lowered the threshold for defining an ''institutional investor'' from $5 million to $1 million.

The Board, effective September 10, 1992, added this nonbanking activity to those activities that are permissible by regulation, currently found in section 225.28(b)(7)(i) of Regulation Y, subject to the disclosure requirements, restrictions on exchanging confidential customer information, and other limitations stated therein.

A bank holding company applied to the Board to expand the authority of its subsidiary to engage in offering investment advisory services for ''institutional customers'' and its affiliates[1] in conjunction with its previously approved brokerage services. The Board previously approved by order (1986 FRB 584) an application for a different bank holding company to offer the combination of investment advice and securities execution services for institutional customers.

The proposed activities in this order (1987 FRB 810) are similar except that the subsidiary would additionally exercise limited investment discretion at a customer's specific request. Under this plan, the subsidiary would offer as a service, within defined parameters established by the client, discretion in buying and selling securities on behalf of the client.

Such investment discretion would be exercised only at the request of a client; the subsidiary does not plan to market or solicit managed accounts. Each client will receive confirmation of each transaction, as well as monthly statements which would indicate in detail the terms of each transaction executed on its behalf. Each client would always be aware of the scope of the subsidiary's activity for its account. The subsidiary would receive a single fee for the combined activities of providing investment advice and exercising limited investment discretion.

The application was approved on August 5, 1987, subject to the commitments made by the applicant and the conditions (whether explicitly stated or incorporated by reference) in the order.

The Board approved another order on October 1, 1987 (1987 FRB 930), similar to the August 5, 1987, order, except that (1) the applicant proposed to lower the test for institutional customers from the $5 million threshold to $1 million; (2) the applicant's wholly owned brokerage subsidiary would share customer lists with its affiliates, but not confidential information obtained from the customer; and (3) the brokerage subsidiary would have officer and director interlocks with the parent bank holding company, but not with its bank affiliates. In the Board's view, these modifications did not alter the underlying rationale of its earlier decision.

The Board approved another order on August 10, 1988 (1988 FRB 700). The principal difference between the August 5, 1987, order and this proposal was the provision of such combined services to *retail* as well as *institutional* customers. The provision of services to retail customers does not include discretionary investment management. To further ensure the separation of the BHC and its bank affiliates and to avoid potential conflicts of interests, the applicant made several commitments, as detailed within the order.

The Board, effective September 10, 1992, added the providing of discretionary investment management to the nonbanking activities that are permitted by regulation, currently found in section 225.28(b)(7)(i) of Regulation Y.

1. The provision of such services by the subsidiary to other affiliates is a permissible servicing activity under section 225.22(a) of Regulation Y.

4(c)(8) of the BHC Act—Offering Full Securities Brokerage Services for Bank-Ineligible Securities Section 3230.3

A bank holding company (applicant) applied for the Board's permission for its subsidiary to provide investment advisory and brokerage services on a combined basis (''full-service brokerage'') to institutional and retail customers and to engage, to a limited extent, in underwriting and dealing in one- to four-family mortgage-related securities and consumer receivable–related securities (herein referred to as ''ineligible securities''). The applicant committed to conduct its ineligible securities underwriting and dealing activities subject to the revenue test and the prudential limitations established by the Board in 1987 FRB 473, except for a market-share limitation which the Board decided not to require for this BHC.

The Board determined previously that full-service brokerage for both institutional and retail customers is closely related and a proper incident to banking under section 4(c)(8) of the BHC Act and does not violate the Glass-Steagall Act (1988 FRB 700 and 1986 FRB 584). This BHC's proposal differs from prior cases in that the subsidiary will provide full-service brokerage to retail customers for ineligible securities that it may hold as principal. The BHC has committed that the subsidiary will provide full and appropriate disclosure of its interest in the transaction as required by the securities laws, the National Association of Securities Dealers, and fiduciary principles.

The Board had previously authorized an underwriting subsidiary to provide full-service brokerage with respect to ineligible securities that it holds as principal, *but only to institutional customers* (1988 FRB 695). Applicant made the same commitments regarding disclosures as found in 1988 FRB 695. The BHC committed further that its subsidiary would prominently disclose in writing to each customer, at the commencement of the relationship, that it is not a bank; that it is separate from any affiliated bank; and that the securities sold, offered, or recommended by the subsidiary are not deposits, are not insured by the FDIC, are not guaranteed by an affiliated bank, and are not otherwise an obligation of an affiliated bank, unless such is in fact the case. The Board emphasized that confirmations sent to customers will state whether the subsidiary is acting as agent or principal with respect to a security. The Board concluded that such disclosure commitments would be adequate. It recognized that in performing the full-service brokerage activity, the underwriting subsidiary would be operating under a more extensive framework of prudential limitations than would be the case if the full-service brokerage activity were conducted by a bank, a subsidiary of a bank, or by another holding company subsidiary. Based on the commitments made, the Board decided on March 14, 1989, to approve the proposed activities (see 1989 FRB 396) subject to all the terms and conditions found in 1987 FRB 473, except for the market-share limitation.

Effective September 10, 1992, the Board added this nonbanking activity to the activities permitted by regulation, currently found in section 225.28(b)(7)(i) of Regulation Y and subject to the Board's disclosure and other requirements and the limitations on exchanging confidential information, as stated therein.

This section discusses and provides a historical reference of previous Board orders that initially authorized, by order, a bank holding company's acting as agent in the private placement of securities and engaging in riskless-principal nonbanking activities. *With the Board's incorporation of private-placement and riskless-principal activities into its adoption of changes to Regulation Y, effective April 21, 1997, the majority of the previous private-placement and riskless-principal commitments are not effective. Only those current requirements listed for private-placement and riskless-principal activities in section 225.28(b)(7) of Regulation Y (the laundry list of permissible nonbanking activities) should be used by the examiner in conducting the supervision and inspection of bank holding companies and their subsidiaries.*

3230.4.1 ENGAGING IN COMMERCIAL-PAPER PLACEMENT ACTIVITIES TO A LIMITED EXTENT

A bank holding company (the applicant) applied pursuant to section 4(c)(8) of the Bank Holding Company Act and section 225.23(a) of the Board's Regulation Y to act as an agent and adviser to issuers of commercial paper in connection with the placement of commercial paper with institutional purchasers. The commercial-paper-placement activity, as proposed, is to be conducted from a wholly owned commercial finance subsidiary (the company) of the applicant's direct subsidiary.

The Board concluded that the proposed commercial-paper-placement activity was so functionally and operationally similar to the role of a bank that arranges a loan participation or syndication as to be a proper incident thereto and that banking organizations are particularly well suited to perform the commercial-paper-placement function. The Board found that the proposal, as limited by the applicant, was consistent with section 20 of the Glass-Steagall Act, and could reasonably be expected to result in public benefits that would outweigh possible adverse effects. The Board found, further, that the applicant could conduct the proposed activities to the extent and in the manner described in the order. The Board's approval (1987 FRB 138) extended only to the activities conducted within the limitations proposed by the applicant for company and the BHC's subsidiary banks and other subsidiaries. The placement of commercial paper in any manner other than as described within the limitations and conditions of the order would not be within the scope of the Board's approval. The Board also required that no lending affiliate of the company would disclose to the company any nonpublic customer information concerning an evaluation of the financial condition of an issuer whose paper is placed by the company or of any other customer of the company, except as expressly required by securities law or regulation.

On May 25, 1988, the Board approved an order (1988 FRB 500) for a bank holding company to engage de novo, through a subsidiary, in acting as an agent and adviser to issuers of commercial paper in connection with the placement of commercial paper with institutional customers, as well as to engage in certain other securities and financial advisory activities. The applicant proposed to place commercial paper in accordance with all the terms and conditions of the above order (1987 FRB 138), except one. The applicant did not propose any quantitative limitations on its placement activity. The Board concluded that the proposed commercial-paper placement did not constitute underwriting or distributing under the Glass-Steagall Act and that the quantitative limitations on the activity were not necessary to ensure compliance with that act. (See section 3230.4.2, in which a subsidiary of a bank holding company was authorized to privately place all types of debt and equity securities.)

3230.4.2 ACTING AS AGENT IN THE PRIVATE PLACEMENT OF ALL TYPES OF SECURITIES AND ACTING AS RISKLESS PRINCIPAL

A bank holding company (the applicant) applied for the Board's approval to transfer the private-placement business of its commercial bank subsidiary to its designated nonbanking subsidiary for securities underwriting and dealing. The subsidiary would act as agent in the private placement of all types of securities, including the providing of related advisory services, and buy and sell all types of securities on the order of investors as a riskless principal.

Because the section 20 subsidiary would be affiliated through common ownership with a member bank, it may not be ‘‘principally engaged'' in the ''issue, flotation, underwriting, public sale, or distribution'' of securities within the meaning of the former section 20 of the Glass-Steagall Act. In an earlier decision (1989 FRB 751), the Board determined that a subsidiary is not engaged principally in section 20 activities if revenues from underwriting and dealing in securities that banks are not authorized to underwrite and deal in directly (bank-ineligible securities) do not exceed 10 percent of the subsidiary's gross revenues (25 percent, effective March 6, 1997). The applicant contended that the proposed private-placement and riskless-principal activities are not the kind of securities activities described in section 20 and, thus, should not be subject to the revenue limit on bank-ineligible securities activities.

The private-placement market involves the placement of new issues of securities with a limited number of sophisticated purchasers in a nonpublic offering. In private-placement transactions, a financial intermediary acts solely as agent of the issuer in finding purchasers. The intermediary does not purchase the securities and then try to resell them.

Privately placed securities are *not* subject to the registration requirements of the Securities Act of 1933. Such securities are only offered to financially sophisticated institutions and individuals,[1] not to the public. The applicant stated that all of the individuals with whom the securities would be placed will qualify as ''accredited investors'' under SEC rules. The Board concluded that the subsidiary's private placement of debt and equity securities within the limits proposed did not involve the underwriting or public sale of securities and that the revenues from the proposed activities should not be subject to the 10 percent revenue limitation (25 percent, effective March 6, 1997) on bank-ineligible securities activities.

The Board noted that other limitations on the activity should ensure that securities would not be offered to the public. First, the applicant agreed that the subsidiary would not make any general solicitation or advertisement to the public regarding the placement of particular securities. Second, the minimum denomination of securities to be placed would be $100,000. Third, the applicant agreed that the subsidiary would not privately place securities that are registered under the Securities Act of 1933 and that the subsidiary would be compelled to honor all provisions of that act, particularly those that limit the scope of private placements to nonpublic transactions. Fourth, the subsidiary agreed not to privately place as agent the securities of investment companies which are sponsored or advised by the applicant or its subsidiaries. Fifth, the subsidiary will not purchase or repurchase for its own account the securities being placed or will not inventory unsold portions of such securities. Sixth, the applicant further agreed to consult with its Federal Reserve Bank staff before transferring its private-placement activities from the subsidiary to any other nonbank subsidiary of the applicant to ensure that the transfer did not evade any of the firewall provisions committed to.

1. The subsidiary would not only place securities with institutional customers but with individuals whose net worth (or joint net worth with a spouse) exceeds $1 million. Such placement activities with individuals would not, in the Board's opinion, result in a public offering.

3230.4.3 INCORPORATION OF PRIVATE-PLACEMENT NONBANKING ACTIVITIES INTO REGULATION Y

The Board has added the activity of acting as agent in the private placement of securities to the laundry list of nonbanking activities (see 12 C.F.R. 225.28(b)(7)(ii)). Regulation Y adopts the definition of private-placement activities that is used by the SEC and the federal securities laws. In taking this action, the Board removed all but one restriction on private placement. The remaining restriction prohibits a bank holding company from purchasing for its own account the securities being placed or holding in inventory unsold portions of issues of these securities. This restriction prevents a bank holding company from classifying its securities underwriting activities as private-placement activities.

3230.4.4 RISKLESS PRINCIPAL

''Riskless principal'' is a broker-dealer that, after receiving an order to buy (or sell) a security from a customer, purchases (or sells) the security for its own account to offset a simultaneous sale to (or purchase from) the customer.

3230.4.4.1 Description of Riskless-Principal Transactions

When acting as a dealer, the securities firm maintains an inventory of securities for its own account and buys and sells securities as principal. Riskless-principal transactions are usually undertaken as an alternative method of executing orders by customers to buy or sell securities on an agency basis. In this situation, when a customer places an order to purchase securities that the broker-dealer does not maintain in its inventory, the firm must purchase the securities from a third party. At this point, the broker-dealer has the option of acting either as the agent for the customer or a riskless principal in making the purchase. If the decision is made to act as a riskless principal, the broker-dealer will purchase the securities from a third-party dealer at the dealer's ''inside price'' (confirming the transaction for its customer) and then, acting as principal, resell them to the customer, adding a markup over cost. If the broker-dealer does not complete the purchase of the securities ordered by the customer, it is not obligated to provide the securities.

3230.4.4.2 Underwriting and Riskless Principal

In riskless-principal transactions, the subsidiary would execute orders by an investor and would not act on behalf of an issuer of new securities. The subsidiary would not be involved in making any public offering of securities as agent for the issuer. Thus, these activities would not constitute underwriting for Glass-Steagall purposes.

3230.4.4.3 Summary of Board Action on Acting as Agent in Private Placement and as Riskless Principal in Buying and Selling Securities

The Board concluded that the securities underwriting and dealing of the subsidiary's riskless-principal activity did not constitute an underwriting of securities. The riskless-principal activity would not be a public sale or underwriting of securities and would not be viewed as a bank-ineligible securities activity for purposes of the current 25 percent revenue test. As a condition for the approval of the riskless-principal activity, the Board required the subsidiary to maintain specific records that would clearly identify such transactions so that examiners will be able to trace the resulting revenue. The riskless-principal activity was found to be closely related to banking. The Board further concluded that the placement activity differed only slightly in scope from those approved previously and that the operational limitations agreed to by the applicant would ensure that the subsidiary would not become involved in the public offering of any securities. The Board approved the application on October 30, 1989 (1989 FRB 829). (See also 1997 FRB 146; 1996 FRB 350, 748; 1995 FRB 49, 880, 1133; 1994 FRB 554, 1014; 1993 FRB 1166; 1992 FRB 294, 335, 552, 868; 1991 FRB 61; and 1990 FRB 26, 79, 545, 567, 568 (footnote 7), 653, 659, 663, 667, 672, 674, 766, 857, 864.)

3230.4.4.4 1996 Changes to the Underwriting Conditions for Riskless-Principal Activities

In connection with a bank holding company proposal considered by the Board on June 10, 1996, the Board reviewed the continued appropriateness of applying the underwriting conditions to the conduct of riskless-principal activities. In that case, the Board determined, based on its experience in monitoring and examining the conduct of riskless-principal activities by bank holding companies, that the underwriting conditions were not necessary to address identifiable adverse effects. Accordingly, the Board permitted the bank holding company to engage in riskless-principal transactions through a nonbank subsidiary without conducting this activity in accordance with the underwriting conditions (See 1996 FRB 748). The Board noted that riskless-principal transactions are essentially equivalent to securities brokerage transactions and, therefore, must be conducted in compliance with federal securities laws. The Board concluded that the definitional limitations (see section 225.28(b)(7)(ii) of Regulation Y) would be all that is needed to purchase (or sell) securities as a riskless principal. The conditions are designed to ensure that bank holding companies do not avoid the Glass-Steagall Act by classifying underwriting and dealing activities as riskless-principal activities. In the June 10 order, the bank holding company agreed that, if riskless-principal services were provided in combination with its advisory services, it would provide its customers with the disclosures established by the Board for full-service brokerage activities of bank holding companies. With respect to its decision, the Board decided to grant identical relief to other bank holding companies that had been previously approved to conduct riskless-principal nonbanking activities.

3230.4.4.5 Incorporation of Riskless-Principal Transactions into Regulation Y

As part of the Board's February 19, 1997, adoption of the final amendments to Regulation Y, it retained the requirement that riskless-principal transactions be conducted in the secondary market. It further determined to eliminate all but two restrictions with respect to riskless-principal transactions. A bank holding company may thus buy and sell in the secondary market all types of securities on the order of customers as a riskless principal, to the extent of engaging in a transaction in which the company, after receiving an order to buy (or sell) a security from a customer, purchases (or sells) the security for its own account to offset a contemporaneous sale to (or purchase from) the customer. This does not include—

1. selling bank-ineligible securities at the order of a customer that is the issuer of the securities, or selling in any transaction in which the bank holding company has a contractual agreement to place the securities as agent of the issuer; or
2. acting as riskless principal in any transaction involving a bank-ineligible security for which the bank holding company or any of its affiliates acts as an underwriter (during the period of the underwriting or for 30 days thereafter) or dealer. A bank holding company or its affiliates may not enter quotes for specific bank-ineligible securities in any dealer quotation system in connection with the bank holding company's riskless-principal transactions, except that the company or its affiliate may enter bid or ask quotations, or publish ‘‘offering wanted’’ or ‘‘bid wanted’’ notices on trading systems other than NASDAQ or an exchange, if the company or its affiliate does not enter price quotations on different sides of the market for a particular security for any two-day period. (See 12 C.F.R. 225.28(b)(7)(ii).)

A BHC applied for the Board's approval, pursuant to section 4(c)(8) and 225.23(a) of the Board's Regulation Y, to acquire, through a securities brokerage subsidiary, a 49 percent interest in a joint venture partnership. The applicant was a one-bank holding company formed over a bankers' bank. The shareholders comprised several hundred banks. The joint venture partnership (the company) proposed to engage in the activity of acting as a municipal securities brokers' broker.[1] This consisted of providing municipal securities brokerage services to other registered securities brokers and dealers, including dealer banks. The company would act as an undisclosed agent in the purchase and sale of municipal securities, including revenue bonds, for the account of its customers.

The applicant's proposal involved the purchase and sale of municipal securities as agent only and did not include dealing or otherwise taking a position in such securities. The activity fell within the third-party securities activities permitted for member banks under section 16 of the Glass-Steagall Act (12 U.S.C. 24), which allows banks to purchase and sell securities ''without recourse, solely upon the order, and for the account of, customers.'' National banks had been permitted to engage in the activity of acting as municipal securities brokers' brokers.

The Board found the activity to be functionally similar to the retail securities brokerage activities performed by banks for their customers as permitted under section 16 of the Glass-Steagall Act. The Board thus concluded that the activity was closely related to banking. The Board's approval of the order was based on several commitments made by the applicant and the other joint venturer. The Board approved the application by order on June 26, 1985 (1985 FRB 651).

1. Rule 15c3-1(a)(8)(ii) implementing section 15(c)(3) of the Securities and Exchange Act of 1934 defines a municipal securities brokers' broker as a ''municipal securities broker or dealer who acts exclusively as an undisclosed agent in the purchase or sale of municipal securities for a registered broker dealer or registered municipal securities dealer'' who has ''no retail customers'' and ''maintains no municipal securities in its proprietary or other accounts.'' Municipal securities brokers' brokers are subject to the federal securities laws applicable to securities brokers and are governed by the rules of the Municipal Securities Rulemaking Board.

Section 4(c)(8) of the BHC Act (Acting as a Conduit in Securities Borrowing and Lending) Section 3230.6

A foreign bank holding company (the applicant), and its wholly owned subsidiary (the company), a commercial banking organization located in New York state, applied pursuant to section 4(c)(8) of the BHC Act and section 225.23(a) of the Board's Regulation Y for prior approval to engage de novo on a domestic and international basis, through the company, in the following activities:

1. providing investment advisory services and financial advisory services, including advice regarding mergers, acquisitions, and capital-raising proposals by institutional customers, pursuant to section 225.28(b) of Regulation Y
2. providing securities brokerage services on an individual basis as well as in combination with investment advisory services (''full-service brokerage''), including exercising limited investment discretion on behalf of institutional customers
3. purchasing and selling all types of securities on the order of institutional and retail customers as a ''riskless principal''
4. engaging in securities credit activities under section 225.28(b)(6) of Regulation Y, including acting as a ''conduit'' or ''intermediary'' in securities borrowing and lending

The Board previously determined by regulation that engaging in the above-listed nonbanking activities (1) and (2) is closely related to banking under section 4(c)(8) of the BHC Act (see section 225.28(b)(6) and (7) of the Board's Regulation Y). The Board previously determined by order that, subject to certain prudential limitations, the proposed riskless-principal activities (item 3) are so closely related to banking as to be a proper incident thereto within the meaning of section 4(c)(8) of the BHC Act. The applicant has committed that the company will conduct its riskless-principal activities using the same methods and procedures and subject to the same prudential limitations established by the Board in its orders that are found at 1989 FRB 829 and 1990 FRB 26.

Banks and BHCs are permitted to borrow and lend securities held in their own portfolios (see the FFIEC's 1985 Supervisory Policy Statement on Securities Lending, *Federal Reserve Regulatory Service* 3–1579.5). In this case, the applicant proposed that the company borrow and lend the securities of noncustomer third parties. The company would seek out counterparties to securities borrowing and lending transactions and would assume much the same risk in these transactions as if it was borrowing or lending its own securities or its customers' securities. In this capacity, it would act as a ''conduit'' or ''intermediary'' in securities borrowing and lending. The company would supply—upon the request of another broker-dealer who is unable to obtain securities needed to satisfy customer or investment or operational needs—securities not available in the company's accounts or customer accounts by seeking out third-party noncustomer lenders. In addition to locating the securities, the company proposes to coordinate, on behalf of the borrower and lender, the exchange of securities and collateral that is necessary to the transaction.[1]

The Board, in its review of this application, believed that banks generally perform services that are operationally or functionally similar to the proposed conduit services. The proposed conduit activity was believed to be similar to the securities borrowing and lending activities that banks conduct. National and state banks are permitted to lend securities from their own portfolio, and with the customer's consent, from the accounts of customers, and banks regularly borrow securities to meet their needs and the needs of customers. The fact that a third party is substituted in place of a trust or other customer of a bank would not change significantly the way in which the securities lending activity would be conducted. The same steps and procedures that would be necessary to effectuate the loan of a customer's securities would be followed in loaning the securities of a noncustomer third party.

The risk associated with the proposed activity is the same risk that a bank would incur in managing the lending of securities from its own portfolio or the portfolio of a customer. The risk to the company, in acting as a conduit, is limited to ensuring that the collateral posted by the

1. The company agreed to coordinate this exchange through accounts established at a specifically named, privately held national clearinghouse for the settlement of transactions in corporate and municipal securities. Once the company had located the desired securities, the securities would be transferred to an account maintained by it at the clearinghouse and simultaneously delivered to an account of the borrower, also at that clearinghouse. At the same time, the borrower would be required to post collateral, which the company would receive into its clearinghouse account and simultaneously deliver to an account maintained by the lender at the clearinghouse.

borrower continuously reflects the market value of the securities loaned. The company committed to mark this collateral to market on a daily basis and to make calls for supplemental collateral where necessary.[2] The company also represented that it would not provide any indemnification to noncustomer third-party lenders of securities.

The Board determined, for the above reasons, that the proposed conduit activity is closely related to banking for the purposes of section 4(c)(8) of the BHC Act and approved the order on October 9, 1992 (1992 FRB 955).

The Board's approval was subject to the following specified conditions:

1. To minimize risk, the company is to act as a conduit only when the potential borrower and lender are matched before the transaction. In addition, it will take various measures to minimize operational risks, including conducting its conduit activities in accordance with the collateral requirements imposed on the borrowers by the Board's Regulation T.[3] A conduit transaction will commence only when a broker-dealer approaches the company and needs to borrow securities. Securities will not be borrowed in anticipation of a transaction.
2. At the end of each day, the company will mark to market the collateral posted by the borrower in all transactions in which it loaned securities or acted as an intermediary for a lender. As proposed, the company would establish credit lines for potential borrowers and lenders.[4]
3. The applicant committed that the company will conduct its conduit activities in compliance with the FFIEC Supervisory Policy Statement on Securities Lending (*Federal Reserve Regulatory Service* 3–1579.5).

2. If the price of the borrowed securities increases, the borrower is required under the Board's Regulation T to provide additional collateral to the company. The company, in turn, through transactions at the clearinghouse, will pass the collateral to the initial lender of the securities. If the borrower is unable to satisfy this requirement, the company is to have the contractual right to terminate the borrowing transaction by purchasing the securities in the open market and delivering them to the lender, who will then be obligated to return the borrower's collateral to the company. Because the borrowed securities will be marked to market daily by the company, the maximum exposure to the company in directly or indirectly borrowing or lending securities is one day's change in the price of the borrowed securities.

3. The applicant committed that the Board's Regulation T—which requires that all securities borrowing and lending transactions be collateralized by at least 100 percent of the value of the securities as computed on a daily basis—shall be the company's minimum guideline for posting collateral, and that the company will require many transactions to be collateralized in excess of 100 percent of the value of securities marked to market.

4. These credit policies are to include a review of all lenders and borrowers and the establishment of a credit committee that will determine limits on the credit exposure of any single borrower. The applicant proposed that the company would transact its business only with a select group of well-capitalized broker-dealers that will not be brokerage customers of the company.

The Board has authorized bank holding company subsidiaries to engage in investment or trading transactions as principal to underwrite and deal in certain securities and money market instruments that are eligible for bank underwriting and dealing by state member banks. Basically, the Board has subjected dealer subsidiaries to the same restrictions that govern underwriting and dealing by state member banks pursuant to 12 U.S.C. 24 and 335. Permissible activities include underwriting and dealing in type I securities as defined in 12 C.F.R. 1, including obligations of the United States, general obligations of states and their political subdivisions,[1] and type I municipal bonds; type II securities as defined in 12 C.F.R. 1, including, in part, municipal revenue obligations for housing, university, or dormitory purposes that do not qualify as type I securities; and banker's acceptances and certificates of deposit. In addition, such dealer subsidiaries are subject to the applicable capital restrictions (10 percent of the lead bank's capital and surplus) on dealing in type II securities in 12 C.F.R. 1.7. These underwriting and dealing activities were added to the permissible activities section of Regulation Y, effective February 6, 1984. Furthermore, dealer subsidiaries are permitted to furnish investment advice with respect to these bank-eligible securities.

The Board has authorized bank-affiliated securities dealers to underwrite, deal in, or privately place type III securities in separately capitalized nonbank subsidiaries subject to prudential limitations and restrictions to preclude such subsidiaries from being principally engaged in the underwriting and distribution of securities. In addition, the Board has authorized broker-dealer subsidiaries and brokerage subsidiaries to privately place any type of debt or equity security.

3240.0.1 HISTORY OF BOARD APPROVALS OF UNDERWRITING AND DEALING IN GOVERNMENT OBLIGATIONS AND MONEY MARKET INSTRUMENTS

On February 27, 1978, the Board approved an application to engage de novo in underwriting and dealing activities then being conducted by the bank holding company's only subsidiary bank. Thus, the formation of the subsidiary transferred these operations from the bank to the nonbank subsidiary. The activity included the underwriting and dealing in obligations of the United States and general obligations of various states and of political subdivisions. The Board determined that this activity is closely related to banking. The Board also approved, on February 27, 1978, another application of a bank holding company that would permit it to retain shares in a firm engaged in U.S. government securities underwriting activities.

On March 20, 1979, the Board approved an application of a bank holding company to acquire a company that would engage de novo in the activities of underwriting and dealing in certain government and municipal securities and in providing portfolio investment advice to individuals, associations, corporations, state and local governments, and financial institutions (''nonbank entities'') and to unaffiliated commercial banks. The Board determined that the proposed activities were closely related to banking.

On March 2, 1982, the Board approved an application of a bank holding company to form an incorporated securities company subsidiary that would engage de novo in the activities of soliciting, underwriting, dealing in, purchasing, and selling obligations of the United States, general obligations of various states, and money market instruments such as banker's acceptances and certificates of deposit. The Board regarded the government securities activities that the bank holding company proposed to engage in as substantially the same as the activities that the Board had approved in previous orders. Insofar as its proposal to deal in banker's acceptances, certificates of deposit, and other money market instruments that state member banks may from time to time be authorized to underwrite and deal in (such instruments are not regarded as ''securities'' subject to the prohibitions in sections 16 and 21 of the Glass-Steagall Act), the Board regarded such activities as closely related to banking because banks engage in such functions. The Board's approval of the bank holding company's application was subjected to the same restrictions and prudent limitations as if the activity were conducted in the affiliate's lead bank. For example, the nonbank subsidiary could not underwrite, deal in, or hold type II

1. The Gramm-Leach-Bliley Act authorized well-capitalized state member banks to deal in, underwrite, purchase, and sell all type I municipal securities and revenue bonds without any limitations relative to the bank's capital. See section 2020.1 of the *Commercial Bank Examination Manual* and SR-01-13.

securities of any issuer in amounts that would not be permitted if such activities were conducted by the subsidiary national bank, nor would it be permitted to sell securities to trust accounts of affiliated banks, except as permitted by regulations of the Comptroller of the Currency. Type II securities can consist of certain types of public housing and dormitory bonds of states and municipalities. The amount of such securities, of a single issue held by the bank, may not exceed 10 percent of the bank's capital and surplus (12 U.S.C 24 (seventh) and (12 C.F.R. 1.3(d)). The Board further ruled that any purchase of securities from the bank holding company's nonbank subsidiary by any of the bank holding company's subsidiary banks at other than current market values would constitute an unsafe or unsound practice.

3240.0.2 ADDING THE ACTIVITY TO REGULATION Y

Effective February 6, 1984, underwriting and dealing in U.S. government obligations and certain money market instruments was added to the list of permissible activities of Regulation Y. The regulation, which was amended in 1997, continues to place the same limitations as would be applicable if the activity were performed by the bank holding company's subsidiary member banks or its subsidiary nonmember banks as if they were member banks. (See Section 225.28(b)(8)(i) of Regulation Y.)

3240.0.3 REGULATION OF DEALER ACTIVITIES

While municipal securities dealers and dealers in government/agency securities are required to register as broker-dealers pursuant to the Securities Exchange Act of 1934, there are at present no registration requirements for firms that deal only in money market instruments. Regardless of whether a bank holding company subsidiary is registered as a broker-dealer with the Securities and Exchange Commission (SEC), Federal Reserve System examiners will conduct inspections to determine whether the subsidiary is in compliance with the provisions of Regulation Y or any specific conditions in a bank holding company order pertaining to the organization under inspection. In addition, examiners will need to focus on financial, managerial, and safety-and-soundness considerations in any bank holding company dealer subsidiary. In the event a firm is a registered broker-dealer subject to examination by the National Association of Securities Dealers (NASD), the inspection should be designed to prevent duplication of effort, relying on work performed by NASD examiners to the greatest extent possible, yet still evaluate the factors discussed above that are relevant for either registered or unregistered dealers.

Effective May 20, 1985, the Federal Reserve Bank of New York adopted a *Capital Adequacy Guideline for U.S. Government Securities Dealers*. The Federal Reserve Bank of New York recommends that U.S. government securities dealers that are not subject to federal oversight agree to comply voluntarily with the capital adequacy guideline. Hence, it is expected that any government securities dealer subject to System inspection will comply with the SEC's Uniform Net Capital Rule (17 C.F.R. 240.15c3-1).

3240.0.4 DEALER ACTIVITIES

A firm operates as a dealer when it underwrites or deals in securities or money market instruments. Those activities are usually distinguished as separate activities from normal investment activities. If the firm holds itself out to other dealers or investors as a dealer or engages in a repetitive pattern of short-term purchases and sales, the firm may be engaged in dealer activities, regardless of its stated investment activities.

As noted previously, when the Board added to the Regulation Y list of permissible activities the activities of underwriting and dealing in U.S. government securities, certain money market instruments, and municipal securities, the Board added a restriction that such nonbank activities be subject to the same restrictions as securities and money market instrument activities of member banks. Accordingly, the following discussion focuses upon *permissible securities activities of all member banks.*

3240.0.5 GOVERNMENT AND MUNICIPAL SECURITIES

The authority under which a bank may engage in securities trading and underwriting is found in section 5136 of the Revised Statutes (12 U.S.C. 24). That authority is restricted by limitations on percentage holding of classes of securities as found in 12 C.F.R. 1.3. That regulation allows banks to deal in, underwrite, purchase, and sell type I securities without limit and type II securities limited to 10 percent of its capital and unimpaired surplus. Banks are prohibited from underwriting or dealing in type III securities for their own accounts. (See section 2020.1 of the *Commercial Bank*

Examination Manual for further information on type I, II, and III securities.)

There are three major types of securities transactions in which banks are involved. First, the bank may buy and sell securities on behalf of a customer. Those are agency transactions in which the agent (bank) assumes no substantial risk and is compensated by a prearranged commission or fee. Second, as a dealer, the bank buys and sells securities for its own account. That is termed a principal transaction because the bank is acting as a principal, buying or selling qualified securities through its own inventory and absorbing whatever market gain or loss is made on the transaction. The third type of securities transaction frequently executed by banks is a contemporaneous ''riskless-principal trade.'' The dealer buys and sells qualified securities as a principal, with the purchase and sale originating almost simultaneously. Exposure to market risks is limited by the brief period of actual ownership, and profits result from dealer-initiated markup, the difference between the purchase and sale prices.

Dealers' securities transactions involve customers and other securities dealers. The word ''customer,'' as used in this section, means an investor. Transactions with other dealers are not considered customer transactions unless the dealer is buying or selling for investment purposes. The following subsections include general descriptions of significant areas of permissible trading and underwriting activities.

3240.0.6 U.S. GOVERNMENT SECURITIES TRADING

U.S. government security trading inventories are generally held with the objective of making short-term gains through market appreciation and dealer-initiated markups. The size of a transaction, the dealer efforts extended, and the nature of the security are common factors that affect the markup differential. Markups on government securities generally range between one and four thirty-seconds of a point. Long maturity issues may have higher markups.

The market risk inherent in U.S. government trading portfolios should be controlled by policy. Standards should be established to limit the total securities inventory and the amount of securities with similar yield or maturity characteristics. Limits imposed by policy should include commitments to purchase new governments on a when-issued basis.

Payments for and deliveries of U.S. government and most agency securities are settled on the business day following the trade. Government dealers and customers can negotiate same-day or delayed settlement for special situations, but the industry recognizes standard settlement as occurring on the trade date plus one business day.

3240.0.6.1 ''When-Issued'' Trading

A significant source of risk to dealers involves ''when-issued'' (WI) trading in government securities. WI trading is the buying and selling of securities in the one- to two-week interim between the announcement of an offering and the security issuance and payment date. The Dealer Surveillance Staff at the Federal Reserve Bank of New York began to require WI position reports from primary government securities dealers and request voluntary WI reports from certain other government securities dealers in 1984. At the time the reporting requirements were adopted, a senior official stated, ''The opportunity to trade with several dealers simultaneously without making payment could result in trading losses which exceed a participant's ability to settle.'' In essence, the fact that settlement date can extend to almost two weeks—as opposed to the ordinary next-day settlement—presents an opportunity for firms to engage in a large volume of trading without drawing on the firm's ability to purchase securities or effect delivery against short positions. Hence, there is increased credit risk in such transactions. Consequently, the dealer's trading position limits should include WI limits to protect against the increased credit risk associated with WI trading.

3240.0.6.2 Due Bills

A ''due bill'' is an obligation that results when a firm sells a security or money market instrument and receives payment, but does not deliver the item sold. Due bills issued should be considered as borrowings by the issuing firm, and, alternatively, due bills received should be considered as lending transactions.

Registered broker-dealers are subject to the SEC's rule 15c3-3 (17 C.F.R. 240.15c3-3), ''Customer Protection—Reserves and Custody of Securities.'' Basically, this rule states the principle that a broker-dealer needs to safeguard customer assets and cannot use such assets to fund its own business activities. While this rule is not directly applicable to unregistered U.S. government securities or money market instrument dealers, the principle is transferable. Dealers should not issue due bills as a means of obtaining operating funds or where the underlying security can be delivered at settlement. Customers of the dealer enter transactions with an implicit understanding that securities transactions will be promptly executed and settled unless there is a clear understanding to the contrary. Consequently, dealers should promptly disclose the issuance of a due bill to a customer when funds are taken but securities or money market instruments are not delivered to the customer. Such disclosure should reference the applicable transaction; state the reason for the creation of a due bill; describe the collateral, if any, securing the due bill; and indicate that to the extent the market value of the collateral is insufficient, the customer may be an unsecured creditor of the dealer.

3240.0.6.3 Clearance

Securities clearance services for the bulk of U.S. government and federal-agency security transactions are provided by the Federal Reserve as part of its telegraphic securities transfer system. The various Federal Reserve Banks will wire transfer most government securities between the book-entry safekeeping accounts of the seller and buyer. The Federal Reserve's systems also are used to facilitate security borrowings, loans, and pledges. Hence, the securities firm will need to use the services of a clearing bank.

3240.0.6.4 Short Sales

Another area of U.S. government security activity involves short-sale transactions. A short sale is the sale and delivery of a security that the seller does not own. It is accomplished by borrowing the security for delivery. The borrowed security is collateralized by an appropriate amount of a similar security. Short sales are conducted to accommodate customer orders, to obtain funds by leveraging existing assets, to hedge the market risk of other assets, or with the expectation that the market price of the sold security will decline sufficiently to allow the bank to complete the transaction by purchasing an equivalent security at a later date and a lower price.

3240.0.6.5 Arbitrage

Arbitrage is the coordinated purchase and sale of two securities or of a security and a futures or options contract in which there is a relative market imbalance. The objective of such activity is to obtain earnings by taking advantage of changing yield spreads. Arbitrage opportunities take many forms and can exist whenever segments of the securities markets are subject to a yield variance.

Exposure on arbitrage and/or short sales should be closely monitored for compliance with predetermined objectives. Risk should be controlled by point-spread limits coordinated with stop-loss buy provisions or sell provisions and by guidelines on the length of time a short position can remain uncovered.

3240.0.7 MONEY MARKET TRADING

Aside from short-term securities, banks customarily trade a substantial volume of other money market instruments such as banker's acceptances. It should be noted that the Supreme Court has opined that commercial paper is a Glass-Steagall security.

3240.0.7.1 Banker's Acceptances

Banker's acceptances are an obligation of the acceptor bank and an indirect obligation of the drawer. They are normally secured by rights to the goods being financed and are available in a wide variety of principal amounts. Maturities are generally less than nine months. Acceptances are priced like Treasury bills, with a discount figured for the actual number of days to maturity based on a 360-day year.

3240.0.7.2 Certificates of Deposit

Negotiable certificates of deposit (CDs) issued by money-center banks are actively traded in denominations of $100,000 to $1 million. Interest generally is calculated on a 360-day year and paid at maturity. Secondary market prices are computed based on current yield, net of accrued interest due the seller. Eurodollar CDs trade like domestic CDs except their yields are usually higher and their maturities often longer.

Money market instruments trade with the same-day or one-day settlement. Publicly quoted yields or dollar prices are usually based on round lot trades of $1 million, except for commercial paper, which trades in round lots of $250,000. Odd-lot prices may vary, but because of the large dollar volume of most trades, the percentage spread between the acquisition cost and sale price is characteristically modest.

Management should attempt to minimize market risk by establishing a maximum holding limit for each class of money market instrument. Policy guidelines also should establish concentration limits for money market instruments issued by a single obligor. Such limits should include commitments.

A sound money market trading policy recognizes the need for a qualitative analysis of the issuers of instruments. Credit approvals should be obtained before trading in CDs and acceptances, and reviews should be conducted on a regular schedule.

Banks dealing in money market instruments are subject to a number of legal restrictions. The sale of federal funds by a member bank to a bank affiliate is limited under section 23A (12 U.S.C. 371(c)) and subject to the restrictions of section 23B of the Federal Reserve Act (12 U.S.C. 371(c-1)). The acquisition, as principal, of a certificate of deposit issued by an affiliate bank also is subject to section 23A limitations and section 23B restrictions. These restrictions do not apply to transactions between bank subsidiaries that are 80 percent or more commonly owned by a bank holding company. These transactions must be conducted on terms that are consistent with safe and sound banking practices.

3240.0.8 REPURCHASE AGREEMENTS AND SECURITIES LENDING

The overwhelming majority of a government security dealer's inventory is financed by repurchase agreements. In addition, many dealers operate a ‘‘matched book’’ repo operation whereby they finance the acquisition or carrying of securities by customers through reverse repurchase agreements and contemporaneously obtain funding for such transactions through the sale of the same or similar securities under a repurchase agreement. In addition, securities dealers often lend or borrow specific issues to effect delivery against short positions or because of failure to receive securities required to be delivered. For prudential guidelines that have been issued to financial institutions in connection with repurchase agreements and securities lending, see the FFIEC supervisory policy statements at sections 2140.0 and 2150.0, which have been adopted by the Federal Reserve Board.

Firms enter into ‘‘reverse repos’’ to finance the U.S. government securities inventory of other dealers or mortgage bankers who have originated pools of mortgages to back federal housing agency securities. Repos are sold to customers in lieu of certificates of deposit. Customers find them attractive because interest can be paid on repos having maturities of less than seven days and because customer funds are collateralized by the security underlying the repurchase transaction.

The rate of interest received and paid is generally dictated by prevailing market rates. Profits are based on a modest positive spread between interest earned and interest paid. A dealer may attempt to improve that modest profit by increasing the volume of such transactions, using the proceeds to finance or pyramid the acquisition of reverse repos or securities to be used in additional repo arrangements.

A common dealer strategy is to vary resale and repurchase maturities in anticipation of interest-rate movements. If an upward rate trend is expected, the dealer will attempt to lock in a cheaper source of funds at the current low rate by negotiating longer maturities for repos and shorter maturities for reverse repos. Conversely, if interest rates are expected to decline, the dealer attempts to negotiate longer-maturity reverse repos to ensure continuing higher earnings, while negotiating shorter-maturity repos to take advantage of cheaper future sources of funds. Care should be taken to limit exposure by instituting policy guidelines that—

1. limit the aggregate amounts of reverse repo and repo positions,
2. specify acceptable amounts of funds for unmatched or extended maturity transactions,
3. determine maximum time gaps for unmatched maturity transactions and minimally acceptable interest-rate spreads for various maturity agreements, and
4. follow the prudential guidelines in the FFIEC's policy statement on repurchase agreements and securities lending. (See sections 2140.0 and 2150.0.)

3240.0.9 POLICY SUMMARY

The legal responsibilities of directors require that they ensure that dealer activities are conducted on a sound and legal basis that can only be accomplished if the directors endorse a written trading policy that addresses each area of market and legal risk. Written policy guidelines should be distributed to each individual engaged in trading activities.

3240.0.10 SCOPE OF THE INSPECTION

The scope of inspection will vary depending on the types of securities or money market instrument underwriting, dealing, and brokerage activities conducted by the subsidiary. Examiners may encounter situations in which a securities subsidiary is an SEC-registered broker-dealer because the subsidiary also executes transactions in municipal securities.

Registered broker-dealers are required to become members of the NASD or some other ‘‘self-regulatory organization.’’ To avoid unnecessary regulatory overlap, examiners can rely on the NASD's compliance examination with respect to investor protection, including compliance with rules of the SEC, NASD, and Municipal Securities Rulemaking Board (MSRB), and the Board's Regulation T governing securities credit (if applicable). Consequently, in commencing such an inspection, examiners should begin by requesting and reviewing the NASD's most recent examination letter to the broker-dealer and serious violations that could endanger the banking organization (for example, fraudulent activities that could subject the organization to losses or lawsuits). Significant violations that have not yet been corrected should be noted in the bank holding company report.

Federal Reserve examiners retain responsibility for inspecting certain areas of registered broker-dealer operations regardless of whether the NASD reviews them. Specifically, System examiners should still evaluate management, financial results, and safety-and-soundness considerations, including internal controls. In addition, examiners still need to verify that registered broker-dealer subsidiaries comply with the provisions of Regulation Y, section 225.28(b)(8)(i), or specific Board orders pertaining to the firm under inspection. Finally, the examiner should be prepared to review in-depth any activities or money market instruments that are not securities that might not have been reviewed by the NASD because the activities are outside their scope of examination.

3240.0.11 INSPECTION OBJECTIVES

1. To determine if the policies, practices, procedures, and internal controls regarding dealer activities are adequate.
2. To determine if officers are operating in conformance with the established guidelines.
3. To evaluate the trading portfolio for credit quality and marketability.
4. To determine the scope and adequacy of the audit-compliance functions.
5. To determine compliance with applicable laws and regulations, including 12 C.F.R. 225.28(b)(8)(i).
6. To ensure investor protection.
7. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulation have been noted.

3240.0.12 INSPECTION PROCEDURES

1. Review the adequacy of the dealer's internal controls. (See section 3240.0.13.)
2. Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the inspection.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned ‘‘Internal and External Audits,’’ and determine if corrections have been accomplished.
4. Obtain a copy of the latest letter received from the self-regulatory organization responsible (if applicable) for examining broker-dealer activities of this subsidiary.
5. Request that the firm provide the following schedules:
   a. aged schedule of securities that have been acquired as a result of underwriting activities
   b. aged schedule of trading-account securities and money market instruments held for trading or arbitrage purposes, which should reflect commitments to purchase and sell securities and all joint-account interests
   c. schedule of short-sale transactions
   d. aged schedule of due bills
   e. list of bonds borrowed
   f. aged schedule of ‘‘fails’’ to receive or deliver securities on unsettled contracts

g. schedule of approved securities borrowers and approved limits
h. schedule of loaned securities
i. schedule detailing account names and/or account numbers of the—
   - affiliated banks' permanent portfolio accounts;
   - personal accounts maintained at the firm by its employees;
   - accounts of brokers or other dealers; and
   - personal accounts of employees of other brokers, dealers, or municipal securities dealers
j. list of all joint accounts entered into since the last examination
k. list of underwriting since the last examination and whether such securities were acquired by negotiation or competitive bid
l. list of all financial advisory relationships

6. Compare balances of appropriate schedules to the general ledger and review reconciling items for reasonableness.
7. Determine the extent and effectiveness of trading-policy supervision by—
   a. reviewing the abstracted minutes of meetings of the board of directors and/or of any appropriate committee,
   b. determining that proper authorization for the trading officer or committee has been made,
   c. ascertaining the limitations or restrictions on delegated authorities,
   d. evaluating the sufficiency of analytical data used in the most recent board or committee trading-department review,
   e. reviewing the methods of reporting by department supervisors and internal auditors to ensure compliance with established policy and law, and
   f. reaching a conclusion about the effectiveness of director supervision of the trading policy. Prepare a memo for the examiner assigned ''Duties and Responsibilities of Directors'' stating your conclusions. All conclusions should be supported by factual documentation.

(Before continuing, refer to steps 14 and 15. They should be performed in conjunction with the remaining examination steps.)

8. Ascertain the general character of underwriting and direct-placement activities and ascertain the effectiveness of department management by reviewing underwriter files and ledgers, committee reports, and offering statements to determine—
   a. the significance of underwriting activities and direct placements of securities as reflected by the volume of sales and profit or loss on operations (compare current data to comparable prior periods);
   b. whether there is a recognizable pattern in—
      - the extent of analysis of material information relating to the ability of the issuer to service the obligation,
      - rated quality of offerings,
      - point spread of profit margin for unrated issues,
      - geographic distribution of issuers, and
      - syndicate participants, and
   c. the volume of outstanding bids. Compare current data to comparable prior periods.
9. Determine the general character of trading-account activities and whether the activities are in conformance with stated policy by reviewing departmental reports, budgets, and position records for various categories of trading activity and determining—
   a. the significance of present sales volume compared to comparable prior periods and departmental budgets;
   b. whether the firm's objectives are compatible with the volume of trading activity;
   c. significant inventory positions taken since the prior examination and determining if—
      - the quality and maturity of the inventory position was compatible with prudent practices, and
      - the size of the position was within prescribed limits and compatible with a sound trading strategy
   d. the exposure on offsetting repurchase transactions by—
      - reviewing the maturities of offsetting ''repo'' and ''reverse repo'' agreements to ascertain the existence, duration, amounts, and strategy used to manage unmatched maturity ''gaps'' and extended (over 30 days) maturities;
      - reviewing records since the last inspection to determine the aggregate amounts of—
        — matched repurchase transactions and
        — ''reverse repo'' financing extended to one or related firms(s); and
      - performing credit analyses of significant concentrations with any single or related entities.

10. Determine the extent of risk inherent in trading-account securities which have been in inventory in excess of 30 days.
    a. Determine the dollar volume in extended holdings.
    b. Determine the amounts of identifiable positions with regard to issue, issuer, yield, credit rating, and maturity.
    c. Determine the current market value for individual issues which show an internal valuation markdown of 10 percent or more.
    d. Perform credit analyses on the issuers of nonrated holdings identified as significant positions.
    e. Perform credit analyses on those issues with valuation writedowns considered significant relative to the scope of trading operations.
    f. Discuss plans for disposal of slow-moving inventories with management and determine the reasonableness of those plans in light of current and projected market trends.
11. Using an appropriate technique, select issues from the schedule of trading-account inventory. Test valuation procedures by—
    a. reviewing operating procedures and supporting workpapers and determining if prescribed valuation procedures are being followed;
    b. comparing dealer-prepared market prices, as of the most recent valuation date, to an independent pricing source (use trade date ‘‘bid’’ prices); and
    c. investigating any price differences noted.
12. Using an appropriate technique, select transactions from the schedule of short sales and determine—
    a. the degree of speculation reflected by basis-point spreads,
    b. present exposure shown by computing the cost to cover short sales, and
    c. if transactions are reversed in a reasonable period of time.
13. Analyze the effectiveness of operational controls by reviewing recent cancellations and fail items (fail to receive securities and fail to deliver securities) that are a week or more beyond settlement date and determine—
    a. the amount of extended fails,
    b. the planned disposition of extended fails,
    c. if the control system allows a timely, productive follow-up on unresolved fails,
    d. the reasons for cancellations, and
    e. the planned disposition of securities that have been inventoried before the recognition of a fail or a cancellation.
14. Determine compliance with applicable laws, rulings, and regulations by performing the following:
    a. *12 C.F.R. 1.3—eligible securities.*
        - Review inventory schedules of underwriting and trading accounts and determine if issues whose par value is in excess of 10 percent of the affiliated lead bank’s capital and unimpaired surplus are type I securities.
        - Determine that the total par value of type II investments does not exceed 10 percent of the affiliated lead bank’s capital and unimpaired surplus, based on the combination of holdings and permanent portfolio positions in the same securities.
        - Elicit management’s comments and review underwriting records on direct placement of type II securities and determine if the broker-dealer is dealing or engaging in impermissible direct placement of type III securities.
    b. *Sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371(c) and 375)—preferential treatment.* Obtain a list of domestic affiliate relationships and a list of directors and principal officers and their business interests from appropriate examiners and determine whether transactions, including securities-clearance services, involving affiliates, insiders, or their interests are on terms less favorable to the bank than those transactions involving unrelated parties.
15. Test for unsafe and unsound practices and possible violations of the Securities Exchange Act of 1934 by—
    a. reviewing transactions, including U.S. government tender-offer subscription files, involving employees and directors of dealer or other banks, and determining if the funds used in the transactions were misused bank funds or the proceeds of reciprocal or preferential loans,
    b. reviewing sales to affiliated companies to determine that the sold securities were not subsequently repurchased at an additional markup and that gains were not recognized a second time,
    c. reviewing securities position records and customer ledgers with respect to large-volume repetitive purchase and sales transactions and—

  - independently testing market prices of significant transactions which involve the purchase and resale of the same security to the same or related parties, and
  - investigating the purchase of large blocks of securities from dealer firms just prior to month-end and their subsequent resale to the same firm just after the beginning of the next month
  d. reviewing customer-complaint files and determining the reasons for such complaints.
16. Discuss with an appropriate officer and prepare report comments concerning—
  a. the soundness of trading objectives, policies, and practices;
  b. the degree of legal and market risk assumed by trading operations;
  c. the effectiveness of analytical, reporting, and control systems;
  d. violations of law;
  e. internal control deficiencies;
  f. apparent or potential conflicts of interest; and
  g. other matters of significance.
17. Reach a conclusion regarding the quality of department management and state your conclusions on the appropriate inspection report pages.
18. Update workpapers with any information that will facilitate future inspections.

3240.0.13 REVIEW OF INTERNAL CONTROLS

As a part of carrying out the inspection procedures for this activity, the examiner is expected to review the dealer's system of internal controls. The examiner should concentrate the internal controls review on the policies, practices, and procedures of the firm.

The system should be documented in a complete, concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. *Items marked with asterisks require substantiation by observation or testing.*

3240.0.13.1 Securities Underwriting Trading Policies

1. Has the board of directors, consistent with its duties and responsibilities, adopted written securities underwriting/trading policies that—
  a. outline objectives?
  b. establish limits and/or guidelines for the following:
    - price markups?
    - quality of issues?
    - maturity of issues?
    - inventory positions (including when-issued (WI) positions)?
    - amounts of unrealized loss on inventory positions?
    - length of time an issue will be carried in inventory?
    - amounts of individual trades or underwriter interests?
    - acceptability of brokers and syndicate partners?
  c. recognize possible conflicts of interest and establish appropriate procedures regarding—
    - deposit and service relationships with municipalities whose issues have underwriting links to the trading department?
    - deposit relationships with securities firms handling significant volumes of agency transactions or syndicate participations?
    - transfers made between trading-account inventory and affiliated investment portfolio(s)?
    - the affiliated bank's trust department acting as trustee, paying agent, and transfer agent for issues which have an underwriting relationship with the trading department?
  d. state procedures for periodic, monthly or quarterly, valuation of trading inventories to market value?
  e. state procedures for periodic independent verification of valuations of the trading inventories?
  f. outline methods of internal review and reporting by department supervisors and internal auditors to ensure compliance with established policy?
  g. identify permissible types of securities?
2. Are the underwriting/trading policies reviewed at least quarterly by the board of directors to determine their adequacy in light of changing conditions?
3. Is there a periodic review by the board to ensure that the underwriting/trading department is in compliance with its policies?

3240.0.13.2 Offsetting Resale and Repurchase Transactions

1. Has the board of directors, consistent with its duties and responsibilities, adopted written

offsetting repurchase transaction policies that—
  a. limit the aggregate amount of offsetting repurchase transactions?
  b. limit the amounts in unmatched or extended (over 30 days) maturity transactions?
  c. determine maximum time gaps for unmatched maturity transactions?
  d. determine minimally acceptable interest-rate spreads for various maturity transactions?
  e. determine the maximum amount of funds to be extended to any single or related firms through "reverse repo" transactions involving unsold (through forward sales) securities?
  f. require firms involved in reverse repo transactions to submit corporate resolutions stating the names and limits of individuals who are authorized to commit the firm?
  g. require submission of current financial information by firms involved in reverse repo transactions?
  h. provide for periodic credit reviews and approvals for firms involved in reverse repo transactions?
  i. specify types of acceptable offsetting repurchase transaction collateral?
  j. require receipt of assurance letters that unregulated securities dealers comply with the Federal Reserve Bank of New York's "Capital Adequacy Guideline for U.S. Government Securities Dealers?"
2. Are written collateral-control procedures designed so that—
  a. collateral assignment forms are used?
  b. collateral assignments of registered securities are accompanied by powers of attorney signed by the registered owner, and are registered securities registered in the dealer or dealer's nominee name when they are assigned as collateral for extended maturity (over 30 days) reverse repo transactions?
  c. funds are not disbursed until reverse repo collateral is delivered into the physical custody of the dealer or an independent safekeeping agent?
  d. funds are only advanced against predetermined collateral margins or discounts?
  e. collateral margins or discounts are predicated upon the following:
    • the type of security pledged as collateral?
    • maturity of collateral?
    • historic and anticipated price volatility of the collateral?
    • creditworthiness of the counterparty?
    • maturity of the reverse repo agreements?
    • accrued interest?
  f. maintenance agreements are required to support predetermined collateral margin or discount by daily mark to market of repurchase agreement securities?
  g. maintenance agreements are structured to allow for obtaining additional securities or cash calls in the event of collateral price declines?
  h. collateral market value is frequently checked to determine compliance with margin and maintenance requirements?

3240.0.13.3 Custody and Movement of Securities

*1. Are the dealer's procedures such that persons do not have sole custody of securities in that—
  a. they do not have sole physical access to securities?
  b. they do not prepare disposal documents that are not also approved by authorized persons?
  c. for the security custodian, supporting disposal documents are examined or adequately tested by a second custodian?
  d. no person authorizes more than one of the following transactions: execution of trades, receipt and delivery of securities, and collection or disbursement of payment?
2. Are securities physically safeguarded to prevent loss, unauthorized disposal, or use?
  a. Are negotiable securities kept under dual control?
  b. Are securities counted frequently on a surprise basis and reconciled to the securities record? Are the results of such counts reported to management?
  c. Does the dealer periodically test for compliance with provisions of its insurance policies regarding custody of securities?
  d. For securities in the custody of others—
    • are custody statements agreed periodically to position ledgers, and any differences followed up to a conclusion?

- are statements received from brokers and other dealers reconciled promptly, and any differences followed up to a conclusion?
- are positions for which no statements are received confirmed periodically, and stale items followed up to a conclusion?

3. Are trading-account securities segregated from other dealer-owned securities or securities held in safekeeping for customers?
*4. Is access to the trading-securities vault restricted to authorized employees?
5. Do withdrawal authorizations require countersignature to indicate security count verifications?
6. Is registered mail used for mailing securities, and are adequate receipt files maintained for such mailings (if registered mail is used for some but not all mailings, indicate criteria and reasons)?
7. Are prenumbered forms used to control securities trades, movements, and payments?
8. If so, is numerical control of prenumbered forms accounted for periodically by persons independent of those activities?
9. Do alterations to forms governing the trade, movement, and payment of securities require—
   *a. signature of the authorizing party?
   b. use of a change-of-instruction form?
10. With respect to negotiability of registered securities—
    a. are securities kept in non-negotiable form whenever possible?
    b. are all securities received and not immediately delivered transferred to the name of the dealer or its nominee and kept in non-negotiable form whenever possible?
    c. are securities received checked for negotiability (endorsements, signature, guarantee, legal opinion, etc.) and for completeness (coupons, warrants, etc.) before they are placed in the vault?

3240.0.13.4 Purchase and Sales Transactions

1. Are all transactions promptly confirmed in writing to the actual customers or dealers?
2. Are confirmations compared or adequately tested to purchase and sales memoranda and reports of execution of orders, and any differences investigated and corrected (including approval by a designated responsible employee)? Are confirmations and purchase and sale memoranda checked or adequately tested for computation and terms by a second individual?
3. Are comparisons received from other dealers or brokers compared with confirmations, and any differences promptly investigated? Are comparisons approved by a designated individual?

3240.0.13.5 Customer and Dealer Accounts

1. Do account bookkeepers periodically transfer to different account sections or otherwise rotate posting assignments?
2. Are letters mailed to customers requesting confirmation of changes of address?
3. Are separate customer-account ledgers maintained for—
   a. employees?
   b. affiliates?
   c. affiliated bank's trust accounts?
4. Are customer inquiries and complaints handled exclusively by designated individuals who have no incompatible duties?

3240.0.13.6 Other

1. Are the preparation, additions, and posting of subsidiary records performed and/or adequately reviewed by persons who do not also have sole custody of securities?
2. Are subsidiary records reconciled, at least monthly, to the appropriate general-ledger accounts, and are reconciling items adequately investigated by persons who do not also have sole custody of securities?
3. Are fails to receive and deliver under a separate general-ledger control?
   a. Are fail accounts periodically reconciled to the general ledger, and any differences followed up to a conclusion?
   b. Are periodic aging schedules prepared?
   c. Are stale fail items confirmed and followed up to a conclusion?
   d. Are stale items valued periodically, and, if any potential loss is indicated, is a particular effort made to clear such items or to protect the bank from loss by other means?
4. With respect to securities loaned and borrowed positions—

a. are details periodically reconciled to the general ledger, and any differences followed up to a conclusion?
b. are positions confirmed periodically?
c. are all policies and procedures in conformance with the FFIEC policy on securities lending contained section 2140.0?

3240.0.14 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Authorization for state member banks of the Federal Reserve System to underwrite and deal in obligations of the United States, various states, and political subdivisions and other authorized obligations for state member banks	24 (7), 335	250.120 250.121 250.122 250.123 250.142	3–414.94 3–414.95 3–414.96 3–414.97 3–415.2 2–425.11	
Initial October 19, 1976, order stating that the activity of underwriting and dealing in certain government and municipal securities was closely related to banking			41 *Federal Register* 47083 (1976)	
Order approving application to engage de novo in underwriting and dealing in municipal securities				1978 FRB 222
Order approving application of a BHC that would permit it to retain shares in a government and municipal securities dealer to engage in underwriting government securities				1978 FRB 222 1978 FRB 223
Order approving application of a BHC to acquire a company that would engage de novo in underwriting and dealing in government and municipal securities and providing investment portfolio advice to associations, state and local governments, and financial institutions (“nonbank entities”), and to unaffiliated banks				1979 FRB 363

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Order approving an application of a BHC to form an incorporated securities company that would engage de novo in the activities of underwriting and dealing in, purchasing, and selling U.S. government and municipal obligations, and money market instruments such as banker's acceptances and certificates of deposit. Securities company limited to permissible BHC activities.				1982 FRB 249
Adding of the activity to the list of permissible activities per Regulation Y		225.28(b)(8)(i)		1984 FRB 121 1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

4(c)(8)—Agency Transactional Services (Futures Commission Merchants and Futures Brokerage) Section 3250.0

A futures commission merchant (FCM) is an entity referred to in the Commodity Exchange Act to denote a registered firm that is in the business of soliciting or accepting orders, as broker, for the purchase or sale of any exchange-traded futures contract and options thereon. For the purposes of this examiner guidance, the term ‘‘FCM activities’’ is used in a broad context and refers to all futures brokerage activities, operations, and their associated risks that are subject to the Federal Reserve System's supervision (see SR-97-33). In connection with these activities, banking organizations may hold customer funds, assets, or property and may be members of futures exchanges and their associated clearinghouses. They may also offer related advisory services as registered commodity trading advisers (CTAs). The guidance addresses the expanding scope of futures activities conducted by different types of banking organizations worldwide, and implements supervisory initiatives to effect more risk-focused and burden-sensitive approaches to the supervision of FCM activities. The guidance is designed to assist examiners in assessing how well a consolidated financial organization manages one or more discrete futures brokerage operations, as well as in making a broader assessment of the organization's overall risk management.

The guidance pertains to FCM subsidiaries of bank holding companies (BHCs), but it is also applicable to FCM subsidiaries of state member banks, Edge Act corporations, and foreign banking organizations. It addresses the broader scope of permissible futures brokerage activities articulated within Regulation Y,[1] and by extension in Regulation K, and focuses on the adequacy of management and the management processes used to control the credit, market, liquidity, reputation, and operations risks entailed in these activities, including brokerage, clearing, funds management, and advisory services.

The guidance takes a global line-of-business supervisory approach to the inspection of FCM activities rather than the traditional full-scope inspections of individual FCM subsidiaries, many of which are primarily supervised by functional regulators. Reviews and reports of functional regulators should be used to the fullest extent when planning and conducting inspections of FCM activities of bank holding companies and other banking organizations to avoid duplication and minimize supervisory burdens. However, in conducting an inspection of various aspects of an FCM's activities, a review of various functions, derived from a sample of the organization's FCM subsidiaries, may be necessary and appropriate to determine the extent of the risks these operations pose to the banking organization and to determine whether management of those risks is satisfactory. The examiner should pay particular attention to activities conducted in FCM subsidiaries that have not been subject to a regular inspection by their functional regulator and to FCM activities of foreign affiliates in which there is uncertainty concerning the level of local supervision.

BHC subsidiaries, banks (generally through operating subsidiaries), Edge Act corporations, and foreign banking organizations (FBOs) operating in the United States may operate futures brokerage and clearing services involving a myriad of financial and nonfinancial futures contracts and options on futures. These activities can involve futures exchanges and clearinghouses throughout the world. In general, most organizations conduct these activities as FCMs.

The Federal Reserve has a supervisory interest in ensuring that the banking organizations subject to its oversight conduct their futures brokerage activities in a safe and sound manner consistent with Regulations Y and K (including any terms and conditions in Board orders for a particular organization). Accordingly, a review of futures brokerage activities is an important

1. The Board broadened the scope of permissible FCM nonbanking activities for a bank holding company with the revision of Regulation Y, effective April 21, 1997. For example, the following activities are permissible:

- Derivative contracts can be executed and cleared on a broad range of nonfinancial commodities.
- Derivative contracts can be cleared without simultaneously providing execution services. Likewise, execution services can be provided without also providing clearing services.
- Foreign-exchange transactional services can be provided in the same FCM subsidiary that provides advice regarding foreign exchange.
- Bank holding companies can engage in FCM activities through a section 20 subsidiary.
- An FCM nonbanking subsidiary can trade for its own account.
- An FCM nonbanking subsidiary may act on exchange-traded futures contracts and on options on futures contracts based on a financial or nonfinancial commodity.
- A bank holding company may combine FCM activities and incidental activities. For example, FCM activities may be combined with futures-related financing to customers, such as financing to cover margin obligations (note: such financing may be prohibited by some exchanges).

element for inspections of BHCs, examinations of state member banks, and reviews of FBO operations. The following guidance on evaluating the futures brokerage activities of bank holding company subsidiaries, branches and agencies of foreign banks operating in the United States, or any operating subsidiaries of state member banks provides a list of procedures that may be used to tailor the scope of an inspection of these activities.

3250.0.1 SCOPE OF GUIDANCE

Examiners are to use a risk-based inspection approach to evaluating FCM activities—including brokerage, clearing, funds management, and advisory activities. Significant emphasis should be placed on evaluating the adequacy of management and the management processes used to control the credit, market, liquidity, legal, reputation, and operations risks entailed in these operations. Both the adequacy of risk management and the quantitative level of risk exposures should be assessed as appropriate to the scope of the FCM's activities. The objectives of a particular inspection should dictate the FCM activities to be reviewed and set the scope of the inspection.

Examiners are to use a functional-regulatory approach to minimize duplicative inspection and supervisory burdens. Reviews and reports of functional regulators should be used to their fullest extent. However, absent recent oversight inspection, or if an examiner believes that particular facts and circumstances at the banking organization or in the marketplace deem it necessary, a review of operations that would normally be assessed by the appropriate commodities regulator may be appropriate (such as a review of front- or back-office operations).

When futures brokerage occurs in more than one domestic or foreign affiliate, examiners should assess the adequacy of the management of the futures brokerage activities of the consolidated financial organization to ensure that the parent organization recognizes and effectively manages the risks posed by its various futures brokerage subsidiaries. Accordingly, in reviewing futures brokerage operations, examiners should identify all bank holding company, bank operating, or FBO subsidiaries that engage in FCM activities and the scope of those activities. Not all subsidiaries may need to be reviewed to assess the risk management of the consolidated organization. Selection of the particular FCM subsidiaries to be reviewed should be based on an assessment of the risks posed by their activities to the consolidated organization.

This guidance primarily addresses the assessment of activities associated with futures brokerage operations. Any proprietary trading that occurs at an FCM should be assessed in connection with the review of proprietary trading activities of the consolidated financial organization, using the appropriate guidance in the Federal Reserve's *Trading and Capital-Markets Activities Manual.* Similarly, when a review of futures advisory activities is planned, examiners should refer to investment, financial, and futures advisory inspection guidance in this manual (sections 3130.0 and 3130.4) and the *Trust Examination Manual* as appropriate.

3250.0.2 EVALUATION OF FCM RISK MANAGEMENT

Consistent with existing Federal Reserve policies, examiners should evaluate the risk-management practices of FCM operations and ensure that this evaluation is incorporated appropriately in the rating of risk management under the bank (CAMELS), BHC (BOPEC), and FBO (ROCA) rating systems. Accordingly, examiners should place primary consideration on findings related to the adequacy of (1) board and senior management oversight; (2) policies, procedures, and limits used to control risks; (3) systems for measuring, monitoring, and reporting risk; and (4) internal controls and audit programs.

3250.0.2.1 Board and Senior Management Oversight

The board of directors has the ultimate responsibility for the level of risks taken by the organization. Accordingly, the board, a designated subcommittee of the board, or a high level of senior management should approve overall business strategies and significant policies that govern risk-taking in the organization's FCM activities. In particular, the board or a committee thereof should approve policies that identify authorized activities and managerial oversight, and articulate risk tolerances and exposure limits of FCM activities. The board should also actively monitor the performance and risk profile of its FCM activities. Directors and senior management should periodically review information that is sufficiently detailed and timely to allow them to understand and assess the various risks involved in these activities. In addition, the board or a delegated committee should periodically reevaluate the business strategies and major risk-management policies and procedures, emphasizing the organization's financial objectives and risk tolerances.

The FCM's senior management is responsible for ensuring that policies and procedures for conducting FCM activities on both a long-range and day-to-day basis are adequate. Senior management or a designated subcommittee of the board should review and approve these policies and procedures annually. The consistency of these policies with parent company limits or other directions pertaining to the FCM's activities should be confirmed. Management must also maintain (1) clear lines of authority and responsibility for managing operations and the risks involved, (2) appropriate limits on risk-taking, (3) adequate systems and standards for measuring and tracking risk exposures and measuring financial performance, (4) effective internal controls, and (5) a comprehensive risk-reporting and risk-management review process. To provide adequate oversight, management should fully understand the risk profile of FCM activities. Examiners should review reports given to senior management and evaluate whether they consist of good summary information and sufficient detail that will enable management to assess and manage the FCM's risk. As part of its oversight responsibilities, senior management should periodically review the organization's risk-management procedures to ensure that they remain appropriate and sound.

Management should also ensure that activities are conducted by competent staff whose technical knowledge and experience are consistent with the nature and scope of the organization's activities. There should be sufficient depth in staff resources to manage these activities if key personnel are not available. Management should also ensure that back-office and financial-control resources are sufficient to effectively manage and control risks. Functions for measuring, monitoring, and controlling risk should have clearly defined duties. There should be adequate separation of duties in key elements of the risk-management process to avoid potential conflicts of interest. The nature and scope of these safeguards should be in accordance with the scope of the FCM's activities.

3250.0.2.2 Policies, Procedures, and Limits

FCMs should maintain written policies and procedures that clearly outline their approach for managing futures brokerage and related activities. Such policies should be consistent with the organization's broader business strategies, capital adequacy, technical expertise, and general willingness to take risk. Policies, procedures, and limits should address the relevant credit, market, liquidity, reputation, and operations risks in light of the scope and complexity of the FCM's activities. Policies and procedures should establish a logical framework for limiting the various risks involved in an FCM's activities and should clearly delineate lines of responsibility and authority over these activities. They should also address the approval of new product lines, strategies, and other activities; conflicts of interest including transactions by employees; and compliance with all applicable legal requirements. Procedures should incorporate and implement the parent company's relevant policies and should be consistent with applicable statutes, Federal Reserve Board regulations, interpretations, Board orders, and supervisory policies and guidance.

A sound system of integrated limits and risk-taking guidelines is an essential component of the risk-management process. Such a system should set boundaries for organizational risk-taking and ensure that positions that exceed certain predetermined levels receive prompt management attention, so they can be either reduced or prudently addressed.

3250.0.2.3 Risk Measurement, Monitoring, and Reporting

An FCM's system for measuring the credit, market, liquidity, and other risks involved in its activities should be as comprehensive and accurate as practicable and should be commensurate with the nature of its activities. Risk exposures should be aggregated across customers, products, and activities to the fullest extent possible. Examiners should evaluate whether the risk measures and the risk-measurement process are sufficiently robust to accurately reflect the different types of risks facing the organization. Clear standards for measuring risk exposures and financial performance should be established. The standards should provide a common framework for limiting and monitoring risks and should be understood by all relevant personnel.

An accurate, informative, and timely management information system is essential to the prudent operation of an FCM. Accordingly, the examiner's assessment of the quality of the management information system is an important factor in the overall evaluation of the risk-management process. Appropriate mechanisms should exist for reporting risk exposures and the financial performance of the FCM to its board and parent company, as well as for internal management purposes. FCMs must establish management reporting policies to apprise their boards of directors and senior management of material developments, the adequacy of risk management, operating and financial performance, and material deficiencies identified during reviews by regulators and by internal or external audits. The FCM should also provide reports to the parent company (or in the case of foreign-owned FCMs, to its U.S. parent organization, if any) of financial performance; adherence to risk parameters and other limits and controls established by the parent for the FCM; and any material developments, including findings of material deficiencies by regulators. Examiners should determine the adequacy of an FCM's monitoring and reporting of its risk exposure and financial performance to appropriate levels of senior management and to the board of directors.

3250.0.2.4 Internal Controls

An FCM's internal control structure is critical to its safe and sound functioning in general and to its risk-management system, in particular. Establishing and maintaining an effective system of controls, including the enforcement of official lines of authority and appropriate separation of duties—such as trading, custodial, and back-office—is one of management's more important responsibilities. Appropriately segregating duties is a fundamental and essential element of a sound risk-management and internal control system. Failure to implement and maintain an adequate separation of duties can constitute an unsafe and unsound practice, possibly leading to serious losses or otherwise compromising the financial integrity of the FCM.

When properly structured, a system of internal controls promotes effective operations and reliable financial and regulatory reporting; safeguards assets; and helps to ensure compliance with relevant laws, regulations, and organizational policies. Ideally, internal controls are tested by an independent internal auditor who reports directly to either the entity's board of directors or its designated committee. Personnel who perform these reviews should generally be independent of the function they are assigned to review. Given the importance of appropriate internal controls to banking organizations of all sizes and risk profiles, the results of audits or reviews, whether conducted by an internal auditor or by other personnel, should be adequately documented, as should management's responses to them. In addition, communication channels should exist that will allow negative or sensitive findings to be reported directly to the board of directors or the relevant board committee (for example, a board audit committee).

3250.0.3 FUTURES EXCHANGES, CLEARINGHOUSES, AND FCMs

Futures exchanges provide auction markets for standardized futures and options on futures contracts. In the United States and most other countries, futures exchanges and FCMs are regulated by a governmental agency. Futures exchanges are membership organizations and impose financial and other regulatory requirements on members, particularly those that do business for customers as brokers. In the United States and most other countries, futures exchanges also have quasi-governmental (self-regulatory) responsibilities to monitor trading and prevent fraud, with the authority to discipline or sanction members that violate exchange rules. FCMs may be members of the exchange on which they effect customers' trades. When they are not members, FCMs must use other firms who are exchange members to execute customer trades.[2]

Each futures exchange has an affiliated clearinghouse responsible for clearing and settling trades on the exchange and for managing associated risks. When a clearinghouse accepts transaction information from its clearing members, it generally guarantees the performance of the transaction to each member and becomes the counterparty to the trade (that is, the buyer to every seller and the seller to every buyer). Daily cash settlements are paid or collected by clearing members through the clearinghouse. The cash transfers represent the difference between the original trade price and the daily official closing settlement price for each commodity futures contract. The two members settle their sides of the transaction with the clearinghouse,

2. A firm or trading company that maintains only a proprietary business may become a member of an exchange without registering as an FCM.

usually by closing out the position before delivery of the futures contract or the expiration of the option on the futures contract.

An exchange member that wishes to clear or settle transactions for itself, customers, other FCMs, or commodity professionals (locals or market makers) may become a member of the affiliated clearinghouse (clearing member) if it is able to meet the clearinghouse's financial-eligibility requirements. In general, these requirements are more stringent than those required for exchange membership. For example, a clearing member usually is required to maintain a specified amount of net capital in excess of the regulatory required minimum and to make a guaranty deposit as part of the financial safeguards of the clearinghouse. The size of the deposit is related to the scale of the clearing member's activity. If it is not a member of the clearinghouse for the exchange on which a contract is executed, an FCM must arrange for another FCM that is a clearing member to clear and settle its transactions.[3]

Margin requirements are an important risk-management tool for maintaining the financial integrity of clearinghouses and their affiliated exchanges. Clearinghouses require that their members post initial margin (performance bond) on a new position to cover potential credit exposures borne by the clearinghouse. The clearing firm, in turn, requires its customers to post margin. At the end of each day, and on some exchanges on an intraday basis, all positions are marked to the market. Clearing members with positions that have declined in value pay the amount of the decline in cash to the clearinghouse, which then pays the clearing members holding positions that have increased in value on that day. This process of transferring gains and losses among clearing-member firms, known as collecting variation margin, is intended to periodically eliminate credit-risk exposure from the clearinghouse.[4] In volatile markets, a clearinghouse may call for additional variation margin during the trading day, sometimes with only one hour's notice, and failure to meet a variation (or initial) margin call is treated as a default to the clearinghouse.

Some clearinghouses also require that their members be prepared to pay loss-sharing assessments to cover losses sustained by the clearinghouse in meeting the settlement obligations of a clearing member that has defaulted on its (or its customers') obligations. Such assessments arise when losses exceed the resources of defaulting members, the guaranty fund, and other surplus funds of the clearinghouse. Each clearinghouse has its own unique loss-sharing rules.[5] At least one U.S. and one foreign exchange have unlimited loss-sharing requirements. Most U.S. clearinghouses relate loss-sharing requirements to the size of a member's business at the clearinghouse. Given the potential drain on a banking organization's financial resources, the exposure to loss-sharing agreements should be a significant consideration in the decision to become a clearing member. A parent bank holding company may not provide a guarantee or become liable to an exchange or clearing association other than for trades conducted by the subsidiary for its own account or for the account of any affiliate. (See section 225.28(b)(6)(iv) of Regulation Y.)

3250.0.4 COMMODITY EXCHANGE ACT, COMMODITY FUTURES TRADING COMMISSION, AND SELF-REGULATORY ORGANIZATIONS

In the United States, the primary regulator of exchange-traded futures activities is the Commodity Futures Trading Commission (CFTC), which was created by and derives its authority from the Commodity Exchange Act (CEA). The CFTC has adopted registration,[6] financial responsibility, antifraud, disclosure, and other rules for FCMs and CTAs, and has general enforcement authority over commodities firms and professionals that buy or sell exchange-traded futures contracts.

3. The nonmember FCM opens an account, usually on an omnibus basis, with the clearing-member FCM. Separate omnibus accounts have to be maintained for customer and noncustomer or proprietary trading activity. If the FCM does not carry customer accounts by holding customer funds and maintaining account records, the clearing member will carry the customer's account on a fully disclosed basis and issue confirmations, account statements, and margin calls directly to the customer on behalf of the introducing FCM. In such cases, the introducing FCM operates as an introducing broker (IB) and could have registered with the Commodity Futures Trading Commission as such.

4. Some foreign exchanges do not allow the withdrawal of unrealized profits as mark-to-market variation.

5. Clearinghouses usually (1) retain the right to use assets owned by clearing members, but under the control of the clearinghouse (for example, proprietary margin); (2) require additional contributions of funds or assets or require the member to purchase additional shares of the clearinghouse; or (3) perfect a claim against the member for its share of the loss.

6. Many FCMs also are SEC-registered as broker-dealers and are subject to SEC and CFTC financial-responsibility rules.

The futures exchanges, in addition to providing a marketplace for futures contracts, are deemed to be self-regulatory organizations (SROs) under the CEA. For example, a number of SROs have adopted detailed uniform practice rules for FCMs, including ''know your customer'' recordkeeping rules and other formal customer-disclosure requirements. The National Futures Association (NFA) also is an SRO, although it does not sponsor a futures exchange or other marketplace. The NFA has adopted sales-practice rules applicable to members who do business with customers. All FCMs that wish to accept orders and hold customer funds and assets must be members of the NFA.

The CEA and rules of the CFTC require the SROs to establish and maintain enforcement and surveillance programs for their markets and to oversee the financial responsibility of their members.[7] The CFTC has approved an arrangement under which a designated SRO (DSRO) is responsible for performing on-site audits and reviewing periodic reports of a member FCM that is a member of more than one futures exchange. The NFA is the DSRO for FCMs that are not members of any futures exchange.

Oversight of FCMs is accomplished through annual audits by the DSRO and the filing of periodic financial statements and early warning reports by FCMs, in compliance with CFTC and SRO rules. In summary, this oversight encompasses the following three elements:

1. *Full-scope audits at least once every other year of each FCM that carries customer accounts.* Audit procedures conform to a Uniform Audit Guide developed jointly by the SROs. The full-scope audit focuses on the firm's net capital computations, segregation of customer funds and property, financial reporting, recordkeeping, and operations.[8] The audit also reviews sales practices (including customer records, disclosures, advertisements, and customer complaints) and the adequacy of employee supervision. The audit's scope should reflect the FCM's prior compliance history as well as the examiner's on-site evaluation of the firm's internal controls. During the off-year, the DSROs perform limited-scope audits of member FCMs. This audit is limited to financial matters such as a review of the FCM's net capital computations, segregation of customer funds, and its books and records.
2. *FCM quarterly financial reporting requirements.* FCMs are required to file quarterly financial statements (form 1-FR-FCM) with their DSROs. The fourth-quarter statement must be filed as of the close of the FCM's fiscal year and must be certified by an independent public accountant. The filings generally include statements regarding changes in ownership equity, current financial condition, changes in liabilities subordinated to claims of general creditors, computation of minimum net capital, segregation requirements and funds segregated for customers, secured amounts and funds held in separate accounts, and any other material information relevant to the firm's financial condition. The certified year-end financial report also must contain statements of income and cash flows.
3. *Early warning reports.* FCMs are required to notify the CFTC and the SROs when certain financial weaknesses are experienced.[9] For example, if an FCM's net capital falls to a specified warning level, it must file a written notice within five business days and file monthly financial reports (form 1-FR-FCM) until its net capital meets or exceeds the warning level for a full three months. If an FCM's net capital falls below the minimum required, it must cease doing business and give telegraphic notice to the CFTC and any commodities or securities SRO of which it is a member. Similar notices must be given by a clearing organization or carrying FCM when it determines that a position of an FCM must be liquidated for failure to meet a margin call or other required deposit.

3250.0.5 FEDERAL RESERVE REGULATION OF FCMs AND CTAs

Bank holding companies are permitted, under Regulation Y (section 225.28(b)(7)(iv)), to engage

7. CFTC Rule 1.51, contract market program for enforcement, requires that SROs monitor market activity and trading practices in their respective markets, perform on-site examinations (audits) of members' books and records, review periodic financial reports filed by members, and bring disciplinary and corrective actions against members for violations of the CEA and CFTC and SRO rules.

8. If an FCM is also a broker-dealer, the DSRO is not required to examine the FCM for compliance with net capital requirements if the DSRO confers with the broker-dealer's examining authority at least annually to determine that the FCM is in compliance with the broker-dealer's net capital requirements and receives the DSRO copies of all examinations.

9. CFTC Rule 1.12 requires the maintenance of minimum financial requirements by FCMs and introducing brokers. These requirements are similar to those applicable to broker-dealers under SEC rules.

in FCM and CTA activities on both domestic and foreign futures exchanges through separately incorporated nonbank subsidiaries. As a general matter, the nonbank subsidiaries of bank holding companies (and some foreign banks) provide services to unaffiliated customers in the United States under section 4(c)(8) of the Bank Holding Company Act (BHC Act) and to unaffiliated customers outside the United States under Regulation K.[10] Banks and the operating subsidiaries of banks usually provide futures-related services to unaffiliated parties in the United States under the general powers of the bank and to unaffiliated parties outside the United States under Regulation K. These various subsidiaries may provide services to affiliates under section 4(c)(1)(C) of the BHC Act.

Regulation Y permits a bank holding company subsidiary that acts as an FCM to engage in other activities in the subsidiary, including futures advisory services and trading, as well as other permissible securities and derivative activities as defined in sections 225.28(b)(6) (financial and investment advisory activities) and 225.28(b)(7) (agency transactional services for customer investments). Section 225.28(b)(7) specifically authorizes FCMs to provide agency services for unaffiliated persons in execution, clearance, or execution and clearance of any futures contract and option on a futures contract traded on an exchange in the United States and abroad. It also includes the authority to engage in other agency-type transactions (for example, riskless principal) involving a forward contract, an option, a future, an option on a future, and similar instruments. Furthermore, this section codifies the long-standing prohibition against a parent bank holding company's issuing any guarantees or otherwise becoming liable to an exchange or clearinghouse for transactions effected through an FCM, except for the proprietary trades of the FCM and those of affiliates.

A well-capitalized and well-managed bank holding company, as defined in section 225.2(r) and (s) of Regulation Y, respectively, may commence activities as an FCM or a CTA by filing a notice prescribed under section 225.23(a) of Regulation Y. Bank holding companies that are not eligible to file notices or that wish to act in a capacity other than as an FCM or CTA, such as a commodity pool operator (CPO), must follow the specific application process for these activities. Examiners should ensure that all of these activities are conducted in accordance with the Board's approval order.

A bank holding company, bank, or FBO parent company of an FCM is expected to establish specific risk parameters and other limits and controls on the brokerage operation. These limits and controls should be designed to manage financial risk to the consolidated organization and should be consistent with its business objectives and overall willingness to assume risk.

3250.0.6 PARTICIPATION IN FOREIGN MARKETS

FCMs frequently transact business on foreign exchanges as either exchange or clearinghouse members or through third-party brokers that are members of the foreign exchange. The risks of doing business in foreign markets generally parallel those in U.S. markets; however, some unique issues of doing business on foreign futures exchanges must be addressed by the FCM and its parent company to ensure that the activity does not pose undue risks to the consolidated financial organization.

Before doing business on a foreign exchange, an FCM should understand the legal and operational differences between the foreign exchange and U.S. exchanges. For example, the FCM should know about local business practices and legal precedents that pertain to business in the foreign market. In addition, the FCM should know how the foreign exchange is regulated and how it manages risk, and should develop policies and the appropriate operational infrastructure of controls, procedures, and personnel to manage these risks. Accordingly, examiners should confirm that, in considering whether and how to participate in a foreign market, an FCM performs due diligence on relevant legal and regulatory issues, as well as on local business practices. Foreign-exchange risks should be understood and authorized by the FCM's parent company, and any limits set by the parent company or FCM management should be carefully monitored. The FCM and its parent company also should assess the regulatory and financial risks associated with exchange and clearinghouse membership in a foreign market, including an understanding of the extent to which the

10. Those nonbank subsidiaries that operate in the United States may open offices outside the United States if (1) the bank holding company's authority under Regulation Y is not limited geographically, (2) the foreign office is not a separately incorporated entity, and (3) the activities conducted by the foreign office are within the scope of the bank holding company's authority under Regulation Y. In addition, a bank holding company may operate a limited foreign-based business in the United States under Regulation K. (See 12 C.F.R. 211.6.)

foreign clearinghouse monitors and controls day-to-day credit risk and its loss-sharing requirements.

3250.0.7 SPECIFIC RISKS AND THEIR RISK-MANAGEMENT CONSIDERATIONS

In general, FCMs face five basic categories of risk—credit risk, market risk, liquidity risk, reputation risk, and operations risk. The following discussions highlight specific considerations in evaluating the key elements of sound risk management as they relate to these risks. The compliance and internal-controls functions provide the foundation for managing the risks of an FCM.

3250.0.7.1 Credit Risk

FCMs encounter a number of different types of credit risks. The following discussions identify some of these risks and discuss sound risk-management practices applicable to each.

3250.0.7.1.1 Customer Credit Risk

Customer credit risk is the potential that a customer will fail to meet its variation-margin calls or its payment or delivery obligations. An FCM should establish a credit-review process for new customers that is independent of the marketing and sales function. It is not unusual for the FCM's parent company (or banking affiliate) to perform the credit evaluation and provide the necessary internal approvals for the FCM to execute and clear futures contracts for particular customers. In some situations, however, the FCM may have the authority to perform the credit review internally. Examiners should determine how customers are approved and confirm that documentation in the customer's credit files is adequate even when the approval is performed by the parent. Customer credit files should indicate the scope of the credit review and contain approval of the customer's account and credit limits. For example, customer credit files may contain recent financial statements, sources of liquidity, trading objectives, and any other pertinent information used to support the credit limits established for the customer. In addition, customer credit files should be updated periodically.

FCM procedures should describe how customer credit exposures will be identified and controlled. For example, an FCM could monitor a customer's transactions, margin settlements, or open positions as a means of managing the customer's credit risk. Moreover, procedures should be in place to handle situations in which the customer has exceeded credit limits. These procedures should give senior managers who are independent of the sales and marketing function the authority to approve limit exceptions and require that such exceptions be documented.

3250.0.7.1.2 Customer-Financing Risk

Several exchanges, particularly in New York and overseas, allow FCMs to finance customer positions. These exchanges allow an FCM to lend initial and variation margin to customers subject to taking the capital charges under the CFTC's (or SEC's) capital rules if the charges are not repaid within three business days. In addition, some exchanges allow FCMs to finance customer deliveries, again subject to a capital charge.

An FCM providing customer-financing services should adopt financing policies and procedures that identify customer-credit standards. The financing policies should be approved by the parent company and should be consistent with the FCM's risk tolerance. In addition, an FCM should establish overall lending limits for each customer based on a credit review that is analogous to that performed by a bank with similar lending services. The process should be independent of the FCM's marketing, sales, and financing functions, but it may be performed by the FCM's banking affiliate. Examiners should determine how customer-financing decisions are made and confirm that documentation is adequate, even when an affiliate approves the financing. In addition, the FCM should review financial information on its customers periodically and adjust lending limits when appropriate.

3250.0.7.1.3 Clearing-Only Risk

FCMs often enter into agreements to clear, but not execute, trades for customers. Under a ''clearing-only'' arrangement, the customer gives its order directly to an executing FCM. The executing FCM then gives the executed transaction to the clearing FCM, which is responsible for accepting and settling the transaction. Customers often prefer this arrangement because it provides the benefits of centralized clearing (recordkeeping and margin payments) with the flexibility of using a number of specialized brokers to execute transactions.

FCMs entering into clearing-only arrangements execute written give-up agreements, which are triparty contracts that set forth the responsibilities of the clearing FCM, the executing FCM, and the customer. Most FCMs use the ‘‘uniform give-up agreement’’ prepared by the Futures Industry Association, although some FCMs still use their own give-up contracts. The uniform give-up agreement permits a clearing FCM, upon giving prior notice to the customer and the executing FCM, to place limits or conditions on the transactions it will accept to clear or terminate the arrangement. If an executed transaction exceeds specified limits, the FCM may decline to clear the transaction unless it is acting as the qualifying or primary clearing FCM for the customer and has not given prior notice of termination.

Clearing-only arrangements can present significant credit risks for an FCM. An FCM’s risk-management policies and procedures for clearing-only activities should address the qualifications required of clearing-only customers and their volume of trading, the extent to which customer-trading activities can be monitored by the clearing-FCM at particular exchanges, and how aggregate risk will be measured and managed.

The FCM should establish trading limits for each of its clearing-only customers and have procedures in place to monitor their intraday trading exposures. The FCM should take appropriate action to limit its liability either by reviewing and approving a limit exception or by rejecting the trade if a clearing-only customer has exceeded acceptable trading limits. Examiners should confirm that the FCM formally advises (usually in the give-up agreement) its customers and their executing FCMs of the trading parameters established for the customer. Examiners should also confirm that the FCM personnel responsible for accepting or rejecting an executed trade for clearance have sufficient current information to determine whether the trade is consistent with the customer’s trading limits. Prudent give-up agreements (or other relevant documents such as the customer account agreement) should permit the FCM to adjust the customer’s transaction limits when appropriate in light of market conditions or changes in the customer’s financial condition.

Some FCMs act as the primary clearing firm (also referred to as the sponsoring or qualifying firm) for customers.[11] A primary clearing firm guarantees to the clearinghouse that it will accept and clear all trades submitted by the customer or executing FCM, even if the trade is outside the agreed-on limits. Because an FCM is obligated to accept and clear all trades submitted by its primary clearing customers, the FCM must be able to monitor its customers’ trading activities on an intraday basis for compliance with agreed-on trading limits. Monitoring is especially important during times of market stress. The FCM should be ready and able to take immediate steps to address any unacceptable risks that arise, for example, by contacting the customer to obtain additional margin or other assurances, approving a limit exception, taking steps to liquidate open customer positions, or giving appropriate notice of termination of the clearing arrangement to enable the FCM to reject future transactions.

Intraday monitoring techniques will vary depending on the technology available at the particular exchange. A number of the larger, more automated U.S. exchanges have developed technologies that permit multiple intraday collection, matching, and reporting of trades—although the frequency of such reconciliations varies. On exchanges that are less automated, the primary clearing FCM must develop procedures for monitoring clearing-only risks. For example, the FCM could maintain a significant physical presence on the trading floor to monitor customer trading activities and promote more frequent collection (and tallying) of trade information from clearing-only customers. The resources necessary for such monitoring obviously will depend on the physical layout of the exchange—the size of the trading floor and the number of trading pits, the floor population and daily trading volumes, and the level of familiarity the FCM has with the trading practices and objectives of its primary clearing customers. The FCM should be able to increase its floor presence in times of market stress.

3250.0.7.1.4 Carrying-Broker Risk

An FCM may enter into an agreement with another FCM to execute and clear transactions

11. Primary clearing customers include institutions and individuals, as well as other nonclearing futures professionals (locals or floor traders), who execute their own trades on the exchange and other nonclearing FCMs that execute trades for unaffiliated customers.

on behalf of the first FCM (typically, when the first FCM is not an exchange or clearing member of an exchange). In such cases, the FCM seeking another or carrying FCM to execute its transactions should have procedures for reviewing the creditworthiness of the carrying FCM. If the FCM reasonably expects that the carrying FCM will use yet another FCM to clear its transactions (for example, if the carrying FCM enters into its own carrying-broker relationship with another firm for purposes of executing or clearing transactions on another exchange), the first FCM should try to obtain an indemnification from the carrying FCM for any losses incurred on these transactions.[12] When carrying transactions occur on a foreign exchange, an FCM should know about the legal ramifications of the carrying relationship under the rules of the exchange and the laws of the host country. Moreover, it may be appropriate for an FCM to reach an agreement with its customers that addresses liabilities relative to transactions effected on a non-U.S. exchange by a carrying broker.

3250.0.7.1.5 Executing-FCM Risk

When an FCM uses an unaffiliated FCM to execute customer transactions under a give-up arrangement, the clearing firm that sponsors the executing FCM guarantees its performance. Therefore, the first FCM should review the subcontracting risk of its executing FCMs and their sponsoring clearing firms. However, unlike the clearing risk inherent in a carrying-broker relationship, the subcontracting risk for an FCM using an executing FCM is limited to transaction risk (execution errors). An FCM's management should approve each executing broker it uses, considering the broker's reputation for obtaining timely executions and the financial condition of its sponsoring clearing firm.

3250.0.7.1.6 Pit-Broker Risk

Usually, FCMs will subcontract the execution of their orders to unaffiliated pit brokers who accept and execute transactions for numerous FCMs during the trading day. The risk associated with using a pit broker is similar to that of using an executing broker: the risk is limited to the broker's performance in completing the transaction. If the pit broker fails, then the primary clearing firm is responsible for completing the transaction. Therefore, an FCM should approve each pit broker it uses, considering the pit broker's reputation for obtaining timely executions and the resources of its sponsoring clearing firm.

3250.0.7.1.7 Clearinghouse Risk

Clearinghouse risk is the potential that a clearinghouse will require a member to meet loss-sharing assessments caused by another clearing member's failure. Before authorizing membership in an exchange or clearinghouse, an FCM's board of directors and its parent company must fully understand the initial and ongoing regulatory and financial requirements for members. The FCM's board of directors should approve membership in a clearinghouse only after a thorough consideration of the financial condition, settlement and default procedures, and loss-sharing requirements of the clearinghouse.

Particularly when it is considering membership in a foreign exchange or clearinghouse, an FCM's board should examine any regulatory and legal precedents related to how the exchange, clearinghouse, or host country views loss-sharing arrangements. As in the United States, some foreign clearinghouses have unlimited loss-sharing requirements, and some have "limited" requirements that are set at very high percentages. However, the loss-sharing provisions of some of the foreign clearinghouses have not yet been applied, which means that there are no legal and regulatory precedents for applying the stated requirements. In addition, the board should be apprised of any differences in how foreign accounts are viewed, for example, whether customer funds are considered separate from those of the FCM, whether the relationship between an FCM and its customer is viewed as an agency rather than a principal relationship, and whether there are material differences in the way futures activities are regulated.

The board also should be apprised of any material changes in the financial condition of every clearinghouse of which the FCM is a member. Senior management should monitor the financial condition of its clearinghouses as part of its risk-management function.

12. The CFTC takes the position that an FCM is responsible to its customers for losses arising from the failure of the performance of a carrying broker. The industry disagrees with this position, and the issue has not been resolved by the courts.

3250.0.7.1.8 Guarantees

FCM parent companies often are asked to provide assurances to customers and clearinghouses that warrant the FCM's performance. These arrangements may take the form of formal guarantees or less formal letters of comfort.

Under Regulation Y (section 225.28(b)(7)(iv)(B)), a bank holding company may not provide a guarantee to a clearinghouse for the performance of the FCM's customer obligations. A bank holding company may provide a letter of comfort or other agreement to the FCM's customers that states the parent (or affiliate) will reimburse the customers' funds on deposit with the FCM if they are lost as a result of the FCM's failure or default. Customers may seek this assurance to avoid losses that could arise from credit exposure created by another customer of the FCM, since the clearinghouse may use some or all of the FCM's customer-segregated funds in the event of a default by the FCM stemming from a failing customer's obligations.[13] Examiners should note any permissible guarantees for purposes of the consolidated report of the parent bank holding company, as they are relevant to calculating the consolidated risk-based capital of the bank holding company.

3250.0.7.2 Market Risk

When an FCM acts as a broker on behalf of customers, it generally is only subject to market risk if it executes customers' transactions in error. In this regard, operational problems can expose the FCM to market fluctuations in contract values. However, when an FCM engages in proprietary trading, such as market making and other position-taking, it will be directly exposed to market risk. Potential market-risk exposure should be addressed appropriately in an FCM's policies and procedures.

An FCM that engages in proprietary trading should establish market-risk and trading parameters approved by its parent company. The FCM's senior management should establish an independent risk-management function to control and monitor proprietary trading activities. Finally, the FCM should institute procedures to control potential conflicts of interest between its brokerage and proprietary trading activities.

13. The letter of comfort would protect customers whose funds were used to cover other customer losses by the clearinghouse. U.S. clearinghouses also have guarantee funds that can be used to reimburse customers at the clearinghouse's discretion.

3250.0.7.3 Liquidity Risk

Liquidity risk is the risk that the FCM will not be able to meet its financial commitments (end-of-day and intraday margin calls) to its clearing FCM or clearinghouse. Clearing FCMs are required to establish an account at one of the settlement banks used by the clearinghouse for its accounts and the accounts of its clearing members. In some foreign jurisdictions, the central bank fulfills this settlement function. An FCM should establish and monitor daily settlement limits for its customers and should ensure that there are back-up liquidity facilities to meet any unexpected shortfalls in same-day funds. To ensure the safety of its funds and assets, an FCM should also monitor the financial condition of the settlement bank it has chosen and should be prepared to transfer its funds and assets to another settlement bank, when necessary.

To control other types of liquidity risks, an FCM should adopt contingency plans for liquidity demands that may arise from dramatic market changes. An FCM, to the extent possible, should monitor the markets it trades in to identify undue concentrations by others that could create an illiquid market, thereby creating a risk that the FCM could not liquidate its positions. Most U.S. clearinghouses monitor concentrations and will contact an FCM that holds more than a certain percentage of the open interest in a product. In some situations, the exchange could sanction or discipline the FCM if it finds that the FCM, by holding the undue concentration, was attempting to manipulate the market. These prudential safeguards may not be in place on foreign exchanges; consequently, an FCM will have to establish procedures to monitor its liquidity risk on those exchanges.

3250.0.7.4 Reputation Risk

FCMs should have reporting procedures in place to ensure that any material events that harm its reputation, and the reputations of its bank affiliates, are brought to the attention of senior management; the FCM's board of directors; and, when appropriate, its parent company. Reports of potentially damaging events should be sent to senior management at the parent bank holding company, who will evaluate their effect on the FCM to determine what, if any, steps should be taken to mitigate the impact of the event on the whole organization.

3250.0.7.4.1 Commodity Trading Adviser

Acting as a commodity trading adviser (including providing discretionary investment advice to retail and institutional customers or commodity pools) may pose reputation and litigation risks to a CTA or an FCM, particularly when retail customers are involved. Accordingly, the FCM's board should adopt policies and procedures addressing compliance with CFTC and NFA sales-practice rules (including compliance with the ''know your customer'' recordkeeping rules).

3250.0.7.5 Operations Risk, Internal Controls, Internal Audits, and Compliance

3250.0.7.5.1 Operations Risk

Operations risk is the potential that deficiencies in information systems or internal controls will result in unexpected loss. Some specific sources of operating risk at FCMs include inadequate procedures, human error, system failure, or fraud. For FCMs, failure to assess or control operating risks accurately can be a likely source of problems. Back-office or transaction-processing operations are an important source of operations-risk exposures. In conducting reviews of back-office operations, examiners should consult the appropriate chapters of the *Trading and Capital-Markets Activities Manual* for further guidance.

Operations risk also includes potential losses from computer and communication systems that are unable to handle the volume of FCM transactions, particularly in periods of market stress. FCMs should have procedures that address the operations risks of these systems, including contingency plans to handle systems failures and back-up facilities for critical parts of risk-management, communications, and accounting systems.

When FCMs execute or clear transactions in nonfinancial commodities, they may have to take delivery of a commodity because a customer is unable or unwilling to make or take delivery on its contract. To address this situation, the FCM should have in place the procedures it will follow to terminate its position and avoid dealing in physical commodities.

3250.0.7.5.2 Internal Controls

Adequate internal controls are the first line of defense in controlling the operations risks involved in FCM activities. Internal controls that ensure the separation of duties involving account acceptance, order receipt, execution, confirmation, margin processing, and accounting are particularly important. Internal controls should also be established to record, track, and resolve errors and discrepancies with customers and other parties.

FCMs should have approved policies that specify documentation requirements for transactions and formal procedures for saving and safeguarding important documents, consistent with legal requirements and internal policies. Relevant personnel should fully understand documentation requirements. Examiners should also consider the extent to which entities evaluate and control operations risks through internal audits, contingency planning, and other managerial and analytical techniques.

3250.0.7.6 Internal Audits and Their Review

An FCM should be subject to regular internal audits to confirm that it complies with its policies and procedures and is managed in a safe and sound manner. In addition, the internal audit function should review any significant issues raised by compliance personnel to ensure that they are resolved. Other staff within the FCM (i.e., compliance personnel) should be able to reach internal audit staff to discuss any serious concerns they might have. Internal audit reports should be forwarded to the FCM's senior management. Material findings and management's plan to resolve the audit issues should be reported to the FCM's board of directors, the parent company, and any designated board committee (for example, an audit committee). Frequently, the internal audit function is located at the parent company, and audit reports are routinely sent to senior management at the parent company and to the audit committee designated by the board of directors.

3250.0.8 INSPECTION GUIDANCE

The review of an FCM's functions should take a functional-regulatory approach, using the findings of the FCM's primary regulators as much as possible. Examiners should especially focus on the significant risks that the FCM poses to the parent company and affiliated banks. These risks should be assessed by reviewing the adequacy of the FCM's policies and procedures, internal controls, and risk-management functions. Compliance with policies and procedures, and with any conditions on the FCM's activities imposed by regulatory authorities (including the Federal Reserve Board), should be fully reviewed.

Bank holding companies, banks, and FBOs may have more than one subsidiary that acts as an FCM in the United States or that engages in futures transactions for customers in foreign markets. To ensure that the FCM/CTA activities of a banking organization are evaluated on a consolidated basis, a cross-section of affiliated futures brokerage and advisory firms should be reviewed periodically—particularly those that present the greatest risk to the consolidated financial organization. Relevant factors to consider when identifying firms for review include (1) the volume of business; (2) whether the FCM has unaffiliated customers; (3) the number of customers; (4) whether the firm provides customer financing; (5) the number of brokers effecting transactions; (6) whether exchange or clearinghouse memberships are involved; (7) whether the FCM provides clearing-only services; and (8) the date and scope of the last review conducted by the Federal Reserve, SRO, or other regulator.

The scope of any review to be conducted depends on the size of the FCM and the scope of its activities. The draft first-day letter should provide an overview of an FCM's authorized activities and conditions, as well as a description of the actual scope of its business. Examiners should review the most recent summary of management points or other inspection results issued by the FCM's SRO or other regulator, as well as any correspondence between the FCM and any federal agency or SRO. If examiners have any questions about the findings of an SRO's or a regulator's results, they should contact the organization to determine whether the matter is material and relevant to the current inspection. The status of any matters left open after the SRO's or regulator's review should also be inquired about.

An important factor in determining the scope of the inspection is whether the FCM has unaffiliated customers or conducts transactions solely for affiliates. Other factors include whether (1) the FCM is a clearing member of an exchange, particularly of a non-U.S. exchange; (2) it acts as a carrying broker on behalf of other FCMs; (3) it has omnibus accounts with other brokers in markets in which it is not a member (U.S. or foreign); (4) it provides advisory or portfolio management services, including discretionary accounts, or has been authorized to act as a commodity pool operator (CPO); (5) it provides clearing services to locals or market-makers; and (6) it provides financing services to customers.[14]

Examiners are not expected to routinely perform a front- or back-office inspection unless (1) the FCM's primary regulator found material deficiencies in either office during its most recent examination or (2) if front- or back-office operations have not been examined by the primary regulator within the last two years. However, examiners may still choose to review a small sample of accounts and transactions to confirm that appropriate controls are in place. In addition, net capital computations of U.S. FCMs do not need to be reviewed; they are reviewed by the FCM's DSRO, and the FCM is subject to reporting requirements if capital falls below warning levels. Examiners should perform a front- and back-office review of the FCM's operations outside of the United States.[15]

Review of audit function. Examiners may rely on well-documented internal audit reports and workpapers to verify the adequacy of risk management at the FCM. Examiners should review the internal audit reports and workpapers to determine the adequacy of their scope and thoroughness in complying with FCM policies and procedures. If an examiner finds that an internal audit adequately documents the FCM's compliance with a policy or procedure pertaining to the management of the various risk assessments required by the current inspection, that fact should be documented in the workpapers, and inspection procedures should be completed in any area not adequately addressed by the internal audit report. Examiners should periodically spot check areas covered by internal audits to ensure the ongoing integrity of the audit process. Finally, examiners should ensure that internal auditors have adequate training to evaluate

14. If the FCM engages in proprietary trading for its own account, particularly for purposes other than hedging (market making or position taking), or if the FCM acts as an intermediary in any over-the-counter futures or other derivative activities, the examiner should advise the examiner in charge of the inspection so that the firm's proprietary trading can be evaluated in connection with similar activities of the consolidated financial organization.

15. The inspection procedures for reviewing front- and back-office operations may be found in sections 2050.3 and 2060.3, respectively, of the *Trading and Capital-Markets Activities Manual.*

the FCM's compliance with its policies and procedures and with applicable laws and regulations (both inside and, if applicable, outside the United States).

If an examiner has determined that it is not necessary to perform a routine back-office review, he or she should confirm that the FCM has addressed operations risks in its policies and procedures. Examiners also should review the internal controls of an FCM to ensure that the firm is operated safely and soundly according to industry standards and that it complies with any Board regulations or conditions placed on the FCM's activities. Examiners should be alert to any ''red flags'' that might indicate inadequate internal controls. An FCM must be organized so that its sales, operations, and compliance functions are separate and managed independently. If an FCM engages in proprietary trading, examiners should confirm that the firm has procedures that protect against conflicts of interest in the handling of customer orders (examples of these conflicts of interest include front-running or ex-pit transactions). To make an overall assessment of the FCM's future business, the results of any review should be consolidated with the results of reviews by other FCMs inspected during this cycle.

3250.0.9 INSPECTION OBJECTIVES

1. To identify the potential and extent of various risks associated with the FCM's activities, including credit, market, liquidity, and reputation risks.
2. To evaluate the adequacy of the audit function and review significant findings, the method of follow-up, and management's response to correct any deficiencies.
3. To assess the adequacy of the risk-management function at the FCM.
4. To assess the adequacy of and compliance with the FCM's policies and procedures and the adequacy of the internal control function.
5. To evaluate and determine the FCM's level of compliance with relevant statutes, Board regulations, interpretations, orders, and policies.
6. To assess the adequacy of risk management of affiliated FCMs on a consolidated basis.

3250.0.10 INSPECTION PROCEDURES

3250.0.10.1 Structural Organization and Activity Analysis

3250.0.10.1.1 General

1. Identify all bank holding company subsidiaries that engage in FCM- or CTA-type activities in the United States or abroad or identify U.S. FCM/CTA subsidiaries of FBOs. Determine which firms should be inspected to provide a global view of the adequacy of management of these activities on a consolidated basis, based on the scope of activities and the degree of supervision by other regulators. Complete applicable procedures below for firms selected for inspection.
2. Review first-day-letter documents, notices filed under Regulation Y, Board orders and letters authorizing activities, previous inspection reports and workpapers, previous audit reports by futures regulators (CFTC, DSRO, National Futures Association, foreign futures regulator) and correspondence exchanged with those regulatory entities, and reports by internal or external auditors or consultants.
3. Note the scope of the FCM's activities, including—
   a. execution and clearing;
   b. execution only for affiliates and third parties;
   c. clearing-only for affiliates, third parties, professional floor traders (locals);
   d. pit brokerage;
   e. advisory;
   f. discretionary portfolio management;
   g. commodities or commodity pool operator (in FCM or in affiliate);
   h. margin financing;
   i proprietary trading;
   j. exchange market maker or specialist;
   k. types of instruments (for example, financial, agricultural, precious metals, petroleum);
   l. contract markets where business is directed;
   m. other derivatives products (should be identified, for example, interest-rate swaps and related derivative contracts, foreign-exchange derivative contracts, foreign government securities, other);
   n. other futures-related activities, including off-exchange transactions;
   o. riskless-principal transactions; and
   p. registered broker-dealers.
4. Note exchange and clearinghouse memberships here and abroad, noting any financial commitments and any guarantees by the FCM

or its parent[16] to the exchange or clearinghouse with respect to proprietary, affiliate, or customer transactions.
5. Note any new lines of business or activities occurring at the FCM or any changes to exchange and clearing memberships since the last inspection.
6. Note the percentage of business conducted for—
   a. affiliate banks,
   b. nonbank affiliates,
   c. customers (note the breakdown between institutional and retail customers and if there is any guarantee or letter of comfort to customers in which the parent company provides that it will reimburse customers for loss as a result of the FCM's failure or other default),
   d. proprietary accounts (hedging, position-taking), and
   e. professional floor traders (locals, market makers).

3250.0.10.1.2 Audit Program

Determine the quality of the internal audit program. Assess the scope, frequency, and quality of the audit program for the FCM and related activities. Consider spot checking areas covered by internal audits.

1. Review the most recent audit report, noting any exceptions and their resolution.
2. Determine whether internal auditors have adequate training to evaluate the FCM's compliance with its policies and procedures and with applicable laws and regulations.
3. Verify that audit findings have been communicated to senior management and material findings have been reported to the FCM's board of directors and parent company.
4. Identify any areas covered by these procedures that are not adequately addressed by the internal audit report.
5. Identify areas of the internal audit report that should be verified as part of the current inspection.

3250.0.10.1.3 Operational Activities

Determine the scope of review that is appropriate to activities and allocate examiner resources, considering the adequacy of internal audit workpapers.

1. Complete the appropriate front- and/or back-office inspection procedures when—
   a. front- and back-office operations have not been examined by the DSRO within the last two years,
   b. material deficiencies in front- or back-office operations were found by the DSRO during the most recent audit, or
   c. the primary regulator for the FCM is not a U.S. entity.
2. Advise the examiner in charge of the inspection of the parent company if the FCM engages in proprietary trading or over-the-counter futures or derivatives business as principal or agent.

3250.0.10.2 Board and Senior Management Oversight

1. Review the background and experience of the FCM's board of directors and senior management, noting prior banking and futures brokerage experience.
2. Determine if the board of directors of the FCM has approved written policies summarizing the firm's activities listed below, and addressing oversight by the board or a board-designated committee:
   a. the risk appropriate for the FCM, including credit, market, liquidity, operation, reputation, and legal risk (see SR-95-51)
   b. the monitoring of compliance with risk parameters
   c. the exchange and clearinghouse memberships
   d. the internal audit function
3. Determine if senior management of the FCM has adopted procedures implementing the board's policies for—
   a. approval of new-product lines and other activities;
   b. transactions with affiliates;
   c. transactions by employees;
   d. compliance with applicable regulations and policies and procedures;
   e. management information reports;
   f. the separation of sales, operations, back-office, and compliance functions; and
   g. reports to the FCM boards of directors on material findings of the complaint or audit

16. The parent bank holding company cannot provide a guarantee or otherwise become liable to an exchange or clearing association other than for those trades conducted by the FCM subsidiary for its own account or for the account of any affiliate. See Regulation Y, section 225.28(b)(7)(iv)(B).

functions and on material deficiencies identified during the course of regulatory audits or inspections.
4. Determine that policies and procedures are periodically reviewed by the board of directors or senior management, as appropriate, and ensure that they comply with existing regulatory and supervisory standards and address all of the FCM's activities.
5. Review management information reporting systems and determine whether the board of directors of the parent company (or a designated committee of the parent's board) is apprised of—
   a. material developments at the FCM,
   b. the financial position of the firm including significant credit exposures,
   c. the adequacy of risk management,
   d. material findings of the audit or compliance functions, and
   e. material deficiencies identified during the course of regulatory reviews or inspections.
6. Review the FCM's strategic plan.
   a. Assess whether there are material inconsistencies between the stated plans and the FCM's stated risk tolerances.
   b. Verify that the strategic plan is reviewed and periodically updated.

3250.0.10.3 Risk Management

3250.0.10.3.1 Credit Risk

1. Review credit-risk policies and procedures.
   a. Verify the independence of credit-review approval from the limit-exceptions approval.
   b. Verify that the procedures designate a senior officer with the responsibility to monitor and approve limit-exception approvals.
2. Determine whether the FCM has authority to open customer accounts without parent company approval.
3. Review the customer base (affiliates, third parties) for credit quality in terms of affiliation and business activity (affiliates, corporate, retail, managed funds, floor traders, etc.).
4. Evaluate the process for customer-credit review and approval. Determine whether the customer-credit review identifies credit risks associated with the volume of transactions executed or cleared for the customer.
5. Evaluate the adequacy of credit-risk-management policies. Determine if they—
   a. establish and require adequately documented credit limits for each customer that reflect their respective financial strengths, liquidity, trading objectives, and potential market risk associated with the products traded;
   b. require periodic updates of such credit limits in light of changes in the financial condition of each customer and market conditions; and
   c. do not permit the FCM to waive important broker safeguards, such as the right to liquidate customer positions upon default or late payment of margin.
6. Consider verifying the above information by sampling customer-credit files.
7. Verify that up-to-date customer-credit files are maintained on site or are available for review during the inspection. If the customer-credit approval was performed by the parent company or an affiliate bank, verify that the FCM's files contain information indicating the scope of the credit review, the approval, and credit limits.
8. Review notifications and approval of limit exceptions for compliance with FCM procedures.
9. Determine whether the FCM has adopted procedures identifying when the FCM should take steps to limit its customer-credit exposure (for example, when to refuse a trade, grant a limit exception, transfer positions to another FCM, or liquidate customer positions).
10. Evaluate the adequacy of risk management of customer-financing activities.
11. Determine that the credit-review process is independent from the marketing, sales, and financing function.
    a. Verify that the FCM has policies that identify customer-credit standards and that it establishes overall lending limits for each customer.
    b. Assess the adequacy of the credit-review process and documentation, even when credit review is performed by an affiliate.
12. Review the instances when the FCM has lent margin to customers on an unsecured basis. If the FCM does not engage in margin financing as a business line, verify that extensions are short-term and within the operational threshold set for the customer.

3250.0.10.3.2 Clearing-Only Risk

1. Determine whether each clearing arrangement is in writing and that it—
   a. identifies the customer and executing brokers, and defines and adequately documents the respective rights and obligations of each party;
   b. establishes overall limits and trading parameters for the customer that are based on the customer's creditworthiness and trading objectives; and
   c. permits transaction limits to be adjusted to accommodate market conditions or changes in the customer's financial condition.
2. When the FCM has entered into a clearing-only agreement with a customer, verify that it has reviewed the creditworthiness of each executing broker or its qualifying clearing firm identified in the agreement.
3. If the FCM acts as the primary clearing firm for locals or other customers, confirm that the firm has adopted procedures for monitoring and controlling exposure. Note whether the firm monitors customer positions throughout the trading day and how this monitoring is accomplished.

3250.0.10.3.3 Carrying Brokers, Executing Brokers, and Pit Brokers

1. If the FCM uses other brokers to execute and/or clear transactions, either on an omnibus or a fully disclosed basis, determine that it has adequately reviewed the creditworthiness and approved the use of the other brokers. If the FCM uses nonaffiliated executing brokers, confirm that it also has considered the reputation of the broker's primary clearing firm. If the other broker is likely to use another broker, determine whether the broker has given the FCM an indemnification against any loss that results from the performance or failure of the other broker.
2. If the FCM uses other brokers to execute or clear transactions in non-U.S. markets, determine whether senior management understands the legal risks pertinent to doing business in those markets and has adopted policies for managing those risks.
3. When the FCM uses third-party "pit brokers" to execute transactions, verify that the FCM has reviewed and approved each broker after considering the reputation of the pit broker's primary clearing firm.

3250.0.10.3.4 Exchange and Clearinghouse Membership

1. Verify that the FCM completes a due-diligence study of each exchange and clearinghouse before applying for membership in the organization.
   a. Determine whether board minutes approving membership demonstrate a thorough understanding of the loss-assessment provisions and other obligations of membership for each exchange and clearinghouse, as well as a general understanding of the regulatory scheme.
   b. Determine whether, in approving membership in a non-U.S. exchange or clearinghouse, the board's minutes indicate a discussion of the regulatory environment and any relevant credit, liquidity, and legal risks associated with doing business in the particular jurisdiction. The minutes should also reflect discussion of any material differences from U.S. precedent in how foreign accounts are viewed, for example, whether customer funds held in an omnibus account are considered separate (segregated) from those of the FCM or whether the relationship between the FCM and its customers is viewed as an agency or principal relationship in the host country.
2. Verify that the FCM has apprised its parent company of the results of its study of the exchange or clearinghouse and that it has written authorization by senior management of its parent company to apply for membership.
3. Verify that the FCM monitors the financial condition of each exchange and clearing organization for which it is a member.
4. Review all guarantees, letters of comfort, or other forms of potential contingent liability. Verify that the parent company has not provided a guarantee to the clearinghouse for the performance of the FCM's customer obligations.[17] Note any guarantees against the parent losses incurred from the failure of an FCM and advise the examiner in charge of the parent company's inspection, who can confirm that guarantees are included in the

17. The parent bank holding company cannot provide a guarantee or otherwise become liable to an exchange or clearing association other than for those trades conducted by the FCM subsidiary for its own account or for the account of any affiliate. See Regulation Y, section 225.28(b)(7)(iv)(B).

bank holding company's calculation of consolidated risk-based capital.

3250.0.10.3.5 Market Risk

1. If an FCM engages in proprietary trading, determine whether policies and procedures are in place to control potential conflicts of interest between its brokerage business and trading activities.
2. When an FCM plans to enter (or has entered into) a foreign market, determine if the FCM performed due-diligence reviews of relevant legal and regulatory issues, as well as on local business practices.

3250.0.10.3.6 Liquidity Risk

1. Verify that the FCM has established and monitors daily settlement limits for each customer to ensure that liquidity is sufficient to meet clearinghouse obligations.
2. Determine whether the FCM has established back-up liquidity facilities to meet unexpected shortfalls.
3. Verify that the FCM monitors by product the amount of open interest (concentrations) that it holds at each exchange, either directly or indirectly through other brokers. If positions are held on foreign exchanges and concentrations are not monitored, verify that the FCM is able to monitor its positions and manage its potential liquidity risks arising from that market.
4. Review liquidity contingency plans for dealing with dramatic market changes.

3250.0.10.3.7 Reputation Risk

1. Review management information reporting systems and determine whether—
   a. the FCM is able to assess the extent of any material exposure to legal or reputation risk arising from its activities, and
   b. the parent company receives sufficient information from the FCM to assess the extent of any material exposure to litigation or reputation risk arising from the FCM's activities.
2. If the FCM provides investment advice to customers or commodity pools, determine whether it has procedures designed to minimize the risks associated with advisory activities. Such procedures might address the delivery of risk disclosures to customers, the types of transactions and trading strategies that could be recommended or effected for retail customers, compliance with the ''know your customer'' recordkeeping and other sales practice rules of the SROs, and conformance to any trading objectives established by the customer or fund.
3. If the FCM acts as a CPO, verify that it has obtained prior Board approval and is in compliance with any conditions in the Board order.

3250.0.10.4 Operations, Internal Controls, and Compliance

1. Determine the extent to which operating risk is evaluated and controlled through the use of internal audits, contingency planning, and other managerial and analytical techniques.
2. Review the most recent summary of management points or similar document and also respective correspondence issued by the FCM's DSRO or other primary futures regulator. Discuss any criticism with FCM management and confirm that corrective action has been taken.
3. Consider reviewing a small sample of accounts and transactions to confirm that appropriate controls are used and that the FCM has incorporated operations risks into its policies and procedures.
4. Review the organizational structure and reporting lines within the FCM and verify separation of sales, trading, operations, compliance, and audit functions.
5. Determine that the FCM's policies and procedures address the booking of transactions by affiliates and employees and other potential conflicts of interest.
6. If the FCM is authorized to act as a CPO, review the most recent NFA or other primary futures regulator's audit, including any informal findings by examiners. Discuss any criticism with the FCM management and confirm that corrective action has been taken.
7. If the FCM executes and clears nonfinancial futures, verify that the FCM has procedures to avoid taking physical possession of the nonfinancial product when effecting ''exchange for physical transactions'' for customers.

8. When the FCM takes physical delivery of commodities due to failure or unwillingness of a customer to make or take delivery of its contracts, determine whether the FCM has and follows procedures to close out its position. Note if the FCM frequently takes delivery of physical commodities.
9. Assess the adequacy of customer-complaint review by reviewing the complaint file and how complaints are resolved. Note if the FCM receives repeat or multiple complaints involving one or more of its activities or employees.
10. Determine whether the FCM has developed contingency plans that describe actions to be taken in times of market disruptions and whether such plans address management responsibilities, including communications with its parent bank holding company, liquidity, the effect on customer-credit quality, and communications with customers.

3250.0.10.5 Conclusions

1. Prepare inspection findings and draw conclusions as to the adequacy of the FCM's risk-management, compliance, operations, internal controls, and audit functions.
2. Present findings to FCM management and submit inspection findings to the examiner in charge of the parent company inspection.

3250.0.11 FCM Supplemental Checklist Questionnaire

	Yes	*No*
3250.0.11.1 General Questions		
1. Is the FCM a separately incorporated subsidiary of the bank holding company as required by Regulation Y, 12 C.F.R. 225.28(b)(6)(iv)?	______	______
2. Has the parent bank holding company provided a guarantee or otherwise become liable to an exchange or clearing association other than for those trades conducted by a subsidiary for its own account or for the account of any affiliate (prohibited by Regulation Y (see 12 C.F.R. 225.28(b)(6)(iv))?	______	______

3. How long has the FCM been in operation?______yrs.
4. Approximately how many customers does the FCM have?______
5. What degree of market participation does the FCM have (mark (x) for the highest level of involvement)?
   a. __________ FCM, nonmember of futures exchange. Must execute trades through exchange members and is subject to NFA rules.
   b. __________ Exchange member. Holds membership on one or more futures exchanges entitling FCM to execute trades on the exchange(s) and subjecting FCM to the rules of exchange(s).
   c. __________ Clearinghouse member. Holds membership in an exchange's clearinghouse as well as exchange membership, thus enabling FCM to execute and clear its own transactions. Such FCM is subject to exchange and clearinghouse rules.
6. If FCM is an exchange member, on which exchange(s) (domestic and foreign) does the FCM have membership(s)?

   ____

   ____

   ____

	Yes	No
7. If FCM is a clearing member, list below the clearinghouse(s) of which it is a member. ____ ____ ____		
8. Does the FCM periodically make an adjusted net capital computation to verify that it maintains capitalization fully adequate to meet its own commitments and those of its customers, including affiliates?	_____	_____
(NOTE: Under the CFTC's net capital computations, there have been no capital requirements for ''hedge'' transactions by FCM affiliate banks. It may be necessary to request that an adjusted net capital computation be made to determine the amount of adjusted net capital required when affiliate trades are treated as third-party transactions.)		
9. Does a review of the FCM's correspondence from its designated self-regulatory organization reveal that the FCM meets CFTC requirements with respect to capital rules, segregation of customer assets, and risk disclosure?	_____	_____
10. If an FCM will receive services from an affiliate (e.g., the lead bank assesses FCM customer-credit risk or monitors customer positions and margin accounts), have the FCM and affiliate entered into a formal service agreement on an explicit fee basis?	_____	_____

3250.0.11.2 Management

	Yes	No
1. Does the FCM's management have expertise and previous experience as a broker, dealer, or participant in cash, futures, or forward markets related to those in which the FCM executes transactions?	_____	_____
2. Does the FCM's management have prior banking experience?	_____	_____
3. Does it appear that management has the expertise necessary to evaluate the viability of various hedging strategies?	_____	_____
4. Does it appear that FCM management has the ability to recognize imprudent or unsafe customer activity that could endanger the FCM?	_____	_____
5. Does the board of directors have written policies that summarize the firm's activities and its oversight function (certain functions may be designated to a board audit or other committee) with respect to—		
a. risk appropriate for the FCM?	_____	_____
b. compliance monitoring and risk parameters?	_____	_____

3250.0.11.3 Controls of Risk Exposure with Customers

	Yes	No
1. Does the FCM have a system for assessing and periodically re-evaluating customer-credit risk?	_____	_____

	Yes	*No*
2. Does the FCM take customer-credit risk into consideration and establish for each customer—	______	______
a. position limits for each contract the customer wishes to trade?	______	______
b. an aggregate position limit for outstanding contracts held by each customer?	______	______
3. Does the FCM have a system for monitoring customer positions to ensure positions are within the limits imposed by the FCM?	______	______
4. Does the FCM have an adequate system in place to monitor its overall risk exposure, primarily customer-default risk, on a daily basis?	______	______
5. Do customer agreements and internal procedures enable the FCM to—		
a. limit the types of trades a customer engages in?	______	______
b. refuse, when appropriate, to execute any trades except those resulting in liquidation of existing positions?	______	______

3250.0.11.4 Margin Requirements

1. Does the FCM have a system for daily monitoring of margin accounts to ensure that margin calls are promptly issued and satisfied?	______	______
2. Does the customer agreement permit and has the FCM adopted procedures for liquidating a customer's position if margin calls are not promptly satisfied?	______	______
3. Do customer-account agreements authorize the FCM to require higher initial and variation margin levels than those set by the exchanges?	______	______
4. Does the FCM have a system in place for obtaining higher customer margins in instances when the FCM determines—	______	______
a. a customer's futures position or deteriorating financial condition necessitates a greater amount of margin to protect the FCM?	______	______
b. volatile market conditions justify higher levels of margin than those required by an exchange?	______	______

3250.0.11.5 Credit Risk

1. Is the credit-review approval independent from the limit-exceptions approval?	______	______
2. Does a senior officer monitor and approve limit-exception approvals?	______	______
3. Does the customer-credit review identify credit risks associated with the volume of transactions executed or cleared for the customer?	______	______
4. Is adequate documentation required and maintained of credit limits for each customer that reflect customers' respective financial strengths and liquidity, trading objectives, and the potential market risk associated with the products traded?	______	______
5. Has the FCM adopted procedures identifying when the FCM should take steps to limit its customer-credit exposure (e.g., when to refuse a trade, grant a limit exception, transfer positions to another FCM, or liquidate customer positions)?	______	______
6. Is the credit-review process independent from the marketing/sales function and the financing function?	______	______

	Yes	No
3250.0.11.6 Clearing-Only Risk		
1. Is each arrangement in writing and does it—		
a. identify the customer, executing brokers, and define and adequately document the respective rights and obligations of each party?	______	______
b. establish overall limits and trading parameters for the customer that are based on the customer's creditworthiness and trading objectives?	______	______
c. permit transaction limits to be adjusted to accommodate market conditions or changes in the customer's financial condition?	______	______
2. Has the FCM or its qualifying clearing firm verified that it has reviewed the creditworthiness of each executing broker?	______	______
3. If the FCM acts as the primary clearing firm for locals or other customers, has the firm adopted procedures for monitoring and controlling exposure throughout the trading day?	______	______
3250.0.11.7 Carrying Brokers, Executing Brokers, and Pit Brokers		
1. If the FCM uses other brokers to execute and/or clear transactions, either on an omnibus or fully disclosed basis, has it adequately reviewed the creditworthiness and approved the use of the other brokers?	______	______
2. Has the FCM been given an indemnification against any loss that results from the performance or failure of the other broker?	______	______
3. If the FCM uses nonaffiliated executing brokers, has it considered the reputation of the broker's primary clearing firm?	______	______
3250.0.11.8 Exchange and Clearinghouse Membership		
1. Does the FCM complete a due-diligence study of each exchange and clearinghouse before applying for membership in such organization?	______	______
2. Do the board minutes approving such memberships demonstrate a thorough understanding of the loss-assessment provisions and other obligations of membership for each exchange and clearinghouse, as well as a general understanding of the regulatory scheme?	______	______
3. In approving membership in a non-U.S. exchange or clearinghouse, do the board minutes evidence a discussion of the regulatory environment and any relevant credit, liquidity, and legal risks associated with doing business in a particular jurisdiction?	______	______
4. Does the FCM monitor the financial condition of each exchange and clearing organization for which it is a member?	______	______
3250.0.11.9 Market Risk		
1. If an FCM engages in proprietary trading, are policies and procedures in place to control potential conflicts of interest between its brokerage business and trading activities?	______	______
2. If an FCM has entered or plans to enter a foreign market, has the FCM performed due-diligence reviews of relevant legal and regulatory issues, as well as on local business practices?	______	______

	Yes	*No*

3250.0.11.10 Liquidity Risk

1. Has the FCM established and does it monitor daily settlement limits for each customer to ensure liquidity sufficient to meet clearinghouse obligations? ______ ______
2. Has the FCM established back-up liquidity facilities to meet unexpected shortfalls? ______ ______
3. Does the FCM monitor the amount of open interest (concentrations) by product that it holds, directly or indirectly, at each exchange? ______ ______

3250.0.11.11 Reputation Risk

1. Is the FCM able to assess the extent of any material exposure to legal or reputation risk arising from its activities? ______ ______
2. Does the parent company receive sufficient information from the FCM's information systems to assess the extent of any material exposure to litigation or reputation risk arising from the FCM's activities? ______ ______
3. If the FCM provides investment advice to customers or commodity pools, does it have procedures designed to minimize the risks associated with advisory activities? ______ ______
4. If the FCM acts as a CPO, has it obtained prior Board approval and is it in compliance with any conditions in the Board order? ______ ______

3250.0.11.12 Internal Controls

1. Does the FCM have written procedures pertaining to the following:
   a. the types of futures and options on futures contracts which the FCM will execute? ______ ______
   b. individuals authorized to effect transactions and sign contracts and confirmations? ______ ______
   c. the firms or individuals with whom FCM employees may conduct business? ______ ______
2. Does the FCM obtain written authorization from customers specifying the individuals who are authorized to execute trades on behalf of the customers? ______ ______
3. Does the FCM have written procedures governing—
   a. the solicitation and acceptance of customers? ______ ______
   b. the execution of purchases and sales? ______ ______
   c. processing transactions? ______ ______
   d. accounting for transactions? ______ ______
   e. clearing of transactions? ______ ______
   f. safekeeping of customer margin deposits or securities deposited as margin? ______ ______
4. Does the FCM have written contracts with all firms or individuals who may conduct business on behalf of the FCM? ______ ______
5. Does the FCM have proper segregation of duties to ensure that individuals involved in executing transactions are not able to make accounting entries? ______ ______
6. Does the FCM have a numbered and controlled system of order tickets and confirmations to prevent unauthorized trading and to verify the accuracy of records and enable reconciliation throughout the system? ______ ______

	Yes	No
7. Does the FCM have procedures to time stamp receipt of all orders at least to the nearest minute and execute all orders strictly in chronological sequence (to the extent consistent with the customers' specifications)?	______	______
8. Does the FCM have a system for routing incoming confirmations to an operating unit separate from the unit that executes transactions?	______	______
9. Does the FCM have a system for comparing internal and external confirmations to ensure that the FCM will not accept or deliver securities and/or margin payments without proper authorization and documentation?	______	______
10. Does the FCM have procedures to ensure that someone outside the trading unit is responsible for resolution of trades in which incoming and outgoing confirmations do not match?	______	______
11. With respect to transactions cleared by others, are procedures in place for verifying and agreeing clearing FCM open position and margin deposit reports?	______	______
12. Does the FCM review daily outstanding contracts, customer positions, and margin balances?	______	______
13. Does FCM management regularly review all adjustments affecting futures positions or income recognition to verify that such adjustments were proper and approved?	______	______
14. Are subsidiary ledgers regularly reconciled to the general ledger?	______	______
15. Has the FCM adopted written supervisory procedures for supervising brokers and others to ensure that they follow written policies and procedures?	______	______
16. Are there written procedures containing criteria for selecting and training competent personnel?	______	______
17. Does the FCM have a comprehensive reporting system for providing management with all the information necessary to effectively manage the FCM's operations?	______	______
18. Are procedures in place to ensure that any futures advisory services (investment advice) furnished—		
a. reflect the views of persons authorized to supervise advisory activities?	______	______
b. are authorized under Regulation Y or by Board order?	______	______
19. Is there a formal and comprehensive internal audit program pertaining to FCM activities?	______	______

3250.0.12 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Brokerage of gold and silver bullion and coins (provided subsequent basis for FCM execution and clearance of futures contracts)				38 *Federal Register* 27,552 (1973)
FCMs for the execution of futures contracts for gold, silver, platinum bullion, and coins				1990 FRB 552 1985 FRB 467 1977 FRB 951
FCMs for the execution and clearance of futures contracts				1982 FRB 651 1982 FRB 514
Engage in FCM activities: U.S. government securities, negotiable money market instruments, foreign exchange				1983 FRB 729 1983 FRB 216
FCM engaged in the execution and clearance of options				1983 FRB 733
Inclusion into Regulation Y permissible nonbanking activities (1984 and 1987)		225.28(b)(7)(iv)		1984 FRB 53 1984 FRB 591
Execution and clearing of futures contracts on a municipal bond index and to provide futures advisory services				1986 FRB 144 1985 FRB 803 1985 FRB 651 1985 FRB 111
Execute, purchase, and sale of gold and silver bullion and coins for the account of customers				1985 FRB 467 1985 FRB 251 1985 FRB 111
Advisory services for futures contracts on stock indexes and options thereon				1987 FRB 220
Advice on certain futures and options on futures				1988 FRB 820
Execution and clearance of futures contracts on stock indexes, options thereon, and futures contracts on a municipal bond index				1985 FRB 970
Execution and clearing futures contracts on stock indexes				1985 FRB 801
Providing investment advice on financial futures and options on futures		225.28(b)(6)(iv) (Regulation Y)		1997 FRB 275 1986 FRB 833

Subject	Laws[1]	Regulations[2]	Interpretations[3]	Orders
Providing investment advice on trading futures contracts and options on futures contracts in nonfinancial commodities				1991 FRB 126
Executing-only and clearing-only trades				1993 FRB 728 1993 FRB 723
Discretionary portfolio management services on futures and options on futures on financial commodities				1995 FRB 386
Discretionary portfolio management services on futures and options on futures on nonfinancial commodities				1995 FRB 803
FCM executing and clearing, and clearing without execution, futures and options on futures on nonfinancial commodities				1993 FRB 1049
Trading for one's own account in futures, options, and options on futures contracts based on certificates of deposit or other money market instruments				1995 FRB 190
Commodity and index swap transactions—originator, principal, agent, broker, or adviser				1995 FRB 191 1995 FRB 190
Trading in futures options on futures contracts based on commodities or on stock, bond, or commodity indexes for one's own account				1995 FRB 185
Discretionary portfolio management services on futures and options on futures on financial commodities				1995 FRB 386 1994 FRB 151
FCM execution, clearance, and advisory services for contracts on financial and nonfinancial commodities for noninstitutional customers				1995 FRB 880
Serving as a commodity pool operator				1996 FRB 569

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Primary clearing firm for a limited number of floor traders and brokerage services for forward contracts on financial and nonfinancial commodities				1997 FRB 138

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

This section serves as a prelude to the futures commission merchant activities (FCM) that are provided as examples of previous Board FCM decisions. Sections 3251.0.1 through 3251.0.13 provide brief historical summaries of Board decisions that may have led to the authorizations that have been incorporated into the April 1997 revision of Regulation Y for this activity. The summaries provide the reader with some historical perspective as to how and why the current provisions of Regulation Y evolved for FCMs. Certain conditions and commitments within these orders may no longer apply to the current provisions of Regulation Y. Therefore, reference must be made to the current Regulation Y, section 225.28(b)(7)(iv).

3251.0.1 FCM BROKERAGE OF FUTURES CONTRACTS ON A MUNICIPAL BOND INDEX

A bank holding company applied pursuant to section 4(c)(8) of the BHC Act and section 225.23(a)(3) of Regulation Y to engage de novo, through a wholly owned subsidiary located in the state of New York, to execute and clear futures contracts on a municipal bond index. The applicant also proposed to offer futures advisory services for a separate fee or as an integrated package of services to futures commission merchant customers through the subsidiary.

The Board had previously approved by regulation the activity of executing and clearing futures contracts on bullion, foreign exchange, U.S. government securities, and money market instruments, primarily on the basis that banks may hold and deal in the underlying cash items. The proposed futures contract on a municipal bond index was based on an index of general obligation bonds selected by the *The Bond Buyer*. The Bond Buyer Municipal Index is composed of 50 tax-exempt municipal revenue and general obligation bonds chosen on the basis of criteria that favor recently issued and actively traded bonds. The index is intended to be an accurate indicator of trends and changes in the municipal bond market. The offering of futures contracts based on the bond index (broad spectrum of municipal securities) could provide FCM customers with a more effective tool for hedging against the price risk associated with a portfolio of municipal bonds than any of the existing interest-rate futures contracts.

Banks are permitted to hold and deal in general obligation bonds, and they are active participants in the cash markets for those bonds. Based on these facts, the Board determined that the applicant's proposal was substantially similar to proposals to broker other financial futures previously approved by the Board, and was thus closely related to banking.

With regard to the proposed advisory activities, the Board had previously approved by order the provision of advisory services relating to approved FCM activities (1984 FRB 780). The applicant proposed to provide advisory services either for a separate fee or as an integral package of services to FCM customers. The services would include written or oral presentations on the historical relationship between the cash and futures markets, a demonstration of examples of financial futures uses for hedging, and assistance in structuring a hedging strategy. The applicant would provide these services only to major corporations and other financial institutions.

Based on all the facts provided, the Board concluded that—

1. the proposed activities by the applicant could reasonably be expected to produce benefits to the public;
2. the proposed FCM activities would entail risks or conflicts of interests different than those considered and addressed by the Board in its approvals of other FCM activities; and
3. the balance of the public-interest factors was favorable.

The Board noted, however, that trading of the futures contract involved in the application had not been approved by the Commodity Futures Trading Commission (CFTC). It therefore conditioned its December 21, 1984, approval of the application on the CFTC's approval of the contract (1985 FRB 111).

3251.0.2 FCM BROKERAGE OF CERTAIN FUTURES CONTRACTS ON STOCK INDEXES INCLUDING OPTIONS

A bank holding company applied, under section 4(c)(8) of the BHC Act and section 225.21(a) of Regulation Y, to engage, de novo through its wholly owned futures corporation, in executing and clearing, on major commodity exchanges, futures contracts on stock indexes and options on such futures contracts. The subsidiary would execute and clear—

1. the Standard & Poor's 100 Stock Price Index futures contract;
2. the Standard & Poor's 500 Stock Price Index futures contract (S&P 500);
3. options on the S&P 500, all of which are traded on the Index and Option Division of the Chicago Mercantile Exchange;
4. the Major Market Index futures contract, currently traded on the Chicago Board of Trade; and
5. the FT-SE 100 Equity Index futures contract, currently traded on the London International Financed Futures Exchange.

The execution and clearance of stock index futures and options traded on major commodity exchanges appeared to be functionally and operationally similar to securities brokerage, permitted for bank holding companies under section 225.28(b)(6)(i) of Regulation Y. Like municipal bond index futures (an activity proposed by an applicant which was previously approved by Board order), these futures contracts are settled in cash and are designed to allow customers to hedge the market risk associated with holding financial assets, in this instance, corporate equity securities. The equities represented by the listed indexes were chosen on the basis of criteria that favor a combination of securities that would accurately reflect fluctuations in the stock market.

The Board approved the application on February 4, 1985, based on the above analysis and on the fact that national banks have been permitted to execute and clear stock index futures, and options thereon, for the account of customers, through their FCM operations subsidiaries (1985 FRB 251). It also took into consideration the fact that trust departments of banks have begun to use stock index futures contracts and options on such contracts to hedge the market risk facing diversified stock portfolios.

3251.0.3 LIMITED FCM CLEARING-ONLY AND EXECUTING-ONLY TRADES

A bank holding company (the applicant) applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.23(a)(3) of Regulation Y to engage de novo in various FCM activities. The activities were to be conducted through its wholly owned FCM subsidiary (the company). The FCM activities consisted of—

1. executing and clearing, executing without clearing, and clearing without executing, as agent for institutional customers, the futures contracts and options on futures contracts listed in appendix A of the order;
2. executing and clearing as agent for institutional customers, through omnibus trading accounts with unaffiliated FCMs, the futures contracts and options on futures contracts listed in appendix B of the order; and
3. providing related investment advisory services.

The applicant proposed to conduct the activities throughout the United States.

The applicant requested authority to conduct, through the company, both execution and clearing activities on the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade (CBOT). The company also planned to conduct FCM activities through omnibus customer trading accounts established in its own name with clearing members of the exchanges on which the company would not be a member.[1]

The applicant also sought authority for the company to clear trades on the CME and the CBOT that had been executed by unaffiliated brokers pursuant to "give-up agreements." Under the applicant's proposal, the company would not be the primary clearing member for any nonclearing member on the CBOT and would not qualify any nonclearing member on the CME. The company also planned to execute trades that would be given up for clearance, at the customer's request, to an unaffiliated FCM.

The Board had previously determined, by regulation and order, that acting as an FCM in executing and clearing all of the proposed financial futures contracts and options on futures contracts, and providing investment advisory services with respect to such contracts, are activities closely related to banking under sec-

1. An omnibus account is an arrangement between a member clearing firm of an exchange and a nonmember FCM that seeks to conduct business on that exchange. Using this arrangement, the member clearing firm executes and clears transactions for the nonmember FCM and its customers. The omnibus account reflects all positions of the FCM's customers but is divided into separate segments for each customer for the purposes of calculating margin requirements, reporting current holdings, and other matters.

tion 4(c)(8) of the BHC Act with two exceptions.[2] See section 225.28(b)(7)(iv) and (b)(6)(iv) of Regulation Y and the Board orders found at 1992 FRB 953, 1991 FRB 64, 1990 FRB 881, and 1990 FRB 554.

On January 9, 1991, the Board denied a bank holding company's application to engage, through a nonbanking subsidiary, in clearing-only activities related to securities options and other financial instruments. The applicant in that case had proposed that its subsidiary primarily clear, but not execute, trades for professional floor traders (primarily market makers and specialists) trading for their own accounts on major securities and commodities exchanges. (See section 3700.12 and 1991 FRB 189.)

In the 1991 case, the Board was concerned that, by not engaging in both the execution and clearance of a trade, the nonbanking subsidiary could not decline transactions that posed unacceptable risk. It would have been obligated to settle each trade entered into by one of its customers, even if the customer did not have the financial resources to honor the obligation. No mechanism existed by which the nonbanking subsidiary could contemporaneously monitor the intra-day trading activities of the floor traders, its primary customers. The Board decided that the proposed nonbanking activity exposed the parent bank holding company to substantial credit risk. This decision was based on (1) the subsidiary's inability to monitor and control the risks to be undertaken and (2) the fact that clearing agents had to guarantee the financial performance of their customers to the clearinghouses of the exchanges on which they operate. The public-benefit considerations therefore precluded approval of that application under section 4(c)(8) of the BHC Act.

The applicant's proposal differed from the 1991 case in several respects. Under the proposal, the company would not serve as the primary or qualifying clearing firm for any unaffiliated customers. Also, the company would clear only those trades that it executed, or that other executing brokers executed and the company accepted for clearance pursuant to a customer's give-up agreement. The executing brokers would be independent from the customers and would have the opportunity to evaluate the trade before it was executed.

All of the company's clearing-only activities would be conducted pursuant to give-up agreements. Under these give-up agreements and other customer agreements, the company would have the right to refuse to accept for clearance any customer trade that it deemed unsuitable. The refusal could stem, for example, from consideration of market conditions or the customer's financial situation or objectives. Also, the applicant represented that it would be able to restrict the number and types of positions to be held by a customer as it deemed reasonable. The company could then refuse to accept trades that posed unacceptable risks.

The company established a framework for limiting risk from the clearing-only activities. It would review the creditworthiness of each potential customer and, based on the review, approve or reject the customer and establish appropriate limits concerning trading, margin, credit, and exposure limits. The company had controls in place to monitor the intra-day trading activities and risk exposure of its customers.

The Board determined that the credit and other risk considerations associated with the proposed clearing-only activities on the CME and CBOT were consistent with previous approvals. The decision was based on (1) the framework for limiting risk from clearing-only activities, (2) the commitments made by the applicant, and (3) the other facts of record. After reviewing other required considerations, the Board approved the application on May 6, 1993 (1993 FRB 723). Approval was subject to the commitments made by the applicant and the terms and conditions set forth in the order as well as in other Board orders related to the proposed activities.

3251.0.4 FCM CLEARING TRANSACTIONS BY PREAPPROVED EXECUTION GROUPS

A foreign banking organization (the applicant) subject to the provisions of the BHC Act applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.23(a) of Regulation Y to engage de novo in clearing trades of sophisticated institutional investors relating to contracts on futures and options on futures. Trades would be cleared through the applicant's majority-owned clearing subsidiary (the com-

2. The two exceptions are the Deutsche Aktienindex 30 Stock Index futures and the German Government Bond Index futures contracts traded on the Deutsche Terminborse GmbH. These two contracts had been approved as FCM activities pursuant to Regulation K. The Board also noted that these contracts served the same functions as the futures contracts for which FCM activities had previously been approved under section 4(c)(8) of the BHC Act.

pany) on the Chicago Mercantile Exchange (CME) and the Board of Trade of the City of Chicago (CBOT) and executed by nonaffiliated floor brokers.

In particular, the applicant proposed to accept for clearance customer orders that are executed by preapproved execution groups pursuant to "give-up agreements."[3] The applicant expected that the company would initially provide only limited execution services. The company would not be the primary clearing firm for any nonclearing member of the CBOT, and would not qualify any nonclearing member of the CME.

The applicant also sought approval to engage in other FCM and data processing and transmission activities. The applicant committed that the company would conduct these activities according to the provisions and subject to the limitations of Regulation Y (section 225.28(b)(7)(iv) and (b)(14)).[4] The company also planned to engage in certain other activities that the applicant maintained were incidental to its FCM services. These activities included the management of institutional-customer funds under its control. The incidental activities would also include providing to institutional customers, on request, general advice about (1) sources of information, (2) the selection and arrangement of an appropriate execution group, (3) the availability of computer software relating to futures and options on futures, (4) order-placement alternatives, and (5) cost-reduction methods in the use of futures and options on futures for hedging purposes. The company committed that it would not provide investment advice relating to futures and options on futures or on any other matter not authorized by the order.

The Board previously denied a proposal in which a nonbanking subsidiary of a BHC would have cleared, but not executed, trades for professional floor traders (primarily market makers and specialists) trading for their own account on major securities and commodity exchanges. (See 1991 FRB 189 and section 3700.12.) In that order, the Board was concerned that, by not engaging in both the execution and clearance of a trade, the FCM nonbanking subsidiary could not decline transactions that posed unacceptable risk. It would have been obligated to settle each trade entered into by one of its customers, even if the customer did not have the financial resources to honor the obligation. No mechanism existed by which the FCM nonbanking subsidiary could contemporaneously monitor the intra-day trading activities of the floor traders, its primary customers. The Board decided that the proposed nonbanking activity exposed the parent bank holding company to substantial credit risk. This decision was based on (1) the FCM's inability to monitor and control the risks to be undertaken and (2) the fact that the clearing agents had to guarantee the financial performance of their customers to the clearinghouses of the exchanges on which they operate. The public-benefit considerations therefore precluded approval of that application under section 4(c)(8) of the BHC Act.

The applicant's proposal differed from the above-mentioned denied application in various respects. In the applicant's case, the company would not serve as the primary or qualifying clearing firm for any broker that executes its clearing-only trades or for any nonaffiliated customer. The company would clear only trades that it executes, or that other executing brokers execute and the company accepts for clearance pursuant to the customer's give-up agreement.

The applicant represented that, under the give-up agreements, the company would have the contractual right to refuse a customer's trade that exceeded established trading limits that were documented in the give-up agreement for that particular customer. The company would have a period of time within which it could determine if the executed trade was properly authorized according to established limits, and could decide to reject the trade.

The company's customer base would consist of sophisticated institutional investors. The company would review the creditworthiness and other characteristics of each potential customer. Based on that review, it would approve or reject the customer and establish appropriate trading, credit, margin, and exposure limits for the customer. It would accept for clearance only trades that had been executed by preapproved execution groups trading on the CBOT and CME. Company would approve an execution group only if the floor brokers, and their primary or qualifying clearing firms, satisfied the com-

3. Under a give-up agreement, the executing floor broker (or give-in broker), pursuant to a customer's instructions, gives up an executed order for clearance to a clearing member other than the executing broker's primary clearing member (or qualifying member). Such agreements are used primarily to allow institutional customers to select a broker who has superior expertise and execution skills with respect to specific contracts or types of orders, while maintaining their accounts and positions with a clearing firm in which they have financial confidence.

4. Company would not trade for its own account except (1) to hedge a cash position in the related financial instrument or (2) to offset or liquidate a clearing error arising in the normal course of business.

pany's financial, managerial, and operational standards.

The Board decided that the credit and the other risk considerations associated with the proposed nonbanking activities were consistent with requirements for approval. The decision was based on (1) the framework described in the order; (2) the fact that the company would not be the primary or qualifying clearing firm for any broker that executed the company's clearing-only trades, or for any nonaffiliated customer; (3) the other contractual and operational distinctions noted between this proposal and the previous denied application (1991 FRB 189); and (4) the other facts of record.

The Board noted that it had recently approved applications by two bank-affiliated FCMs to engage in clearing-only activities, also on the CBOT and the CME (1993 FRB 723 and 1993 FRB 728). For a brief summary of the initial order, see section 3251.0.3.

The Board approved the application on August 2, 1993 (1993 FRB 961). The approval was subject to the facts of record, all the commitments made by the applicant, and the limitations and conditions stated in the order.

3251.0.5 FCM—EXECUTING AND CLEARING, AND CLEARING WITHOUT EXECUTING, FUTURES AND OPTIONS ON FUTURES ON NONFINANCIAL COMMODITIES

A bank holding company (the applicant, a BHC within the meaning of the BHC Act) applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.3 of the Board's Regulation Y to act, through a wholly owned subsidiary (the company), as a futures commission merchant (FCM) for unaffiliated customers in executing and clearing, and clearing without executing, futures and options on futures on *nonfinancial commodities*. Initially, the applicant proposed to conduct these activities in futures and options on futures on heating oil, crude oil, corn, wheat, soybeans, cattle, and hogs. The applicant must give at least 20 days' written notice to the Federal Reserve before it engages in FCM activities with respect to additional contracts linked to other physical commodities, unless other contracts are approved for any other bank holding company under the BHC Act.

The company is engaged in executing and clearing on major commodities exchanges futures and options on futures on financial commodities and certain broad-based and widely traded stock and bond indices.[5] The company proposed to engage in its proposed activities on the CBOT, CME, and New York Mercantile Exchange (NYMEX).

The company *will not* trade in the proposed derivative instruments for its own account. However, when a customer defaults on a contract after the termination of futures trading and the company is required to make or take delivery of the underlying commodity, or when it exercises its right to liquidate a customer's account, the company is permitted to take the necessary actions to mitigate its damages. These actions include acting for its own account in retendering or redelivering the commodity, entering into an exchange-for-physical transaction, or entering into an offsetting transaction in the cash market, provided these and other appropriate actions are taken as soon as practicable.

The company will limit its proposed services only to institutional customers and will not provide such services to retain brokerage customers, locals, or market makers. Approximately 10 percent of its business will be conducted on behalf of managed commodity funds (regulated by the Commodity Futures Trading Commission (CFTC) and the National Futures Commission). None of the managed funds would be owned, sponsored, advised by, or otherwise affiliated with the applicant. The company will not act as a commodity trading advisor,[6] or otherwise provide investment advice on the proposed instruments.

The Board had not previously approved the execution and clearance by bank holding companies of futures and options on futures on nonfinancial commodities. The Board's approval had been limited to acting as an FCM in the execution and clearance on major commodities exchanges of futures and options on futures on a variety of financial commodities, such as gold

5. See 1985 FRB 970. The company already engages in FCM activities on the Chicago Mercantile Exchange (CME), Chicago Board of Trade (CBOT), Commodity Exchange, London International Financial Futures and Options Exchange, Marche a Terme International de France, and Singapore International Monetary Exchange.

6. As defined in the Commodities Exchange Act, a commodity trading advisor includes, with certain exceptions, ''any person who, for compensation or profit, engages in the business of advising others, either directly or through publications or writings, as to the value of commodities or as to the advisability of trading in any commodity for future delivery on or subject to the rules of any contract market, or who for compensation or profit, and as part of the regular business, issues or promulgates analyses or reports concerning commodities.'' (7 U.S.C. 2)

and silver bullion and coins, foreign exchange, government securities, certificates of deposit and money market instruments that banks may buy and sell for their own accounts, and stock and bond indices.[7]

3251.0.5.1 BHC's Execution and Clearance of Futures and Options on Futures on Nonfinancial Commodities

National banks engage in a broad range of FCM activities involving all types of exchange-traded futures and option contracts consisting of financial and nonfinancial commodities for the accounts of customers, and for their own accounts, for hedging purposes. The Office of the Comptroller of the Currency (OCC) reasoned that the clearing process for any futures contract or option on a futures contract involves essentially an extension of credit because, upon receiving an executed order from a customer, the clearing broker supplies its own credit in an order on behalf of the customer and then sends the order to the exchange clearing organization for settlement. The OCC also determined that the execution, clearance, and advisory services provided by an FCM to its customers are essentially the same whether or not the underlying commodities are financial or nonfinancial.

Some national banks act as an FCM in the execution and clearance of futures and options on futures on a broad array of financial and nonfinancial commodities. The state of New York Banking Department has also permitted several New York–chartered banks to engage, to a limited extent, in FCM activities involving derivative instruments on nonfinancial commodities.

The Board has previously authorized bank holding companies to conduct FCM activities involving numerous instruments based on financial commodities. The Board determined that acting as an FCM in connection with contracts involving nonfinancial commodities is operationally and functionally similar to conducting FCM activities with respect to derivative contracts involving financial commodities. In both instances, the FCM monitors customer credit risk and trading exposure; assesses and collects initial and maintenance margins from customers; and brokers, executes, and clears trades.

Acting as an FCM for derivative instruments involves functions, skills, risks, and expertise that are substantially similar to those associated with the execution and clearance of financial futures and option contracts that the Board previously approved. The mechanics of executing and clearing trades are operationally the same whether the commodity underlying the exchange-traded derivative instrument is financial or nonfinancial. The rules and regulations of the CFTC, as well as the rules, procedures, practices, capital requirements, and safeguards of the various commodities exchanges, govern both the execution and clearance of nonfinancial futures and options and the execution and clearance of financial futures and options.

In 1991, the Board permitted bank holding companies to provide investment advice on trading futures contracts and options on futures contracts in nonfinancial commodities, such as agricultural and energy commodities. (See 1991 FRB 126.) It concluded that (1) providing investment advice on investing in futures and options on nonfinancial commodities appeared to be the functional equivalent of providing advice on futures and options on futures on financial commodities and (2) exchange-traded futures and options on futures involving nonfinancial commodities were essentially financial instruments.

The Board concluded, based on an analysis of the range of FCM activities currently existing in banking (as summarized above and cited in the order), that the activity of acting as an FCM in the execution and clearance of futures and options on futures on nonfinancial commodities, as proposed by the applicant, is an activity that is closely related to banking for the purposes of the BHC Act.

3251.0.5.2 FCM's Execution and Clearance of Futures and Options on Futures on Nonfinancial Commodities

The Board noted that both the company and the commodities exchanges on which the proposed FCM activities would be conducted are subject to regulatory oversight by the CFTC. The company's trading and clearance activities would also be subject to regulation and review by the CFTC and the commodities exchanges. The

7. See section 225.28(b)(7)(iv) of Regulation Y (12 C.F.R. 225). See also 1985 FRB 251, 1985 FRB 111, 1977 FRB 951, and 38 *Federal Register* 27,552 (1973). The applicant's proposed clearing without execution activities were approved in 1993 (FRB 723–728). The company proposed to conduct its clearing-only activities subject to the same conditions and limitations set forth in these Board orders, including the use of the "give-up agreement" by and among the company, its customers, and the nonaffiliated executing FCM that allows the company to refuse to clear trades that exceed specified risk parameters.

applicant committed to conduct the proposed activities subject to the same rules and procedures the Board imposed on FCM activities in derivatives of financial commodities, including prohibitions on extending credit to customers for the purpose of meeting margin requirements. The applicant committed to take several further steps in the event that one of the company's customers has an open position in a contract after futures trading is ceased, and the customer is not willing or is unable to make or take delivery. Based on the commitments made by the applicant for conducting the proposed activities, the limitations on the activities cited in the order, and all the facts on record, the Board approved the application on September 28, 1993, subject to all the terms and conditions set forth in the order and the noted Board regulations and orders that relate to the proposed activities. (See 1993 FRB 1049.)

3251.0.6 FCM AND RELATED ADVISORY SERVICES FOR OPTIONS ON EUROTOP 100 INDEX FUTURES AND THE ONE-MONTH CANADIAN BANKER'S ACCEPTANCE FUTURES

A foreign bank (the applicant) subject to the provisions of the BHC Act applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.23 of Regulation Y for its section 20 subsidiary (the company) to act as an FCM for and provide advisory services to nonaffiliated persons, in connection with the purchase and sale of futures and options on futures contracts that are based on bonds or other debt instruments; certain commodities; or stock, bond, or commodity indices. The applicant proposed contracts that were not previously considered by the Federal Reserve System: options on Eurotop 100 Index futures, to be traded on the Commodity Exchange, Inc. (Eurotop contracts), and the one-month Canadian Banker's Acceptance Futures, to be traded on the Montreal Exchange (banker's acceptance futures). These contracts are based on a financial instrument or a broad-based financial index and are comparable to contracts previously considered by the Federal Reserve System. They have essentially the same terms and serve the same functions as futures and options contracts for which FCM and related advisory services have been approved by the Board under section 4(c)(8) of the BHC Act. The Board concluded that the skills necessary to engage in providing FCM and futures advisory services are the same as those used to provide such services with regard to previously approved contracts. The Board thus approved the applicant's provision of these FCM and related advisory services for these contracts by the company, concluding that the activity is closely related to banking within the meaning of section 4(c)(8) of the BHC Act. (See 1995 FRB 188–189.)

3251.0.7 FCM TRADING FOR ITS OWN ACCOUNT IN FUTURES, OPTIONS, AND OPTIONS ON FUTURES CONTRACTS BASED ON CERTIFICATES OF DEPOSIT OR OTHER MONEY MARKET INSTRUMENTS

A foreign bank (the applicant) subject to the provisions of the BHC Act applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.23 of Regulation Y for its section 20 subsidiary (the company) to trade as an FCM in all futures, options, and options on futures contracts based on certificates of deposit or other money market instruments that are permissible investments for national banks. The Board had previously authorized company to trade for its own account, for purposes other than hedging, in futures, options, and options on futures contracts based on U.S. government securities that are permissible investments for national banks and in similar contracts based on certain money market instruments. (See 1991 FRB 759.) In that order, the Board noted that trading in these contracts would require a market judgment on interest rates. It was noted that banks, through their core lending and funding activities, had developed expertise in judging interest-rate and price movements. For those reasons, and because that proposal would not authorize company to trade in derivative contracts based on securities or instruments that a state member bank could not purchase for its own account, the Board determined the trading activity to be closely related to banking under section 4(c)(8) of the BHC Act.

The Board concluded that its reasoning in the 1991 order could be applied currently to this expanded 1994 proposal. The Board noted that the Office of the Comptroller of the Currency had determined that trading in futures and options contracts based on bank-eligible securities or instruments is an activity that is within the legally authorized powers of national banks (OCC Interpretive Letter No. 494 (December 20, 1989)). The Board thus concluded that the proposed trading activity is conducted by banks and is so operationally and functionally similar to activities conducted by banks that banks are particularly well-equipped to engage in the activity. It therefore concluded that trading for one's own account, for purposes other than hedging, in futures, options, and options on futures contracts based on certificates of deposit or other money market instruments that are permissible investments for national banks is an activity that is closely related to banking within the meaning of section 4(c)(8) of the BHC Act. (See 1995 FRB 190.)

3251.0.8 FCM ENGAGING IN COMMODITY AND INDEX SWAP TRANSACTIONS AS AN ORIGINATOR, PRINCIPAL, AGENT, BROKER, OR ADVISOR

A foreign bank (the applicant) subject to the provisions of the BHC Act applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.23 of Regulation Y for its section 20 subsidiary (the company) to engage in FCM activities and in acting as an originator, principal, agent, broker, or advisor with respect to swaps and swap-derivative products and over-the-counter option transactions based on certain commodities; stock, bond, or commodity indices; or a hybrid of interest rates and these commodities or indices (commodity and index swap transactions).[8] Except for certain advisory services, the Board had not determined whether these proposed activities are closely related to banking under section 4(c)(8) of the BHC Act. The Board had determined, by order or regulation, that acting as an originator, principal, broker, agent, or advisor with respect to interest-rate and currency swaps and swap-derivative products relating thereto (financial swap transactions) are activities closely related to banking and are thus permissible for bank holding companies. (See Regulation Y, section 225.28(b)(6) and 1993 FRB 345.)

8. The proposed activities are subject to the same commitments relating to interest-rate and currency swap transactions and related swap-derivative products. (See 1993 FRB 345.)

The applicant anticipates that the section 20 subsidiary's swap transactions will be based on a variety of stock and bond indices, similar to those previously approved in connection with proposed FCM activities (or to a specially tailored basket of securities selected by the parties) (index transactions), or they could be based on precious metals and energy products or related commodity indices (commodity transactions). They also could include hybrid transactions that are based on a combination of interest rates and such indices or commodities.

Commodity and index swap transactions are operationally, structurally, and functionally similar to financial swap transactions. Both types of swaps involve privately negotiated financial transactions. The parties involved in the transaction agree to exchange specified payment streams over a specific period of time, based on a predetermined formula. For an interest-rate swap, the basic structure is an exchange between two counterparties of the payment streams that arise out of different interest payment obligations, calculated on the basis of an agreed-upon notional principal amount. With the commodity or index swap transaction, the parties exchange payment streams based on a notional principal amount and the prices of certain commodities or the value of or returns on certain securities or indices of securities, or on a combination of these and other measures such as interest rates. For both types of swap transactions, the parties enter into these contracts to meet various common investment objectives, including taking positions in the market for the underlying assets for investment purposes, limiting one's exposure to market uncertainties and future price fluctuations, and preserving principal while participating in the potential returns of a particular financial market or economic sector. Since a swap transaction is negotiated between parties, the economic terms of the transaction (including the duration of the contract; notional principal amount; method of calculating and frequency of payments; and underlying assets, rates, or indices upon which the payments are to be determined) can be individually tailored to meet specific financial goals and risk sensitivities of the counterparty.

National banks have been authorized by the OCC to engage in activities that involve matched and unmatched commodity and index swap transactions (including related swap-derivative products and over-the-counter options). The New York State Banking Department also approved these activities for state-chartered banks under its jurisdiction. In addition, the Board permits state member banks to enter into perfectly matched commodity and index swap transactions, provided the transactions are consistent with their state charters. Further, the Federal Reserve Bank of New York, acting under delegated authority, has approved proposals by state member banks to engage in such activities on an unmatched basis. (See 12 C.F.R. 208.128.)

For the foregoing reasons and based on the facts of record, the Board determined that engaging in commodity and index swap transactions is an activity conducted by banks. The Board also considered the similarities between these transactions and the financial swap transactions noted above, as well as the fact that banks and other intermediaries play a similar role in financial swap transactions and commodity and index swap transactions. It was noted that all of these contracts represent forms of financial intermediation that banks have historically engaged in. Based on all the facts on record, the Board concluded that these proposed activities are closely related to banking under section 4(c)(8) of the BHC Act.

As noted previously, the company also proposes to provide advisory, agency, and brokerage services with respect to commodity and index swap transactions. The Board believes that the authority of banks to conduct these activities could be implicit in or incidental to their authority to engage in the transactions as principal. In its analysis, the Board noted that banks can develop a familiarity and expertise as to the structure and economic effects of these transactions, which should well equip them to provide the intended advisory, agency, and brokerage services. National banks have been expressly authorized to provide advisory, execution, and other services with respect to exchange-traded futures and options on futures contracts based on financial and nonfinancial commodities. (See OCC Interpretive Letter No. 494.) The exchange-traded transactions are used for purposes similar to the over-the-counter transactions for which the applicant proposes that the company render advisory, agency, and brokerage services. The pricing bases for, economic effects of, and risk presented by the two types of transactions are also similar in important respects.

Based on the facts on record, the Board determined that the proposed advisory, agency, and brokerage services are activities conducted by banks or are operationally and functionally similar to such activities. Thus, they are closely related to banking under section 4(c)(8) of the BHC Act. (See 1995 FRB 190–191.)

3251.0.9 FCM TRADING IN FUTURES, OPTIONS, AND OPTIONS ON FUTURES CONTRACTS BASED ON COMMODITIES OR ON STOCK, BOND, OR COMMODITY INDICES FOR ITS OWN ACCOUNT

A foreign bank (the applicant) subject to the provisions of the BHC Act applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.23 of Regulation Y for its section 20 subsidiary (the company) to engage in *trading for its own account* for purposes other than hedging in futures, options, and options on futures contracts based on certain commodities or on stock, bond, or commodity indices—transactions that have not been expressly authorized for banks. The instruments to be traded are generally the same as those previously approved by the Board in considering FCM and futures advisory activities of bank holding company subsidiaries, such as crude oil futures, Standard & Poor's 500 Stock Price Index futures, and municipal bond index futures. (See 1993 FRB 1,049 and 1994 FRB 151 and also SR-93-27 (refer to Appendix A).) The applicant proposes to engage in FCM activities and go beyond furnishing those FCM and related advisory services and seeks the Board's permission for the company to trade these instruments for its own account. Such activities include arbitrage operations, market making for customer-accommodation purposes, and proprietary trading (taking positions for investment purposes), as well as hedging transactions.

The proposed activities could consist of exchange-traded instruments that could be based on commodities such as crude oil, providing for delivery of the underlying commodity upon expiration of the contract. The applicant confirmed that it does not intend to take delivery of such commodities but plans to take several actions to avoid delivery of commodities other than precious metals. These actions include closing positions in expiring contracts during trading periods and engaging in exchange-for-physical transactions after trading closes. The Board stipulated, as a condition of approval, that the applicant could not take delivery of the commodities, except in unusual circumstances. Whenever delivery is taken, the applicant is required to notify the Federal Reserve System and divest itself of the commodity promptly. The Board views the contracts as financial instruments, despite the possibility that trading in such contracts can result in the delivery and ownership of commodities that banking organizations are generally not permitted to hold. The Board also noted, with respect to the proposed exchange-traded transactions that are based on an index of securities or commodities, that (1) the transactions would be settled in cash and (2) they would not provide for the delivery of the underlying securities or commodities.

The Board had not previously approved this trading activity, with respect to the instruments proposed, for bank holding companies or their subsidiaries under section 4(c)(8) of the BHC Act. The Board has, however, authorized acting as an FCM and providing advisory services with respect to the instruments to be traded. The Board also approved similar trading with respect to instruments based on U.S. government securities and money market instruments. (See 1991 FRB 759.) With respect to section 20 nonbank subsidiaries, the Board has recognized the utility of trading in these instruments to hedge market exposure resulting from other trading activities, indicating that these bank holding company subsidiaries may engage in such risk-management transactions as a necessary incident to their underwriting and dealing activities. (See 1994 FRB 449.) No federal bank regulatory authority had expressly permitted banks to trade in the proposed instruments for their own accounts for purposes other than hedging.

The Board believes that the proposed trading activities are closely related to banking. It noted that banks engage in activities with respect to the instruments in question that are similar to or related to the proposed trading activities and that they engage in trading activities for the same purposes with respect to similar instruments, including exchange-traded contracts based on bank-eligible securities and instruments and over-the-counter transactions based on commodities and various indices.

The Board further noted that banking organizations have substantial experience with exchange-traded derivative transactions based on commodities or on commodity or securities indices. It also noted important similarities between the proposed instruments and transactions that have been authorized for banks for nonhedging purposes. Moreover, the Board believes that the risks inherent in the proposed trading activities are similar to those that are experienced by banks that engage in swaps and other permissible transactions; hence, the proposed transactions require analytical skills; risk-management policies, procedures, and techniques; and computer and operations systems similar to those used by banks for engaging in those permissible transactions. Based on this reasoning, the Board determined the proposed activity to be closely related to banking under section 4(c)(8) of the BHC Act. The Board's December 23, 1994, approval is subject to all the facts of record, all the commitments made in connection with the application, and the conditions cited in the order. (See 1995 FRB 185.) These include adhering to future supervisory or examination policies and guidance issued by the Board for a banking organization's derivatives business, including policies or guidance with respect to customer transactions, trading and marketing practices and policies, and related systems and controls.

3251.0.10 APPENDIX A—PREVIOUS PRIOR-APPROVAL REQUIREMENTS FOR BANK HOLDING COMPANIES PROPOSING TO ENGAGE IN FCM ACTIVITIES

In May 1993, the Board reduced the prior-approval requirements for bank holding companies proposing to engage in certain futures commission merchant (FCM) activities. (See SR-93- 27.) First, the Board delegated to Reserve Banks its authority to approve proposals by bank holding companies to act as an FCM in executing and clearing any futures contract on a financial commodity or stock or bond index that the Board has previously approved, on any Board-approved exchange. The Board also delegated to Reserve Banks its authority to approve proposals by bank holding companies to act as an FCM or commodity trading advisor in providing investment advisory services for previously approved financial instruments.

In addition, the Board modified and, in certain cases, eliminated the prior-approval requirement for bank holding companies seeking to act as an FCM for additional financial instruments or to act as an FCM on additional exchanges in which the bank holding company already has Federal Reserve System approval to engage generally in FCM activities. Any bank holding company that had previously received approval to act as an FCM under either Board order or the former sections 225.25(b)(18) and (b)(19) of Regulation Y could act as an FCM subject to certain limitations and conditions. These requirements were replaced by the April 1997 Regulation Y revision at section 225.28(b)(7)(iv).

3251.0.11 PROVIDING DISCRETIONARY PORTFOLIO MANAGEMENT SERVICES ON FUTURES AND OPTIONS ON FUTURES ON FINANCIAL COMMODITIES

A foreign bank (the applicant), a bank holding company within the meaning of the BHC Act, applied under section 4(c)(8) of the act to engage through company in providing discretionary portfolio management services with respect to exchange-traded futures and options on futures on financial commodities.[9] The provision of discretionary portfolio management services, with respect to futures and options on futures on financial commodities, had not been previously considered by the Board as to whether it is closely related to banking under section 4(c)(8) of the act.

In providing discretionary management services, company would manage customers' accounts and purchase and sell in its sole discretion exchange-traded futures and options on futures on financial commodities for such accounts. Company would provide discretionary management services in combination with providing futures commission merchant (FCM) transactional services and would only provide such services to institutional customers.[10] Company would not act as a counterparty on customer transactions or trade these instruments for its own account. In addition, company would not purchase or sell over-the-counter contracts for accounts over which it exercises discretion.

The Board has permitted bank holding company FCMs and commodity trading advisors to provide investment advice with respect to futures and options on futures on financial and nonfinancial commodities. (See Regulation Y, section 225.28(b)(6) and 1994 FRB 151.) The bank holding company argued that discretionary management is a normal manner of providing investment advice to institutional customers. Indeed, the Board permits bank holding companies to act as discretionary portfolio managers as part of providing investment advisory and full-service brokerage services with respect to securities. (See Regulation Y, section 225.28(b)(6) and (b)(7)(i).) In addition, the Office of the Comptroller of the Currency permits national banks to engage in discretionary funds management with respect to futures and options on futures.[11]

The applicant also indicated that company would provide the proposed futures-related discretionary portfolio management services in accordance with the limitations and conditions that would be imposed if company were providing portfolio management services in the securities context. In this regard, the applicant committed that company would only provide the proposed discretionary portfolio management services to institutional customers and only at the request of such customers.

The applicant also indicated that it would have a fiduciary relationship with all customers to whom it provides the proposed discretionary management services and has committed that company would comply with applicable law, including fiduciary principles. As one method of meeting its fiduciary obligations, the bank holding company committed that company would obtain the consent of customers before engaging, as principal or agent, in a transaction in which any affiliate of company acts as principal in futures or options on futures transactions on the customer's behalf. Company and its affiliates also agreed not to share any confidential information concerning their respective customers without the consent of the customer. In addition, the applicant stated that company would exercise its discretionary management authority only in purchasing and selling exchange-traded instruments. Therefore, concerns surrounding over-the-counter instruments, such as the potential for abuses due to the lack of price transparency, were not presented by the proposal.

For these reasons, the Board concluded that providing discretionary portfolio management services with respect to futures and options on futures on financial commodities is closely related to banking and a proper incident to banking for purposes of section 4(c)(8). The application was approved by the Board on February 9, 1995. (See 1995 FRB 386.)

9. The bank holding company also proposed to engage in a variety of data processing, securities, futures, and foreign exchange–related activities through company and another subsidiary. The Board previously has determined by order or regulation that these activities are closely related to banking. The bank holding company committed to conduct these activities in accordance with the conditions established by the Board in Regulation Y and prior orders.

10. Company would provide these services to commodity pools but would not become a commodity pool operator.

11. See OCC Interpretive Letter No. 494 (December 20, 1989).

3251.0.12 FCM EXECUTION, CLEARANCE, AND ADVISORY SERVICES FOR CONTRACTS ON FINANCIAL AND NONFINANCIAL COMMODITIES FOR NONINSTITUTIONAL CUSTOMERS

A foreign banking organization (the notificant) subject to the provisions of the Bank Holding Company Act (BHC Act) provided notice under section 4(c)(8) of the BHC Act (12 U.S.C. 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) of its proposal that its indirect U.S. subsidiary (the indirect subsidiary)[12] acquire certain assets and assume certain liabilities of a company.[13] The notificant would engage indirectly in FCM execution, clearance, and advisory activities with respect to futures and options on futures on financial and nonfinancial commodities[14] and in buying and selling foreign exchange in the spot, forward, and over-the-counter options markets on the order of investors as riskless principal.[15] The Board had previously determined by order and regulation that the above proposed activities are closely related to banking within the meaning of section 4 of the BHC Act.[16]

3251.0.12.1 Providing FCM Services to Certain Sophisticated Noninstitutional Customers

First, the notificant proposed that the indirect subsidiary would provide FCM execution, clearance, and advisory services with respect to contracts on both financial and nonfinancial commodities to persons that do not qualify as institutional customers but who trade futures and options on futures solely to hedge risks arising from their business activities (noninstitutional commercial hedger customers), such as farmers. The Board has limited bank holding companies to providing nonfinancial commodities–related FCM services only to institutional customers. Similarly, with respect to contracts on financial commodities, the Board

12. The indirect subsidiary is wholly owned by the notificant. The indirect subsidiary engages in various futures commission merchant, foreign-exchange, and securities-related activities. See 1994 FRB 646 and 649.

13. The acquired firm was a clearing member of certain financial and nonfinancial commodities exchanges. The FBO stated that the indirect subsidiary would become a clearing member of those exchanges. In addition, that subsidiary would provide FCM services with respect to two exchange-traded contracts that had not previously been approved by the Board (heating oil crack-spread options and gasoline crack-spread options) and would purchase and sell through the use of omnibus account arrangements certain futures and options on futures on nonfinancial commodities traded on two other exchanges.

14. These activities include providing execution-only and clearing-only services to customers. See 1993 FRB 723 and 1994 FRB 151.

15. The indirect subsidiary would provide the proposed riskless-principal services only to institutional customers, except that it would provide such services to certain noninstitutional customers when they direct it to convert funds from one currency to another to trade futures and options on futures contracts. Foreign exchange–related advisory services would not be provided to these noninstitutional customers.

16. See 12 C.F.R. 225.28(b)(7)(iv) and 225.28(b)(6) and 1990 FRB 649 (1990).

has not permitted bank holding companies to provide execution-only or clearing-only services to noninstitutional customers and only permits bank holding companies to provide advisory services to financially sophisticated customers that have significant dealings in the underlying commodities.[17]

The indirect subsidiary's noninstitutional commercial hedger customers would be engaged or would be affiliated with a commercial enterprise that is engaged in producing, manufacturing, processing, or merchandising products or in providing services that are related to the commodities underlying the futures and options on futures contracts in which the customers would trade. The noninstitutional commercial hedger-customers would not be engaged in executing their own trades on the floor of any commodities exchanges. The notificant stated that the indirect subsidiary would require noninstitutional commercial hedger customers to state in writing that they would only engage in ''bona fide hedging transactions,'' as defined by the Commodity Futures Trading Commission (CFTC).[18] In addition, an initial credit-review process will be established to determine whether a noninstitutional commercial hedger customer's proposed hedging activities are appropriate in light of the customer's net worth and business activities. The indirect subsidiary will not permit noninstitutional commercial hedger customers to trade in any commodities other than those that the customer would trade to hedge risks from its commercial activities, and it would establish a system to detect any unauthorized trading activities.

By limiting transactional services and advice to areas in which the customer has special expertise, the proposed limitations address the concern that the customer would rely unduly on the bank holding company's advice or that the customer would be unable to detect conflicts of interest or advice that is motivated by the bank holding company's self-interest. Moreover, the notificant will abide by all the other limitations designed to more specifically address the potential risks that may result from providing clearing-only and execution-only services to these customers.

3251.0.12.2 Foreign-Exchange Activities

Second, in connection with the proposal that the indirect subsidiary will buy and sell foreign exchange on the order of customers as riskless principal, the notificant proposed that the indirect subsidiary be permitted to purchase and sell foreign exchange for its own account for limited purposes while also providing foreign-exchange-related execution and advisory services.[19] In several limited circumstances, the Board has permitted a bank holding company to provide foreign-exchange-related transactional and advisory services in a subsidiary that purchases and sells foreign exchange for its own account.[20] For example, the Board has permitted bank holding companies to provide foreign-exchange-related advice and transactional services through a subsidiary engaged in purchasing and selling foreign exchange for its own account to hedge positions in permissible interest-rate or currency-swap transactions or to hedge risks arising from the permissible securities underwriting and dealing activities of the subsidiary.[21]

The indirect subsidiary will take positions in foreign exchange only as a means to hedge financial-statement translations of income for its foreign parent and as necessary for the payment of invoices denominated in foreign currencies. It would not enter into a foreign-exchange transaction for its own account with a customer if the customer is receiving foreign-exchange services relating to such transaction from this subsidiary. The notificant committed that the indirect subsidiary will observe the standards of care and conduct applicable to fiduciaries with respect to its foreign-exchange-related advisory activities and will provide foreign-exchange-related execution and advisory services only to institu-

17. See 1993 FRB 1049 and 12 C.F.R. 225.25(b)(19) (contracts on financial commodities). These limitations address concerns that, in futures transactions, unsophisticated customers may place undue reliance on investment advice received from a banking organization and may not be able to detect investment advice that is motivated by the advisor's self-interest. Similarly, in cases involving clearing-only transactions, the limitation helps address the added risk to the bank holding company that results from its more limited ability to review and reject trades that have been executed through another FCM.

18. See 17 C.F.R. 1.3(z).

19. The indirect subsidiary currently provides foreign-exchange-related execution and advisory services to its customers. In permitting bank holding companies to provide foreign-exchange execution and advisory services on a combined basis, the Board has relied on the representation that the subsidiary providing the foreign-exchange-related services would not purchase or sell foreign exchange for its own account.

20. The Board also previously has noted that in conducting foreign-exchange operations, commercial banks combine the functions of giving advice, executing transactions, and taking positions in foreign exchange.

21. See 1994 FRB 157 and 1993 FRB 892.

tional customers. The notificant also committed that the indirect subsidiary's personnel engaged in purchasing and selling foreign exchange for its own account will not have access to information about the foreign-exchange trading activities of customers and that customer representatives will not have access to information about the foreign-exchange activities of personnel engaged in purchasing and selling foreign exchange for the indirect subsidiary's own account.[22]

3251.0.12.3 Board's Decision on the Proposed FCM Activities

Based on the foregoing and all the facts of record, the Board approved the notification subject to all the terms and conditions set forth in the order and in the above-noted Board regulations and orders that relate to these activities. The Board's determination is subject to all the terms and conditions set forth in the Board's Regulation Y, including those in sections 225.7 and 225.23(b). The Board's decision is specifically conditioned on compliance with all the commitments made. The notice was approved on July 14, 1995 (see 1995 FRB 880).

3251.0.13 FCM SERVING AS A PRIMARY CLEARING FIRM FOR A LIMITED NUMBER OF FLOOR TRADERS AND BROKERAGE SERVICES FOR FORWARD CONTRACTS ON FINANCIAL AND NONFINANCIAL COMMODITIES

A foreign banking organization and its parent holding companies (the notificants), bank holding companies within the meaning of the Bank Holding Company Act, requested the Board's approval under section 4(c)(8) of the BHC Act (12 U.S.C. 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) to acquire all the voting securities of a company (the company) and thereby engage in a wide range of nonbanking activities, including securities- and derivatives-related activities. The company and its principal subsidiary (the subcompany) engage worldwide in a wide range of investment advisory, securities underwriting, and futures-related activities. The notificants proposed to merge the subcompany and the company into the notificants' existing nonbank section 20 company (the section 20 company). The section 20 company would continue as a registered broker-dealer with the Securities and Exchange Commission under the Securities Exchange Act of 1934 and as a member of the National Association of Securities Dealers. The section 20 company would also become registered as a futures commission merchant (FCM) and a commodity trading advisor (CTA).[23]

The notificants proposed to engage in a variety of FCM-related activities the Board previously had determined, by regulation or order, were so closely related to banking as to be proper incidents thereto within the meaning of section 4(c)(8) of the BHC Act. The proposed activities included engaging in execution-only, clearing-only, and omnibus account activities with respect to futures and options on futures based on financial and nonfinancial commodities, and providing discretionary portfolio management services with respect to futures and options on futures on financial and nonfinancial commodities.[24] (See 1997 FRB 138–142.) The section 20 company committed to providing these futures-related execution-only, clearing-only, and discretionary portfolio management services only to institutional customers and certain sophisticated noninstitutional commercial hedger customers.[25]

3251.0.13.1 Primary Clearing Firm for a Limited Number of Professional Floor Traders

The notificants also proposed that the section 20

22. To address potential conflicts of interest in connection with providing the proposed foreign-exchange riskless-principal services, the notificant committed that the indirect subsidiary will disclose to each customer that receives advice relating to over-the-counter transactions in the foreign-exchange market that it may have an interest as a counterparty principal in the course of action ultimately chosen by the customer. Also, in any case in which the indirect subsidiary has an interest in a specific over-the-counter foreign-exchange transaction as counterparty principal, it will advise its customer of that fact before recommending participation in that transaction.

23. The subcompany was already registered as an FCM and CTA.

24. The notificants committed that the section 20 company would provide these services in accordance with the limitations previously established by the Board. See 1993 FRB 723, 1993 FRB 1049, and 1994 FRB 151.

25. The notificants stated that all noninstitutional commercial hedger customers would meet the requirements previously reviewed by the Board. See 1995 FRB 880.

company provide clearing-only services to, and serve as the primary clearing firm for, certain professional floor traders on two exchanges with respect to the futures contracts and options on futures contracts traded on such exchanges.[26] The Board previously has determined that providing clearing services with respect to exchange-traded securities, options, futures, and options on futures contracts is closely related to banking within the meaning of section 4(c)(8) of the BHC Act. In 1991, however, the Board denied an application by the notificants to engage de novo in providing the proposed services to an unlimited number of market makers and other professional floor traders dealing for their own accounts.[27]

In the 1991 order, the Board recognized that a company serving as the primary clearing firm for professional floor traders may be exposed to significant financial risks because the company generally would not have the ability to reject an executed trade presented to it for clearance, even when the company believes the trade presents unacceptable risks in light of market conditions or the traders' financial position. The Board also noted that, at the time of the 1991 application, the applicants lacked appropriate operational systems to track and manage the intraday risks arising from the trading activities of the floor traders. This lack of a mechanism to monitor intraday trading activities presented the possibility that a professional floor trader could incur substantial losses through the trading of options or futures contracts, which the applicants would be obligated to clear and guarantee, before the applicants could act to mitigate their credit-risk exposure.

It was noted that since 1991, the Board and bank holding companies have gained substantial experience with the conduct, methods, procedures, and regulation of clearing-only activities. Also, since 1991, the Board had authorized bank holding companies to provide clearing-only services with respect to futures contracts and options on futures contracts for customers other than professional floor traders, subject to certain conditions designed to ensure that the bank holding companies have the ability to manage the attendant financial risks.[28]

The Board concluded that the facts of record indicated that the subcompany had and the section 20 company would have sufficient risk-management policies, procedures, and systems to permit the notificants and the section 20 company to adequately monitor and control the risks, including the intraday risks, associated with the section 20 company's proposal to serve as the primary clearing firm for a limited number of professional floor traders on the two exchanges. Specifically, the section 20 company would use the subcompany's established trading, credit, margin, and exposure limits for each professional floor trader for which the section 20 company serves as the primary clearing firm. Adherence to these limits is monitored on an intraday basis by experienced personnel who are physically present on the floor of the two exchanges. These personnel visually monitor the trading activities of floor traders on the exchanges and review trades submitted by the floor traders for clearance.[29] If an employee of the section 20 company determines that a floor trader is exceeding the limits it has established, or is otherwise engaged in questionable trading activities, the employee would have the ability

26. A primary clearing firm is obligated to accept and clear all trades submitted by a professional floor trader, even if the trade was initially presented to, and rejected by, another clearing firm. Once a primary clearing firm clears a trade for a professional floor trader, the firm becomes obligated to settle the trade in the event of a default by the professional floor trader. The company served as the primary clearing firm for professional floor traders on the two exchanges. The notificants requested authority for the section 20 company to act as the primary clearing firm for up to 20 professional floor traders on one exchange and 40 professional floor traders on the other.

27. See 1991 FRB 189.

28. In particular, the bank holding companies agreed to provide the clearing-only services pursuant to ''give-up'' agreements, which provide the bank holding companies with the right to refuse to accept for clearance any customer trade that the bank holding company deems unsuitable in light of market conditions or the customer's financial situation or objective. In addition, the bank holding companies agreed to establish procedures to monitor the intraday trading activities and risk exposure of their clearing-only customers.

29. The Board recognizes that trades on the two relevant exchanges are not electronically submitted to the clearing firm or the exchange. Instead, trading cards for each trade are submitted by each professional floor trader to its clearing firm, which enters the trade into the exchange's clearing system. Both exchanges require that the subcompany collect the trading cards from each floor trader at least once during each half-hour period, thereby providing the subcompany personnel with an opportunity to review the intraday trading activities of floor traders. The rules of one exchange also require that the subcompany enter all collected trades into the exchange's on-line clearing system within 45 minutes of the end of the half-hour period during which the trades were collected. That exchange's on-line clearing system also permits the subcompany to monitor the trading activities of floor traders, both individually and in the aggregate, on an intraday basis, and allows the subcompany to identify any potentially unmatched trades. Although the other exchange does not operate an on-line clearing system, the subcompany personnel maintain tally sheets that are updated every 30 minutes and reflect all trades submitted by each professional floor trader throughout the day.

to limit or halt the floor trader's activities, require the floor trader to post additional margin, partially or entirely liquidate the floor trader's positions, or immediately revoke the floor traders membership on the exchange.[30] The notificants' operations managers on the two exchanges also would personally guarantee the section 20 company against any losses that it may incur from serving as the primary clearing firm for floor traders on the exchanges, thereby providing such personnel with an incentive to closely monitor the trading activities of the floor traders. The notificants also stated that the section 20 company would install an on-line risk-management system that would provide its personnel with intraday data on the trading activities of the professional floor traders, and the ability to analyze its exposure to such trading activities on an intraday basis.

The Board noted that the type of risk-management systems necessary to appropriately manage the risks arising from a particular activity necessarily depends on the scope and nature of the proposed activity. In this regard, the Board noted that the section 20 company proposed to serve as the primary clearing firm for only a limited number of professional floor traders on two exchanges. These exchanges have relatively small trading areas and volumes, which permit personnel on the floors of the exchanges to monitor trading activity. The Board noted that the Federal Reserve Bank had conducted an on-site operational and managerial infrastructure review used by the subcompany to monitor and control the financial risks associated with its primary clearing activities on the two exchanges. Based on that review and other facts of record, the Board concluded that the subcompany had the managerial and operational resources and systems to adequately monitor and control the financial risks arising from its role as primary clearing firm on the two exchanges.

The Board also noted that approval of the proposal could reasonably be expected to produce public benefits. Specifically, the Board noted that the subcompany served as the primary clearing firm for a significant percentage of the professional floor traders on the two exchanges and that the notificants' proposal would permit the section 20 company to continue providing primary clearing services to such professional floor traders.

In light of all the facts of record, including the limited nature of the section 20 company's proposed clearing-only activities for professional floor traders, the commitments provided by the notificants, and the operational and managerial systems that the section 20 company will have in place to monitor and control the risks arising from the proposed activities, the Board concluded that the credit and other risk considerations associated with the proposed clearing-only activities for professional floor traders on the two exchanges are consistent with approval of this notice and that, therefore, the proposed activity is a proper incident to banking within the meaning of section 4(c)(8) of the BHC Act.

3251.0.13.2 Brokerage Services with Respect to Forward Contracts Based on Certain Financial and Nonfinancial Commodities

The notificants also proposed that the section 20 company act as broker with respect to forward contracts based on certain financial and nonfinancial commodities. In this capacity, the company would assist customers in arranging forward contracts with third parties pursuant to which the customers would make (or receive) delivery of financial and nonfinancial commodities on a future date.[31] The section 20 company would act as a broker only with respect to forward contracts that are based on those financial and nonfinancial commodities that also serve as the basis for an exchange-traded futures contract.[32] The Board recognized that banking regulators had not expressly permitted banks to engage in the proposed activity.

Bank holding companies are permitted to act as a broker in the execution and clearance of futures contracts and options on futures contracts based on financial and nonfinancial commodities.[33] As noted above, the forward contracts that the section 20 company proposed to broker would be based on the same financial and nonfinancial commodities that underlie futures contracts that bank holding companies

30. The subcompany's risk-management personnel also electronically receive trade information from the two exchanges up to four times a day. Reports based on such data are prepared by risk-management personnel and reviewed daily.

31. Because the section 20 company will act only as a broker, the section 20 company will not itself be required to take physical delivery of the nonfinancial commodities underlying the forward contracts that it arranges under any circumstances.

32. Exchange-traded futures contracts may be based on a wide variety of commodities, including precious metals, oil, cocoa, or wool.

33. See 1993 FRB 1049.

are permitted to broker as an FCM. Bank holding companies also are permitted to broker forward contracts on foreign exchanges and arrange swap transactions that are based on nonfinancial commodities or indices of nonfinancial commodities.[34] Accordingly, based on these and other facts of record, the Board concluded that acting as a broker for forward contracts based on those financial and nonfinancial commodities that underlie an exchange-traded futures contract is a permissible activity for bank holding companies under section 4(c)(8) of the BHC Act.

34. See 1995 FRB 185.

3251.0.13.3 Conclusion

Based on all the facts of record, the Board approved the notice subject to all the terms and conditions discussed in the order and in the section 20 orders, as modified by the modification orders. (See 1997 FRB 138.)

With the adoption of the April 1997 revision to Regulation Y, the Board authorized certain types of other transactional services in section 225.28(b)(7)(v). Bank holding companies can provide to customers as *agent* transactional services with respect to swaps and similar transactions—

1. any transaction that is described in section 225.28(b)(8) of the regulation;
2. any transaction that is permissible for a state member bank; and
3. any other transaction involving a forward contract, option, futures, option on a futures or similar contract (whether traded on an exchange or not) relating to a commodity that is traded on an exchange.

Under this provision of the current rule, a bank holding company can provide transactional services for customers involving any derivative or foreign-exchange transaction that the bank holding company is permitted to conduct for its own account (item 1 above). A bank holding company may also act as a broker with respect to forward contracts based on a financial or nonfinancial commodity that also serves as the basis for an exchange-traded futures contract. This permits a bank holding company to act as agent in a forward contract that involves the same commodities and assessment of risk that underlie the permissible FCM activities of bank holding companies. This authority is not extended to forward contracts for the delayed sale of commercial products (such as automobiles, consumer products, etc.) or real estate.

Before the incorporation of the above transactions into the authority of Regulation Y, such activities had been previously approved individually by Board order. This section provides, as historical examples, summaries of such activities that were previously approved by Board order. Such orders led to the incorporation of the nonbanking activity into the April 1997 Regulation Y "laundry list." The reader of these examples should only consider the current provisions for "other transactional services" as found in section 225.28(b)(7)(v) of Regulation Y. There should be no reliance on previous Board order commitments, supervisory policies, and interpretations that relate to this nonbanking activity that were in existence before April 21, 1997, unless such provisions remain. Certain former provisions or commitments may no longer be applicable.

3255.0.1 BROKERING OPTIONS ON SECURITIES ISSUED OR GUARANTEED BY THE U.S. GOVERNMENT AND ITS AGENCIES AND OPTIONS ON U.S. AND FOREIGN MONEY-MARKET INSTRUMENTS

A bank holding company applied for the Board's approval under section 4(c)(8) and section 225.21(a) of the Board's Regulation Y to engage de novo, through a wholly owned indirect subsidiary, in certain futures commission merchant and broker-dealer activities. One of the activities proposed for Board approval consisted of engaging in brokerage activities with respect to options on certain physicals, that is, securities issued or guaranteed by the U.S. government and its agencies and U.S. and foreign money-market instruments. The Board concluded that an option on a physical appears to serve the same function as other instruments in that it offers the investor a means to hedge portfolio risk. The Board had previously approved applications to engage in discount securities brokerage for retail customers with respect to corporate securities, and had added discount securities brokerage to the list of permissible nonbanking activities for bank holding companies generally. As a broker for options on physicals, it was stated that the indirect subsidiary would act solely as agent on behalf of nonaffiliated persons for the purchase and sale of options.[1] The services performed by a broker of options on the proposed securities appeared to be similar to those of other brokers. The Board thus concluded on December 8, 1983, that the proposal was closely related to banking (1984 FRB 238).

3255.0.2 BROKERING OPTIONS IN FOREIGN CURRENCY ON EXCHANGES REGULATED BY THE SEC

A BHC applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.21(a) of the Board's Regulation Y to engage

1. A broker of options on U.S. government and agency securities and options on money market instruments is a securities broker under the securities laws.

de novo, through a wholly owned subsidiary, in executing and clearing options in foreign currency. The Board referenced its approval to a previous order regarding the brokering of options on certain financial physicals (see subsection 3255.0.1 above). The Board concluded that its rationale for this prior action was equally applicable to the brokerage of options in foreign exchange. The Board noted that the applicant had been active in the cash and forward markets for foreign currency and had the expertise to provide the proposed services to customers. The Board concluded on March 19, 1984, that, in the manner proposed, the applicant's proposal to broker options in foreign currency was closely related to banking (1984 FRB 368).

In considering the potential for adverse effects, the Board took into account and relied on the regulatory framework established pursuant to law by the SEC for the trading of options. In addition, the Board noted that the applicant would not trade any of the options involved for its own account.

3255.0.3 EXECUTING AND CLEARING CFTC-REGULATED OPTIONS ON BULLION AND FOREIGN EXCHANGE ON AUTHORIZED COMMODITY EXCHANGES

A BHC applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.21(a) of the Board's Regulation Y to engage de novo through its wholly owned subsidiary in executing and clearing options. As part of that request, the BHC requested the Board to approve the executing and clearing of CFTC-regulated options on bullion and foreign exchange on authorized commodity exchanges. In making a determination that the activity was closely related to banking, the Board noted—

1. that it previously determined the brokering of futures and options on futures in bullion and foreign exchange to be a permissible nonbanking activity under the former section 225.25(b)(18) of Regulation Y (currently section 225.28(b)(7)(iv));
2. that options on physicals serve essentially the same function as futures and options on futures; and
3. that the brokering of options on certain physicals, that is, U.S. government securities, money market instruments, and options on foreign currency regulated by the SEC, is closely related to banking (1984 FRB 368, see subsection 3255.0.2, above).

The Board determined that the proposed CFTC-regulated options on physicals are functionally and operationally comparable devices for hedging investment-portfolio risk. The Board also determined that the applicant's proposal was substantially similar to proposals to engage in options activities previously approved by the Board. It noted that the applicant had been active in the cash and forward markets for bullion and foreign currency and that it possessed the expertise to provide the proposed services to customers. The Board therefore concluded the activity to be closely related to banking and approved the application on June 5, 1984, in the manner proposed (1984 FRB 591).

Under Regulation Y, a bank holding company may engage in—

1. underwriting and dealing in government obligations and money market instruments (see section 3260.0.1),
2. certain investing and trading activities as principal, and
3. buying and selling bullion and related activities.[1]

A bank holding company may engage or trade as principal in the following:

1. foreign exchange
2. forward contracts, options, futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on any rate, price, financial asset (including gold, silver, platinum, palladium, copper, or any other metal approved by the Board), nonfinancial asset, or group of assets, other than a bank-ineligible security,[2] if—
   a. a state member bank is authorized to invest in the asset underlying the contract;
   b. the contract requires cash settlement;
   c. the contract allows for assignment, termination, or offset prior to delivery or expiration, and the company—
      (1) makes every reasonable effort to avoid taking or making delivery of the asset underlying the contract; or
      (2) receives and instantaneously transfers title to the underlying asset, by operation of contract and without taking or making physical delivery of the asset; or
   d. the contract does not allow for assignment, termination, or offset prior to delivery or expiration and is based on an asset for which futures contracts or options on futures contracts have been approved for trading on a U.S. contract market by the Commodity Futures Trading Commission, and the company—
      (1) makes every reasonable effort to avoid taking or making delivery of the asset underlying the contract; or
      (2) receives and instantaneously transfers title to the underlying asset, by operation of contract and without taking or making physical delivery of the asset
3. forward contracts, options,[3] futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on an index of a rate, a price, or the value of any financial asset, nonfinancial asset, or group of assets, if the contract requires cash settlement

Before the incorporation of these activities involving investment transactions as principal into the authority of Regulation Y, certain of the activities had been approved individually by Board order. Following the Board's adoption of the April 1997 revised Regulation Y, a bank holding company can continue to trade in foreign exchange and bank-eligible securities. Bank holding companies, however, are no longer required to have a separate subsidiary to provide advice to customers when engaging in trading activities as principal.

This section provides, as historical examples, summaries of such activities that were previously approved by Board order. Such orders may have led to the incorporation of the nonbanking activity into the April 1997 Regulation Y "laundry list." The reader of these examples should only consider the current regulatory provisions as currently found in section 225.28(b)(8) of Regulation Y. Only minimum reliance should be placed on previous Board order commitments, supervisory policies, and interpretations that relate to this nonbanking activity that were in existence before April 21, 1997, unless such provisions remain currently. Certain former provisions or commitments may no longer be applicable.

3260.0.1 UNDERWRITING AND DEALING IN GOVERNMENT OBLIGATIONS AND MONEY MARKET INSTRUMENTS

A bank holding company may engage in underwriting and dealing in obligations of the United States, general obligations of states and their

1. A bank holding company is authorized to buy, sell, and store gold, silver, copper, platinum, and palladium bullion, coins, bars, and rounds, and any other metal approved by the Board.
2. See sections 3260.0.4.6 and 3920.0.
3. This does not include acting as a dealer in options based on indexes of bank-ineligible securities when the options are traded on securities exchanges. These options are securities for purposes of the federal securities laws.

political subdivisions, and other obligations that state member banks of the Federal Reserve System may be authorized to underwrite and deal in under 12 U.S.C. 24 and 355. This activity includes banker's acceptances and certificates of deposit, under the same limitations as would be applicable if the activity were performed by the bank holding company's subsidiary member banks or its subsidiary nonmember banks as if they were member banks. See Regulation Y, section 225.28(b)(8)(i) and section 3240.0.

3260.0.2 FOREIGN EXCHANGE

A bank holding company may engage as principal in foreign exchange. See Regulation Y, section 225.28(b)(8)(ii)(A).

3260.0.3 DEALING IN GOLD, SILVER, PLATINUM, AND PALLADIUM BULLION AND COINS

On September 27, 1973, the Board approved a foreign banking organization's request to acquire 30 percent of the voting shares of a domestic company engaged in the trading and arbitrage of gold and silver bullion on various exchanges and in the open market. The subsidiary is enabled to participate in the domestic gold bullion market under 12 U.S.C. 24 (para. 7), which specifically authorized national banks to deal in bullion.

The Board found that buying and selling gold and silver bullion and silver coin, dealing in exchange and silver futures, and arbitraging gold and silver in markets throughout the world are activities closely related to banking or managing or controlling banks. Thus, in approving the application, the Board maintained its basic position that it will benefit the public to allow foreign banks to engage in U.S. activities on a nondiscriminatory basis. (See 1973 FRB 775.)

In another case, a BHC applied for the Board's permission to engage in certain activities related to dealing in gold and silver bullion. The activities consisted of (1) buying and selling gold and silver bullion, bars, rounds, and bullion coins for its own account and the account of others; (2) financing the production, refining, and fabrication of gold and silver, including lending and borrowing gold and silver in connection with such financing; (3) arbitraging gold and silver in markets throughout the world; and (4) providing various incidental services for customers, such as arranging for the safe custody, assaying, and shipment of gold and silver.[4]

The Board determined previously that many of the proposed activities are permissible for BHCs. A BHC may engage in the purchase and sale of gold and silver for its own account and for the account of others.[5] The Board believed the assaying and arranging for transport to be part of this activity.[6] Financing activities for the production and fabrication of gold and silver are permissible activities. (See section 225.28(b)(1) of Regulation Y—Extending credit and servicing loans.) The Board approved the application by order on November 24, 1986 (1987 FRB 61). (See SR-87-7.)

In a subsequent case, a foreign banking organization presented its application to the Board, pursuant to section 4(c)(8) of the BHC Act, requesting permission to engage in the activity, through its wholly owned subsidiary, of purchasing and selling platinum coins issued by the Canadian and Australian governments as legal tender. The subsidiary would acquire the platinum coins issued by the Canadian and Australian governments solely for the purpose of effecting distribution. It would maintain an inventory of the coins. However, it would not purchase the coins for investment or speculation for its own account or offer its customers investment advice regarding their purchase and sale. It would enter into forward contracts with its customers. In considering the BHC's application, the Board noted that the Office of the Comptroller of the Currency had authorized national banks to purchase and sell platinum coins and that the proposed activities were operationally and functionally similar to purchasing and selling gold and silver coins. The Board found the purchasing and selling of platinum coins that function as legal tender to be closely related to banking. The related application was approved on June 25, 1990 (1990 FRB 681).

In a more recent case, a foreign bank subject to the provisions of the BHC Act applied for the

4. The applicant further notified the Board of its intention to purchase and sell for its own account options, futures, and options on futures on gold and silver bullion. The applicant committed to take positions in these investments only as a means of hedging its position in the underlying commodity, that is, gold and silver. The activity was thus permissible under section 4(c)(1)(C) of the BHC Act, which allows BHCs to furnish services to or perform services for such BHCs or its banking subsidiaries.

5. See 1986 FRB 345, 1986 FRB 146, 1985 FRB 467, and 1981 FRB 635.

6. The Board allowed another BHC to provide storage facilities, weighing, coin-counting, and transportation services for bullion and coin. (See 38 *Fed. Reg.* 27,552 (1973).)

Board's permission under section 4(c)(8) of the act and section 225.23 of Regulation Y for its section 20 subsidiary to trade platinum coin and bullion for its own account. The Office of the Comptroller of the Currency has determined that a national bank may engage in this activity. (See OCC Interpretive Letter No. 553, May 2, 1991, relying, in part, on the fact that several countries had recently introduced platinum coins.) The Board had not previously determined that this activity was closely related to banking under section 4(c)(8) of the act. As stated previously, it had determined that the purchase and sale of platinum coins that function as legal tender is an activity that is closely related to banking. (See 1994 FRB 346 and 1990 FRB 681.) The Board had also approved as a nonbanking activity, under Regulation K, trading in platinum by bank holding company subsidiaries located abroad (1994 FRB 177 and 1990 FRB 552). On the basis of these decisions, the Board concluded that the proposed activity is closely related to banking. (See 1995 FRB 190.)

With respect to palladium, a bank holding company applied for the Board's approval under section 4(c)(8) of the act and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) to engage de novo through a wholly owned asset-management subsidiary that will be established to serve as the general partner of limited partnerships (the partnerships) for investing in a wide variety of commodities and exchange-traded and over-the-counter instruments, including trading in precious metals. The partnerships would trade and invest in coin and bullion consisting of such precious metals as palladium, platinum, gold, and silver.

The Board has previously determined that it is closely related to banking under the act for bank holding companies to trade in all the instruments and commodities it proposed for the partnerships, except palladium.[7] Banks currently are permitted to engage in palladium trading.[8] Therefore, the Board concluded that trading palladium coin and bullion is closely related to banking within the meaning of section 4(c)(8) of the act.

7. See 12 C.F.R. 225.28(b)(6)(iv), 1987 FRB 61 (trading gold and silver bullion and coin), and 1995 FRB 190 (trading platinum coin and bullion for a BHC's own account).

8. See OCC Interpretive Letters Nos. 683 (1995) and 553 (1991).

3260.0.4 ENGAGING AS PRINCIPAL IN DERIVATIVES INVOLVING FINANCIAL ASSETS AND NONFINANCIAL ASSETS OR GROUPS OF ASSETS

A bank holding company may engage as principal in forward contracts, options, futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on any rate, price, financial asset, nonfinancial asset, or group of assets, other than a bank-ineligible security. A financial asset includes gold, silver, platinum, palladium, copper, and any other metal approved by the Board. See Regulation Y, section 225.28(b)(8)(ii)(B).

3260.0.4.1 Trading for a Company's Own Account in Futures, Options, and Options on Futures Based on U.S. Government Securities and Certain Money Market Instruments

A foreign bank, subject to the provisions of the BHC Act, applied to the Board under section 4(c)(8) and section 225.23 of the Board's Regulation Y to engage through a wholly owned subsidiary in trading activities for its own account. The trading included futures, options, and options on futures based on U.S. government securities that are permissible investments for national banks (bank-eligible securities) and certain money market instruments.[9]

The Board had previously determined that BHCs could purchase derivative instruments based on government securities for the purpose of reducing interest-rate exposure. (See 12 C.F.R. 225.142, Statement of Policy Concerning Bank Holding Companies Engaging in Futures, Forward, and Option Contracts on U.S. Government and Agency Securities and Money Market Instruments.) Previously, the Board approved applications to trade in derivative instruments based on foreign exchange for the company's own account for other than hedging purposes. (See 1989 FRB 217.) Section 225.28(b)(7)(iv) and 225.28(b)(6)(iv) of Regulation Y detail a BHC's ability to act as futures commission merchant and to offer advice with regard to futures

9. See 1991 FRB 759 for a listing of the derivative instruments to be traded, which are listed in appendix A. The subsidiary would hedge its positions in these instruments with the instruments listed in appendix B of the order.

and options on futures on bank-eligible securities, respectively.

The purchasing and selling of derivative instruments that represent the right to purchase and sell bank-eligible securities is considered by the Board to be closely related to banking.[10] The experience gained by banks in dealing with the securities underlying these instruments would equip the banks to trade in instruments based on these securities. In addition, the derivative instruments based on money market instruments require a market judgment on interest rates. Banks have developed an expertise in such judgments through their lending and funding activities. The Board thus concluded on July 12, 1991, the activity of trading for a company's own account in derivative instruments based on bank-eligible securities and certain money market instruments to be closely related to banking. (See 1991 FRB 759).

3260.0.4.2 Dealing as a Registered Options Trader on Foreign-Exchange Options

A foreign bank subject to the BHC Act applied under section 4(c)(8) of the act to deal, through its wholly owned U.S. subsidiary, as a registered options trader (trader) on foreign-exchange options. As a trader, the subsidiary would act as dealer and market maker in such options to assist in the maintenance of a ''fair and orderly'' market on the designated exchange. A trader deals for its own account in order to maintain a ''fair and orderly'' market in certain options when a lack of price continuity or temporary disparity exists on options for which the trader makes a market. The subsidiary would be obliged to make a market in the proposed foreign-currency options, or bid and offer, for all traders who approach it on the designated exchange. The subsidiary would not be obliged in any way as to the price and quantity it bids and offers. A trader is permitted to ''leave the floor,'' that is, not trade, if it meets minimum trading levels each quarter.

The Board previously recognized that foreign-exchange activities have traditionally been conducted at banks and are permissible activities under the BHC Act.[11] The Board noted that the Office of the Comptroller of the Currency authorized national banks to deal in foreign-currency options as a trader on a securities exchange. It also noted that through bank participation in the interbank market for foreign-currency options, banks developed experience in dealing, market making, and risk management, which are deemed essential elements of the activities proposed. For these reasons and the facts presented in the BHC's application, the Board approved the nonbanking activity as being closely related to banking. The application was approved by the Board on July 30, 1990 (1990 FRB 776).

3260.0.4.3 Acting as a Specialist in Options on Foreign Exchange

A foreign bank subject to the BHC Act applied for the Board's approval under section 4(c)(8) of the act (12 U.S.C. 1843(c)(8)) and section 225.21(a) of the Board's Regulation Y (12 C.F.R. 225.21(a)) for its wholly owned subsidiary (the company) to act as the sole specialist in deutsche mark options on a specified exchange (the exchange). As a specialist, the subsidiary would act as a dealer and market maker in these options for the purpose of assisting in the maintenance of a fair and orderly market on the exchange.

The Board found the activity of engaging as a specialist in foreign-currency options on the exchange to be closely related to banking for purposes of section 4(c)(8) of the BHC Act. Banks provide services that are operationally similar to the activities proposed. The Board deemed banking organizations to be particularly well equipped to provide the proposed activities. The Board believes that banks possess substantial experience in dealing in foreign exchange and related services that are similar to the functions involved in the BHC's proposed specialist activity. Foreign-exchange activities were noted as having been traditionally conducted by banks that are major participants in all aspects of the foreign-exchange markets. Banks act as market makers in various currencies. Banks trade for their own account as well as for their customers in virtually all foreign-exchange markets and instruments, including trading in foreign-currency options on regulated exchanges, as proposed by this BHC applicant.

The Board believes the financial risk in this case to be sufficiently minimized since (1) the rules of the exchange allow the specialist to set

10. The applicant was not authorized to purchase derivative instruments based on securities or instruments that a state member bank may not purchase for its own account.

11. See 1989 FRB 217, 308, and 580.

the price and quantity that it will buy and sell in order to limit its risk in an adverse or volatile market; (2) the specialist is prohibited from speculating; and (3) the BHC has committed not to write unhedged options, having developed substantial experience with hedging from its existing foreign-currency and options business. The company will be a registered broker-dealer with the Securities and Exchange Commission (SEC) and will thus be subject to the SEC's net capital rule. The Board expects that the company will maintain capital adequate to support its activity and to cover reasonable expenses and losses at all times.

The Board considered its earlier decision (1986 FRB 141) to deny a proposal to act as a specialist in French franc options on the exchange, summarized in section 3700.8. The Board believes that the facts and circumstances in this case were different in several significant respects from the current situation. The current proposal did not raise the issues relating to potential conflicts of interest and risk raised by the earlier decision (1986 FRB 141). The markets for deutsche marks and deutsche mark options are more liquid than they were for French francs at that time. Further, the market for foreign-currency options has broadened significantly on the exchange, and the involvement of commercial banks in that market has become more widespread. The Board approved the BHC's application by order on June 22, 1989. (See 1989 FRB 580.)

3260.0.4.4 Acting as a Dealer, Broker with Respect to Interest-Rate and Currency Swaps and Related Transactions

A bank holding company applied pursuant to section 4(c)(8) of the BHC Act and section 225.23(a) of the Board's Regulation Y for its wholly owned subsidiary to engage de novo in—

1. intermediating in the international swap markets by acting as originator and principal in interest-rate swap and currency-swap transactions;
2. acting as an originator and principal with respect to certain risk-management products such as caps, floors, and collars, as well as options on swaps, caps, floors, and collars (swap-derivative products);
3. acting as a broker or agent with respect to the foregoing transactions and instruments; and
4. acting as an adviser to institutional customers regarding financial strategies involving interest-rate and currency swaps and swap-derivative products.

The Board has permitted bank holding companies under section 4(c)(8) of the act to provide advice in connection with interest-rate and currency swaps, interest-rate caps, and similar transactions.[12] (See 1987 FRB 59 and 1989 FRB 308.) However, the Board had not previously approved the remaining activities proposed under section 4(c)(8) of the act. The Board determined that the remaining activities proposed are closely related to banking for the reasons summarized below.

Intermediating in the International Swap Market; Acting as an Originator and Principal with Respect to Certain Risk-Management Products—Caps, Floors, Collars, and Options on Swaps, Caps, Floors, and Collars

1. Banks, in particular, the money center banks, do conduct the proposed intermediation

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12. Swap terminology:

Interest-rate swap. An exchange between two counterparties of different payment streams arising out of fixed-rate and floating-rate payment obligations. The exchange is made using the same currency and is calculated by reference to a mutually agreed-upon ‘‘notional'' principal amount.

Currency swap. An exchange between two counterparties of a fixed-rate interest obligation in one currency for a fixed-rate interest obligation in another currency. Currency swaps may involve an initial physical exchange of principal at an agreed-upon current exchange rate or an exchange of interest payments in different currencies on an agreed-upon notional amount with no actual transfer of principal. In either case, there will be periodic exchange of fixed-rate interest payments over the course of the swap. Upon maturity, there would be a re-exchange of the original principal amounts.

Cap. An agreement under which one party purchases from the other a promise to pay, at predetermined future times, the excess, if any, of a specified floating interest rate over a fixed per annum rate. Caps may be sold separately or packaged with an interest-rate swap.

Floor. An agreement under which one party purchases a promise by another to pay the amount, if any, by which a specified floating interest rate is lower than a fixed per annum rate at specified times during the life of the agreement. Floors may be sold separately or packaged with an interest-rate swap.

Collar. The simultaneous sale of a cap and purchase of a floor, or purchase of a cap and sale of a floor.

Agent or broker in swap market. An agent or broker in the swap market locates, for a fee, a suitable counterparty for a party seeking to enter into a swap agreement.

Intermediary in swap market. A party that is willing to step between the two parties of a swap agreement and act as a principal counterparty with each of the other participants, thus taking on the credit risk of each of the participants. Upon entering into a swap with one counterparty, the intermediary enters into an equivalent and offsetting swap with another counterparty.

activities within the international swap market.

2. Banks have participated in the swap markets for several years as end-users, entering into swaps and purchasing swap-derivative products in order to hedge other business risks or to match assets and liabilities.

Acting as a Broker or Agent with Respect to These Transactions and Instruments

1. Banks provide services that are operationally similar to the proposed activities.
2. The Board had previously determined that acting as a broker with respect to foreign-exchange forward transactions is closely related to banking since banks have historically engaged in the provision of assistance with respect to foreign exchange. (See 1983 FRB 221.) Currency swaps are very similar to foreign-exchange forward transactions. The primary difference is the exchange of interest rates in connection with currency swaps. Interest-rate swaps are similar to currency swaps in that they involve agreements to exchange different payment streams that arise out of a prescribed principal amount. Similarly, caps, floors, and collars involve agreements to pay an amount by reference to a prescribed interest rate.

The Board approved the application on June 26, 1989 (see 1989 FRB 582), subject to the commitments included in the order to minimize the potential risk (that is, credit, price, basis, portfolio, and operations risk) and the possible conflicts of interest.

3260.0.4.5 Currency Swaps for Hedging a BHC's Own Position in Foreign Currency

A foreign bank, subject to section 4 of the BHC Act, applied for the Board's permission to acquire, through its wholly owned subsidiary, all the shares of a company located in New York, New York. The acquired company would engage in several nonbanking activities. One of the activities, not previously approved by the Board for BHCs, consisted of entering into currency-swap transactions for hedging the BHC's own position in foreign currency. The Board previously found that banks engage in this activity and thus concluded that the activity is closely related to banking.[13] In conducting this activity, the applicant is to use the same policies, quantitative limitations, and internal controls and audit programs applicable to its trading in futures, options, and options on futures and similar contracts used for hedging, including the guidelines in the Board's policy statement.[14] The application was approved on August 15, 1990 (1990 FRB 860).

3260.0.4.6 Derivative Transactions as Principal (Commodities Underlying Derivative Contracts)

On June 27, 2003, the Board amended section 225.28 of Regulation Y (12 C.F.R. 225.28(b)(8)(ii)(B)), effective August 4, 2003, to permit bank holding companies (BHCs) to enter into commodity derivative contracts (commodity contracts) that are settled by the BHC receiving and transferring title to the underlying commodity instantaneously, by operation of contract, without taking physical possession of the commodity. The Board also modified the existing condition in Regulation Y that generally prevented BHCs from engaging as principal in a physically settled commodity contract unless the contract specifically provides for assignment, termination, or offset before delivery (the contractual offset requirement).

The restrictions in Regulation Y that were effective before August 4, 2003, were designed to reduce the potential that BHCs would become involved in and bear the risks of physical possession, transport, storage, delivery, and sale of bank-ineligible commodities. These restrictions ensured that the commodity derivatives business of a BHC was largely limited to acting as a financial intermediary that facilitates transactions for customers who use or produce commodities or are otherwise exposed to commodity-price risk as part of their regular business.

The former Regulation Y derivatives restrictions, however, impeded the ability of BHCs to participate substantially in certain derivatives markets. Notably, in some over-the-counter (OTC) forward markets (U.S. energy markets, for example), the physically settled derivative contracts traded by market participants do not specifically provide for assignment, termination, or offset prior to delivery and, thus, did not conform to the contractual offset requirement of

13. See 1989 FRB 582.

14. Statement of Policy Concerning Bank Holding Companies Engaging in Futures, Forward and Options Contracts on U.S. Government and Agency Securities and Money Market Instruments. See 12 C.F.R. 225.142 (establishing guidelines for trading in forward, futures, and option contracts on financial instruments).

Regulation Y. Moreover, participants in these markets generally settle contracts by temporarily taking and making delivery of title to the underlying commodities and, thus, did not comply with the requirement in Regulation Y that the BHC make every reasonable effort to avoid taking or making delivery of the asset underlying the contract (the delivery avoidance requirement).

Financial intermediary participants in these markets generally enter into back-to-back derivative contracts with third parties that effectively offset each other. That is, financial intermediaries in these markets that enter into a contract to buy, for example, a certain number of barrels of oil from a certain counterparty in a certain future month generally also will enter into another contract, before the expiration of the original contract, to sell the same number of barrels of oil to another counterparty in the same future month on substantially identical delivery terms. These market practices typically result in the creation of a chain of contractual relationships that begins with a commodity producer, passes through a number of intermediaries who have entered into matched contracts both to buy and sell the same commodity at the same future time, and ends with a purchaser that intends to take physical delivery of the commodity. On the maturity date of the derivative contracts, the producer will be responsible for making physical delivery, and the ultimate buyer will be responsible for accepting physical delivery, while each intermediate participant in the chain will be deemed, by operation of contract, to have instantaneously received and transferred legal title to the commodity.

The Board believes that a BHC that takes title to a commodity on an instantaneous, pass-through basis takes no risk that is greater than or different in kind from the risk that the BHC has as a holder of a commodity derivative contract that met the former requirements of Regulation Y. Instantaneous receipt and transfer of title to (but not physical possession of) commodities does not appear to involve the usual activities relating to, or risks attendant on, commodity ownership. Instead, such transactions involve the routine operations functions of passing notices, documents, and payments—functions that BHCs regularly perform in their role as financial intermediaries in other markets. Moreover, although BHCs that receive and transfer title to commodities on an instantaneous, pass-through basis face default risks, they are not significantly different than the default risks associated with cash-settled derivative contracts or derivative contracts that include the assignment, termination, or offset provisions previously required by Regulation Y. In addition, banking organizations that engage in derivatives activities, including the modified Regulation Y commodity derivatives activities, will remain subject to the general securities, commodities, and energy laws and the rules and regulations of the Securities and Exchange Commission, the Commodity Futures Trading Commission (CFTC), and the Federal Energy Regulatory Commission.

For the above reasons, the Board modified Regulation Y by changing the delivery avoidance requirement to allow BHCs to take or make delivery of title to commodities underlying commodity derivative transactions on an instantaneous, pass-through basis. A BHC takes and makes delivery of title to a commodity on an instantaneous, pass-through basis for purposes of Regulation Y only if the BHC takes delivery of title to the commodity from a seller and immediately thereafter makes delivery of title to the commodity to a buyer. Accordingly, the revised delivery avoidance requirement does not provide authority for a BHC to take physical delivery of commodities for use or investment or to make physical delivery of commodities out of the inventory of the BHC. In other words, the BHC must not be the original seller of the commodity in the initial position in the delivery chain or the ultimate buyer of the commodity in the last position in the delivery chain.

The Board's modification of Regulation Y also changed the contractual offset requirement to permit BHCs to participate in physically settled derivative markets in which the standard industry documentation does not allow for assignment, termination, or offset. In particular, the modified Regulation Y allows BHCs to enter into commodity contracts that do not require cash settlement or specifically provide for assignment, termination, or offset before delivery so long as the contracts involve commodities for which futures contracts have been approved for trading on a U.S. futures exchange by the CFTC (and the BHC complies with the revised delivery avoidance requirement).[15]

15. The CFTC publishes annually a list of the CFTC-approved commodity contracts. See, for example, Commodity Futures Trading Commission, *FY 2001 Annual Report to Congress* 126. With respect to granularity, the Board intends this requirement to include all types of a listed commodity. For example, any type of coal or coal derivative contract would satisfy this requirement, even though the CFTC list specifically approves only Central Appalachian coal.

The Board's modifications of the derivatives provisions in Regulation Y are effective for all BHCs. (See 2003 FRB 385.)

3260.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Investment transactions as principal		225.25(b)(8)		
Investing and trading activities—engaging as principal	1843(c)(8)—section 4(c)(8) of the BHC Act	225.28(b)(8)(ii)		
BHCs can (1) take and make delivery of title to commodities underlying commodity derivatives contracts on an instantaneous, pass-through basis and (2) enter certain commodity derivative contracts that do not require cash settlement or specifically provide for assignment, termination, or offset prior to delivery		225.28(b)(8)(ii)(B)		2003 FRB 385

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Effective December 31, 1980, the Board amended section 225.28(b) of Regulation Y (12 C.F.R. 225.28(b)(2)(i)) to include the performance of real estate appraisals in the list of activities permissible for bank holding companies to engage in. The Board concluded that banks perform real estate appraisals either in connection with extensions of credit involving real estate lending or as a discrete activity. In addition, such an appraisal activity calls upon the necessary skills and resources often possessed by banking organizations. The Board thus determined that the activity of performing appraisals of real estate is closely related to banking and that its performance by bank holding companies will yield net benefits to the public.

In addition to authorizing the appraisals of real estate as a nonbanking activity, the Board has previously determined by order that the appraisal of certain types of personal property, both tangible and intangible, is closely related to banking (1985 FRB 118). Providing personal property appraisals was added to the list of permissible nonbanking activities in Regulation Y. It was combined with the already-approved activity of providing real estate appraisals (12 C.F.R. 225.28(b)(2)(i)). The action was approved by the Board on October 31, 1986, effective December 15, 1986, without any conditions. In permitting bank holding companies to engage in the activity of providing valuations of companies, the Board noted that the commercial lending and trust departments of banks commonly make valuations of a broad range of tangible and intangible property, including the securities of closely held companies. Providing valuations of companies necessarily involves the appraisal of various types of intangible personal property, such as securities of closely held corporations, as well as any tangible personal property that a company might possess.

Banks currently engage in the appraisal of personal property through their trust departments. Trust departments value private business interests for their own trust accounts and other types of personal property in a customer's estate for probate and tax purposes. Banks engage in property appraisal activities in connection with secured lending activities and routinely appraise property which they take as collateral on loans, including perishable commodities, durable goods, computer software, crops, livestock, machinery, and equipment.

Banks also engage in appraisal activities in connection with their leasing activities. With regard to leasing, banks determine the residual value of leased property, such as vehicles and equipment, in order to establish the terms of a lease. Some money-center banks have appraised aircraft and locomotives, in connection with their leasing or lending transactions. Finally, banks may become involved in personal property appraising when they appraise real property, since certain types of real property, such as factories or apartment buildings, contain fixtures or other personal property that must be evaluated separately to determine the value of the real property.

3270.0.1 SCOPE OF INSPECTION

As noted within the subsequent inspection procedures, a sampling of real estate and personal property appraisals is to be reviewed to determine whether the appraised value of the property is reasonable and the documentation supports the appraisal.

Regulatory appraisal standards for federally related transactions are discussed below and must be considered in determining the scope of the inspection. The types, components, and procedures that should be used in evaluating real estate appraisals are included in section 2231.0, which contains guidelines for use by bank holding companies and subsidiaries for real estate appraisal and evaluation programs. Personal property appraisal involves estimating or determining the value of property other than real property.

3270.0.2 APPRAISAL STANDARDS FOR FEDERALLY RELATED TRANSACTIONS

The Board approved, on June 27, 1990, Appraisal Standards for Federally Related Transactions[1] that represent amendments to Regulation H (12 C.F.R. 208) and Regulation Y (12 C.F.R. 225) that are designed to protect federal financial and public policy interests in real estate transactions requiring the services of an appraiser. The regulations are intended to supplement the Board's appraisal guidelines currently in effect. Section

1. "Federally related transaction" refers to any real estate–related financial transaction entered into on or after August 9, 1990, that (1) the Board or any regulated institution engages in or contracts for and (2) requires the services of an independent appraiser.

208.50 of Regulation H refers to the appraisal standards for federally related transactions entered into by state member banks. The appraisal standards for federally related transactions are found in subpart G, section 225 of Regulation Y. The amendments were the result of implementing provisions of title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) regarding real estate appraisals. The Regulation Y amendments identify which transactions require an appraiser (section 225.63),[2] set forth minimum standards for performing appraisals (section 225.64), and distinguish those appraisals requiring the services of a state-certified appraiser from those requiring a state-licensed appraiser (section 225.63). The effective dates are August 9, 1990, for the appraisal standards and July 1, 1991, for the appraiser certification and licensing requirements. Other provisions address appraiser independence (section 225.65), professional association membership, and competency.

3270.0.3 APPRAISER'S QUALIFICATIONS

With respect to an institution's selection of appraisers, examiners need to consider the following:

1. The professional certification, license, or other recognition of the competence of the appraiser. For real estate appraisals, the appraiser must have the proper state certification or license required by section 225.63 of Regulation Y. Examiners should also consider the September 1992 Guidelines for Real Estate Appraisal and Evaluation Programs. For personal property appraisals, the appraiser's qualifications might be evidenced by certification from a nationally recognized personal property appraisal organization or they may be supported by license or other recognition of the competence of the appraiser.
2. The reputation and standing of the specialist in the view of his peers and others familiar with the person's capability of performance.
3. The relationship, if any, of the appraiser to the bank holding company in order to determine independence and objectivity.
4. The appraiser's documented accomplishments (for example, the appraiser's personal "qualifications statement" or job history resume).
5. Whether the appraiser's experience and knowledge or expertise relates to the property appraised.
6. Whether the appraiser meets continuing-education requirements for licensing or certification. Membership or the absence of membership in any particular appraisal organization should not be accepted as prima facie evidence of an appraiser's qualifications.

2. The Appraisal Standards for Federally Related Transactions that are found in Regulation Y were amended, effective December 28, 1998, to exclude from the Board's appraisal requirements transactions involving the underwriting of or dealing in mortgage-backed securities. The amendment permits bank holding company subsidiaries engaged in the underwriting of and dealing in securities to underwrite and deal in mortgage-backed securities without demonstrating that the loans underlying the securities are supported by appraisals that meet the Board' s appraisal requirements.

3270.0.4 KEY COMPONENTS OF A PERSONAL PROPERTY APPRAISAL REPORT

When reviewing personal property appraisals, the appraisal should describe the following:

1. the kind of value being determined, such as fair market value, liquidation value, replacement/reproduction value, etc.
2. the property being valued
3. the detailed procedures used to estimate the values, such as—
   a. analysis of comparable sales,
   b. estimation and analysis of income, and
   c. the appraised values as of a specific date
4. the name of the individual who made the appraisal and who is responsible for its validity and objectivity (to the person receiving the appraisal, to third parties, and to the public)
5. the personal qualifications data of the appraiser

3270.0.5 APPRAISAL OF CONSTRUCTION AND CONSTRUCTION-ANALYSIS SERVICES

The activity of providing construction-analysis services, including appraisal of construction projects at various stages of development and disbursement of construction loan funds in accordance with the terms of the loan agreement, is included within the permissible activities of real estate appraising and loan servicing.

3270.0.6 INSPECTION OBJECTIVES

1. To determine what financial effect the activity has on the parent holding company and the bank subsidiaries.
2. To determine whether the company has formal written policies and procedures. For real estate appraisals, the policies and procedures should be consistent with the Guidelines for Real Estate Appraisal and evaluation programs in section 2231.0.
3. To determine if there is compliance with the appraisal standards for federally related transactions detailed in the Board's Regulations H and Y.
4. To determine whether the appraisals were performed on an independent basis.
5. To determine whether the individuals performing the appraisals are qualified and that the appraisals are reasonable.
6. To determine whether the appraisals are current, complete, and reasonably accurate.
7. To determine if real estate appraisals are performed by state-licensed or state-certified appraisers.

3270.0.7 INSPECTION PROCEDURES

1. Review the company's financial statements and determine if there are any factors or trends that could have an adverse impact on the parent holding company or the bank subsidiaries.
2. Review the company's policies and procedures to determine that the following are present:
   a. Adequate minutes are prepared of the board and board committee meetings.
   b. Professional liability insurance and blanket bond coverage, if appropriate, are in place and the coverage appears sufficient.
   c. Only qualified individuals are authorized to perform appraisals.
3. Review a sampling of the real estate and personal property appraisals to determine how a value is derived and whether this value is adequately substantiated.
4. For the appraisals reviewed in procedure 3, determine the reason for each appraisal. If it is for the purpose of valuing collateral for a loan extended by or to a bank affiliate, does the value appear realistic in relation to the loan amount?
5. Check for compliance with section 106(b) of the 1970 Amendments of the BHC Act (prohibition against tie-in arrangements). (See section 3500.0.)

3270.0.8 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Real estate appraisal activity approval		225.28(b)(2)(i)		1980 FRB 962 and 984 1997 FRB 275
Acquisition of a nonbanking subsidiary that performs valuations of companies and of large blocks of stock for a variety of purposes				1985 FRB 118
Personal property appraisal activity approval		225.28(b)(2)(i)		1986 FRB 833 1997 FRB 275
Appraisal standards for federally related transactions		225 subpart G, 225.61–225.67	4–053	1990 FRB 639 1999 FRB 50

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The activities of check-guaranty and check-verification services permit bank holding companies to authorize the acceptance by subscribing merchants of certain personal checks tendered by the merchant's customers in exchange for goods and services, and to purchase validly authorized checks from merchants in the event the checks are subsequently dishonored.

The Board determined, previously, that check-guaranty services were closely related to banking, and had approved applications by bank holding companies on a case-by-case basis to engage in the activity (1979 FRB 263 and 1981 FRB 740). See also 1999 FRB 582, 1996 FRB 348 (fraud-detection services), 1994 FRB 1107, and 1995 FRB 492 (ATM network services).

The Board noted the potential for unfair competition or conflicts of interest with respect to the authorization of checks not drawn on affiliated banks. To minimize this possibility, the Board has maintained a condition in Regulation Y, noted in previous orders, stating that the check guarantor cannot discriminate against checks drawn on unaffiliated banks.

3320.0.1 INSPECTION OBJECTIVES

1. To determine the extent of exposure to guaranteed bad-check losses.
2. To determine whether management is qualified and effective in controlling losses.
3. To determine whether administrative and operating procedures and check-guaranty and check-verification transactions are processed in accordance with established Board or Board committee authorization policies and procedures, including adequate internal control procedures.
4. To determine whether recordkeeping and data processing are adequate and current to avoid losses resulting from outdated or inaccurate information.
5. To determine whether any significant contingent liabilities exist.
6. To determine whether the financial condition of the nonbanking subsidiary will have an adverse influence on the financial condition of the consolidated corporation.

3320.0.2 INSPECTION PROCEDURES

1. Review financial statements to determine the financial condition of the company and past and current operating trends. Test the accuracy of those records against the financial statements for each material asset, liability, and equity account.
2. Review the minutes of the board of directors and executive committees and correspondence exchanged with the company's legal counsel.
3. Review authorization records for check-guaranty and check-verification services for adequacy to determine whether check clearance is verified and whether the company has an accurate record of its contingent liability for guaranteed checks.
4. Review collection records to determine whether follow-up procedures on purchased guaranteed bad checks are adequate and whether they evidence timely collection contacts and successful recoveries.
5. Determine whether collection-problem checks are turned over to attorneys or collection agencies for appropriate collective or legal action on a timely basis.
6. Review the company's history of bad-check losses and the current status of uncollected bad checks, and determine whether adequate reserves have been set aside for those losses.
7. Determine whether fee calculations and billing procedures ensure accuracy and propriety.

3320.0.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Engage de novo through a new nonbank subsidiary in the activity of check verification				1979 FRB 263
Retail check-authorization and check-guaranty activities				1981 FRB 740 1999 FRB 582
Fraud-detection services				1996 FRB 348 (see footnote 15)
Amendment of Regulation Y adding check verification as a permissible activity		225.28(b)(2)(iii)		1986 FRB 833 1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The Board authorized the addition of operating a collection agency to the list of approved activities. A collection-agency subsidiary seeks to collect payment on the overdue bills of debtors, charging the party submitting the claim a flat dollar amount or a specified percentage commission contingent on the amount collected. The Board determined that operating a collection agency is closely related to banking as banks engage in debt-collection activities for loans they originate and service, including overdue credit-card accounts.

The Board recognized the potential for unfair competition and conflicts of interest through the operation of a collection agency. Accordingly, the Board established the following conditions on operating a collection agency:

1. The collection agency shall not obtain the names of customers of competing collection agencies from an affiliated depository institution that maintains trust accounts for those agencies
2. The collection agency shall not provide preferential treatment to an affiliate or a customer of such affiliate seeking collection of an outstanding debt.

3330.0.1 INSPECTION OBJECTIVES

1. To determine whether the collection agency is obtaining the names of customers of competing collection agencies from an affiliated depository institution that maintains trust accounts for those agencies.
2. To determine whether the collection agency provides preferential treatment to an affiliate or a customer of such affiliate seeking collection of an outstanding debt.
3. To determine what effect the activity has on the parent company, its subsidiaries, and the overall consolidated organization, and whether the company or activity evidences a going concern.
4. To determine whether the company has formal written policies and operating and internal control procedures to successfully administer the activity.
5. To determine the extent of management expertise, experience, and involvement with the administration of the activity.
6. To determine the extent of compliance with laws, regulations, and interpretations associated with the activity, including the Fair Credit Reporting Act, Fair Debt Collection Practices Act, and Right to Financial Privacy Act.
7. To determine whether the company administers formal training programs which include proper operating and compliance methods.
8. To determine whether any significant contingent liabilities exist and whether those liabilities resulted from the failure of the bank holding company or its nonbanking subsidiary to fulfill its responsibilities as an agent for its customers.

3330.0.2 INSPECTION PROCEDURES

1. Review financial statements to determine the financial condition of the company and past and current operating trends. Test the accuracy of the financial statements against the company's financial records and other supportive corroborating evidence.
2. Review the minutes of the board of directors and executive committees, and correspondence exchanged with the company's legal counsel with regard to possible contingency losses.
3. Review collection records for adequacy, and determine whether the amount of payments received is independently verified.
4. Review collection records—tickler files—to determine whether follow-up procedures on acquired accounts are adequate and whether they evidence timely collection contacts and successful recovery rates.
5. Determine whether appropriate legal action is used and authorized by customers on a timely basis.
6. Determine whether fee calculations and billing procedures ensure accuracy and propriety.
7. Review parent company and subsidiary administrative and operating policies, and determine whether the collection agency is prohibited from obtaining the names of customers of competing collection agencies from an affiliated depository institution that maintains trust accounts for those agencies.
8. Review customer lists and billings and any prioritized collection schedules, and determine whether the collection agency is providing any preferential treatment to an affiliate or a customer of such affiliate seeking collection of an outstanding debt.

3330.0.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Amendment of Regulation Y adding collection-agency services as a permissible activity		225.28(b)(2)(iv)		1986 FRB 833 1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Section 4(c)(8) of the BHC Act (Operating a Credit Bureau) — Section 3340.0

A bank holding company that engages in the activity of operating a credit bureau gathers, stores, and disseminates factual information relating to the identity and paying habits of consumers. Credit bureaus then provide this information for a fee to credit grantors, such as retailers, banks, and finance companies, to enable the institutions to arrive at prudent credit-granting decisions. The Board concluded that the activity is closely related to banking as banks maintain credit files and analyze credit information as part of their consumer-lending function.

The Board recognized that possible adverse effects could result from a potential conflict of interest when a bank holding company performs credit bureau activities. For example, under the Fair Credit Reporting Act, a credit bureau is required to investigate the accuracy of any item of information disputed by a consumer (15 U.S.C. 1681(i)). A bank holding company credit bureau may not conduct an impartial investigation if the disputed information originates with an affiliate. The Board thus imposed the condition that a credit bureau could not provide preferential treatment to a customer of an affiliated financial institution.

Regulation Y allows bank holding companies to engage only in consumer-credit-reporting activities rather than credit-reporting activities concerning large commercial institutions.

3340.0.1 Inspection Objectives

1. To determine whether the activity is limited to only consumer-credit-reporting activities.
2. To determine whether the bank holding company gives preferential treatment to a customer of an affiliated financial institution.
3. To determine the adequacy of internal policies and operating and internal control procedures.
4. To determine whether any significant contingent liabilities exist which arose from the failure of the holding company and its nonbanking subsidiary to fulfill their responsibilities as an agent for their customers.
5. To determine whether appropriate steps have been taken to ensure compliance with the Fair Credit Reporting Act, Equal Credit Opportunity Act, and Right to Financial Privacy Act.
6. To determine whether adequate controls exist to prevent unauthorized access into any computerized credit bureau credit files to preserve the confidentiality of the information stored for customers' use.

3340.0.2 INSPECTION PROCEDURES

1. Review the company's financial statements for accuracy, and determine if there are any factors or trends that could have an adverse impact on the parent company or its banking or nonbanking subsidiaries.
2. Review recordkeeping practices, and determine whether such management information systems are adequate to service customers and limit the risk of loss resulting from weak recordkeeping activities.
3. Review customer logs or client lists, and determine whether the activity is limited to only consumer-credit-reporting activities.
4. Review the activity and billings for a customer of an affiliated financial institution, and compare those findings to the activities and billings of other customers. Determine whether the bank holding company is giving preferential treatment to a customer(s) of an affiliated financial institution.
5. Review the company's policies and operating and internal control procedures for the activity, and determine whether they have been documented and whether they are being tested for compliance as part of the company's internal/external audits.
6. Review correspondence with legal counsel, and determine whether any significant contingent liabilities exist due to the failure of the holding company and its nonbanking subsidiary to fulfill their responsibilities as an agent for their customers.
7. Determine whether internal control procedures and compliance audits test for compliance with the Fair Credit Reporting Act, Equal Credit Opportunity Act, and Right to Financial Privacy Act.
8. Determine what steps have been taken to prevent unauthorized access to any computerized credit bureau credit files to preserve the confidentiality of the information stored for customers' use.

3340.0.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Denial of a BHC's proposal to engage in providing credit ratings for large businesses				1985 FRB 118
Activity is closely related to banking and a permissible nonbanking activity for consumer-credit reporting only		225.28(b)(2)(v)		1986 FRB 833 1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Section 106(b) of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972(b)) generally prohibits a bank from tying a product or service to another product or service offered by the bank or any of its affiliates. A prohibited tie-in can occur if a bank (1) varies the consideration for a product or service (the ‘‘tied product’’) from the bank or any of its affiliates, or (2) requires the customer to purchase another product or service from the bank or any of its affiliates as a condition for providing a product or service to a customer.

The intent behind section 106(b) is to affirm the principles of fair competition by eliminating the use of tie-in arrangements that suppress competition. Section 106(b) is intended to prevent banks from using their market power over certain products (specifically credit) to gain an unfair competitive advantage in other products. The restrictions of section 106(b) on banks are broader than those of the antitrust laws, as no proof of economic power in the tying-product market or anticompetitive effects in the tied-product market are required for a violation to occur. Although banks, like their nonbank competitors, were already subject to general antitrust prohibitions on tying, section 106 was enacted because Congress concluded that special restrictions were necessary given the unique role of banks in the economy.

Although the 1970 legislation amended the Bank Holding Company Act, it is applicable to all commercial banks, whether or not they are subsidiaries of holding companies. The term ‘‘company’’ is not used in section 106(b) but in another part of the 1970 legislation. Therefore, it is not relevant to section 106.

3500.0.1 ANTI-TYING RESTRICTIONS AND OTHER PROVISIONS

Section 106 of the BHC Act Amendments has five restrictions that are applicable to banks. These restrictions apply only when the products are separately available for purchase. The first two restrictions prohibit conditions constituting traditional tie-in arrangements; restrictions three and four prohibit reciprocal-dealing arrangements; and the fifth, with certain exceptions, prohibits an exclusive-dealing arrangement. Exempted from these prohibited conditional transactions are practices known as ‘‘traditional banking practices.’’

Specifically, section 106 prohibits a bank, in any manner, from fixing or varying the consideration for extending credit, leasing or selling property of any kind, or furnishing any service on the condition or requirement that the customer—

1. obtain additional credit, property, or service from the bank, other than a loan, discount, deposit, or trust service (a ‘‘traditional bank product’’);
2. obtain additional credit, property, or service from the bank’s parent holding company or the parent’s other subsidiaries;
3. provide additional credit, property, or service to the bank, other than those related to and usually provided in connection with a loan, discount, deposit, or trust service;
4. provide additional credit, property, or service to the bank’s parent holding company or any of the parent’s other subsidiaries; or
5. not obtain other credit, property, or service from the competitors of the bank, the bank’s parent holding company, or the parent’s other subsidiaries, except that the lending bank may impose conditions and requirements in a credit transaction to ensure the soundness of the credit.

3500.0.1.1 Section 106 Statutory Exceptions

The statutory ‘‘traditional bank product exception’’ of section 106 permits a bank to tie a product to a traditional bank product (a loan, discount, deposit, or trust service) offered by that bank, but not by any affiliated bank or nonbank. For example, a bank could condition the use of its messenger service on a customer’s maintaining a deposit account at the bank. Although the statutory traditional bank product exception appears to have been effective in preserving traditional relationships between a customer and bank, the statutory exception is limited in an important way. It does not extend to transactions involving products offered by affiliates. Section 106(b) provides a second statutory exception that authorizes the Board to prescribe exceptions by regulation or order when it determines that an exception will not be contrary to the purposes of this section.

Before the 1997 implementation of the revisions to Regulation Y, the tie-in provisions of section 106(b) applied to bank holding companies and their nonbank subsidiaries as though they were banks. The nonbank provisions were applied under section 4(c)(8) of the Bank Holding Company Act. A bank holding company and any nonbank subsidiary were prohibited from tying their products or services either to other products or services offered by the same company or to products or services offered by any affiliate, including a bank affiliate. With the 1997 revisions, *the tie-in prohibitions were eliminated for bank holding companies and their nonbank subsidiaries, except when electronic benefit transfer services are provided.* Bank holding companies and their nonbank subsidiaries are still subject to anti-tying restrictions with respect to electronic benefit transfer services, as set forth in section 7(i)(11) of the Food Stamp Act of 1977 (7 U.S.C. 2016(i)(11)). (See the tie-in arrangements discussion in section 3070.0.7.4.)

Section 106 prohibits not only tying arrangements, but reciprocity arrangements. Reciprocity arrangements condition the availability of, or vary the consideration of, one product on a customer's providing of another product. The statutory prohibition on reciprocity arrangements contains an exception to preserve traditional banking relationships. The exception provides that a bank may condition the availability of a product or service on the customer's providing to the bank some product or service "related to and usually provided in connection with" a loan, discount, deposit, or trust service. Like the statutory traditional bank product exception to the tying prohibition, the reciprocity prohibition does not apply to interaffiliate transactions. The 1997 Regulation Y revision extends the statutory exception for traditional banking relationships to cover such interaffiliate transactions.

3500.0.2 ANTI-TYING REGULATORY EXCEPTIONS

3500.0.2.1 Traditional Bank Product Exception

The traditional bank product exception of Regulation Y (12 C.F.R. 225.7 (b)(1)) permits a bank to extend credit, lease or sell property, provide any service, or fix or vary its consideration on the condition that a customer obtain a traditional bank product (that is, a loan, discount, deposit, or trust service) from an affiliate of the bank. Effective in April 1997, the traditional bank product exception was extended to affiliates' transactions. Interaffiliate arrangements are exempt to the same extent as interbank arrangements.

Section 106 and the Board's regulation also allow—

1. a broker-dealer affiliate to tell a customer that it can only receive placement services (or a discount thereon) if it obtains a loan from an affiliated bank, and
2. a broker-dealer affiliate to tell a customer that it can only receive placement services (or a discount thereon) if it obtains a loan from a nonbank affiliate.

This regulatory exception is a limited extension of the traditional bank product exception provided in section 106 and is coextensive with the statuatory exception.[1]

3500.0.2.2 Safe Harbor for Combined-Balance Discounts

A bank may vary the consideration for any product or package of products based on a customer's maintaining a combined minimum balance in certain products specified by the bank (eligible products) if—

1. the bank offers deposits, and all such deposits are eligible products, and
2. balances in deposits count at least as much as nondeposit products toward the minimum balance. (See Regulation Y, section 225.7 (b)(2).)

A question was raised as to whether insurance products may be included among the products offered by a bank as part of a combined-balance discount program (eligible products) operated pursuant to the Board's safe harbor, if the program otherwise meets the requirements of the safe harbor. If insurance products are deemed to be eligible products, it was also questioned whether the principal amount of annuity products may be counted towards the minimum balance, and whether insurance premiums may be counted towards the minimum balance for

1. See Chairman Greenspan's August 23, 1994, letter to the Honorable John D. Dingell, Chairman, Committee on Energy and Commerce, U.S. House of Representatives. See AD-94-68, August 26, 1994, and the Board's issuance of anti-tying exceptions on December 15, 1994, and April 20, 1995.

non-annuity insurance products. Board staff issued the following response to these questions.

To qualify for the Board's safe harbor, all deposits must be eligible products under the combined-balance discount program, and deposit balances must be weighed at least as much as nondeposit products towards the minimum balance.[2] The Board's requirement that deposit balances be weighed at least as much as nondeposit products towards the minimum balance was included in the safe harbor to allow banks and their affiliates to price products they include in a combined-balance program in an economically rational way—while limiting the bank's ability to use product weighting to require the purchase of certain nontraditional products. This requirement specifically provides for the inclusion of certain products with values that could be greater than the typical retail deposit, while allowing deposits to remain a viable way for customers to reach the minimum balance.

On this basis, any financial products offered by a bank or its affiliates, including insurance products, may be properly included among the eligible products in that bank's combined-balance discount program. The principal amount of an annuity may be counted in determining the size of the customer's balance in eligible products, as may the premiums paid in a given policy year on non-annuity insurance products. The principal amount of an annuity is closely analogous to the principal amount of a deposit, as both represent a customer's initial cash investment with the relevant financial institution. Similarly, insurance premiums are money actually paid by the customer to the insurance underwriter.

3500.0.2.2.1 Combined-Balance Discount—Members of a Household or Family, Taken Together, May Constitute a ''Customer''

A bank holding company's legal counsel raised a question whether members of a household or family, taken together, may be considered a ''customer'' for purposes of the combined-balance discount safe harbor set forth in section 225.7(b) of Regulation Y.

The bank holding company desired to offer its customers discounts on the products and services of its subsidiary banks if a customer's household maintains a specific minimum balance with its banks and their affiliates. The minimum balance would be computed by adding the balances held by an individual customer in products (both bank and nonbank) specified by the company's affiliated bank, including deposits, to balances held in the same products by all other members of that customer's household.

Board staff noted that the safe harbor would be available only if all deposits are eligible products under the combined-balance discount program and deposit balances are weighed at least as much as nondeposit products towards the minimum balance. Board staff also noted that aggregating balances held at the bank holding company's affiliates by members of a family or household would make it easier for customers to achieve the minimum balance necessary to receive the favorable pricing on bank products and services, and thus appear to be pro-consumer and not anticompetitive.

Accordingly, Board staff opined[3] that the term ''customer,'' as used in section 225.7(b)(2) of Regulation Y, may include separate individuals who (1) are all members of the same immediate family (as defined in section 225.41(b)(3) of Regulation Y) and (2) reside at the same address. Staff also indicated that the bank holding company must not operate the program in an anticompetitive manner.

3500.0.2.3 Safe Harbor for Foreign Transactions

The Board has adopted a safe harbor from the anti-tying rules for transactions with corporate customers that are incorporated or otherwise organized and that have their principal place of business outside the United States. This safe harbor also applies to individuals who are citizens of a foreign country and are not resident in the United States. (See Regulation Y, section 225.7(b)(3).) However, the safe harbor would not protect tying arrangements involving a customer that is a U.S.-incorporated division of a foreign country. Furthermore, the safe harbor would not shelter a transaction from other antitrust laws if they were otherwise applicable.

3500.0.3 APPLICABILITY OF ANTI-TYING EXCEPTIONS TO ENTITIES OTHER THAN BANKS

The Board's anti-tying rules adopt a definition of bank that clarifies that any exemptions afforded

2. Eligible products under the safe harbor are those ''products specified by the bank'' as part of the combined-balance discount program. (See 12 C.F.R. 225.7(b)(2).)

3. See the Board staff opinion dated November 26, 2002.

to banks would generally be applicable to credit card and other limited-purpose institutions and to U.S. branches and agencies of foreign banks.

3500.0.4 TIE-IN ARRANGEMENTS RELATING TO NONBANK BANKS

The Competitive Equality Banking Act, effective August 10, 1987, made nonbank banks and their affiliates subject to the anti-tying provisions of section 106 of the BHC Act Amendments and to the insider and preferential lending restrictions of section 22(h) of the Federal Reserve Act. Thus, the nonbank bank may not condition the granting of credit on the purchase of a product or service from the parent holding company or vice versa.

3500.0.5 VOLUNTARY VERSUS INVOLUNTARY TIE-IN ARRANGEMENTS

Voluntary as well as involuntary tie-ins have been a matter of concern. The customer, hoping to enhance his or her chance for bank accommodations (especially during periods of tight money), voluntarily patronizes subsidiaries of the bank. Voluntary tie-ins are said to have ‘‘just as serious’’ an economic effect as coercive ones because competition would be lessened to the extent that the tied product is no longer bought entirely on its economic merit.

3500.0.6 INSPECTION OBJECTIVES

1. To determine whether the bank holding company has adequate policies and procedures to ensure the compliance of its subsidiary banks with section 106(b) of the BHC Act Amendments.
2. To evaluate transactions between a company organized as a direct subsidiary of a bank holding company and affiliated banks for their compliance with federal laws and regulations and related policy guidance.
3. To ascertain, to the extent possible, that neither voluntary nor involuntary overt tie-in arrangements are present in credits extended by any BHC subsidiary bank.

3500.0.7 INSPECTION PROCEDURES

The Federal Reserve, as part of its inspections of bank holding companies and their subsidiaries and its examinations of state member banks and their subsidiaries, has had a long-standing policy that examiners should evaluate compliance with section 106(b) and the prohibitions against tie-in arrangements. During the course of all holding company inspections, the examiners should follow the inspection instructions set forth below, focusing on a bank holding company’s responsibility to oversee and safeguard against potentially illegal tie-in arrangements by its banking subsidiaries and affiliates. The examiner’s review should focus on (1) the bank holding company’s establishment and monitoring of the internal controls and procedures for each bank subsidiary or affiliate and on its monitoring of compliance with written policies and procedures pertaining to tie-in arrangements, (2) the training provided to management and staff who are responsible for monitoring banking subsidiaries and affiliates for compliance with anti-tying provisions, and (3) the extent to which the bank holding company oversees internal loan reviews of pertinent bank extensions of credit to borrowers whose credit facilities or services may be susceptible to improperly imposed tie-in arrangements in violation of section 106(b) or the Board’s regulations.

At a minimum, during the course of all bank holding company inspections, examiners are to thoroughly evaluate the organization’s monitoring and overseeing of compliance with section 106(b) and the Board’s regulations by its banking subsidiaries and affiliates. Examiners should use the following inspection procedures and checklist below. In addition, before beginning an inspection of any banking organization, Reserve Bank staff should evaluate the activities of the target banking organization to determine whether it presents an increased opportunity for a bank to illegally tie its services or credit facilities to other services or facilities. If it does, the current inspection procedures, plus the checklist, should be used to check for compliance with section 106(b) and the Board’s anti-tying regulations.

Following are the inspection procedures for tie-in arrangements:

1. Review the BHC’s internal controls that are intended to prevent illegal tie-ins by its banks and affiliates.
2. Review the holding company’s program to monitor subsidiary banks and their affiliates’ internal loan reviews. Such reviews should

include the inspection of credit files for loan agreements and other documentation that place conditions or restrictions on borrowers that indicate a possible tie-in. The bank holding company should conduct or oversee internal loan reviews of files for insurance applications, particularly if an insurance subsidiary maintains a consistently high penetration rate on credits granted by bank affiliates, which could indicate the presence of voluntary or involuntary tie-in arrangements.

3. Ascertain whether the bank holding company has policies requiring the periodic review of servicing contracts between the bank and its affiliates, as well as policies for reviewing the substance of actual transactions, to determine—
   a. the capacity in which the bank and its tied affiliate are acting (for example, is it acting as principal on its own behalf or as an agent for the affiliate bank);
   b. the nature of all services provided; and
   c. billing arrangements, frequency of billing, method of computation, and basis for such fees.
4. Review the bank holding company's policy statement on the prohibition of tie-in arrangements, the adequacy of training provided to employees, and whether management and its internal auditors have periodically confirmed that there is full compliance with such internal policy.
5. Report on the "Examiner's Comments and Matters Requiring Special Board Attention" page any significant comments on tie-ins reviewed. (Comments would also be appropriate if controls to prevent tie-ins had not been established.)

3500.0.8 INSPECTION CHECKLIST FOR COMPLIANCE WITH THE TIE-IN ARRANGEMENT PROHIBITIONS

Provided below is a checklist of questions that has been designed to ensure, during Federal Reserve inspections, an examiner's adequate, complete evaluation of a banking organization's compliance with section 106(b) of the BHC Act Amendments and the Board's anti-tying regulations. The checklist generally addresses written policies and procedures in this area and training and internal audit programs.

A. Written Policies and Procedures

1. Does the bank holding company have a holding-company-wide policy statement that—
   a. states that certain tie-in arrangements are illegal and
   b. provides specific examples of impermissible practices relevant to the product line?
2. Do the bank holding company's bank subsidiaries and affiliates have copies of the holding company's written policy statement referred to in question A.1, and has it been revised, as appropriate, to provide specific examples of impermissible practices relevant to the particular product line?
3. Is the policy statement reviewed and updated regularly to ensure that the examples accurately reflect the products and services offered by the holding company and its subsidiaries?
4. Does the policy statement contain procedures for employees to follow if questions arise concerning the application of the prohibitions against tie-ins?
5. If the bank holding company does not have the holding-company-wide policy statement referred to in question A.1 (and that meets the requirements in questions A.2, 3, and 4), does each of the holding company's banking subsidiaries and affiliates have its own policy statement that meets those requirements?

B. Training

1. Do the bank holding company and its bank and nonbank subsidiaries have training programs to ensure that employees are aware of the prohibitions against illegal tie-in arrangements?
2. Is participation in a training program required of new employees?
3. Is an annual compliance-review program required for employees?
4. If the inspection involves a bank that is not part of a holding company structure, does the bank meet the requirements described in questions B.1 through 3?

C. Audit Procedures

1. Do the bank holding company and its bank subsidiaries and affiliates have annual audit procedures in place to ensure compliance with the prohibitions on tie-in arrangements?
2. Do counsel or other competent experts review

transactions in the appropriate areas of the bank holding company, its bank subsidiaries, and affiliates to ensure compliance with the prohibitions against tie-in arrangements?

A foreign bank that operates in the United States through a branch, agency, or commercial lending company subsidiary, or that owns or controls a U.S. bank or Edge corporation, must conform to the nonbanking restrictions of the BHC Act.

The BHC Act also provides exemptions that permit a foreign bank with U.S. banking operations to engage in certain nonbanking activities. As with domestic bank holding companies, pursuant to section 4(c)(8), a foreign bank may own shares of any company that the Board has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. As described below, a foreign bank may also qualify for additional exemptions pursuant to sections 4(c)(9) and 2(h). These latter exemptions apply only to foreign banking institutions and seek to limit the extraterritorial application of federal banking law while preserving national treatment of these institutions' domestic counterparts.

3510.0.1 REGULATION K

Regulation K implements the nonbanking restrictions of section 4 of the BHC Act by applying the limits to any foreign banking organization (FBO). An FBO is (1) any foreign bank that either operates a branch, agency, or commercial lending company subsidiary in the United States, or that controls a U.S. bank, and (2) any company that owns or controls a foreign bank described in (1). (See 12 C.F.R. 211.21(o) to apply these limits.) Regulation K requires any FBO that engages in activities in the United States to conform those activities to the nonbanking restrictions by either limiting the activities or obtaining an exemption. (See 12 C.F.R. 211.23(n).)

Regulation K implements statutory exemptions from the BHC Act for certain activities of foreign banks. Sections 4(c)(9) and 2(h) of the BHC Act provide exemptions that are available to ''qualifying foreign banking organizations'' (QFBOs).

Section 2(h) allows a foreign company that is principally engaged in banking business outside the United States to own foreign affiliates that engage in impermissible nonfinancial activities in the United States, subject to certain requirements. These include requirements that the foreign affiliate must derive most of its business from outside the United States and that it may engage in the United States in only the same lines of business it conducts outside the United States.

Section 4(c)(9) allows the Board to exempt foreign companies from the nonbank activity restrictions of the BHC Act when the exemption would not be substantially at variance with the BHC Act and would be in the public interest. Under this authority, the Board has exempted, among other things, all foreign activities of QFBOs from the nonbanking prohibitions of the BHC Act.

To qualify as a QFBO (and, hence, to be eligible for the 4(c)(9) and 2(h) exemptions), an FBO must chiefly engage in banking activities worldwide; that is, it must demonstrate that more than half of its business is banking and that more than half of its banking business is outside the United States. Regulation K sets forth a multistep test for determining when an FBO primarily engages in banking activities worldwide. This so-called QFBO test is met if ''disregarding [the FBO's] U.S. banking business, more than half of [the FBO's] worldwide business is banking; and more than half of its banking business is outside the United States.'' (See 12 C.F.R. 211.23(a).)

Under the QFBO test, an FBO must satisfy at least two of the following criteria:

1. the banking assets held outside the United States must exceed total worldwide nonbanking assets;
2. revenues derived from the business of banking outside the United States must exceed total revenues derived from its worldwide nonbanking business; or
3. net income derived from the business of banking outside the United States must exceed total net income derived from its worldwide nonbanking business.

In addition, the FBO must meet at least two of the following criteria:

1. the banking assets held outside the United States must exceed the banking assets held in the United States;
2. revenues derived from the business of banking outside the United States must exceed the revenues derived from the business of banking in the United States; or
3. net income derived from the business of banking outside the United States must exceed

net income from the business of banking in the United States.

Regulation K provides rules on how to calculate the assets, revenues, and net income of the FBO and its foreign subsidiaries.[1] In calculating assets, revenues, or net income held or derived from the business of banking ''outside the United States,'' the FBO may not include assets, revenues, or net income, whether held or derived directly or indirectly, of a subsidiary bank, a branch, an agency, a commercial lending company, or another company engaged in the business of banking in the United States, including any territory of the United States, Puerto Rico, Guam, American Samoa, or the Virgin Islands.

Regulation K provides a broader definition of ''banking'' for use in the QFBO test. A QFBO may include assets, revenues, and income from any activity that a U.S. bank holding company may perform abroad pursuant to section 211.10 of Regulation K, if the activity is conducted by the foreign bank itself or by a subsidiary. Thus, for example, an FBO may treat certain insurance and securities activities as banking activities for determining QFBO status. (See 12 C.F.R. 211.23(b)(2) and 211.10.) However, this broader definition of banking applies to the QFBO test only. It does not define the types of permissible banking activities that a QFBO may perform in the United States.

An FBO may be unable to satisfy the QFBO test because a substantial part of its financial activities is conducted outside of the foreign bank itself. This might occur, for example, when an FBO conducts substantial life insurance activities through a parent or sister company of the foreign bank. Such an FBO may nevertheless be eligible for some more limited exemptive relief if it meets a modified test. Under this modified test, when calculating assets, revenues, or net income for the prong of the QFBO test that measures whether more than half of an FBO's business is banking, the FBO may count banking activities conducted outside the foreign banking chain. For the other prong of the test, which determines whether more than half of an FBO's banking business is outside the United States, the banking-chain requirement would still apply. An FBO that meets this modified test will be eligible for all of the exemptions other than the exemption for limited commercial and industrial activities provided under section 2(h) (as implemented by 12 C.F.R. 211.23(f)(5)).[2] However, any foreign banks within the FBO that independently meet the QFBO test would be eligible for all of the exemptions available to QFBOs. The modified test is intended to limit the extraterritorial effect of the BHC Act on foreign firms and to avoid penalizing a consolidated group that engages mostly in activities permissible for a U.S. banking organization.

An FBO that does not qualify, or that ceased to qualify for two consecutive years (as reported in the Annual Report of Foreign Banking Organizations, Form FR Y-7, that the FBO filed with the Board), is not eligible for the exemptions afforded by sections 2(h) and 4(c)(9). An FBO that does not qualify for these exemptions may only engage in activities in the United States that are permissible for a domestic bank holding company. An FBO that no longer qualifies under the QFBO test may seek a determination of continued eligibility from the Board. Otherwise, the FBO may only continue to engage in activities begun, or retain investments acquired, before the end of the first fiscal year in which it failed to qualify. Other activities or investments must cease or be divested within three months of the filing of the second FR Y-7, which demonstrates that the foreign bank no longer qualifies for the exemptions. The Board also has the authority to grant exemptive relief under Regulation K to foreign organizations that do not include foreign banks. (See 12 C.F.R. 211.23(e).)

3510.0.2 NONBANKING EXEMPTIONS FROM THE BHC ACT FOR QFBOs UNDER SECTIONS 4(C)(9) AND 2(H)

Sections 2(h) and 4(c)(9) of the BHC Act are exemptive provisions that seek to limit the extraterritorial impact of federal banking law. While there is considerable overlap in these two sections (for example, only a QFBO is eligible for both kinds of exemptions), they also have significant differences (for example, section 2(h) only exempts certain types of activities, whereas

1. A subsidiary is any company that either (1) has 25 percent or more of its voting shares directly or indirectly owned, controlled, or held with the power to vote by a company, including a foreign bank or a foreign banking organization, or (2) is otherwise controlled or capable of being controlled by a foreign bank or foreign banking organization. See 12 C.F.R. 211.21(z).

2. Any FBO that qualifies as a financial holding company (FHC) would be able to make merchant banking investments and investments in connection with its insurance business in the United States to the extent permitted for an FHC. The lack of eligibility for the exemption in section 211.23(f)(5) would not negate or otherwise affect such authority.

section 4(c)(9) may also exempt specific activities or investments upon Board order).

3510.0.2.1 Section 4(c)(9) of the BHC Act

Section 4(c)(9) of the BHC Act authorizes the Board to exempt the U.S. activities of a QFBO, through order or regulation, if the exemption ''would not be substantially at variance with the purposes of [the BHC Act] and would be in the public interest.'' The Board has implemented this provision in Regulation K to permit a QFBO to engage directly or indirectly in any activity outside of the United States; hold the shares of any company that engages in activities in the United States that are ''incidental'' to foreign business; hold a *noncontrolling* interest in any chiefly foreign company that engages in any activity in the United States, if the foreign company derives more than half its assets and revenues from outside the United States; or own or control voting shares of any company acquired in good faith in a fiduciary capacity as permitted by section 4(c)(4) of the BHC Act. An FBO is *not* permitted to own more than 10 percent of the shares of a foreign company that directly or indirectly engages in underwriting, selling, or distributing securities to an extent not permitted for bank holding companies.[3] (See 12 C.F.R. 211.23(f)(1), (2), (3), (4), and 5(i) and (ii).)

The provision that permits a QFBO to own shares of a foreign company that engages in incidental, international activities in the United States has been defined by interpretation. That is, an activity is ''incidental'' to a foreign company's activities outside of the United States only if it is an activity that an Edge or agreement corporation may perform in the United States. Section 211.6 of Regulation K defines the permissible activities of an Edge or agreement corporation.[4] An application to the Federal Reserve is not required before a QFBO engages in an activity that is incidental to international business under this exemption.

A QFBO may also request a specific exemption from the BHC Act under section 4(c)(9) to perform otherwise impermissible activities in the United States. The Board considers these requests on a case-by-case basis.

3510.0.2.2 Section 2(h) of the BHC Act

Section 2(h) of the BHC Act permits a QFBO to own or control the voting shares of a foreign company that is principally engaged in business outside of the United States and that engages directly or indirectly in activities in the United States that are the same as or related to the company's lines of business abroad.

Section 2(h) is designed to allow a QFBO that has foreign commercial or industrial affiliates to continue to hold those affiliates, even if the affiliate engages in activities in the United States that would ordinarily be prohibited by section 4 of the BHC Act. The U.S. activities must be the same kind of activity the affiliate conducts outside the United States and the foreign affiliate must be chiefly foreign, that is, it must derive more than half of its assets and revenues from outside the United States. The U.S. branches and agencies of a QFBO may not lend to an affiliate held under section 2(h) except on an arm's-length basis.

A QFBO may *not* engage in financial activities in the United States on the basis of section 2(h). Regulation K provides a list of activities that are considered ''financial.'' These activities should be referenced to Division H (Finance, Insurance, and Real Estate) of the Standard Industrial Classifications (SIC), as well as to selected activities in other divisions of the SIC that are considered financial in nature.[5]

3. Specifically, Regulation K permits a QFBO to (1) engage in activities of any kind outside the United States; (2) engage directly in activities in the United States that are incidental to its activities outside the United States; (3) own or control voting shares of any company that is not engaged, directly or indirectly, in any activities in the United States other than those that are incidental to the international or foreign business of such company; and (4) own or control voting shares of any company in a fiduciary capacity under circumstances that would entitle such shareholding to an exemption under section 4(c)(4) of the BHC Act if the shares were held or acquired by a bank.

4. Generally, these activities must have an international nexus and may consist of receiving deposits from foreign governments and persons; receiving deposits from other persons under certain conditions; holding or investing liquid funds in certain forms or instruments; engaging in certain credit activities or borrowing funds; receiving or collecting payments under certain conditions; performing foreign-exchange activities; acting as a fiduciary, an investment adviser, or a broker or performing other activities related to investing under certain conditions; providing banking services for employees; and engaging in other activities with prior Board approval. See 12 C.F.R. 211.6(a).

5. The North American Industry Classification System (NAIS) replaces the use of SIC codes. The NAICS codes differ from the SIC codes. To evaluate compliance with section 2(h) of the BHC Act, examiners should consult Regulation K directly when determining whether particular activities are permissible. Regulation K refers to NAICS codes.

Section 2(h) is implemented in Regulation K as follows: A QFBO may own or control voting shares of a foreign company that is engaged directly or indirectly in business in the United States other than that which is incidental to its international or foreign business, subject to the following limitations:

1. More than 50 percent of the foreign company's consolidated assets shall be located, and consolidated revenues derived from, outside the United States.[6] (See 12 C.F.R. 211.23(f)(5)(i).)
2. The foreign company shall not directly underwrite, sell, or distribute, nor directly own or control more than 10 percent of the voting shares of a company that underwrites, sells, or distributes, securities in the United States except to the extent permitted bank holding companies. (See 12 C.F.R. 211.23(f)(5)(ii), 12 C.F.R. 225.124, and section 3510.0.2.3.)

Regulation K places additional restrictions on the 2(h) exemption when a QFBO owns a foreign company that is a subsidiary. Specifically, the foreign company must be, or must control, an operating company. Its direct or indirect activities in the United States are subject to the following limitations:

1. The foreign company's activities in the United States shall be the same kind of activities or related to the activities engaged in directly or indirectly by the foreign company abroad, as measured by the "establishment" categories of the SIC. An activity in the United States shall be considered related to an activity outside the United States if it consists of supply, distribution, or sales in furtherance of the activity. (See 12 C.F.R. 211.23(f)(5)(iii)(A).)
2. The foreign company may engage in activities in the United States that consist of banking securities, insurance or other financial operations, or types of activities permitted by regulation or order under section 4(c)(8) of the BHC Act only under regulations of the Board or with the prior approval of the Board, subject to the following:
   a. Activities within Division H (Finance, Insurance, and Real Estate) of the SIC shall be considered banking or financial operations for this purpose, with the exception of acting as operators of nonresidential buildings (SIC 6512), operators of apartment buildings (SIC 6513), operators of dwellings other than apartment buildings (SIC 6514), operators of residential mobile home sites (SIC 6515), and operating title abstract offices (SIC 6541).
   b. The following activities shall be considered financial activities and may be engaged in only with the approval of the Board under section 211.23(g) of Regulation K:[7] credit reporting services (SIC 7323); computer and data processing services (SIC 7371 to 7379); armored car services (SIC 7381); management consulting (SIC 8732, 8741, 8742, and 8748); certain rental and leasing activities (SIC 4741, 7352, 7353, 7359, 7513, 7514, 7515, and 7519); accounting, auditing, and bookkeeping services (SIC 8721); courier services (SIC 4215 and 4513); and arrangement of passenger transportation (SIC 4724, 4725, and 4729).

The restriction in paragraph 2b. above reflects the fact that section 2(h) is not the source of authority for a QFBO to engage in banking, securities, or other financial activities in the United States through a subsidiary.

The section 2(h) exemption only applies to the nonfinancial, nonbanking activities of an FBO. To preserve competitive equity, the exemption does not permit an FBO to control a foreign nonbanking company that engages in, or that holds more than 5 percent of the voting shares of another company that engages in, banking, securities, insurance, real estate, or other financial activities in the United States. These activities may be performed only with Federal Reserve approval under section 4(c)(8) or 4(c)(9) of the BHC Act.

3510.0.2.3 Foreign Banks' Underwriting of Securities

A number of foreign banks, which are subject to

6. If the foreign company fails to meet the requirements of paragraph (f)(5)(i) (12 C.F.R. 211.23) for two consecutive years (as reflected in annual reports (FR Y-7) the FBO filed with the Board), the foreign company must be divested or its activities must be terminated within one year of the filing of the second consecutive annual report that reflects nonconformance with the requirements of paragraph (f)(5)(i), unless the Board grants consent to retain the investment under 12 C.F.R. 211.23(g).

7. Section 211.23(g) of Regulation K permits a foreign banking organization to request a case-by-case exemption from the nonbanking restrictions to engage in otherwise impermissible activities pursuant to section 4(c)(9) of the BHC Act.

the BHC Act, had participated as co-managers in the underwriting of securities that were distributed in the United States. These banks did not have the authority to engage in securities underwriting activity in the United States. The U.S. offices of affiliates of the foreign banks were used to engage in activities conducted in support of the underwriting transactions, for which these U.S. offices were compensated by the foreign bank. The foreign bank became a member of the underwriting syndicate but it did not distribute any of the securities in the United States or elsewhere. The foreign banks took the position that they were not engaged in underwriting in the United States because any underwriting obligation was booked outside the United States.

A foreign bank that is subject to the BHC Act may engage in underwriting activities in the United States only if it has been authorized under section 4 of that act. Section 225.124 of the Board's Regulation Y states that a foreign bank will not be considered to be engaged in the activity of underwriting in the United States if the shares to be underwritten are distributed outside the United States. In the transactions in question, all of the securities were distributed in the United States.

In 1985, the Board amended Regulation K in section 211.23(f)(5)(ii) to provide clarification that a foreign banking organization shall not ''directly underwrite, sell, or distribute, nor own or control more than 10 percent of the voting shares of a company that underwrites, sells, or distributes securities in the United States, except to the extent permitted bank holding companies.'' When proposing this provision, the Board stated ''...that no part of the prohibited underwriting process may take place in the United States and that the prohibition on the activity does not depend on the activity being conducted through an office or subsidiary in the United States.''

Regulation K defines ''engaged in business'' and ''engaged in activities'' to mean conducting an activity through an office or subsidiary in the United States. The Regulation K definition of ''engaged in business,'' adopted in 1979, however, does not authorize foreign banking organizations to evade regulatory restrictions on securities activities in the United States by using U.S. offices and affiliates to facilitate the prohibited activity. Also, the framework of the Gramm-Leach-Bliley Act (the GLB Act) requires that banking organizations meet certain financial and managerial requirements of the GLB Act and the Board's Regulation K to engage in these activities in the United States.

The Board therefore issued an interpretation on February 7, 2003 (effective February 19, 2003), clarifying that the underwriting by foreign banks of securities to be distributed in the United States is an activity conducted in the United States, regardless of the location at which the underwriting risk is assumed and the underwriting fees are booked. Consequently, any banking organization that wishes to engage in such activity must either be a financial holding company under the GLB Act or have authority to engage in underwriting activity under section 4(c)(8) of the BHC Act (so-called section 20 authority). Revenue generated by underwriting bank-ineligible securities in such transactions should be attributed to the section 20 company for those foreign banks that operate under section 20 authority. (See 12 C.F.R. 211.605.)

3510.0.3 GRANDFATHER RIGHTS

Section 8 of the International Banking Act (IBA) provides grandfather rights to foreign banks that operated a branch, agency, or subsidiary commercial lending company at the time of enactment of the IBA.

Section 8(c) of the IBA permanently grandfathers activities engaged in directly or through an affiliate on or before July 26, 1978, or for which an application to engage in such activities had been filed on or before that date.[8] Grandfathered nonbanking activities may not be expanded through the acquisition of any interest in or the assets of a going concern engaged in the same activities. The Board may, subject to opportunity for hearing, terminate these grandfather rights where it is necessary to prevent undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices in the United States. A foreign bank that is required to terminate its indirect grandfathered activity may retain ownership of the shares of the grandfathered company for a period of two years from the date of the Board's action.

Grandfather rights conferred under section 8(c) of the IBA shall terminate immediately upon the filing of an FHC declaration by the foreign bank or foreign company. With respect to a foreign bank or foreign company that did

8. The term ''affiliate'' means any company that controls, is controlled by, or is under common control with the foreign bank or the parent of the foreign bank.

not file an FHC declaration by November 12, 2001, the Board has the authority, giving due regard to the principle of national treatment and equality of competitive opportunity, to impose such restrictions and requirements on the conduct of any grandfathered activities as are comparable to those imposed on a U.S. FHC, including a requirement to conduct such activities in compliance with any prudential safeguards established under 12 U.S.C. 1828a.

3510.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Foreign banking organizations	1841(h) 1843(c)(9) 3106	211.23(f)(5)		
Underwriting of securities in the United States is an activity conducted in the United States		211.605	3–693	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

This section provides a ''grandfather'' exemption from the general prohibitions of section 4 for a small group of bank holding companies which are themselves banks. For such bank holding companies and their wholly-owned subsidiaries, the exemption provides for continued ownership of nonbank shares which were lawfully acquired and owned directly or indirectly prior to enactment of the Act (May 9, 1956). At the time of its enactment, this section accommodated only three bank holding companies.

It should be noted that this section, in referring to shares indirectly owned through subsidiaries, limits the exemption to ''wholly-owned subsidiaries.'' The reason for this limitation apparently ties to the Federal Reserve Act and other federal banking statutes which permit National and member banks to engage through wholly-owned operating subsidiaries in various bank-related activities.

It is required that the shares covered under this section have been continuously held since May 9, 1956. Such interpretation is in keeping with other sections of the Act.

Section 4(c)(11) (Authorization for BHCs to Reorganize Share Ownership Held on the Basis of Any Section 4 Exemption) Section 3530.0

Section 4(c)(11) was adopted to authorize bank holding companies to reorganize share ownership held on the basis of any section 4 exemption. Reorganization is permitted with respect to section 4(a)(2) grandfathered activities engaged in prior to June 30, 1968, retaining indefinite grandfather authority. Shares held pursuant to Board approval under section 4(c)(8) or any other section 4 exemption also come within section 4(c)(11)'s reorganization authority.

Under section 4(c)(11), a bank holding company is authorized to reorganize its share ownerships, shift its activities among its various entities and form new subsidiaries without Board approval as long as there is no change in the activities of the bank holding company system. Congress also felt it entirely appropriate for these companies to expand their activities so long as such expansion did not produce anticompetitive or other adverse effects. Accordingly, internal expansion of the grandfathered activities was permitted but the provision was added that this section does not authorize the grandfathered companies to acquire, either directly or indirectly, any interest in or the assets of any going concern outside the holding company system (unless the acquisition is pursuant to a contract entered into before June 30, 1968). Congress reasoned that purchasing a going concern engaged in the grandfathered activities of a holding company would tend to have an anticompetitive effect in that it would reduce the number of firms competing against each other in a given activity.

This section provided an exemption from the general prohibitions of section 4 for shares held or activities which became subject to the Act by the 1970 amendments.

Section 4(c)(12) provided not only for continued ownership of shares or performance of activities so held or performed as of December 31, 1970, but also for others permitted afterward by the Board. As stated in subparagraphs (A) and (B) of section 4(c)(12), the 10-year exemption applied if such bank holding companies: (A)(i) ceased to be bank holding companies by December 31, 1980; or (A)(ii) ceased to retain direct or indirect ownership of the nonbank shares or engage in the nonbank activities by December 31, 1980; or (B) complied with such other condition as the Board may prescribe.

A company was required to file an irrevocable declaration that it would cease to be a bank holding company by January 1, 1981, unless the Board granted it hardship exemption under section 4(d) of the Act. Such a company could then expand its nonbanking activities *de novo* without notification to the Board and could acquire a going concern nonbank company 45 days after informing the appropriate Reserve Bank of the proposed acquisition unless notified otherwise within that time. If an irrevocable declaration was not filed, then no acquisition could have been made or activities commenced under section 4(c)(12) except with prior Board approval. These limitations did not apply to acquisitions made pursuant to a binding commitment entered into before March 23, 1971.

Few bank holding companies have claimed an exemption under section 4(c)(12). It is unlikely that many situations involving section 4(c)(12) will be encountered by inspection personnel. However, if a 4(c)(12) company has committed to cease the nonbanking activities examiners must ensure that the divestiture has occurred.

3540.0.1 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Divestitures		225.138		
Successor rights				1977 FRB 946

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Section 4(c)(13) of the BHC Act governs the international activities of bank holding companies. In general, the act authorizes the Board to permit domestic bank holding companies to invest in companies that do no business in the United States except what is incidental to international or foreign business. Bank holding companies may invest in the same companies as Edge corporations.

3550.0.1 INVESTMENTS AND ACTIVITIES ABROAD

The investment provisions of Regulation K (sections 211.8, 211.9, and 211.10) implement section 4(c)(13) of the BHC Act. In general, an "investor" under Regulation K may invest, directly or indirectly, in a subsidiary or joint venture or may make portfolio investments, subject to the limits in section 211.8 and the general provisions in section 211.9(a). (See SR-02-03 and SR-02-02.)

Bank holding companies may invest in the same types of entities as Edge and agreement corporations. However, member banks may invest directly in only foreign banks; domestic or foreign organizations formed for the sole purpose of holding shares of a foreign bank; foreign organizations formed for the sole purpose of performing nominee, fiduciary, or other banking services incidental to the activities of a foreign branch or foreign bank affiliate of the member bank; and subsidiaries established pursuant to section 211.4(a)(8) of Regulation K (that is, a company that engages solely in activities in which the member bank is permitted to engage or that are incidental to the activities of the member bank's foreign branch). (See all sections of Regulation K for any other activity or investment authorizations, limitations, requirements, or prohibitions not discussed in this section.)

In general, the Board has limited the types of activities that a bank holding company may engage in through the ownership of foreign companies to banking or financially related activities, and to those that are necessary to carry on such activities. These include all of the activities permitted under section 211.10 of Regulation K and section 4(c)(8) of the BHC Act, including equity securities underwriting and management consulting. Many of the activities permitted abroad are not subject to the same limits as those imposed domestically under section 4(c)(8) (for example, brokerage of all types of insurance is permitted abroad).

Activities abroad, whether conducted directly or indirectly, are to be confined to activities of a banking or financial nature and to those that are necessary to carry on such activities. At all times, investors[1] must act in accordance with high standards of banking or financial prudence, having due regard for diversification of risks, suitable liquidity, and adequacy of capital. The Board follows the policy of allowing activities abroad to be organized and operated as best meets corporate policies. The following provides a limited discussion of general investment activities under Regulation K. The regulation should be referred to for more specific requirements and limitations.

In general, an investor may make (1) an investment in a subsidiary, (2) an investment in a joint venture, or (3) a portfolio investment in an organization. With regard to an investment in a subsidiary, the subsidiary must engage in activities authorized under section 211.10 of Regulation K, or in other activities that the Board has determined to be permissible (for a particular case). In the acquisition of a going concern, existing activities that are not otherwise permissible for a subsidiary may account for not more than 5 percent of either the acquired organization's consolidated assets or consolidated revenues. For an investment in a joint venture, no more than 10 percent of the joint venture's consolidated assets or consolidated revenues can be attributable to activities that are not listed in section 211.10.

For portfolio investments in an organization, the investor and its affiliates' total direct and indirect portfolio investments in an organization that is engaged in activities not permissible for joint ventures, when combined with all other shares in the organization (held under any other authority), cannot exceed—

1. 40 percent of the total equity of the organization, or
2. 19.9 percent of the organization's voting shares.

In addition to the individual investment limits, these portfolio investments are subject to an

1. For purposes of sections 211.8, 211.9, and 211.10 of Regulation K, a direct subsidiary of a member bank is deemed to be an investor.

aggregate equity limit. (See section 211.10(a)(15) of Regulation K.) For investments in organizations engaged in activities that are not permissible for joint ventures, when combined with shares held directly and indirectly by the investor and its affiliates under the equity dealing provisions of Regulation K, the investments cannot exceed—

1. 25 percent of the bank holding company's tier 1 capital, where the investor is a bank holding company;
2. 20 percent of the investor's tier 1 capital, where the investor is a member bank;[2] and
3. the lesser of 20 percent of any parent insured bank's tier 1 capital or 100 percent of the investor's tier 1 capital, for any other investor.

3550.0.2 INVESTMENT PROCEDURES

Except as the Board may otherwise determine, direct and indirect investments must be made in accordance with the general-consent, limited-general-consent, prior-notice, or specific-consent procedures of section 211.9 of Regulation K. The investment procedures of section 211.9(a) include the following requirements:

1. *Minimum capital adequacy standards.* The investor, the bank holding company, and the member bank must be in compliance with applicable minimum standards for capital adequacy set out in the capital adequacy guidelines. If the investor is an Edge or agreement corporation, the minimum capital required is total and tier 1 capital ratios of 8 percent and 4 percent, respectively.
2. *Composite rating.* For an investor to make investments under the general-consent or limited-general-consent procedures of sections 211.9(b) and (c), the investor and any parent insured bank must have received a composite rating of at least 2 at the most recent examination.
3. *Modification or suspension of procedures.* The Board may, at any time upon notice, modify or suspend the investment procedures for any investor or for the acquisition of shares of organizations engaged in particular kinds of activities.
4. *Long-range investment plan.* Any investor may submit a long-range investment plan to the Board for its specific consent. If approved by the Board, the plan shall be subject to the other procedures of section 211.9 only to the extent the Board determines is necessary to ensure the safety and soundness of the operations of the investor and its affiliates.
5. *Prior specific consent for initial investment.* For its initial investment in its first subsidiary or joint venture under subpart A of Regulation K, an investor must apply for and receive the prior specific consent of the Board, unless an affiliate previously has received approval to make such an investment.
6. *Expiration of investment authority.* Authority to make investments that was granted under prior-notice or specific-consent procedures shall expire one year from the earliest date on which the authority could have been exercised, unless the Board determines a longer period shall apply.
7. *Conditional approval; access to information.* The Board may impose such conditions on investment authority granted under section 211.9 as it deems necessary. The Board may also require termination of any activities conducted under subpart A of Regulation K, if an investor is unable to provide information on its activities or those of its affiliates that the Board deems necessary to determine and enforce compliance with U.S. banking laws.

3550.0.3 GENERAL CONSENT FOR WELL-CAPITALIZED AND WELL-MANAGED INVESTORS

The Board has granted its limited general consent to make investments by well-capitalized and well-managed investors. For these general-consent provisions to apply, the investor, any parent-insured bank, and any parent bank holding company must be well capitalized and well managed both before and immediately after the proposed investment. The investments are subject to the limitations discussed below.

3550.0.3.1 Individual Limit for Investment in a Subsidiary

The Board grants its general consent for investments by well-capitalized and well-managed investors, subject to certain investment limitations. For an investment in a subsidiary, the total amount that may be invested directly or indirectly (in one transaction or a series of transac-

2. For this purpose, a direct subsidiary of a member bank is deemed to be an investor.

tions) may not exceed 10 percent of the investor's tier 1 capital, where the investor is a bank holding company; 2 percent of the investor's tier 1 capital, where the investor is a member bank; or the lesser of 2 percent of the tier 1 capital of any parent-insured bank or 10 percent of the investor's tier 1 capital, for any other investor.

3550.0.3.2 Individual Limit for Investments in a Joint Venture

For individual investments in a joint venture, the total amount invested directly or indirectly (in one transaction or a series of transactions) may not exceed 5 percent of the investor's tier 1 capital, where the investor is a bank holding company; 1 percent of the investor's tier 1 capital, where the investor is a member bank; or the lesser of 1 percent of the tier 1 capital of any parent-insured bank or 5 percent of investor's tier 1 capital, for any other investor.

3550.0.3.3 Individual Limit for Portfolio Investment

For a portfolio investment, the total amount invested directly or indirectly (in one transaction or a series of transactions) in such company, general partnership, or unlimited-liability company cannot exceed the lesser of $25 million or—

1. 5 percent of the investor's tier 1 capital, in the case of a bank holding company or its subsidiary or an Edge corporation engaged in banking; or
2. 25 percent of the investor's tier 1 capital, in the case of an Edge corporation not engaged in banking.

3550.0.3.4 Aggregate Investment Limits

The amount of all investments made, directly or indirectly, during the previous 12-month period under section 211.9, when aggregated with the proposed investment, shall not exceed 20 percent of the investor's tier 1 capital, where the investor is a bank holding company; 10 percent of the investor's tier 1 capital, where the investor is a member bank; or the lesser of 10 percent of the tier 1 capital of any parent-insured bank or 50 percent of the tier 1 capital of the investor, for any other investor.

3550.0.4 LIMITED GENERAL CONSENT FOR AN INVESTOR THAT IS NOT WELL CAPITALIZED OR WELL MANAGED

3550.0.4.1 Individual Limit

For investors that are not well capitalized and well managed, the Board has granted limited general consent for an investor to make an investment in a subsidiary or joint venture, or to make a portfolio investment. The total amount invested, directly or indirectly (in one transaction or a series of transactions), cannot exceed the lesser of $25 million or 5 percent of the investor's tier 1 capital, where the investor is a bank holding company; 1 percent of the investor's tier 1 capital, where the investor is a member bank; or the lesser of 1 percent of any parent insured bank's tier 1 capital or 5 percent of the investor's tier 1 capital, for any other investor.

3550.0.4.2 Aggregate Limit

The amount of limited-general-consent investments made by such an investor directly or indirectly during the previous 12-month period, when aggregated with the proposed investment, cannot exceed 10 percent of the investor's tier 1 capital, where the investor is a bank holding company; 5 percent of the investor's tier 1 capital, where the investor is a member bank; and the lesser of 5 percent of any parent insured bank's tier 1 capital or 25 percent of the investor's tier 1 capital, for any other investor.

3550.0.5 CALCULATING COMPLIANCE WITH THE INDIVIDUAL AND AGGREGATE GENERAL-CONSENT LIMITS

When determining compliance with the individual and aggregate general-consent limits, an investment by an investor in a subsidiary can only be counted once, notwithstanding that the subsidiary may, within 12 months of making the investment, downstream all or any part of the investment to another subsidiary. Also, when determining compliance with these limits, an investor is not required to combine the value of all shares of an organization held in trading or dealing accounts under section 211.10(a)(15) of

Regulation K with investments in the same organization.

3550.0.6 OTHER ELIGIBLE INVESTMENTS UNDER GENERAL CONSENT

In addition to the general-consent authority already discussed, the Board has granted its general consent for any investor to make the following investments: any investment in an organization in an amount equal to cash dividends received from that organization during the preceding 12 calendar months, and any investment that is acquired from an affiliate at net asset value or though a contribution of shares.

3550.0.7 INVESTMENT INELIGIBLE FOR GENERAL CONSENT

An investment in a foreign bank is ineligible for general consent if (1) after the investment, the foreign bank would be an affiliate of a member bank, and (2) the foreign bank is located in a country in which the member bank and its affiliates have no existing banking presence.

3550.0.8 INVESTMENTS MADE WITH PRIOR NOTICE TO OR THE SPECIFIC CONSENT OF THE BOARD

An investment that does not qualify for general consent under section 211.9(b), (c), or (d) of Regulation K may be made after the investor has provided the Board with 30 days' prior written notice. The notice period commences at the time the notice is received. However—

1. the Board may waive the 30-day period if it finds the full period is not required for consideration of the proposed investment, or that the circumstances presented require immediate action, and
2. the Board may suspend the 30-day period or act on the investment under its specific-consent procedures.

Any investment that does not qualify for either the general-consent or the prior-notice procedure cannot be consummated without the specific consent (that is, express approval) of the Board.

3550.0.9 EXAMINATION OF FOREIGN SUBSIDIARIES OF BHCs

The procedures involved in examining foreign subsidiaries of domestic bank holding companies are generally the same as those used in examining domestic subsidiaries engaged in similar activities. The on-site examination of foreign subsidiaries is, however, necessarily limited. In most cases, examiners should try to implement asset-appraisal procedures by using records at the location of the U.S. parent or bank. Overseas examinations are intended primarily to appraise the firm's internal-control systems and the sufficiency of the firm's reporting to its parent company. For examination objectives and procedures for foreign subsidiaries, see the instructions for similar section 4(c)(8) investments in other sections of this manual.

3550.0.10 INVESTMENTS BY BANK HOLDING COMPANIES, EDGE CORPORATIONS, AND MEMBER BANKS IN FOREIGN COMPANIES

Subject to the limitations within subpart A of Regulation K, the Board allows, with its specific consent, banking organizations to acquire and hold investments in foreign companies that do business in the United States subject to the following conditions:

1. The activities abroad, whether conducted directly or indirectly, must be confined to activities of a banking or financial nature and those that are necessary to carry out such activities. When engaging in these activities, the investors are to act in accordance with high standards of banking and financial prudence, having due regard for diversification of risks, suitable liquidity, and adequacy of capital.
2. The activities are either those that the Board has determined to be usual in connection with the transaction of banking or other financial operations abroad as listed in section 211.10 of Regulation K, including those activities authorized with the Board's specific approval, and those that have been determined to be usual in connection with the transaction of the business of banking or other financial operations abroad, consistent with the Federal Reserve Act or the BHC Act.

3550.0.11 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Investment and activities abroad		211.8		
Investment procedures		211.9		
Use of foreign subsidiaries to sell long-term debt obligations in foreign markets			3–706	
Investment by U.S. banking organizations in foreign companies that transact business in the United States		211.602	3–715	
Investment by U.S. banking organizations in futures commission merchant activities overseas				1982 FRB 671
Investment by U.S. banking organization in general life insurance underwriting overseas				1984 FRB 168 1985 FRB 269
Investment by U.S. banking organization in property and casualty insurance underwriting overseas				1985 FRB 267 1985 FRB 808
Investment by U.S. banking organization in physical commodities brokered overseas				1981 FRB 369
Investment in Edge Act corporation	611–632			
Investment in foreign banking corporation	601–604/ 611–618			

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

In 1982 the Bank Holding Company Act of 1956 was amended by the Bank Export Services Act (BESA). The Bank Export Services Act provided an exemption to the prohibitions of Section 4 of the BHC Act for a bank holding company's investment in the shares of any company that is an export trading company. The (BESA) was designed to increase U.S. exports by encouraging investments and participation in export trading companies by bank holding companies and the specified investors.

An export trading company is a company that is exclusively engaged in activities related to international trade and, by engaging in one or more export trade services:

1. derives at least one-third of its revenues in each consecutive four-year period (excluding a two-year start up period) from the export of goods and services produced in the United States by persons other than the export trading company or its subsidiaries; and
2. derives revenues from the export, or facilitating the export, of goods or services produced in the United States and those revenues exceed revenues from the import, or facilitating the import into the United States, of goods or services produced outside the United States.

A bank holding company's direct and indirect investment in export trading companies may not exceed 5 percent of the bank holding company's consolidated capital and surplus. The total amount of extensions of credit by a bank holding company and its subsidiaries to its affiliated export trading company may not exceed 10 percent of the bank holding company's consolidated capital and surplus.

A bank holding company may not invest in an export trading company, unless the Board has been given sixty days prior written notice of the proposed investment. The Board may disapprove any proposed investment only if:

1. Such disapproval is necessary to prevent unsafe or unsound banking practices, undue concentration of resources, decreased or unfair competition, or conflicts of interest; or
2. It finds that such investment would affect the financial or managerial resources of a bank holding company to an extent that is likely to have a materially adverse effect on the safety and soundness of any subsidiary bank of such bank holding company; or
3. The bank holding company fails to furnish the information required by the Board.

An Edge Act or agreement corporation that is a subsidiary of a bank holding company may invest directly or indirectly in the aggregate up to 5 percent (25 percent in the case of a corporation not engaged in banking) of the voting stock or other evidences of ownership in one or more export trading companies.

Sections 23A and 23B of the Federal Reserve Act applies to transactions between an export trading company and its affiliated banks. Regulation K, however, grants relief from section 23A's collateral requirements where a bank issues a letter of credit or advances funds to an affiliated export trading company solely to finance the purchase of goods for which: (1) the export trading company has a bona fide contract for the subsequent sale of the goods; and (2) the bank has a security interest in the goods or in the proceeds from their sale at least equal in value to the letter of credit or the advance. All other ''covered transactions'' between a bank and an affiliated export trading company should conform to sections 23A and 23B of the Federal Reserve Act.

3560.0.1 INSPECTION PROCEDURES

Export Trading Companies are generally subsidiaries of bank holding companies. Regulations applicable to them are contained in Section 211.31–4 of Regulation K. Inspections of Export Trading Companies will usually be conducted by international examiners or examiners having specialized training. Examiners conducting inspections of Export Trading Companies should be familiar with these sections as well as Section 4(c)(14) of the BHC Act.

There is no standardized inspection report form for inspections of Export Trading Companies. However, as a minimum, the report is to include the following items:

Page	*Description*
—	Cover Name of organization Location Name of parent Location of parent Date inspection commenced Date of financial statements
i	Table of Contents Same information as cover
1	Examiner's comments Scope of inspection Summary of condition Violations Operating results Adequacy of accounting records, internal controls, and audit
2	Comparative balance sheets
3	Comparative income statements
4	Classified Assets
	CONFIDENTIAL
A	Officers[1]
B	Directors[1]
C	Confidential comments Assessment of management

1. Same information in tabular form as in Edge report.

Inspection procedures should follow the Export Trading Company Questionnaire, illustrated herein. The questionnaire will be part of a special inspection report, prepared separately, or in conjunction with, a holding company inspection.

A copy of the Export Trading Company report as well as a copy of the Export Trading Company Questionnaire will be retained and included in the workpapers for the BHC inspection. Significant findings will be incorporated into the "Examiner's Comments" page, or the Analysis of Financial Factors page, when appropriate.

3560.0.1.1 Export Trading Company Questionnaire

	Yes	*No*	*NA*	*Comments*
1. Is the Bank Holding Company (BHC) or banking Edge Corporation investment in the Export Trading Company (ETC) limited to 5% of its consolidated capital and surplus? Reference: BESA, Section 203; BHC Act, Section 4(c); Regulation K, Section 211.33(a)		( )		
2. Is the investment in the ETC by an Edge Corporation not engaged in banking limited to 25% of its consolidated capital and surplus? Reference: Same as question 1.		( )		
3. Did the BHC or Edge Corporation furnish the Federal Reserve Board through the local FRB written notice of its proposed investment in the ETC at least 60 days prior to its investment in the ETC? Reference: BESA, Section 203; BHC Act, Section 4(c); Regulation K, Section 211.34		( )		
4. Do the direct and indirect outstanding credit extensions to the ETC by the investor and its subsidiaries exceed 10% of the investor's consolidated capital and surplus? Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(B); Regulation K, Section 211.33(b)	( )			
5. If the BHC or its subsidiary has extended credit to an affiliated ETC or to any of the ETC's customers:				
a. are the terms of the credit any more favorable than those afforded to similar borrowers in similar circumstances;	( )			
b. does the credit involve more than normal risk of repayment; and	( )			
c. does the credit present any unfavorable features? Reference: Regulation K, Section 211.33(b)(2)	( )			
6. If the BHC or its subsidiary has extended credit to another investor with at least 10% interest in the ETC, or to an affiliate of the investor:				
a. are the terms of the credit any more favorable than those afforded to similar borrowers in similar circumstances;	( )			

	Yes	*No*	*NA*	*Comments*
b. does the credit involve more than normal risk of repayment; and,	( )			
c. does the credit present any unfavorable features?	( )			
Reference: Same as question 5.				
7. Do covered transactions (under Sections 23A and 23B of the Federal Reserve Act) between a bank and an affiliated ETC meet the collateral requirements of Section 23A unless exempted because the bank has extended a letter of credit or advance to the affiliated ETC solely for the purchase of goods for which:		( )		
a. the ETC has a bona fide sales contract; and				
b. the bank has a security interest in the goods, or in the proceeds from their sale at least equal in value to the letter of credit or advance?				
Reference: Regulation K, Section 211.33(b)(3)				
8. Has the ETC received an export trade Certificate of Review which exempts it from antitrust laws?		( )		
Reference: BESA, Section 301				
9. Has the ETC Certificate holder submitted an annual report to the Secretary of Commerce as required?		( )		
Reference: BESA, Section 308				
10. Is the ETC exclusively engaged in activities related to international trade?		( )		
Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(F) Regulation K, Section 211.32(a)				
11. Is the ETC operated principally for the purposes of exporting goods or services produced in the U.S., or for purposes of facilitating the exportation of goods or services produced in the U.S. by unaffiliated persons by providing one or more export trade services?		( )		

	Yes	*No*	*NA*	*Comments*
The term ‘‘export trade services’’ includes, but is not limited to, consulting, international market research, advertising, marketing, insurance other than acting as principal, agent or broker in the sale of insurance on risks resident or located, or activities performed, in the United States, except for insurance covering transportation of cargo from any point of origin in the U.S. to point of origin in the U.S. to a point of final destination outside the U.S., product research and design, legal assistance, transportation, including trade documentation and freight forwarding, communication and processing of foreign orders to and for exporters and foreign purchasers, warehousing, foreign exchange, financing, and taking title to goods in order to facilitate U.S. exports. An ETC may engage in importing, barter, and third-party trades only if these activities further U.S. exports and only if the preponderance of ETC activities do not involve importing and the revenues from export activities exceed revenues from import activities. Reference: Same as question 10.				
12. If the ETC has expanded its activities significantly beyond those in the original notice to the Board, such as to taking title to goods, product research and design, product modification, or activities not specifically covered in the BHC Act, has the investor given a 60 day notice in advance to the Board? Reference: Regulation K, Section 211.34		( )		
13. If the ETC has been in operation more than six years, is more than one-third of the ETC’s revenue in the last consecutive four-year period derived from exports or facilitating exports of U.S. goods and services produced in the U.S. by persons other than the ETC or its subsidiaries? Revenue includes net sales revenue from the trading of goods by the ETC for its own account and gross revenue from all other activities of the ETC. Reference: Regulation K, Section 211.32(a)		( )		

	Yes	*No*	*NA*	*Comments*
14. Does the ETC engage in agricultural production, manufacturing or product modification of goods, e.g., repackaging, reassembly, or extracting by-products other than incidental product modification as necessary to conform to the requirements of foreign countries for sale of the goods in the foreign countries? Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(c) Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(c)	( )			
15. Does the ETC take title to goods for which it has received no firm purchase order or commitment? Reference: BESA, Section 103(a)(3)	( )			
16. What period of time do the goods on which the ETC has taken title remain in the inventory of the ETC?				
Does this activity appear unduly speculative? Reference: Same as question 15.	( )			
17. Do the nature and terms of sale of goods retained by the ETC appear to be in line with proper ETC business operations, i.e., not unduly speculative and related to authorized activities? Reference: Same as question 15.		( )		
18. If the ETC acts as a principal, agent, or broker in the sale of insurance, does such activity exclude the sale of insurance on risks or activities located or performed in the U.S. Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(F)		( )		
19. If the ETC engages in, or holds shares of a company engaged in underwriting, selling or distributing securities in the U.S., are such activities limited to the same extent as for BHC's under applicable Federal and State banking laws and regulations? Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(C), 12 USC, Section 1843(c)(14)(C)(i)		( )		

	Yes	No	NA	Comments
20. Does the ETC take positions in commodities, commodity contracts, securities or foreign exchange other than as may be necessary in the course of the ETC's authorized business transactions? Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(D)	( )			
21. Are activities of the ETC Certificate holder in compliance with the Certificate of Review? (If not, the ETC could be subject to antitrust laws.) Reference: BESA, Section 306		( )		
22. Does the ETC capital base appear to adequately support the strength of the ETC and its ability to withstand unexpected adverse developments so as not to affect the financial resources of the parent or the safety and soundness of affiliated banks? Reference: 43 *Federal Register,* 26,448(1983).		( )		
23. Is there any evidence of adverse effect of the investment in the ETC on the investment in the ETC on the financial or managerial resources of the BHC or Edge Corporation investor, or on the safety and soundness of any subsidiary bank of a BHC investor? Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(A)(iv)(11)	( )			
24. Has the ETC's capital to asset ratio remained at all times at or above the minimum established in the original notice to the Board?		( )		
25. Is the ETC in compliance with operational policies, including maximum financial leverage per transaction, as established in the original notice to the Board?		( )		

( ) = Exception

_______________________________ Prepared by: _______________________
Export Trading Company

_______________________________ Date: _______________________
Bank Holding Company Investor

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Examination Date

As a general rule, a bank holding company must provide 60 days' prior written notice to its Reserve Bank to engage in any nonbanking activity, or to acquire or retain the shares of a company engaged in an activity based on section 4(c)(8) or 4(a)(2). When a bank holding company gives notice to a Reserve Bank for approval to engage in, or retain or acquire shares in a company engaged in, a nonbank activity, the BHC must be of the opinion that the activity is closely related to banking and, assuming this test is met, that the activitiy is a proper incident thereto. In addition, a BHC that also is an FHC must provide 60 days' prior written notice to its Reserve Bank to engage in an activity that is complementary to a financial activity under section 4(k)(1)(B). In considering such a notice, the Board must determine whether performance of the activity can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.

As an exception to the general rule, no prior notice is required for a bank holding company that is qualified under section 4(j)(4) of the BHC Act to engage de novo, directly or through a subsidiary, in an activity that the Board permitted under section 225.28 of Regulation Y before November 12, 1999. After passage of the Gramm-Leach-Bliley Act of 1999, this list of activities cannot be expanded. For all bank holding companies that are not qualified under section 4(j)(4), for all other nonbanking activities based on section 4(c)(8) or section 4(a)(2), and for all activities that are complementary to a financial activity under section 4(k)(1)(B), the bank holding company must provide the appropriate prior written notice of its proposal to its Reserve Bank.[1] The Board must review the notice without disapproving it each time the bank holding company wishes to engage in a proposed activity. The inspection objective and procedures set forth below can be implemented for each of the activities summarized in subsequent sections.

3600.0.1 INSPECTION OBJECTIVE

1. To determine what financial effect nonbanking activities have on the parent and the bank subsidiaries, and if there is any degree of exposure in the activities because of a lack of appropriate audit systems and controls.

3600.0.2 INSPECTION PROCEDURES

1. Review the company's financial statements for accuracy and determine if any factors or trends could have an adverse impact on the parent holding company or the bank subsidiaries.
2. Review the adequacy of the company's policies, procedures, practices, internal controls, and audit coverage regarding nonbanking activities, and whether they are adhered to.

1. A bank holding company that is qualified under section 4(j)(4) of the BHC Act may provide 12 calendar days' prior written notice before engaging by acquisition in an activity permitted under section 225.28 or engaging in an activity based on section 4(c)(8) and approved by the Board by order.

Two bank holding companies (Company A) and (Company B) had requested the Board to determine whether their planned nonbank subsidiary activities were of the kind described in Section 4(c)(8) of the BHC Act. The applications had been filed prior to the passage of the Bank Holding Company Act Amendments of 1970. The applicants proposed to expand their activities under a ‘‘pool reserve plan’’ to include correspondent banks. Such activities were limited to subsidiary banks.

The ‘‘pool reserve plan’’ was described as a method of pooling of loss reserves with respect to term loans to small businesses and the establishment of uniform credit standards in that regard. The ‘‘pool reserve plan’’ permitted banks to adopt a uniform and liberal credit policy in extending credit and the usual method of exchanging participations between the banks.

The General Counsel of the Board of Governors determined, on October 14, 1971, pursuant to delegated authority, that the proposed activities would be ‘‘so closely related to banking or managing or controlling banks as to be a proper incident thereto’’ in accordance with Section 4(c)(8) of the BHC Act, as amended by the BHC Act Amendments of 1970. The approval (1971 FRB 1037) included the following conditions that:

1. The subsidiary was to amend its charter so that the charter would authorize it to perform its functions, and make its services available to banks, but not to lenders other than banks, and to amend its proposed contracts with correspondent banks;
2. Any correspondent banks could terminate their contract with the subsidiary respecting future transactions upon 90-day prior written notice, and that;
3. The subsidiary be subject to the same limitations with the respect to the ownership of any collateral acquired in the course of the conduct of its proposed activities as were its parents, (Company A and Company B).

3600.5.1 NEW YORK INVESTMENT COMPANY

On May 10, 1977, the Board approved an application of a foreign-owned domestic bank to form a holding company, and, at the same time, for that holding company to acquire substantially all of the voting shares of an investment company organized and operating under article XII of the New York State Banking Law (a New York investment company).

The investment company at that time was engaged in providing lending and international banking services, including letters of credit, acceptances, and other financing facilities in connection with exports and imports, international transfers of funds, and foreign-exchange services; investments and foreign-exchange transactions for its own account; leasing improved real estate and data processing equipment; and maintenance of credit balances incidental to or related to the foregoing activities. Although the holding company believed that certain of the activities of the New York investment company had already been determined by the Board to be permissible for bank holding companies, it requested approval of its application on the basis that *all* the activities that a New York investment company is permitted to engage in under New York law are closely related to banking. A New York investment company had not previously been determined by the Board to be an activity permissible for bank holding companies.

The Board noted that the structural and competitive circumstances under which a New York investment company operates are unique to New York and have served in the past as a means for foreign-bank entry into New York in cases where entry through a direct branch or agency was either unavailable or undesirable for the purposes sought. Most of the lending and banking services offered by these companies are also offered by commercial banks generally and, in this connection, compete with foreign banking organizations and domestic commercial banks and their Edge corporation subsidiaries. However, under article XII of the New York State Banking Law, a New York investment company is permitted to engage in various other activities which the Board does not consider to be closely related to banking.

Based on the foregoing, the Board's approval in this case was limited to and contingent upon the New York investment company's (1) continuing to engage principally in transactions involving international or foreign commerce, and not accept demand deposits; (2) complying with all Board or legislatively imposed reserve and interest-rate requirements; (3) divesting of offices in another state within two years; (4) confining activities of its foreign branch to those permitted in the Board's order; and (5) not engaging in the activities of underwriting, selling, or distributing securities; buying or selling coin and bullion; or acting as a financial agent of the U.S. government or as a depositary of public moneys of the United States, or in any new activity which New York investment companies by subsequent enactment may be permitted to engage in, without the prior approval of the Board. (See 1977 FRB 595.)

3600.5.2 ENGAGING IN BANKING ACTIVITIES THROUGH FOREIGN BRANCHES OF A NONBANK COMPANY

A bank holding company applied for the Board's approval to retain direct or indirect ownership of a subsidiary, "CBC," a Delaware-chartered corporation, after it established branches in Nassau and Luxembourg, to engage in certain commercial banking activities. The activities included accepting funds in U.S. dollars or foreign currency in wholesale money markets in amounts over $100,000, making commercial loans in amounts over $100,000, placing funds with and making loans and advances to subsidiary and affiliated organizations, engaging in foreign-exchange transactions, and other activities constituting commercial banking outside the United States. CBC held the shares of a number of nonbanking subsidiaries of the BHC pursuant to section 4(c)(1)(C) of the BHC Act, which permits a subsidiary of a bank holding company to perform services for its parent company.

The purpose of the proposal was to provide the BHC with increased flexibility in funding its domestic operations by allowing CBC to gain access to the offshore wholesale money market. The proposed foreign branches of CBC, by obtaining banking licenses, would give direct access to Eurocurrency interbank markets, and the activities of the proposed branches were expected to be viewed as an integral part of a large U.S.–headquartered entity, making the branches competitive in the offshore interbank markets.

The Board decided that the lending and banking services that the proposed branches would offer were generally offered by commercial banks, and thus are permissible activities of foreign branches of domestic banks and foreign subsidiaries of bank holding companies. The proposed activities of CBC's branches were substantially similar to activities that the Board had previously approved under section 4(c)(8) of the BHC Act for the foreign branches of the New York investment company, incorporated under article XII of the New York Banking Law (see 1977 FRB 595 and 1979 FRB 667). CBC did not propose to engage in any activity that would not be permitted for a separately incorporated foreign subsidiary of a bank holding company. The Board, therefore, ruled that the proposed activities of CBC were closely related to banking (1982 FRB 251).

CBC proposed to engage in no banking activities in the United States, stating that its only U.S. activities would consist of its indirect nonbanking activities through subsidiaries. The subsidiaries would be funded through funds raised by the proposed foreign branches. In this connection, the BHC committed to accepting no placement of or deposits from,[1] or extending no credit to (other than a subsidiary or affiliated organization) a United States resident.[2] The BHC committed that the liabilities to CBC of any person, other than an affiliate, would not exceed 10 percent of the capital and surplus of CBC. The Board felt that these prudential conditions were adequate to meet any supervisory concerns to which the proposal might give rise and thus approved the application, subject to the obtaining of the necessary licensing requirements of the countries involved.

1. A placement or deposit received from a foreign branch, office, subsidiary, affiliate, or other foreign establishment (''foreign affiliate'') controlled by one or more domestic corporations is not regarded as a placement or deposit received from a U.S. resident if such funds are used in its foreign branches or that of other foreign affiliates of the controlling domestic corporation(s).

2. Credit extended to a foreign affiliate, controlled by one or more domestic corporations, is not regarded as credit extended to a U.S. resident if the proceeds will be used in its foreign business or that of other foreign affiliates of the controlling domestic corporation(s).

A domestic bank holding company (the BHC) and a foreign banking organization (the FBO), subject to the BHC Act, applied for the Board's permission to engage in operating a securities exchange under the authority of section 4(c)(8) of the BHC Act and section 225.24 of Regulation Y. The BHC proposed to control approximately 17 percent of the voting shares of group (the group), and the FBO planned to control approximately another 11 percent of the voting shares of the group. The group owned about 54.1 percent of a financial network subsidiary (FNS), which operated an electronic securities exchange (the exchange) for the secondary trading of equity and equity-related securities listed on the London Stock Exchange (LSE). The BHC and FBO indicated that the group planned to establish an office in the United States. In anticipation of the establishment of this office, the BHC and FBO requested the Board's approval to acquire their interests in the group. A BHC must obtain the Board's approval if a foreign company held by the BHC seeks to engage in business in the United States.

The exchange is a screen-based electronic market that provides securities trade matching, trade execution, and related services to U.S. and foreign market makers, broker-dealers, and institutional investors that become members of the exchange. Members may access the exchange and enter bid and ask quotations using electronic terminals that are linked to designated financial networks (for example, a Bloomberg terminal) or through a personal computer linked directly to the exchange. The exchange can be accessed from terminals located anywhere in the world. Trading, however, may occur only during the operating hours of the LSE. Orders entered in the exchange's system appear on separate electronic order books for each security, which display the best bid and ask quotes for the security in descending order. The exchange automatically and continuously matches equal bid and ask offers for each listed security on a first-come, first-served basis.

FNS does not take a principal position in securities, clear or settle the securities transactions executed on the exchange, or assume any principal risk for securities trades executed on the exchange. FNS and its shareholders are not obligated to guarantee any member's trades. Each member of the exchange must be a member of the London Clearing House, or must appoint a member of the London Clearing House to clear the member's trades on the exchange. Trades matched by the exchange are registered at the end of each business day with the London Clearing House in the name of the appropriate clearing member. London Clearing House then becomes the counterparty to each side of the trade until the trade is settled. The trade is settled through a designated system operated by a corporation established by the Bank of England to settle uncertificated U.K. equities.

The exchange is a recognized investment exchange under section 37(3) of the U.K. Financial Services Act of 1986, and is regulated and supervised by the U.K. Financial Services Authority (FSA), under the securities laws of the United Kingdom. While FNS makes its services available to customers in the United States, the SEC has granted it a limited volume exception from the registration requirements of the Securities Exchange Act of 1934. The SEC exemptive order permits FNS to operate in the United States without registering as a securities exchange provided (1) the exchange's average daily volume of trades involving U.S. members does not exceed $40 million, and (2) the exchange's worldwide average daily volume does not exceed 10 percent of the average daily trading volume on the LSE. The SEC exemptive order requires the exchange to comply with other conditions that are designed to ensure orderly and fair markets and to protect U.S. investors.

The Board had not previously determined by regulation or order that the operation of a securities exchange is closely related to banking within the meaning of section 4(c)(8) of the BHC Act. The principal function of a securities exchange is to provide a centralized facility for the execution, clearance, and settlement of securities transactions. The Board indicated in its order that banks and BHCs are authorized to provide securities brokerage services to their customers and, as part of those services, to execute and clear such transactions on a securities exchange. The Board also noted that BHC subsidiaries authorized to act as dealers in securities (section 20 subsidiaries) may provide securities execution, clearance, and settlement services in connection with their dealer operations. In addition, the Board noted that broker or dealer subsidiaries of banks and BHCs often become members of securities exchanges and thus acquire a small ownership (less than 5 percent) in a mutually owned exchange (for example, the New York Stock Exchange). Through the development of these relationships, banks and BHCs have gained considerable experience with and knowledge of the rules and operations of securities exchanges.

Banks and BHCs also provide services that are functionally and operationally similar to those of the exchange. Banks and BHC subsidiaries acting as securities brokers may execute cross-trades for their customers and thereby match equal bid and offer orders received from them. In addition, section 20 subsidiaries may, if authorized, act as a specialist or market maker on a securities exchange such as the NYSE or NASDAQ. A specialist generally maintains a book of current buy and sell orders received from other brokers and matches equal bid and offer quotes for execution. Market makers on NASDAQ also publish bid and ask prices at which they stand ready to execute transactions in the relevant security.

For the above reasons, and based on all the facts on record, the Board concluded that operating a securities exchange is an activity that is closely related to banking for the purposes of section 4(c)(8) of the BHC Act. The application was approved on November 8, 1999. See 2000 FRB 61 for the order and more specific information regarding the Board's approval.

A foreign banking organization (FBO)[1] subject to the BHC Act and several bank holding companies (BHCs), deemed to be BHCs (all referred to as the notificants) within the meaning of the BHC Act, requested the Board's approval under section 4(c)(8) of the BHC Act and section 225.24 of the Board's Regulation Y (12 C.F.R. 225.24) to retain 12.5 percent of the voting interests in Indent Company (Indent), and to engage through Indent and other nonbank subsidiaries in acting as a certification authority (CA) in the United States in connection with financial and nonfinancial transactions and other related activities. Indent represents a joint venture among the notificants and other commercial banks and foreign banking organizations. As proposed, Indent would act as the global rule-making and coordinating body for a network of financial institutions that would act as CAs and thereby provide services designed to verify or authenticate the identity of customers conducting financial and nonfinancial transactions over the Internet and other ''open'' electronic networks. To provide these services, Indent and its network of participating financial institutions (the identity system) would use digital certificates and digital signatures created through the use of public-key cryptography.

In a CA system using public-key cryptography, a company generates (or is assigned) a public-key/private-key pair and registers with a CA as the unique ''owner'' of the key pair.[2] Private keys and public keys are a set of different but related mathematical functions that can be used to encrypt and decrypt electronic communications. A message encrypted by a particular private key can be decrypted only by its corresponding public key. Although a private key and its corresponding public key are related, a private key cannot feasibly be derived from its corresponding public key. Thus, while a private key must be kept confidential by the company that is the registered owner of the key pair, the company's public key can be made publicly available without jeopardizing the confidentiality of the company's private key.

A company sending a business communication (for example, a purchase order) to another entity over an open electronic network like the Internet uses its confidential private key to digitally sign the message being sent. A digital signature is a compressed and encrypted version of the message to which it is attached. The entity receiving the digitally signed message then uses the sender's public key to decrypt the digital signature.[3] If the receiver successfully decodes the signature with the sender's public key, the receiver can be assured that the message was created using the sender's private key.[4]

To be assured that the message was actually sent by the purported sender, however, the receiver must confirm that the private-key/public-key pair used to sign and decode the message is uniquely ''owned'' by the purported sender. A CA provides this assurance by issuing ''digital certificates'' certifying that the relevant private-key/public-key pair is uniquely associated with the message sender and by verifying upon request the validity of such digital certificates.

The notificants and other financial institutions participating in the identity system (participants)[5] would create unique private-key/public-key pairs for, and issue digital certificates on behalf of, eligible customers that contract with one of the participants to receive Indent identity-authentication services.[6] Each participant would

1. Foreign banks may engage in permissible nonbanking activities in the United States directly through a U.S. branch or agency. A foreign bank, however, must receive the Board's approval under section 4(c)(8) of the BHC Act to engage in the United States in activities that are deemed to be closely related to banking.

2. A number of nonbanking companies currently operate CA systems that rely on public-key cryptography to provide identity-authentication services to senders and receivers of electronic communications.

3. The sender's public key may be attached to the digitally signed communication, or the receiver of the message may obtain the sender's public key from a publicly available database.

4. The receiver also can confirm that the message was not altered after it was signed by comparing the message received with the decrypted version of the message text embedded in the digital signature.

5. Participation in the identity system is available only to organizations that are engaged primarily in the business of providing financial services; are subject to regulation and examination by a government authority in their home country; and that meet certain eligibility criteria, such as minimum capital requirements and debt-rating criteria. A participant also must agree to be bound by the identity system operating rules and to execute certain participation agreements. Financial institutions would not be required to purchase an ownership interest in Indent to become a participant.

6. The participants may provide identity system–related services only to customers that have agreed to be bound by applicable provisions of Indent's operating rules and have signed the appropriate customer agreements. Indent's operating rules allow the participants to provide identity system–related services only to business entities, such as corporations and governmental organizations, and not to natural persons. Indent's operating rules and customer agreements would make each customer contractually responsible for ensuring that its private key is kept confidential.

act as a repository for the digital certificates that it has issued, that is, it would maintain a database containing information on the status of the outstanding, expired, or revoked digital certificates that it has issued to customers. The participants also would verify for third parties the validity of digital certificates issued to their customers and, upon request of the third party, may provide an explicit warranty as to the validity of the customers' digital certificates.[7] The participants also may process and transmit verification and warranty requests received from customers concerning digital certificates issued by other participants in the identity system. In addition, the participants may provide customers with a limited range of software and hardware that is required for customers to use the identity system.[8]

Indent would provide the infrastructure framework within which the participants would act as CAs and provide related services. The primary function of Indent would be to act as the "root certification authority" of the identity system, that is, issuing digital certificates to the participants that establish their status as CAs in the identity system and authenticating for customers of, and the other participants in, the identity system the identity of the participants.[9] Indent also would (1) establish and maintain the operating rules governing the identity system, including the minimum technical requirements for digital certificates and other components of the system; (2) monitor compliance by the participants with the identity system's operating rules and technical standards; and (3) monitor collateral requirements and aggregate warranty exposure for the participants in the identity system.[10]

Section 4(c)(8) of the BHC Act provides that a bank holding company may, with the Board's approval, engage in any activity that the Board determines to be closely related to banking. The Board previously has authorized BHCs under section 4(c)(8) of the BHC Act to act as CAs and provide identity-authentication services in connection with payment-related and other financial transactions conducted over electronic networks.[11] The Board has not previously authorized BHCs under section 4(c)(8) to act as CAs or provide identity-authentication services in connection with nonfinancial transactions.

Banks and BHCs have long provided identity-authentication services in connection with nonfinancial transactions conducted by third parties and for their own traditional banking and lending activities. For example, banks and BHCs are authorized to provide notary services to customers.[12] The role of a notary is to authenticate signatures on financial or nonfinancial documents for the benefit of third parties.[13] To verify a signature on a paper-based document, a notary must verify the identity of the person signing the document. The Board noted that the role a CA serves with respect to electronic documents is functionally similar to the role a notary serves with respect to paper-based documents.[14]

Banks have traditionally identified their customers to third parties through the issuance of letters of introduction or letters of reference.[15] In addition, banks and BHCs routinely authenticate the identity of customers and noncustomers in connection with their authorized check-cashing functions.[16]

7. The operating rules of the identity system would provide that a company relying on a digital certificate issued by the participant would have recourse against the participant only if the company purchased an explicit warranty from the participant, and then only up to the amount of the purchased warranty. The participant that issues a digital certificate could refuse to issue a warranty for a digital certificate for any bona fide reason. The identity system would limit the aggregate amount of warranties that the participant may have outstanding at any one time, and would require each participant to post collateral with Indent to cover its warranty exposure.

8. For example, the participants may provide smart cards containing digital certificates and smart-card readers to their customers.

9. Digital certificates issued by the participant to a customer are digitally signed by the participant with its own private key and are accompanied by a digital certificate issued by Indent. The digital certificates Indent issues would certify that the participant is an authorized participant in the identity system and that the private key the participant uses to digitally sign its certificates is uniquely associated with it, thereby authenticating the identity of the participant.

10. The activities of the notificants and Indent would be limited to providing the identity-authentication and related services described above. The notificants and Indent would not provide a general encryption or electronic message service, or any warranty of the underlying financial or nonfinancial transactions between customers whose identities are authenticated through the use of the identity system.

11. See Regulation Y, section 225.28(b)(14); 1997 FRB 602, 606; and 1982 FRB 505, 510.

12. See 1998 FRB 481.

13. 58 Am. Jur. 2d *Notaries Public* § 31 (2d ed. 1989).

14. The American Bar Association, for example, has noted that the issuance of digital certificates by CAs is "analogous to traditional certification processes undertaken by notaries with respect to documents executed with pen and ink." "Digital Signature Guidelines," published by the Information Security Committee of the Electronic Commerce and Information Technology Division, Section of Science and Technology, American Bar Association. (Aug. 1, 1996), p. 54.

15. Banks have drafted letters of introduction or letters of reference on behalf of their customers for the purpose of introducing the customer to other banks or third parties with which the customer seeks to do business.

16. Under the Uniform Commercial Code (UCC), a bank that accepts a check for deposit warrants to the drawee bank

Banks and BHCs also have long been authorized to issue signature guarantees to issuers of securities and their transfer agents in connection with the transfer of securities.[17] A bank issuing a signature guarantee warrants that the customer's signature endorsing a certificated security or authorizing the transfer of an uncertificated security is authentic. The issuing bank also warrants that the signer was an appropriate person to endorse the security or authorization (or, if the signature is by an agent, that the agent had actual authority to act on behalf of the appropriate person) and that the signer had legal capacity to sign. In light of these warranties, a bank providing a signature guarantee must verify the identity of the customer providing the endorsement or signing the instruction.[18]

Identity-authentication services are an integral part of many traditional banking functions. Banks and BHCs have developed sophisticated methods for authenticating the identity of customers and noncustomers that transact business or communicate with the bank or BHC through electronic means or otherwise. Many of these activities are operationally and functionally similar to the proposed activities, and make banks and BHCs particularly well equipped to provide the proposed services. For example, banks and BHCs maintain systems to electronically authenticate the identity of persons engaged in credit and debit card, automated teller machine (ATM), home banking, and wire transfer transactions with the institution.[19] Banks and BHCs also electronically authenticate the identity of persons in connection with the check and credit card verification services they are authorized to provide to merchants and other businesses.[20]

The Board noted that state banks and national banks have recently been authorized to act as CAs and to provide identity-authentication services in connection with financial and nonfinancial transactions conducted over electronic networks. Based on the foregoing, the Board concludes that acting as a CA and, more generally, authenticating the identity of customers conducting financial and nonfinancial transactions are activities that are closely related to banking within the meaning of section 4(c)(8) of the BHC Act.

Indent and the notificants also propose to engage in a number of activities as part of and in connection with their proposed CA activities. These activities include (1) processing, transmitting, and storing data necessary for the operation of the identity system, such as digital certificates, requests for verification of digital certificates, and warranty requests; (2) developing and marketing software and hardware necessary for operating the identity system; and (3) complying with, monitoring, and enforcing the collateral-posting requirements associated with identity warranties. In addition, Indent would establish operating policies, procedures, and guidelines for the identity system.

The Board's Regulation Y permits BHCs to provide data processing and data transmission services and facilities (including software and hardware) for the processing and transmission of financial, banking, or economic data, and to engage in activities related to making, acquiring, brokering, or servicing extensions of credit, such as posting collateral and monitoring collateral requirements.[21] Regulation Y also permits BHCs to engage in incidental activities that are necessary to the conduct of an activity that is closely related to banking. Indent and the notificants have represented that they would engage in the additional activities only in connection with their CA activities and would not engage in such activities separate or apart from their CA activities. The notificants also have committed that the data processing and data transmission activities of the notificants and Indent, including any proposed development or sale of hardware and software, will comply with the Board's regulations and interpretations. In light of the nature of these additional activities and the fact that they would be conducted only in connection with the CA activities of Indent and the notificants, and all the other facts of record, the Board concludes that these activities are encompassed within the activities previously approved by the Board by regulation or are incidental to

that all endorsements on the check are genuine, and the bank is liable to the drawee bank for the amount of the check plus expenses and lost interest if an endorsement on the check was forged.

17. Broker-dealer subsidiaries of BHCs also have provided signature guarantees.

18. A bank issuing a signature guarantee is liable to the issuer of the security or its transfer agent for any loss that results from a breach of any of these warranties by the bank.

19. Article 4A of the UCC encourages banks to develop and maintain commercially reasonable security procedures, such as algorithms or other encryption devices, for authenticating the identity of customers that transmit wire transfer instructions to the bank.

20. See Regulation Y, section 225.28(b)(2)(iii) and 1985 FRB 648.

21. See Regulation Y, section 225.28(b)(2) and (14). A BHC may develop and sell hardware and software that is designed and marketed for processing and transmitting financial, banking, or economic data. It may also develop and sell general purpose hardware so long as it does not constitute more than 30 percent of the cost of any packaged offering.

the permissible CA activities of Indent and the notificants and, therefore, are permissible under Regulation Y.[22]

Based on the facts stated in the Board's order, the Board determined that the certification authority and other activities discussed were closely related to banking under section 4(c)(8) of the BHC Act. The Board issued its approval order on November 10, 1999. See 2000 FRB 56. See the Board's order for more specific information and for the more detailed information and references in the order's footnotes.

22. The notificants may engage in data processing and data transmission activities, including the development and sale of hardware and software, pursuant to this order only to the extent such activities are necessary to permit the proper operation of the identity system. The notificants and Indent also must conduct their data processing and data transmission activities subject to the software and hardware limitations in Regulation Y.

A bank holding company (the applicant) applied under section 4(c)(8) of the Bank Holding Company Act and the Board's Regulation Y to engage de novo through a wholly owned subsidiary (the company) in privately placing limited partnership interests in a group of partnerships having a limited number of investors. The company was to serve as the investment adviser, administrator, and sole general partner of a series of seven partnerships (the partnerships) that would be sold to a number of institutional investors. The company would maintain an equity interest of approximately 1.25 percent of the total capitalization in each partnership.

The partnerships were to be engaged solely in investing in limited amounts of debt and equity securities, including interests in real estate investment equity trusts (REITs).[1] The partnerships, together with the applicant and its other subsidiaries, were not to hold more than 5 percent of any class of voting securities of any issuer, and not more than 25 percent of the total equity of any issuer.[2] The equity investments were to be held in accordance with section 4(c)(6) of the BHC Act and section 225.22(d)(5) of Regulation Y.

The company also proposed to privately place limited partnership interests with new sophisticated institutional investors and possibly form similar additional partnerships in the future. The company was not to privately place debt securities issued by the partnerships without prior approval from the Federal Reserve System. The applicant committed that the private placement of limited partnership interests would conform to the limitations and conditions for private placements in previous Board orders approving private-placement activities (for example, 1990 FRB 26 and 1989 FRB 829).[3] Each investor was required to have an initial minimum investment of $100,000. Investors with $250,000 or more under management by the company, however, would be permitted to invest in any partnership in any amount. The applicant would continue the company's practice of allowing existing investors in a partnership to add to their investment in the partnership in any amount. The application was approved on June 28, 1994 (1994 FRB 736).

Subsequently, another bank holding company (the BHC applicant) applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.23 of Regulation Y to engage de novo, through a wholly owned asset-management subsidiary (AMS), in establishing and serving as the general partner of limited partnerships (the limited partnerships) that would invest in a wide variety of commodities and exchange-traded and over-the-counter instruments including those specified in the Board order. AMS would be the general partner of each partnership and would hold a nominal equity interest in each one. In this case, AMS would not provide investment advice directly to the limited partnerships, but would employ unaffiliated investment advisers to manage the investments of the limited partnerships, pursuant to parameters set by AMS. Interests in the limited partnerships would be privately placed with institutional customers by the BHC applicant's subsidiary banks.

One or more of the limited partnerships could invest a substantial portion of their assets in commodity pools, which would require the applicant to register as a commodity pool operator (CPO). The interests purchased by the limited partnerships would consist of less than 5 percent of the outstanding voting securities of any commodity pool and less than 10 percent of the total equity of any commodity pool. The applicant proposed that the limited partnerships purchase such assets with debt. It further stated that it would not permit any limited partnership that invested in distressed debt instruments to use borrowed funds to purchase or carry distressed debt instruments or to use the distressed debt instruments as collateral in acquiring other assets. The applicant also indicated that the leverage employed by the limited partnerships would include margin credit from broker-dealers, reverse repurchase agreements, and short sales.

The limited partnerships would invest in debt and equity instruments and distressed debt instruments.[4] The applicant stated that invest-

1. The partnerships were not to invest in futures contracts or options on futures contracts on any financial or nonfinancial commodity, or knowingly invest in debt that, upon acquisition, is in default without the prior approval of the Federal Reserve System. The applicant further committed that it would not use the investments of the partnerships to obtain or exercise control over any issuer of securities owned or held by the partnerships. Also, no directors, officers, or employees of the applicant and its affiliates will serve as directors, officers, or employees of any issuer of which the applicant and its affiliates held more than 10 percent ownership of total equity.

2. The applicant committed that all subordinated debt of an issuer would be subject to this 25 percent limit.

3. See the current Regulation Y, section 225.28(b)(7)(iii), regarding private-placement services.

4. The Board had previously permitted bank holding com-

ments in debt and equity securities and distressed debt would be made in accordance with the BHC Act's limitations and those of previous Board decisions. (See 1995 FRB 1128 and section 3104.0.)

The limited partnerships, together with the applicant and its subsidiaries, would make investments not greater than 5 percent of any class of voting securities of any issuer, and not greater than 25 percent of the total equity, including the subordinated debt, of any issuer. No directors, officers, or employees of the applicant would serve as directors, officers, and employees of any issuer of which the applicant and its subsidiaries (that is, the limited partnerships) would hold more than 10 percent of the total equity. For this case, the Board required AMS to consolidate the assets and liabilities of the limited partnerships in the financial statements of AMS for regulatory capital purposes. In addition, AMS was required to establish an appropriate risk-management structure consisting of investment and position limits for each investment adviser before engaging in the proposed activities. Compliance and trading limits would be monitored by computerized systems to be established by the applicant. The Board approved the notice on April 24, 1996, subject to all the facts of record and the commitments furnished. See 1996 FRB 569. For more recent Board orders whereby bank holding companies propose to act as a CPO and to control a private limited partnership that invested solely in permissible investments for a bank holding company, see 1999 FRB 209, 1998 FRB 852, and 1998 FRB 361.

panies to sponsor, organize, and manage closed-end investment companies and unregistered limited partnerships that invest in securities.

3600.13.1 SERVING AS AND CONTROLLING A PRIVATE LIMITED PARTNERSHIP AS A COMMODITY POOL OPERATOR

A bank holding company applied for the Board's approval under section 4(c)(8) of the Bank Holding Company Act (BHC Act) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) to engage de novo through a wholly owned asset-management subsidiary (ASM) that would be established to serve as the general partner of limited partnerships (the partnerships) that would invest in a wide variety of commodities and exchange-traded and over-the-counter instruments, including interests in investment funds that invest in futures and options on futures on financial and nonfinancial commodities (commodity pools). It was indicated that the partnerships would not directly invest in futures or options on futures contracts for purposes other than hedging. The partnerships would purchase and sell derivative contracts on precious metals and financial commodities, instruments, and indices for hedging purposes. It was further stated that one of the limited partnerships may invest a substantial portion of its assets in commodity pools, which would require the ASM (the general partner) to become a registered commodity pool operator (CPO) with the Commodity Futures Trading Commission (CFTC). As such, the ASM would register as a CPO with the CFTC, and a portion of the general partner's activities would become subject to the recordkeeping, reporting, fiduciary standards, and other requirements of the Commodity Exchange Act (7 U.S.C. 2 et seq.), CFTC, and National Futures Association.

The Board previously has found that a subsidiary of a state member bank may serve as the CPO of investment funds engaged in purchasing and selling futures and options on futures on certain commodities.[1] In addition, the Board has permitted bank holding companies to trade futures and options on futures on financial and nonfinancial commodities.[2] For these reasons, the Board has concluded that serving as a CPO, and controlling as a CPO a private limited partnership that invests solely in investments that a bank holding company is permitted to make directly, under the circumstances of this case (1996 FRB 569) are closely related to banking. See also 1998 FRB 1075, 1998 FRB 852–854, 1998 FRB 361, and 1994 FRB 736.

1. See 1996 FRB 239.
2. See 1995 FRB 185.

3600.17.1 ENGAGING IN TITLE INSURANCE AGENCY ACTIVITIES PURSUANT TO REGULATION Y

A bank holding company applied under section 4(c)(8) of the BHC Act and section 225.23(a) of the Board's Regulation Y to acquire all the outstanding shares of a title insurance agency. The title insurance agency is to conduct activities pursuant to exemption G of the Garn–St Germain Depository Institutions Act of 1982 (the act) and section 225.28(b)(11)(vii) of Regulation Y. Title VI of the act amended section 4(c)(8) of the BHC Act to provide that insurance agency, brokerage, and underwriting activities are not ''closely related to banking'' and thus are not permissible activities for bank holding companies, unless the activities are included within one of seven specific exemptions (A through G) in section 4(c)(8).

The applicant claimed that it was authorized to operate a title insurance agency under exemption G, which authorizes those bank holding companies that engaged in insurance agency activities before 1971 to engage, or control a company engaged in, insurance agency activities. The company has been engaged in the sale of insurance related to extensions of credit by its subsidiary banks since 1939.

The bank holding company applicant was one of 16 active companies with grandfather rights under exemption G.[1] Previously, the Board determined (1985 FRB 171) that those companies that had received Board approval to engage in general insurance agency activities before 1971 would be grandfathered under exemption G with respect to the sale of any type of insurance that is within the scope of general insurance agency activities—even an insurance agency activity (such as title insurance) not actually offered by the applicant bank holding company before 1971. The Board found that there is no requirement in the statute that a company qualifying for exemption G engage only in those insurance agency activities it conducted with Board approval before 1971. Thus, although the Board may not have specifically approved title insurance before 1971, provided the proposed activity is encompassed within the authorization of insurance agency activities, the activity falls within exemption G.

The Board determined selling title insurance through a title insurance agency to be permissible pursuant to exemption G and the Board's regulations. The Board approved the application on November 17, 1988 (1989 FRB 31).

1. There are currently 12 companies remaining.

3600.21.1 UNDERWRITING AND DEALING IN COMMERCIAL PAPER TO A LIMITED EXTENT

A bank holding company applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.21(a) of the Board's Regulation Y to underwrite and deal in third-party commercial paper to a limited extent. As proposed, the activity will be conducted through a commercial finance subsidiary (the company). The company is to act for issuers as an underwriter of commercial paper, purchasing commercial paper for resale to institutional investors such as banks, insurance companies, mutual funds, and nonfinancial businesses. In addition, the company may place commercial paper as agent for issuers and advise issuers on the rates and maturities of proposed issues that are likely to be accepted in the market—activities previously approved by the Board (1987 FRB 138). The activities in this order (1987 FRB 367) differ from those previously authorized (1987 FRB 138) in that the applicant will underwrite and deal in commercial paper as principal.

The Board may not approve a proposal of a member bank affiliate if upon consummation it would be ‘‘engaged principally’’ in the flotation, underwriting, public sale, or distribution of commercial paper (hereafter referred to as ‘‘underwriting and dealing in’’) within the meaning of the former section 20 of the Glass-Steagall Act (12 U.S.C. 377). The Board concluded that even if placement of commercial paper were deemed to constitute an activity, the commercial lending subsidiary would not be ‘‘engaged principally’’ in underwriting and dealing in securities. The subsidiary's activity was not substantial under a former 5 percent limit on the subsidiary's gross income (increased to 25 percent, effective March 6, 1997) from its commercial paper activities and a former 5 percent limit on its market share. The company is required to restrict its commercial paper activities so it does not exceed these limits.

The Board concluded that underwriting and dealing in commercial paper is closely related to banking on the same basis as acting as placement agent and adviser to issuers in commercial paper (1987 FRB 138). Banks provide services that are operationally and functionally similar to the services of underwriting and dealing in commercial paper. Banking organizations are particularly well equipped to provide such services. In the Board's view, the underwriting and dealing activity represents a natural extension of commercial lending activities traditionally conducted by banks, involving little additional risk or new conflicts of interest, and potentially yielding significant public benefits in the form of increased competition and convenience.

The Board concluded that the applicant could conduct the activities to the extent and in the manner described in the order, consistent with the former section 20 of the Glass-Steagall Act and section 4(c)(8) of the BHC Act. The Board's approval extended only to commercial paper underwriting, dealing, placement, and advisory activity conducted in accordance with the limitations stated in the order. (1987 FRB 367)

3600.21.2 ENGAGE IN UNDERWRITING AND DEALING, TO A LIMITED EXTENT, IN MUNICIPAL REVENUE BONDS, MORTGAGE-RELATED SECURITIES, AND COMMERCIAL PAPER

On April 30, 1987, the Board approved by order the applications of three bank holding companies to engage through subsidiaries in underwriting and dealing in commercial paper, one- to four-family mortgage-backed securities, and municipal revenue bonds.[1] (For a complete description of the nonbanking activities authorized by the Board in this order, see 1987 FRB 473.) The subsidiaries are to be involved in underwriting and dealing in U.S. government securities as their major activity. Board approval could only occur if the affiliates would not be ‘‘principally engaged’’ in underwriting and dealing in ‘‘securities’’ under the provisions of the former section 20 of the Glass-Steagall Act.

A hearing was held on February 3, 1987, because of the important legal and factual issues involved. The Board reaffirmed its finding in its previous decisions (1987 FRB 138 and 367) that the applicants were not principally engaged in

1. The applicants had previously received Board approval under section 4(c)(8) of the BHC Act for the subsidiaries mentioned in the order to engage in underwriting and dealing in U.S. government and agency and state municipal securities that state member banks are authorized to underwrite and deal in under section 16 of the Glass-Steagall Act. The newly proposed underwriting and dealing activities were approved in addition to the previously approved activities.

the proposed securities activities if they limited their underwriting and dealing income from these securities to 5 percent of the total gross income of the affiliate, and if they limited their market share in each of these securities to 5 percent of the total domestic market.[2] The Board established a number of conditions to ensure that the underwriting activity would be consistent with safe and sound banking practices and would avoid conflicts of interest, undue concentration of resources, and other adverse effects.

The Board determined, consistent with its previous underwriting and dealing decisions in administering the Glass-Steagall Act, that a range of between 5 percent and 10 percent of gross revenue and market share is the appropriate framework for determining whether an affiliate is engaged principally in securities activities. The lower end of the range—5 percent—was the level applied at the time. The Board noted that it would review this level within a year on the basis of experience gained from operations to determine whether a higher level would be permissible. On September 21, 1989, the Board modified section 20 orders to increase from 5 percent to 10 percent the revenue limit on the amount of total revenues a section 20 subsidiary may derive from ineligible securities underwriting and dealing activities (increased to 25 percent, effective March 6, 1997) (1989 FRB 751).[3]

The Board's approval of the applications extends only to the activities conducted within the limitations of the order and is subject to the gross revenue limitation discussed above. Two of the applicants also proposed to underwrite and deal in consumer-receivable-related securities (CRRs). Although the companies noted certain similarities between these securities and mortgage-related securities, the Board did not believe that the record before the Board provided a sufficient basis for it to make a formal finding (as required by the BHC Act) that underwriting and dealing in CRRs is closely related to banking and a proper incident thereto. The Board noted that the market for CRRs was relatively new and untested compared with the market for one- to four-family mortgage-related securities and municipal revenue bonds. The Board indicated that it would reconsider the matter within 60 days on the basis of more complete information to be submitted by the applicants regarding the types of assets that would be securitized, the manner in which this would be accomplished, and other matters bearing on risk.

In a subsequent order, six BHCs applied for and received the Board's conditional approval (1987 FRB 731) for the activity, but the Board stayed its order for the same period of time applicable to the stay issued by the Second Circuit Court of Appeals (see footnote 2 and section 3600.21.3). After approving the order set out in 1987 FRB 731, the Board approved several other orders that rely on this order and the limitations imposed therein. (See the following Board orders: 1987 FRB 607, 616, 618, 620, 622, 731, 738, 742, 928; 1988 FRB 133, 500, 699, 700, 706, 819; 1989 FRB 33, 190, 396, 398, 520, 645, 647; 1990 FRB 79, 158, 256, 461, 554, 568, 573, 652, 682, 756; 1991 FRB 954; 1992 FRB 338; 1993 FRB 141, 716; and 1994 FRB 249, 346.)

The major difference between the three applications decided on April 30, 1987, and the two applications previously approved by the Board (1987 FRB 138 and 367) is that the underwriting would take place in an affiliate engaged in underwriting and dealing in U.S. government securities. This arrangement raised the major legal question of whether these government securities could serve as a basis for measuring the principal activity of the affiliate. In its approval, the Board took into account the fact that the Glass-Steagall Act specifically allows member banks to underwrite U.S. government securities, and that the act intends affiliates to have a broader scope for underwriting than member banks. On that basis, the Board had previously allowed affiliates of member banks to engage in underwriting of U.S. government securities.

2. The U.S. Court of Appeals for the Second Circuit upheld the Board's determination that the underwriting subsidiaries would not be engaged principally in ineligible securities underwriting and dealing under the above revenue limitation; the U.S. Supreme Court declined to review that decision (*Securities Industry Association v. Board of Governors of the Federal Reserve System*, 839 F.2d 47 (2d Cir. 1988), *cert. denied*, 108 S.Ct. 697 (1988)). The Supreme Court also let stand the lower court's determination that the 5 percent market share limitation was not adequately supported by the facts of record, thus sustaining elimination of the market share test that had been invalidated by the U.S. Court of Appeals. Accordingly, the Board decided not to impose a market share limitation on orders approved on August 4 and 8, 1988.

3. The Board in this order also modified its section 20 orders to permit underwriting and dealing in securities of affiliates if the securities are rated by a nonaffiliated, nationally recognized rating organization or are issued or guaranteed by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or the Government National Mortgage Corporation, or represent interests in such obligations.

3600.21.3 ENGAGE IN LIMITED UNDERWRITING AND DEALING IN CONSUMER-RECEIVABLE-RELATED SECURITIES

Six bank holding companies applied for the Board's approval to engage in limited underwriting and dealing in consumer-receivable-related securities (CRRs). CRRs, which were first issued in 1985, consist of debt obligations that are secured by or represent an interest in a diversified pool of loans to or receivables from consumers, such as loans to individuals to finance the purchase of automobiles or personal credit card accounts.

The Board concluded that underwriting and dealing in CRRs is an activity closely related to banking on the basis that banks provide services that are operationally and functionally so similar to the services proposed that banking organizations are particularly well equipped to provide them. In accordance with section 16 of the Glass-Steagall Act, banks underwrite and deal in certain mortgage-related securities that are issued or guaranteed by the United States or by U.S. government agencies. Some of the securities represent interests in pools of mortgage loans for residential housing purposes made by banks and other financial institutions. Such securities are very similar to CRRs.

Both CRRs and bank-eligible mortgage-related securities represent interests in pools of loans made by financial institutions to individuals to finance the purchase of housing or consumer goods and services.

The techniques involved in underwriting and dealing in bank-eligible mortgage-related securities are also very similar to those that would be involved in conducting the approved activity with respect to CRRs. In each case, the underwriter must perform substantially identical functions of evaluating prepayment risk, analyzing credit and cash flow from a pool of numerous individuals' loans, negotiating or bidding, and distributing and dealing.

In addition, banks now directly perform some of the functions involved in the approved activity. Banks select the consumer loans that form the pool of interests that are then sold to investors. Banks also advise issuers of CRRs and assist issuers in privately placing these securities.

Because of the similarity between securities involved in CRRs and the previously approved bank-ineligible one- to four-family mortgage-related securities nonbanking activities set forth in a previous order (1987 FRB 473), the Board required that this activity be conducted in accordance with the same requirements established in that order. This includes a requirement that the securities be rated for investment quality by a nationally recognized agency.

The Board concluded, based on the reasons set forth in its previous order (1987 FRB 473), that the approved activity would not result in a violation of the former section 20 of the Glass-Steagall Act and is closely related and a proper incident to banking. The Board's approval of these applications is restricted to underwriting and dealing to a limited extent in securities representing an interest in or backed by a diversified pool of loans to or receivables from individuals for the purchase of consumer goods and services, and the limitations of section 225.25(b)(16) of Regulation Y. (1987 FRB 731)

3600.21.4 LIMITED UNDERWRITING AND DEALING IN DEBT AND EQUITY SECURITIES

Five bank holding companies applied for the Board's approval under section 4(c)(8) of the BHC Act for their wholly owned subsidiaries to underwrite and deal in, on a limited basis—

1. debt securities, including, without limitation, sovereign debt securities, corporate debt, debt securities convertible into equity securities, and securities issued by a trust or other vehicle secured by or representing interests in debt obligations; and
2. equity securities, including, without limitation, common stock, preferred stock, American Depositary Receipts, and other direct and indirect equity ownership interests in corporations and other entities.

Section 16 of the Banking Act of 1933 (the Glass-Steagall Act) prohibits a member bank from underwriting and dealing in these securities (referred to hereafter as ‘‘bank-ineligible securities’’). However, as far as the Glass-Steagall Act is concerned, an affiliate of a member bank may underwrite and deal in bank-ineligible securities so long as it is not engaged principally or substantially in that activity (12 U.S.C. 377).

The applicants had previously received Board approval to underwrite and deal in U.S. government and agency securities and state and municipal securities that state member banks are specifically authorized to deal in under section

16 of the Glass-Steagall Act (referred to hereafter as ‘‘bank-eligible securities’’). The Board had also authorized the subsidiaries to underwrite and deal in commercial paper, one- to four-family mortgage-backed securities, municipal revenue bonds, and consumer-receivable-related securities—all securities that member banks may not underwrite or deal in under section 16 of the Glass-Steagall Act.[4]

To ensure that the subsidiaries would not be principally or substantially engaged in underwriting or dealing in the ineligible securities in violation of the former section 20 of the Glass-Steagall Act, the Board's approval was made subject to the requirement that gross revenues from those ineligible securities activities would not exceed 5 percent of the subsidiary's total gross revenues on average (moving average) over any two-year period. (See 1989 FRB 192 and 196–197.) The Board increased this level to 10 percent on September 5, 1989.

The subsidiaries are also subject to a framework of structural and operating limitations established to avoid the potential for conflicts of interest, unsound banking practices, unfair competition, loss of public confidence in affiliate banks, and other adverse effects from the conduct of the bank-ineligible securities underwriting and dealing activity.

The Board recognized that underwriting and dealing in securities is a natural extension of activities currently conducted by banks, involving manageable risks and potential conflicts of interest when conducted in an organizational structure that insulates these activities from banking activities supported by the federal safety net of deposit insurance and access to Federal Reserve lending. The Board has acknowledged that certain bank holding companies have an existing expertise in securities underwriting, dealing, brokerage, investment advisory activities, and broad financial skills that make them well equipped to provide the new services.

The Board's approval of each application is subject to the conditions stated in previous orders (see 1989 FRB 192; 1990 FRB 158, 455, 573, 652, 683, 756; 1991 FRB 672; 1993 FRB 133, 719; and 1994 FRB 249, 449). The conditions consist of structural and operating limitations designed to avoid conflicts of interest and potential adverse effects, and other conditions designed to ensure safe and sound operations. The conditions include requirements, limitations, and prohibitions with regard to—

1. capital adequacy;
2. credit extensions to customers of the underwriting subsidiary;
3. maintaining the separateness of an underwriting affiliate's activity;
4. disclosures by the underwriting subsidiary;
5. marketing activities on behalf of an underwriting subsidiary;
6. investment advice by bank or thrift affiliates;
7. extensions of credit to the underwriting subsidiary and to purchasers or issuers of ineligible securities (or to major users of projects funded by industrial revenue bonds);
8. transfers of information;
9. reporting and recordkeeping requirements;
10. transfer of activities and formation of subsidiaries of an underwriting subsidiary to engage in underwriting and dealing; and
11. reciprocal arrangements and prohibitions against discriminatory treatment regarding unaffiliated securities firms.

3600.21.5 ACTING AS A DEALER-MANAGER IN CONNECTION WITH CASH-TENDER AND EXCHANGE-OFFER TRANSACTIONS

In connection with a bank holding company application to underwrite and deal in, to a limited extent, all types of equity securities through its section 20 nonbanking subsidiary, an applicant also proposed to act as a dealer-manager in connection with cash-tender and exchange-offer transactions. Dealer-managers generally act as agent for tender or exchange offerors in arranging or facilitating mergers, acquisitions, and other corporate transactions. All-cash tender offers do not, of themselves, involve the issuance, public sale, or distribution of securities. The Board thus concluded that all revenues derived from the section 20 company acting as a dealer-manager in connection with such tender offers may be treated as bank-eligible revenues for purposes of determining compliance with the Board's 10 percent revenue limitation (changed to 25 percent, effective March 6, 1997) on bank-ineligible securities activities. The Board approved the application on November 24, 1993 (see 1994 FRB 49, footnote 5).

4. See the following Board orders: 1987 FRB 473, 607, 616, 618, 620, 622, 731, 738, 742, 928; 1988 FRB 133, 500, 699, 706, 819; 1989 FRB 33, 190, 396, 398, 520, 645, 647; 1990 FRB 79, 158, 256, 461, 554, 568, 573, 652, 682, 756; 1991 FRB 672; 1993 FRB 133, 719; and 1994 FRB 249, 449.

3600.21.6 UNDERWRITING "PRIVATE OWNERSHIP" INDUSTRIAL DEVELOPMENT BONDS

A bank holding company (the notificant) provided notice under section 4(c)(8) of the Bank Holding Company Act (BHC Act) (12 U.S.C. 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) of its proposal to engage de novo through its section 20 subsidiary (the company) in underwriting, to a limited extent, certain "private ownership" industrial development bonds. The bonds are issued for the provision of the following governmental services: water facilities, sewer facilities, solid waste disposal facilities, electric energy and gas facilities, and local district heating or cooling facilities (collectively, traditional governmental services). The notificant controls one bank subsidiary.

The company is currently engaged in limited underwriting and dealing in certain municipal revenue bonds, activities permissible under section 20 of the Glass-Steagall Act (12 U.S.C. 377).[5] The company is a broker-dealer registered with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) and is a member of the National Association of Securities Dealers, Inc. (NASD). Thus, the company is subject to the recordkeeping and reporting obligations, fiduciary standards, and other requirements of the Securities Exchange Act of 1934, the SEC, and the NASD. The notificant engages directly and through subsidiaries in other permissible nonbanking activities.

The Board previously determined that the activities of underwriting and dealing in municipal revenue bonds, including industrial development bonds, are so closely related to banking as to be proper incidents thereto within the meaning of section 4(c)(8) of the BHC Act.[6] Certain bank holding companies previously requested approval to underwrite and deal in only municipal revenue bonds, as opposed to a full range of debt securities. Their requests were limited to underwriting and dealing in industrial development bonds that are "public ownership" industrial development bonds. Public ownership industrial development bonds are those "tax-exempt bonds where the issuer, or the governmental unit on behalf of which the bonds are issued, is the sole owner for federal income tax purposes of the financed facility."[7]

The notificant plans to engage through the company in underwriting private ownership industrial development bonds issued solely for the provision of traditional governmental services. It committed to conduct this activity subject to the same limitations and other conditions that govern underwriting and dealing in public ownership industrial development bonds.[8]

The underwriting risk and the risk analysis required to underwrite private ownership industrial development bonds issued for traditional governmental services is essentially the same as the risk and analysis related to underwriting traditional public ownership bonds. For each, the funds for the repayment of the bonds are derived from revenue generated by the financed facility, including revenue resulting from a service contract between the owner/lessor of the financed facility and a state or local government or political subdivision, pursuant to which the state or local government or political subdivision agrees to purchase the output of the facility.[9] The notificant committed that all the private ownership bonds that the company would

5. See 1993 FRB 716.

6. *Citicorp, J.P. Morgan & Co. Incorporated, and Bankers Trust New York Corporation*, 1987 FRB 473, *aff'd sub nom. Securities Industry Ass'n v. Board of Governors of the Federal Reserve System*, 839 F.2d 47 (2d Cir.), *cert. denied*, 486 U.S. 1059 (1988), as modified by order approving modifications to section 20 orders, 1989 FRB 751 ("*Citicorp/Morgan/Bankers Trust*"). See also *J.P. Morgan & Co. Incorporated, et al.*, 1989 FRB 192, *aff'd sub nom. Securities Industry Ass'n v. Board of Governors of the Federal Reserve System*, 900 F.2d 360 (D.C. Cir. 1990).

7. See 1987 FRB 502. Examples of financed facilities include airports and mass-commuting facilities.

8. *Citicorp/Morgan/Bankers Trust*. All the bonds that the notificant proposed that the company underwrite would qualify as "exempt facility bonds" under the Internal Revenue Code (the code). See 26 U.S.C. 142. The types of exempt facility bonds that the company would underwrite may, subject to certain volume caps and other limitations, be tax-exempt under the code even if the proceeds of the bonds are used to finance facilities that are privately owned. See 26 U.S.C. 103, 141, 142, 146, and 147.

9. Typically, in the case of public ownership bonds, the governmental unit that issues the bonds owns the financed facility and repays the bonds from the revenue generated by the facility and this service contract. The governmental unit may also enter into a contract with a third party to operate the financed facility. In the case of the private ownership bonds that the notificant plans to underwrite, the governmental unit that issues the bonds either uses the proceeds of the bonds to acquire or construct a facility, which the governmental unit then leases to a third party, or lends the proceeds of the bonds to a third party to acquire or construct the facility. The third party agrees to make lease payments or loan repayments to the governmental unit that enable the governmental unit to pay debt service on the bonds. As security for the lease or loan agreement, the third party assigns and pledges the revenues generated by the facility and a service contract with a state or local government or political subdivision.

underwrite would be rated "investment quality" by a nationally recognized rating agency to the same extent as are the municipal revenue bonds that the company currently underwrites.

Considering these circumstances, the Board concluded that underwriting and dealing in private ownership bonds issued for the provision of traditional governmental services is a permissible activity if conducted subject to the conditions and prudential limitations set forth in *Citicorp/Morgan/Bankers Trust* (1987 FRB 473 and 1989 FRB 751 (Modification Order)) and agreed to in 1993 FRB 716. The notification was approved on October 24, 1995 (see 1995 FRB 1116).

A foreign bank subject to the Bank Holding Company Act applied for the Board's approval to engage in various nonbanking activities, one being to purchase mortgage loans and to issue securities for its own account, through a wholly owned subsidiary or third party servicers, and to sell securities guaranteed by the Government National Mortgage Association (GNMA). Because National Banks are specifically authorized under the Glass–Steagall Act (12 U.S.C. 24) to issue and sell securities guaranteed by GNMA, as well as to underwrite and deal in such securities, the Board concluded that the issuance and sale of GNMA securities is closely related to banking (1988 FRB 573). In addition, the Board determined that the statutory exemption reflects a Congressional determination that GNMA securities are not the type of securities that would lead to unsound speculation or that the public interest in the issuance and sale of GNMA securities by banks outweighs any potential harm resulting therefrom. Also, the Board previously determined that underwriting and dealing in GNMA certificates is of sufficiently low risk to be generally permissible activities for bank holding companies (12 C.F.R. 225.25(b)(16)).

A foreign bank, subject to Section 4 of the BHC Act, applied for the Board's permission to acquire, through its wholly owned subsidiary, all the shares of a company located in New York, New York. The acquired company would engage in several nonbanking activities. Two of the activities, not previously approved by the Board for BHCs, consisted of acting as a sales tax refund agent for the State of Louisiana and Cashing U.S. Dollar Payroll Checks Drawn on Unaffiliated Banks. Both activities were found to be closely related to banking subject to the facts and conditions found in the Board order and briefly discussed below. The application was approved on August 15, 1990 (1990 FRB 860).

3600.24.1 ACTING AS A SALES TAX REFUND AGENT FOR THE STATE OF LOUISIANA

The company being acquired serves as the State's exclusive sales tax refund agent for its tax-free shopping program for foreign visitors. Under the program, foreign visitors present sales invoices evidencing sales taxes paid in Louisiana to the company's office in the state. It refunds the tax in U.S. dollars to the visitor, less a handling fee. A portion of the handling fee is then remitted to the State and local tax authorities refund to the company the amount of tax refunds advanced. The Board found the activity to be closely related to banking since banks: (1) routinely forward to taxing authorities tax receipts delivered to the bank on taxes due; (2) commonly act as fiscal agent for government authorities which involves disbursing funds on behalf of state and local governments.

3600.24.2 CASHING U.S. DOLLAR PAYROLL CHECKS DRAWN ON UNAFFILIATED BANKS

The company being acquired also cashes, and the Applicant plans to continue cashing, U.S. dollar payroll checks on a limited basis, primarily to accommodate employees in airport facilities that lack banking services, but where the company maintains offices. Since check cashing is a fundamental banking activity performed routinely by banks, and the company being acquired proposed to cash only checks drawn on unaffiliated banks, the Board found the activity to be closely related to banking. The Board stipulated, however, that the Applicant was not to use the acquired company's offices as branches of the Applicant or any affiliated bank.

Permissible Activities by Board Order (Providing Government Services) Section 3600.25

A bank holding company (the notificant) requested the Board's approval, under section 4(c)(8) of the BHC Act and section 225.24(a) of Regulation Y, to acquire through its wholly owned subsidiary a cash-express company, certain assets of an exchange company, and another firm to engage in various nonbanking activities. Many of the nonbanking activities had previously been determined by the Board to be closely related to banking in Regulation Y, by order, or by interpretation. In addition to those nonbanking activities already approved, the notificant requested the Board's approval to engage in providing various governmental service activities at the offices of the cash-express company:

1. postage stamps and postage-paid envelopes
2. vehicle registration services, including the sale, distribution, and renewal of license plates and license tags for motor vehicles
3. public-transportation tickets and tokens
4. notary public services

The Board noted that banks are permitted to provide customer access to the type of government services involved in the proposal, whereby the banks may be acting in an agency capacity or accomplishing the distribution of some of the services using automated teller machines (ATMs).[1] The Board thus concluded that the proposed nonbank activities are closely related to banking. Based on all the facts and commitments provided by the notificant, and the representations and conditions relied upon in reaching a decision, the Board approved the proposal on April 2, 1998 (1998 FRB 481).

1. See 12 C.F.R. 7.1010 and OCC Interpretive Letter No. 718 (March 14, 1996) (postage stamps, acting as an agent for the state in selling and renewing license plates and license tags, and public-transportation tickets from ATMs). See also OCC Conditional Approval Letter No. 267 (January 12, 1988)(notary services).

A BHC Applicant requested the Board's permission under section 4(c)(8) of the BHC Act to acquire all the outstanding shares of a company engaged in title insurance agency and real estate settlement activities. The Board previously determined that title insurance agency activities are permissible under section 4(c)(8)(G) of the BHC Act, for which the BHC Applicant qualifies.

The real estate settlement services consist of: (1) reviewing the status of the title in the title commitment, resolving any exceptions to the title, and reviewing the purchase agreement to identify any requirement in it in order to ensure compliance with them; (2) verifying payoffs on existing loans secured by the real estate and verifying the amount of and then calculating the pro rating of special assessments and taxes on the property; (3) obtaining an updated title insurance commitment to the date of closing, preparing the required checks, deeds, affidavits, and obtaining any authorization letters needed; (4) establishing a time and place for the closing, conducting the closing, and ensuring that all parties properly execute all appropriate documents and meet all commitments; (5) collecting and disbursing funds for the parties, holding funds in escrow pending satisfaction of certain commitments, preparing the HUD settlement statement, the deed of trust, mortgage notes, the Truth-in-Lending statement, and purchaser's affidavits; and (6) recording all of the documents required under law.

In reviewing the proposed activity, the Board noted that real estate settlement services are provided by the Applicant's bank subsidiaries in connection with their origination of mortgage loans, and banks within the Applicant's state are generally permitted to conduct real estate settlement activities. It was further noted that banks routinely prepare collateral security agreements and other documentation required to close loans in accordance with federal and state lending requirements as part of the general lending activities authorized under the Board's Regulation Y.

The Board concluded that aspects of the proposed real estate settlement activities are directly linked to permissible title insurance agency activities by BHCs. These activities can directly affect the insured risks under a title insurance policy. Title insurance agents have special experience in assessing potential title defects that can arise in real estate settlement. Title insurance agents thus have the expertise to generally engage in real estate settlements.

For these reasons, the proposed real estate settlement activities conducted through a permissible title insurance agency, were deemed by the Board to be closely related to banking for purposes of section 4(c)(8) of the BHC Act. The Board approved the application by order on October 15, 1990 (1990 FRB 1058).

A bank holding company (the applicant) applied under sections 3(a)(3) and 4(c)(8) of the BHC Act to acquire another company (the company), thereby indirectly acquiring its subsidiary (the subcompany) as well as the subsidiary bank and nonbank companies of the company and the subcompany. Upon consummation of the transaction, the company and subcompany would be subject to the provisions of the BHC Act. Both companies applied for permission under section 3(a)(1) of the BHC Act to become a bank holding company.

The applicant also applied for the Board's permission to engage, through one subsidiary of the subcompany (the adviser), in providing administrative and certain other services to mutual funds, nonbanking activities that the Board has not previously considered under section 4(c)(8) of the BHC Act. The applicant also applied for the Board's permission to acquire certain other nonbanking subsidiaries of the company (as listed in appendix B of the order) to engage in making or servicing loans, providing trust services, and providing investment advisory nonbanking services pursuant to section 225.28(b)(1), (b)(5), and (b)(6) of Regulation Y.

In addition, the applicant provided notice of its intent to indirectly acquire a foreign trust company, a trust administration company, and an advisory company. The companies engage in activities that are permissible under section 211.10 of Regulation K.

3600.27.1 GLASS-STEAGALL ACT ISSUES IN PROVIDING ADMINISTRATIVE SERVICES

The administrative services the applicant proposed to provide through the adviser and its affiliates raised a number of issues under the Glass-Steagall Act. Under that act, a company that owns a member bank may not control "through stock ownership or in any other manner" a company that engages principally in distributing, underwriting, or issuing securities.

Because mutual funds continuously issue and redeem securities, the Board in 1972 issued an interpretation setting out its position on the Glass-Steagall Act as it governs the relationship between mutual funds and companies that own member banks (12 C.F.R. 225.125). The Board found that the Glass-Steagall Act prohibits affiliates of banks from sponsoring, organizing, or controlling mutual funds or distributing their shares.

The Board also found, however, that the Glass-Steagall Act does not prohibit all relationships between a bank holding company and a mutual fund and that it is permissible, under the BHC Act and the Glass-Steagall Act, for bank holding companies to provide investment advice to mutual funds. Also, the Board found that the Glass-Steagall Act does not prohibit bank holding companies from providing certain other services to mutual funds, such as acting as custodian, transfer agent, or registrar.[1] Banks and affiliates of banks may serve as investment adviser, transfer agent, custodian, and registrar. *They may not act as distributor to the fund.* The application raised the question whether it was consistent with the Glass-Steagall Act for an affiliate of a member bank to act as an administrator to a mutual fund.

3600.27.2 PERMISSIBILITY OF PROPOSED ADMINISTRATIVE-SERVICES ACTIVITIES

The adviser furnishes a variety of services to open-end investment companies (mutual funds) and closed-end investment companies in the United States. Because certain of the activities of the adviser and its affiliates are prohibited by the Glass-Steagall Act, the applicant has taken steps and has committed to terminate the

1. The Board imposed a number of restrictions on the relationship between bank holding companies and mutual funds to avoid conflicts of interest and to address potential safety-and-soundness concerns. The Board's rule includes restrictions preventing a bank holding company or any of its subsidiaries from—

- acting as investment adviser to any investment company that has a name similar to the holding company or any of its subsidiary banks;
- purchasing for its own account shares of any investment company for which the holding company serves as investment adviser;
- purchasing in its sole discretion in a fiduciary capacity shares of an investment company advised by the holding company; or
- extending credit to an investment company advised by the holding company as collateral for a loan used to purchase shares of the investment company.

In addition, the rule requires that, in cases in which a customer purchases or sells securities of the fund through the holding company or is advised by the holding company to purchase shares of the fund, the customer be informed in writing of the holding company's involvement with the fund, and be informed that the shares of the fund are not federally insured and are not guaranteed by, or obligations of, a bank.

adviser's role as a sponsor of new mutual funds. The applicant also committed that it would not acquire those of the adviser's subsidiaries that engaged in the distribution of mutual fund shares. The applicant further committed that it would not be involved in the distribution of the shares of any mutual fund. The applicant represented to the Board, that, after the acquisition of the company, neither the adviser nor any of its affiliates would be obligated by any agreement to engage in any sales activities in connection with any mutual fund's shares and would not enter into any distribution agreement with any mutual fund, unless permitted to do so by a change in current law.

The adviser will not—

1. engage in the development of marketing plans except to give advice to the distributor regarding regulatory compliance;
2. engage in advertising activities with respect to the funds and will not be involved in the preparation of a fund's sales literature, except to review it for the sole purpose of ensuring compliance with pertinent regulatory requirements; or
3. permit employees of the adviser to engage in sales activities at meetings or seminars (such activities would be conducted solely by the fund's distributor).

It was noted that the applicant did not propose providing administrative services to those mutual funds that are marketed and sold primarily to customers of any of the applicant's subsidiary banks.

The Board believes that it is permissible under the Glass-Steagall Act for the applicant to provide the following administrative services to mutual funds as proposed:

1. maintaining and preserving the records of the fund, including financial and corporate records
2. computing the fund's net asset value, dividends, and performance data and financial information regarding the fund
3. furnishing statistical and research data
4. preparing and filing with the Securities and Exchange Commission (SEC) and state securities regulators registration statements, notices, reports, and other material required to be filed under applicable laws
5. preparing reports and other informational materials regarding the fund, including proxies and other shareholder communications, and reviewing prospectuses
6. providing legal and regulatory advice to the fund in connection with its other administrative functions
7. providing office facilities and clerical support for the fund
8. developing and implementing procedures for monitoring compliance with regulatory requirements and compliance with the fund's investment objectives, policies, and restrictions as established by the fund's board
9. providing routine fund accounting services and liaison with outside auditors
10. preparing and filing tax returns
11. reviewing and arranging for payment of fund expenses
12. providing communication and coordination services with regard to the fund's investment adviser, transfer agent, custodian, distributor, and other service organizations that render recordkeeping or shareholder communication services
13. reviewing and providing advice to the distributor, fund, and investment adviser regarding sales literature and marketing plans to ensure regulatory compliance
14. providing the distributor's personnel with information about fund performance and administration
15. participating in seminars, meetings, and conferences designed to present information to brokers and investment companies, but not in connection with the sale of shares of the funds to the public, concerning the operation of the funds, including administrative services provided by the bank holding company to the funds
16. assisting existing funds in the development of additional portfolios
17. providing reports to the fund's board regarding fund activities

A mutual fund administrator provides services that are essentially ministerial or clerical. The administrator does not have policymaking authority or control over the mutual fund. The policymaking functions rest with the board of directors of the mutual fund. The board of directors is responsible for the selection and review of the major contractors to the fund, including the investment adviser and, in certain circumstances, the administrator.

The Investment Company Act of 1940 requires that at least 40 percent of the board of directors of a mutual fund be disinterested persons who are not affiliated with the investment adviser, with any person that the SEC has determined to have a material business or professional relationship with the fund, with any employee or officer of the fund, with any registered broker or dealer, or with any other interested or affiliated person. These unaffiliated board members must approve the fund's contracts with its investment adviser, underwriter, and often its administrator. The applicant committed that the adviser will provide administrative services only to mutual funds whose board of directors consists of a majority of disinterested persons.

In situations in which the applicant's subsidiaries serve as administrator to the mutual fund, the Board permitted one representative of the administrator to serve as a director of the fund. The applicant contended that such an interlocking director would facilitate the provision of administrative services by providing the fund with a person knowledgeable in the operation of the fund who would be in a position to advise the board of directors on administration.

The applicant proposed that a director interlock would be used only in situations in which a company unaffiliated with it serves as the investment adviser to the mutual fund. With regard to the adviser's serving as an administrator, this interlocking director would be deemed an interested person and would be excluded from those actions that must be taken by disinterested board members, such as the approval of an investment advisory contract or a contract for the administrator. The applicant committed that the adviser would serve as administrator only to mutual funds for which a majority of the board of directors are disinterested individuals. The Board believed that, in this proposed arrangement, the applicant would not control a mutual fund if one employee of the adviser or an affiliate[2] would serve as a director of a mutual fund to which the advisor provides administrative services.

The applicant plans, in a small number of cases, to provide mutual funds with a combination of administrative, investment advisory, and other services. The OCC has permitted national banks that serve as investment adviser to mutual funds also to provide some administrative services to those mutual funds. In addition, a number of national banks have been providing these and other services as ''subadministrator'' to mutual funds that are advised by the bank or an affiliate.

In the Board's opinion, permitting a bank holding company that serves as investment adviser to a mutual fund and also in essence provides ministerial or supporting functions as administrator to that fund would not significantly increase the bank holding company's ability to control the mutual fund. In other words, the adviser would not, by virtue of becoming an administrator to a fund that it or an affiliate advises, become involved in policymaking functions of these funds to a greater extent than when it provides solely investment advisory services. The Board believes that control would continue to rest with the board of directors of the mutual fund.

With regard to providing a combination of advisory and administrative services, the applicant further committed that it would not have any director or officer interlocks with these mutual funds. It would also not have any director or officer interlocks with mutual funds to which it provides both advisory and administrative services.

In providing the combination of services, the applicant would be subject to the Board's interpretation on investment advisory activities (12 C.F.R. 225.125) and would therefore be required to conform the adviser's activities to the interpretation within two years. On this condition, and subject to the commitments made by the applicant, the Board concluded that the proposal was permissible under the Glass-Steagall Act.

3600.27.3 BOARD'S CONCLUSION ON PROVIDING ADMINISTRATIVE SERVICES

The Board found the applicant's proposed activities to be closely related to banking because (1) it had previously determined by regulation that a bank holding company could act as investment adviser to a mutual fund; (2) national banks, including national bank trust departments, provide administrative services to mutual funds; and (3) it had also permitted bank holding companies to provide certain individual financial data processing services (calculation of investment values and tax consulting) by a mutual fund administrator. The Board thus approved the application on April 21, 1993 (1993 FRB 626), based on the facts of record and all of the commitments and representations made by the applicant, and subject to the terms and conditions set forth in the order.

2. This director cannot serve as an officer, director, or employee of the applicant, its bank, or any subsidiary bank or bank holding company of the applicant.

A foreign banking organization (FBO), subject to the provisions of the Bank Holding Company Act, had requested the Board's approval to acquire, through a wholly owned subsidiary (the company), substantially all the assets of an asset-management partnership (the partnership). The company would be an investment adviser registered with the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940. The company's acquisition of the partnership would also include a membership interest in a services firm that would provide transfer-agency services to mutual funds advised by the company (the funds).

The FBO, among other things, proposed to provide marketing support to a mutual fund by directly contacting broker-dealers, 401(k) plan providers, financial planners, insurance companies, and other financial intermediaries to recommend the funds. It would be primarily responsible for the development of marketing plans and the preparation of advertising and sales literature materials for the funds. The Board had not previously considered whether a bank holding company could provide promotional or marketing services to the extent that was proposed.

3600.28.1 CONTROL CONSIDERATIONS INVOLVING PROMOTIONAL AND MARKETING ACTIVITIES

Under the Glass-Steagall Act, a company that owns a member bank may not own or control "through stock ownership or in any other manner" a company that engages principally in distributing, underwriting, or issuing securities.[1] The Board has found that this provision prohibits affiliates of banks from sponsoring, organizing, or controlling a mutual fund. The Board previously has determined, however, that the Glass-Steagall Act does not prohibit a bank holding company from providing advisory and administrative services to a mutual fund.[2]

The proposed promotional and marketing activities would not, it was believed, cause the FBO to control the funds or to be involved in the underwriting and distribution of the funds' securities to the public. The proposed promotional activities involved contact only with financial intermediaries. The activities are similar to the activities previously approved by the Board. The Board had previously permitted bank holding companies to present information about the operations of the mutual funds advised and administered by the bank holding company at meetings or seminars for brokers of mutual funds.[3] In addition, the Office of the Comptroller of the Currency (OCC) had also authorized subsidiaries of national banks to provide marketing and advertising support to mutual funds in connection with their brokerage and advisory services.

As for the distribution and sales of the funds, it was proposed that an independent distributor be given that responsibility.[4] The independent distributor would serve as the principal underwriter of the funds and would enter into sales agreements with financial intermediaries to sell shares of the funds on their behalf.[5] Actual sales would be conducted by the independent distributor or by an independent broker-dealer for the funds.

The FBO did not propose to solicit retail customers to purchase shares in particular funds, to accept orders for the purchase of shares, or to engage in any retail sales activities. Neither the company nor any of its employees would receive transaction-based income or commissions in connection with the company's promotional or marketing activities.

The company would have primary responsibility for preparing the advertising and marketing materials. The independent distributor, however, would be responsible for placing all advertisements. The independent distributor would also have legal responsibility, under the rules of the National Association of Securities Dealers (NASD), for the form and use of all advertising and sales literature prepared by the company, and would also be responsible for filing these materials with the NASD or SEC.

For the reasons cited, the Board believed that the promotional and marketing activities pro-

1. 12 U.S.C. 221a and 377.
2. See 12 C.F.R. 225.28(b)(6) and 12 C.F.R. 225.125.
3. See 1993 FRB 626 (footnote 15).
4. The FBO committed that none of its U.S. affiliates, including the company, would be obligated by any agreement to engage in any sales activities with regard to shares of the funds, nor would such affiliates enter into any distribution agreement with the funds without the prior approval of the Board.
5. The funds could enter into distribution agreements with intermediaries, but in no event could the company enter into such agreements.

posed by the FBO would not involve the company in the underwriting or distribution of shares of the funds for the purposes of the Glass-Steagall Act.

3600.28.2 MANAGEMENT INTERLOCK CONTROL CONSIDERATIONS

The FBO also proposed that the chief executive officer serve as the chairman of the four-member board of trustees of the funds and that no more than three officers or employees of the company serve as junior-level officers of the funds. The employees would serve as assistant secretary, assistant treasurer, or assistant vice president of the funds, and would be supervised by the board of trustees or senior-level officers. These employees would have no policymaking authority at the funds and would not be responsible for, or involved in, making recommendations on policy decisions. No employee or officer of the company would serve as a senior-level officer of the funds.

The Board had previously authorized a bank holding company to have director and officer interlocks with mutual funds that the bank holding company advises or administers.[6] The Board concluded that the proposed interlocks between the company and the funds, in this case, would not compromise the independence of the boards of trustees of the funds, compromise the independent distribution of the funds, or result in control of the funds by the FBO.

Based on the facts given, the Board concluded that the control of the funds would rest with the independent members of the boards of trustees of the funds, and that the proposed interlocks between the company and the funds would not compromise the independence of the boards of the funds or permit the FBO to control the funds. The Board concluded that the proposal was consistent with the Glass-Steagall Act. The notice was approved on June 16, 1997. See 1997 FRB 679, 1998 FRB 1075–77, 1998 FRB 852–853, and 1998 FRB 680–82.

6. See 1996 FRB 1129.

A bank holding company gave notice under section 4(c)(8) of the Bank Holding Company Act (BHC Act) (12 U.S.C. 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) of its intention to engage de novo through its mortgage subsidiary in providing employment histories to third parties for a fee.

The employment histories to be provided by the mortgage subsidiary would include the names of past and current employers of an individual and the salary and length of employment for each position, if the individual has consented to the release of such information. The mortgage subsidiary would compile an individual's employment history from information available from state departments of employment services and other similar sources. This information would be provided for a fee to any third-party credit grantor for the purpose of assessing the creditworthiness of a prospective borrower.[1]

3600.29.1 CREDIT-RELATED EMPLOYMENT HISTORIES

The mortgage subsidiary will provide employment histories to third-party credit grantors, including depository and nondepository grantors, for use in making decisions to extend credit only with the express consent of the individual involved. The bank holding company committed that the mortgage subsidiary will comply with the Fair Credit Reporting Act (15 U.S.C. 1681 et seq.) (FCRA) and all applicable state and federal laws and regulations.

In the normal course of their lending activities, banks collect and analyze employment and salary information, including names of past and current employers and salary histories. The Board previously determined that providing past credit information, which includes employment history information, to a credit grantor who is considering a borrower's application for credit is an activity that is closely related to banking and permissible for bank holding companies.[2] Accordingly, the Board concluded that providing employment histories to third-party credit grantors for use in making decisions to extend credit is an activity that is closely related to banking.

3600.29.2 NON-CREDIT-RELATED EMPLOYMENT HISTORIES

The bank holding company also intends to provide employment histories to third-party depository institutions and their affiliates, including credit unions and their affiliates, for use in the regular course of their business, including the hiring of employees. The mortgage subsidiary would provide this information to such entities only with the express consent of the individual involved. Regardless of whether the customer is a third-party depository institution or other credit grantor, the activity would only involve providing employment information. The bank holding company does not plan to provide any additional service, such as analyzing an individual's creditworthiness. The bank holding company committed that its mortgage subsidiary will comply with the FCRA and all applicable state and federal laws and regulations in performing the proposed activity.

The Board had not previously determined whether providing such employment information to third parties for a fee is closely related to banking under section 4 of the BHC Act and, therefore, permissible for bank holding companies. The Board had previously permitted bank holding companies to provide employment information, including employment histories, to depository institutions and their affiliates in connection with the provision of career counseling services (see section 3600.15.1.1).[3] To the extent that these organizations use the information to be provided by the mortgage subsidiary for other purposes, it will only be used in connection with the operation of their banking business.

The Board thus concluded that providing employment histories for use by depository institutions and their affiliates in the regular course of their business is an activity that is closely related to banking. For these reasons, the Board, on May 8, 1995, approved the bank holding company's notice to provide such employment information (1995 FRB 732). The

1. Credit grantors could include lessors if the leasing transaction was the functional equivalent of an extension of credit.

2. See Regulation Y, section 225.25(b)(24) (12 C.F.R. 225.25(b)(24)). The bank holding company committed that it would not promote its mortgage subsidiary as a provider of employment information to non–depository institutions for general business purposes unrelated to credit decisions.

3. See 1994 FRB 51.

approval was specifically conditioned on compliance with the commitments made in connection with the notice.

3600.30.1 REAL ESTATE TITLE ABSTRACTING ACTIVITIES

A bank holding company (the notificant) gave notice under section 4(c)(8) of the Bank Holding Company Act (the BHC Act) (12 U.S.C. 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) of its intention to acquire a title abstracting company (the company) and thereby engage in real estate title abstracting in the state of Iowa.[1] Real estate title abstracting, as proposed by the notificant, is limited to reporting factual information concerning the interests or ownership of selected real property. An abstracter obtains this information by performing a title search of records maintained at a local public records office to determine the ownership history of the property, including any liens, encumbrances, mortgages, or future interests affecting it. The abstracter then prepares a written report, also known as an ‘‘abstract of title,'' that recites the results of the title search. Because Iowa state law does not permit the sale of title insurance, real estate lenders obtain the opinion of an attorney certifying that title to a particular parcel of real property is free of defects. The abstract of title provides the factual information necessary for the attorney to determine whether a lender would have an unencumbered security interest in the property to be mortgaged.

The notificant proposes to provide real estate title abstracting services to affiliated and unaffiliated lenders in an Iowa county. The company would perform the proposed activities in connection with real estate loans made by affiliates or unaffiliated companies and, in certain cases, when no financing is provided, such as in connection with intrafamily transfers of real estate and property distributed as part of estate planning.

The notificant would not provide any insurance against title defects, guarantee any title, or provide any certification with respect to a title. The notificant would be liable for damages caused by negligence in performing a title search but would not be responsible for any defects in the title.[2] The equivalent of title insurance in Iowa is provided by the attorney who certifies that the title is free from defects. The Board has not previously determined that providing real estate title abstracting is closely related to banking under section 4(c)(8) of the BHC Act and, therefore, permissible for bank holding companies.

The Board believes that the proposed real estate title abstracting activities are integrally related to the provision of loans secured by real estate. A bank must be aware of any encumbrances on property that serves as collateral for a loan made by the bank. Banks in the state typically rely on an attorney's opinion, based on information in an abstract of title, to determine that they have a secured position in real estate serving as collateral. The abstract of title provides information necessary to determine the adequacy of the real estate collateral for the loan and is an integral part of secured real estate lending in Iowa. Thus, the bank has a particular need for the information in the abstract of title. Accordingly, the Board believes that the proposed activities are integrally related to the provision of secured real estate lending and, therefore, are closely related to banking.

The Office of the Comptroller of the Currency (OCC) has authorized national banks to conduct this activity.[3] The OCC has concluded that the performance of a title search and the preparation of an abstract of title are necessary parts of the real estate lending process and that it would be convenient and useful under the applicable standards in the National Bank Act for national banks to be able to perform these tasks themselves.[4]

The proposed activities are not equivalent to providing title insurance—an activity that is not generally permissible under section 4(c)(8) of the BHC Act.[5] Title insurance generally includes providing an indemnification against losses resulting from a title defect discovered after the conveyance of property. Title insurance typically protects a purchaser or lender against claims not identified by a title search or claims not specifically exempted by the title insurance policy. The notificant does not propose to certify or guarantee title and would not be liable to the purchaser or the lender for any title defects.

1. The notificant would merge the company into its wholly owned leasing subsidiary.

2. Title abstracters may insure against liability for negligence by purchasing an errors and omissions policy.

3. OCC Interpretative Letter No. 450, September 22, 1988.

4. National banks are not permitted to sell title insurance.

5. Section 4(c)(8) provides that insurance agency, brokerage, and underwriting activities are not ‘‘closely related to banking'' and, thus, are not permissible activities for bank holding companies, unless the activities are included within one of seven specific exemptions (A through G) in section 4(c)(8) (12 U.S.C. 1843(c)(8)(A)–(G)).

The Board concluded, based on all the facts of record, that the proposed activities are closely related to banking and approved the notice on June 30, 1995. (See 1995 FRB 805.) Approval of the proposal was specifically conditioned on the notificant's compliance with the commitments made in connection with the notice.

3600.30.2 AIRCRAFT TITLE ABSTRACTING ACTIVITIES

An attorney representing a bank holding company (BHC) requested an opinion as to whether the providing of title abstracts on U.S.-registered aircraft would be a permissible activity for a new subsidiary of a BHC. The aircraft title abstracting activities would be limited to reporting factual information concerning the ownership history of the relevant aircraft and the existence of liens or encumbrances affecting the aircraft. The information would be obtained by performing a title search of records. The title search would be documented in a written report, known as an ‘‘abstract of title,’’ describing the factual information located by the title search concerning the existing title owner of the aircraft, previous transfers of the aircraft's title, and the existence of any liens or encumbrances affecting title to the aircraft.[6] The subsidiary would provide the information to affiliated and unaffiliated lenders and other parties in connection with aircraft financing and sales transactions. The aircraft title abstracting activities would not include providing insurance against defects in the title of any aircraft, guarantee any aircraft title, or provide any certification with respect to an aircraft title. Based on facts and information provided and other facts, the Legal Division staff issued an opinion on October 7, 2002, that concluded that the proposed aircraft title abstracting to be conducted by the subsidiary would be within the scope of the title abstracting activities previously authorized by the Board on June 30, 1995. (See 1995 FRB 805, 806.)

6. The attorney requesting the opinion reported that federal law requires that all changes in title of, and liens and encumbrances affecting, U.S.-registered aircraft must be filed with the Federal Aviation Administration.

The BHC Act states that a nonbank activity is impermissible unless explicitly exempt from the general prohibition of section 4. While this could cause an unlimited list of impermissible activities, the Board has compiled a list of activities which have been specifically determined to be impermissible (see Manual section 3000.0, Appendix 3).

The inspection objective is to determine whether a specific activity conducted by a bank holding company or its subsidiary is permissible for the bank holding company. The Board has ruled specific activities to be impermissible although it has stated also that certain impermissible activities may be engaged in under limited special circumstances.

In addition, a bank holding company may be entitled to grandfather privileges which are considered as either permanent (where there is no deadline for termination of an activity) or temporary, in which case the activity must have been terminated prior to December 31, 1980. A holding company may be granted an exemption from section 4 of the Act (i.e., family, hardships, etc.) which allows it to engage in activities that would otherwise be impermissible. Because of the variety of factors which must be considered, the examiner should exercise care when determining the permissibility of an activity for a bank holding company.

The subsections of this chapter present a *selected number* of those activities which have been determined to be impermissible for bank holding companies. While an activity is permissible only after it has been determined as such by the Board, it must be remembered that in determining permissibility, the Board has in some instances (i.e., data processing services, courier services, etc.) included restrictions which would limit the overall nature or performance of the activity. Therefore, even the permissible activities may become impermissible if the actions of the bank holding company are not in accordance with the stated restrictions.

The Board of Governors has ruled that land development[1] is impermissible for bank holding companies. However, for land acquired through foreclosure, a limited amount of development may be allowed in an effort to minimize the potential loss on the project. Each case must be considered separately to determine if it warrants additional development.

The basic determination of impermissibility was established by the Board in denying a portion of the application by UB Financial Corp., Phoenix, Arizona, to retain the H. S. Pickrell Company, Phoenix, Arizona (1972 FRB 429). The order stated in part, ‘‘The Board is of the opinion that the activities of purchasing and selling of land or participating as a joint venturer in real estate development are not so closely related to banking as to be a proper incident thereto, and that insofar as the application pertains to those activities, it should be denied.’’

The determination that limited development for land acquired through foreclosure is permissible is contained in a Board order dated November 1, 1973, in connection with an application by Liberty National Corporation, Oklahoma City, Oklahoma, to retain Liberty Mortgage Company, Oklahoma City, Oklahoma (1973 FRB 919), in which it is indicated that a limited amount of real estate development might be permissible if necessary to minimize losses on real estate acquired in connection with debts previously contracted.

1. The Board, by specific order, has permitted a limited incursion into this area as an accommodation to BHCs acquiring thrifts or to thrifts that qualify as ‘‘banks’’ and seek to form bank holding companies (1986 FRB 487, 731)

3700.2.1 PREMIUM FUNDING

Insurance premium funding, sometimes known as equity funding, is the financing of the sales of mutual fund shares and life insurance policies as a package. It should not be confused with loans made to an insured for the purpose of paying premiums on hazard insurance (insurance premium financing); in that case the lender may be named loss payee or owner of the policy and the lender has the right to submit the policy for cancellation in order to collect the amount owed. Insurance premium financing is a permissible activity pursuant to Section 225.25(b)(1) of Regulation Y (Refer to 1974 FRB 310).

The Board has determined insurance premium funding to be impermissible for bank holding companies (12 C.F.R. 225.126). This determination is based on the policies contained in sections 20, 21, and 32 of the Banking Act of 1933 (the Glass–Steagall Act Provisions) as described in the opinion of the United States Supreme Court in Investment Company Institute v. Camp, 401 U.S. 617 (1971).

''In the Board's opinion, the Glass–Steagall Act provisions, as interpreted by the U.S. Supreme Court, forbid a bank holding company to sponsor, organize or control a mutual fund'' (12 C.F.R. 225.125). In enacting the Glass–Steagall Act, Congress indicated that affiliations of commercial banks and securities companies give rise to a potential conflict of interest and unsound banking practices. Pursuant to section 4(c)(8) of the Act, the Board is required to consider whether the performance of a particular nonbank activity by a holding company produces benefits to the public that outweigh possible adverse effects, such as potential conflict of interest and unsound banking practices. Therefore, the potential conflict of interest and unsound banking practices arising in the affiliation of commercial banks and mutual funds precludes the Board from approving insurance premium funding as a permissible banking activity.

3700.2.2 LIFE INSURANCE UNDERWRITING

The life insurance discussed in this section is that life insurance which is not sold in connection with a credit transaction by a bank holding company or its subsidiary. The Board has ruled that this activity is impermissible for bank holding companies (12 C.F.R. 225.126). The Board developed its position during consideration of the application of First Oklahoma Bancorporation, Inc., Oklahoma City, Oklahoma, for prior approval pursuant to section 4(c)(8) of the Act to acquire sufficient additional shares of Underwriters Life Insurance Company, Oklahoma City, Oklahoma, so as to own at least 80 per cent of the outstanding shares and thereby to engage in the activity of underwriting life insurance not sold in connection with a credit transaction by a bank holding company or a subsidiary.

In acting on the First Oklahoma application, the Board relied on an earlier decision denying an application by Transamerica Corporation, San Francisco, California, to retain its shares of Occidental Life Insurance Company of California (1957 FRB 1014). In the Transamerica case, a hearing examiner found that the life insurance underwriting activities of Occidental were not so closely related to banking to be a proper incident to managing and controlling banks. In the First Oklahoma case, the application was presented on the question of whether the activities of Underwriters Life were so closely related to banking or managing or controlling banks as to be a proper incident thereto. The Board determined in First Oklahoma, that there was no reasonable basis for the contention that the activities of Underwriters Life were permissible.

The activity of acting as an underwriter (reinsurer) for credit life and credit accident and health (disability) insurance is, however, considered a permissible activity (12 C.F.R. 225.135).

3700.2.3 SALE OF LEVEL-TERM LIFE INSURANCE

The Board has stated that the sale of level-term life insurance is not covered by section 225.25(b)(8)(ii) of Regulation Y. This position was stated in its order approving the application by Fidelity Corporation of Pennsylvania, Rosemount, Pennsylvania, to acquire Local Finance Corporation, Providence, Rhode Island, excepting those proposed activities of level-term life insurance sales (1973 FRB 472). Insurance that does not decline in coverage as the outstanding loan balance is reduced results in the insured party carrying more insurance than is necessary to cover the outstanding loan balance. Because of this position, the Board would not allow the sale of this type of insurance by the applicant and its subsidiary.

3700.2.4 UNDERWRITING REAL ESTATE MORTGAGE GUARANTEE INSURANCE

Mortgage guaranty insurance is essentially a limited guarantee of a mortgage loan. Such insurance typically covers the top 20 or 25 percent of a mortgage loan. In the event of default by the borrower, the lender acquires title to the property and then submits a claim to the insurer. The insurer then has a choice of two options: (1) take title to the property and pay the lender the unpaid principal and interest; or (2) pay the lender the 20 or 25 percent insured portion of the loan, with the lender retaining title to the property.

The Board has determined that ''the underwriting of mortgage guarantee insurance is principally a credit determination, similar to those made by banks in their regular course of business'' (1974 FRB 727). Therefore, this activity is considered closely related to banking for purposes of permissibility under section 4(c)(8) of the Act. However, the Board noted that the private mortgage insurance industry was relatively young and still developing with a limited, untested, operating history. In addition, the Board believed that the times were such that it was ''desirable for bank holding companies generally to slow their present rate of expansion and direct their energies toward strong and efficient operations within their existing activities, rather than toward expansion into new activities'' (the go-slow policy), and, therefore, concluded that it would not be appropriate to adopt the underwriting of mortgage guarantee insurance as permissible for bank holding companies.

3700.2.5 UNDERWRITING PROPERTY AND CASUALTY INSURANCE

On May 12, 1978, the Board denied NCNB Corporation's application to retain its indirect subsidiaries, Superior Insurance Company and Superior Claim Service, both of Florence, North Carolina. These companies engaged, respectively in the activities of underwriting property and casualty insurance related to extensions of credit by NCNB's affiliates, in adjusting insurance claims and in appraising and valuing property in connection therewith. Neither of these activities had previously been determined by the Board to be closely related to banking. The Board concluded that the circumstances presented did not provide a reasonable basis for believing that the proposed activity was closely related to banking or managing and controlling banks (1978 FRB 506).

3700.2.6 TITLE INSURANCE

The Board issued a letter (See Board letter re Independence Bancorp, Inc., dated 3/17/86) to a bank holding company which filed an application with the Board to acquire a *de novo* title abstract company which planned to engage in, among other things, the sale of title insurance. The sale of title insurance had not been previously approved by the Board as a permissible nonbanking activity. In responding to the application, the Board determined that the proposed title insurance activities were not closely related to banking.

The Board's discretion to decide what types of insurance activities are closely related to banking was removed by the Garn–St Germain Depository Institutions Act of 1982 (''Garn Act''), which amended section 4(c)(8) of the BHC Act. The Garn Act stated that ''it is not closely related to banking or managing or controlling banks for a bank holding company to provide insurance as a principal, agent, or broker. . . .'' The Garn Act lists certain specific exceptions to this general prohibition, none of which permits the sale of title insurance. The Board thus concluded that the Garn Act does not allow it the discretion to approve this type of nonbanking activity.

3700.3.1 BROKERAGE

Real estate brokerage is the negotiating of a real estate contract between a buyer and seller for which the broker receives a fee or commission and in which the broker takes no possessory interest in the subject matter of the contract. The Board has stated that this activity is considered impermissible for bank holding companies. The Board's position was expressed in its order approving an application by Boatmen's Bancshares, Inc., St. Louis, Missouri, to acquire Williams, Kurrus and Company, St. Louis, Missouri (1972 FRB 428). The Board stated that it had determined that real estate brokerage activities were not so closely related to banking or managing or controlling banks as to be a proper incident thereto. Since Boatman's had not demonstrated to the Board's satisfaction that the real estate brokerage field activities are so closely related to banking or managing or controlling banks as to be a proper incident thereto, the Board approved the Boatman's application on the condition that Boatman's terminate its real estate brokerage activities.

3700.3.2 SYNDICATION

The Board ruled that this activity is not permissible for bank holding companies. The Board's position was developed during consideration of the application of BankAmerica Corporation, San Francisco, California, for prior Board approval to engage *de novo* under section 4(c)(8) of the Act in the activity of real estate syndication through a subsidiary, BankAmerica Realty Services, Inc., San Francisco, California. The Board concluded that the subsidiary's proposed activities of organizing, promoting, selling partnership interests, and acting as the sole general partner of real estate syndicates went beyond the functions performed by an advisory company to a real estate investment trust permissible under section 225.25(b)(4) of Regulation Y.

The Board also stated that it felt that the policies contained in sections 20 and 32 of the Banking Act of 1933 (the Glass–Steagall Act Provisions) must be considered in conjunction with section 4(c)(8) of the Act. These policies, described in the opinion of the United States Supreme Court in Investment Company Institute v. Camp, 401 U.S. 617 (1971), forbid a bank holding company to sponsor, organize or control an open-ended investment company (mutual fund) or a closed-end investment company primarily or frequently engaged in the issuance, sale and distribution of securities. Because the activities of real estate syndication resemble the issuance, sale and distribution of securities of a closed-end investment company, this activity is not permissible for a bank holding company (12 C.F.R. 225.125).

The Board has stated that general management consulting is not so closely related to banking or managing or controlling banks as to be a proper incident thereto. This ruling is contained in the Board's order denying the application of First Commerce Corporation, New Orleans, Louisiana, to acquire W. R. Smolkin & Associates, Inc., New Orleans, Louisiana. In its order the Board describes general management consulting as follows:

"... including, but not limited to, the provision of analysis or advice as to a firm's (i) purchasing operations, such as inventory control, sources of supply, and cost minimization subject to constraints; (ii) production operations, such as quality control, work measurement, product methods, scheduling shifts, time and motion studies, and safety standards; (iii) marketing operations, such as market testing, advertising programs, market development, packaging, and brand development; (iv) planning operations, such as demand and cost projections, plant location, program planning, corporate acquisitions and mergers, and determination of long-term and short-term goals; (v) personnel operations, such as recruitment, training, incentive programs, employee compensation, and management-personnel relations; (vi) internal operations, such as taxes, corporate organization, budgeting systems, budget control, data processing systems evaluation, and efficiency evaluation; or (vii) research operations, such as product development, basic research, and product design and innovation." (1972 FRB 674) The Board denied the case and determined that the activity of providing general management consulting services could lead to unwanted conflict of interest situations for BHCs that advised clients that were also customers of its own subsidiary banks. The Board also desired to maintain a distinct separation between banking and commerce.

In its order denying the application of Marine Midland Banks, Inc., Buffalo, New York, to acquire Carter H. Golembe Associates, Inc., Washington, D.C., the Board further defines the concept of management consulting by stating that Golembe, "... provides consulting services on a confidential basis to banks, bank holding companies and bankers' associations. It makes bank feasibility studies and renders advice with respect to geographic expansion, product extension, mergers and acquisitions and applications to State and federal regulatory agencies. A portion of Golembe's consulting services also relates to internal bank operations, such as marketing, trust and bank credit card operations and loan or interest rate policies. Other studies and analyses are performed upon request of individual banks. Golembe also provides advice with respect to the organization and operation of State Bankers' associations and serves as a consultant to various banking groups with respect to legislative and regulatory matters affecting the banking industry. The foregoing consulting services furnished by Golembe are considered by the Board to be but a specialized form of management consulting." (1972 FRB 676)

Management consulting to nonaffiliated commercial banks and nonbank depository institutions has been determined by the Board to be a permissible activity for bank holding companies under section 4(c)(8) of the Act (Regulation Y, section 225.25(b)11, as amended).

The Board has ruled that this activity is impermissible for bank holding companies. However, bank holding companies may conduct property management activities for three types of property as follows:

1. Property held in a fiduciary capacity;
2. Property owned by the holding company or its subsidiary for its own bank and bank-related operations;
3. Property acquired by the holding company or its subsidiary as a result of a default on a debt previously contracted.

The Board announced on June 30, 1972, that it would not include this general activity on the list of permissible activities. Because the Board did not intend to limit any authority given by statute or regulation to a holding company or its subsidiary concerning property management, the Board described in its order the three types of property, as shown above, for which a holding company or its subsidiary could engage in property management activities (1972 FRB 652).

In addition to the prohibition of property management activities in general, the Board has ruled that the operation of a commercial parking lot is impermissible. In its order approving the application by Multibank Financial Corporation, Boston, Massachusetts, to acquire the B. M. C. Durfee Trust Company, Fall River, Massachusetts, a commercial bank, the Board stated that operating a commercial parking lot was not considered closely related to banking and conditioned its approval on divestment of the parking lot operation (1973 FRB 679).

The Board through its rulemaking authority did not include operating a travel agency on the list of permissible activities for bank holding companies. This activity is considered not to be closely related to banking or managing or controlling banks (1976 FRB 148). The Board referenced a decision of the United States Court of Appeals for the District of Columbia, Courier Association vs. Board, 516 F. 2d 1229 (1975).

The Board felt the only relevant criteria for this activity was whether banks have generally provided the service. The Board noted that there were few bank-affiliated travel agencies, most of which had only been recently established. The Board concluded that operating a travel agency was not closely related to banking.

On June 1, 1978, the Comptroller of the Currency issued Banking Circular No. 108, which requested all national banks then operating travel agencies, to divest themselves of those agencies within a reasonable period of time not to exceed three years. The Comptroller's office concluded that the continued operation of a travel agency by a national bank is inappropriate and may expose the bank to a substantial risk of loss by litigation. This action by the Comptroller precludes bank holding companies from relying on section 4(c)(5) of the Act to conduct travel agencies. Thus, holding companies have no authority to engage in travel agency activities under the Act unless grandfathered.

On April 2, 1979, the Board issued a letter, a copy of which went directly to all bank holding companies engaging in the activity of operating a travel agency pursuant to section 4(c)(5) of the Act, indicating that no bank holding companies could engage in the activity solely pursuant to section 4(c)(5) and that those engaged in such activity had to terminate the activity by December 31, 1980 (Z–8421 on office copy only).

Subsequently, a bank holding company applied to the Board to acquire a company (''Company'') that engages in a variety of data processing and data transmission activities for customers. The Company's data bases that are provided to customers included a program by which customers could receive airline and hotel information and could make airline and hotel reservations. The Board determined that the receipt of such information and the ability to make airline and hotel reservations was not closely related to banking. Accordingly, the Board required, as a condition for approval of the application, the bank holding company to eliminate the travel reservation service from the roster of third party data base programs provided by Company (Refer to 1986 FRB 497).

As part of the Security Pacific Corporation's (bank holding company) application to acquire Duff & Phelps, Inc. (Company), which engaged in investment advisory, investment management, and financial advisory services, the Board, on December 11, 1984, denied the Applicant's request to engage in the activity of providing credit ratings on bonds, preferred stock and commercial paper. Private credit ratings were included as part of the investment research reports sold to institutional investors. The Company also provided credit ratings on a fee basis for companies that request public disclosure. As part of the public rating process, the rated company is given the opportunity to make a presentation to the Company's Credit Rating Committee.

In this situation, the Security Pacific Corporation had a vested interest in the ratings of the corporations to which it lends in the ratings of municipal bonds it underwrites, in the ratings of the commercial paper and municipal bonds for which it provides backup lines of credit, and in the ratings of fixed-income securities which it holds for trades. Numerous potential conflicts existed such as: possible inadvertent releases of confidential information obtained during the credit rating process; the advance release to the Applicant of credit ratings for companies to which the Applicant had very large loans outstanding; the potential for pressures by the Applicant on the Company to modify favorably the credit rating of one of the Applicant's major customers; and the subtle pressure on the Company's staff resulting from ownership by Applicant about companies in which the Applicant had a substantial interest. Similar conflicts could have also arisen between the Company's credit rating function and the Applicant's investment of trust assets.

The Applicant acknowledged the potential conflicts but argued that various steps could be taken to ameliorate them and bring them within a manageable framework. The Applicant therefore proposed a number of techniques for isolating the credit rating activities of the Company from influence by the Applicant, including the establishment of a separate corporation with a number of independent directors, a prohibition on contacts between the Applicant and the members of the Company's Credit Rating Committee, and also certain record keeping requirements for that committee.

The Board considered these positive suggestions as well as others to assure full disclosure of the relationships between the Applicant and any of the companies that would be rated by the Company as well as a prohibition on the Company rating the Applicant's securities, securities which the Applicant has underwritten, or securities for which the Applicant provided a guarantee or backup letter of credit. The Board, however, believed that the conflicts in the relationship between a major lender and a credit rating company were so pervasive that they could not be overcome through adoption of an information barrier. The employees of the Company would inevitably be aware of interests of the Applicant in firms being rated by them and, it seems reasonable to assume that this knowledge could, at times, influence their decisions.

The Board's concerns regarding conflicts of interest with respect to the credit rating activity were not based on any doubts regarding the integrity of the parties to the application, but rather were based on the Board's responsibility to assess the possible adverse effects that might be associated with an affiliation between a bank holding company and a public credit rating organization. Thus the Board was acting in furtherance of one of the general purposes of the Bank Holding Company Act, "to prevent possible future problems rather than to solve existing ones." The Board, in view of the pervasive conflicts of interest between the Applicant's existing operations and the Company's credit rating business, decided against approving the performance of public credit ratings.

Currency options are a new and innovative aspect of foreign exchange. A currency option represents the contractual right (but not the obligation) to purchase or sell a predetermined amount of currency at a specific price at any time before a specific date. Currency-options advocates argue that currency options eliminate the risk of a loss due to exchange movements and give the holder a chance to profit if the currency fluctuation is favorable. They require a premium to be paid when the contract is entered into. The premiums can run from about 1.5 percent to 5 percent, depending on the expiration date and the exercise price of the option.

Currency options are traded on two types of markets: the over-the-counter, or interbank market, and on three regulated exchanges, the Chicago Mercantile Exchange (CME), the Chicago Board Options Exchange (CBOE), and the Philadelphia Exchange (PHLX). The CBOE, a securities exchange, uses multiple ‘‘market makers’’ instead of specialist positions; the CME, a commodities exchange, like other commodities exchanges, does not use specialist positions.

Most of the writing of currency options is currently done by banks which will customize the option, with maturity dates and currency values in excess of the standardized exchange contracts. Banks developed the over-the-counter market where they trade currency options among themselves, and banks are also the largest customers on the exchanges where they hedge the risks associated with their foreign-exchange positions.

In general, the specialist system is unique to securities exchanges, and specialists exist for the purpose of achieving certain market results. Commodity exchanges do not use the services of specialists. The rules of the Securities and Exchange Commission permit the designation of specialists to ‘‘engage in a course of dealings for . . . their . . . own account to assist in the maintenance, so far as practicable, of a fair and orderly market . . .’’ provided that the securities exchanges adopt the following types of rules governing specialists: minimum capital requirements, rules to suspend or remove specialists if they fail to perform their designated market functions, rules restricting dealing activities to those reasonably necessary to permit the specialist to maintain a fair and orderly market or necessary to permit him or her to act as an odd-lot dealer, provisions governing his or her brokerage activities in specialist securities, and procedures to provide for the effective and systematic surveillance of the activities of specialists (17 C.F.R. 240.11(b)(1)). In addition, the IRS formerly granted special tax treatment to specialists transactions.

The rules of the PHLX require that odd-lot orders must be given to the specialist. The specialist functions as a broker with respect to certain transactions that cannot be executed by floor traders immediately, for example, stop-loss orders and limit orders. All such orders are given to the specialist for execution and become part of his ‘‘book’’; PHLX rules address priority of orders (customers’ orders receive priority) and conflicts of interest by governing specialists’ trades and those of affiliated persons and firms in ‘‘securities’’ in which the person is designated as specialist.

There is one specialist position for each currency option traded on the PHLX, and the primary function of a specialist is to act as market maker, as necessary, for its assigned currency option. The specialist thus undertakes all activity, including dealing for its own account, to the extent necessary, as required to maintain a fair and orderly market in options on a particular currency. In essence, the specialist makes a continuous two-sided market in the assigned currency option when market forces do not.

Although currency options are functionally equivalent to other instruments which banks regularly deal in for their own account, the applicant’s proposed activities were not considered as closely related to banking. The applicant’s analysis did not focus on the critical components of the proposed specialist activities, which are distinct from the foreign-exchange brokerage and dealing activities generally conducted by banks. Because the proposed specialist activities are to be carried out in the context of market making on a regulated exchange, they were significantly different from the foreign-exchange activities currently conducted by banks. When a bank engages in foreign-exchange trading, it does so to service the needs of its customers and to generate trading profits. However, unlike traditional foreign-exchange trading, bank customers are not serviced directly by a specialist. Instead, the exchange benefits from the specialist’s efforts if markets are perceived to be deep and liquid. Depth and liquidity make the contracts viable and the exchange profitable, and do not directly benefit the bank’s customers.

The applicant’s original proposal implicitly acknowledged that banks have not traditionally been involved with trading on stock exchanges, and thus have not generally possessed the experience and expertise in trading, hedging, and managing aggregate exposure required for the successful operation of a specialist position. The applicants originally proposed to engage in the activities through a joint venture because they lacked the requisite trading expertise to profitably undertake the activity alone. In its discussion of the management of risk exposure of the specialist, the applicants originally stated, ‘‘The choice of the appropriate hedge to start with and the monitoring over the life of the option of that hedge are specialized and difficult tasks that require expertise and experience.’’ Conducting exchange specialist activities requires the floor-trading experience and back-office capabilities of an experienced exchange member.

As of December 1984, only one commercial bank, Bank of America, acted as a specialist in exchange-traded currency options. In January 1984, the Office of the Comptroller of the Currency granted permission for Bank of America to act as the specialist in PHLX-traded options on the Deutschemark through a joint venture subsidiary with Tague Securities Corporation. The Board, however, was not bound to a determination that specialist activities were closely related to banking simply because one bank engages in the activity. Bank of America apparently considered it necessary to conduct its specialist activity through a joint venture with a securities firm, which reinforced the view that the activity requires experience and expertise not generally possessed by banks.

Given the applicant’s acknowledgment of the importance of floor-trading expertise and experience to the specialist function, and the substantive absence of bank involvement in such an activity, the Board concluded that the proposed activities were not closely related to banking and thus denied the applicant’s request.

A bank holding company applied to acquire all the voting shares of a company (''Company'') that engages in a variety of data processing and data transmission activities for customers such as securities and commodities exchanges, brokerage firms, commercial banks, savings and loan associations, insurance companies, and investment managers. In addition to engaging in other nonbanking activities, the company designs and assembles the hardware that is used in connection with the services it provides. The Board had not previously considered whether the assembly of hardware designed for the processing and transmission of banking, financial and economic data is closely related to banking or permissible as an incidental activity.

The bank holding company stated that Company's assembly of hardware was incidental to its provision of data processing services because such assembly was necessary to assure the availability, reliability, and quality of components used by Company, and that stock quotation firms like Company could only assure such product characteristics by the design and assembly of the hardware that provides the quotation information. In support of the argument, the bank holding company asserted that competitors of Company also design and assemble the hardware that provides the Company service.

In view of the fact that finished hardware of the type provided by Company is available, and, in fact, is marketed by companies providing services similar to Company, the Board found that the continuation of Company's design and assembly of hardware activities could not be considered ''necessary'' to the Company's provision of its permissible data processing services, and thus could not be considered incidental to Company's provision of permissible services. As a condition for approval of the bank holding company's application to acquire all of the voting shares of Company, the Board required the bank holding company to divest of Company's hardware assembly activities within two years of the acquisition (Refer to 1986 FRB 497).

In 1971 and again in 1984, the Board issued for public comment proposals to expand the activities permissible to bank holding companies under section 4(c)(8). Included in those proposals was the provision of armored car services. The proposals would have authorized bank holding companies to provide fully insured transportation of cash, securities, and valuables (primarily between commercial customers and financial institutions) and such ancillary services as coin wrapping, change delivery, mail delivery, payroll-check cashing, servicing of automatic teller machines, and leasing safes to commercial customers.

In response to both the 1971 and 1984 proposals, the Board received various comments against adding this activity to the Regulation Y list of permissible nonbanking activities, primarily from armored car operators and their trade associations. The commenters maintained that the activity is not closely related to banking but, rather, is essentially a transportation activity requiring no banking expertise.

In view of the issues raised by the comments on this activity and the minimal interest by bank holding companies, the Board decided not to add the activity to the Regulation Y list of permissible activities. However, the Board stated it would consider individual applications for this activity (1973 FRB 898); 51 *Federal Register* 39,999 (1986). The Board expressed no opinion as to whether the activity would meet the *National Courier* test and would be a proper incident to banking.

In 1988, a bank holding company (the applicant) filed an application to engage in armored car activities through a de novo nonbank subsidiary. After notice of the application was published, the Board received comments opposing the proposal and was requested to order a formal hearing. In response, the Board published an order requiring a formal public administrative hearing on the application. One issue, among others, that the Board directed to be considered was whether the proposed armored car services were ‘‘so closely related to banking or managing or controlling banks as to be a proper incident thereto’’ under section 4(c)(8) of the BHC Act.

An administrative hearing was held on June 16 and July 11, 1989, before an administrative law judge (ALJ). The ALJ issued a recommended decision in which he concluded that the proposed armored car activities were not ‘‘closely related to banking’’ and recommended that the Board deny the application. The ALJ found that none of the *National Courier* criteria were demonstrated by the record. The ALJ's conclusion relied on certain operational distinctions between the proposed armored car services and the services banks traditionally perform themselves.

Following receipt of exceptions to the recommended decision, the Board reviewed the entire record of the proceedings and determined that the ALJ had erred in concluding that armored car services were not ‘‘closely related to banking.’’ The Board concluded that, even accepting the factual findings, the slight operational distinctions cited in the recommended decision were not significant. The Board found that although there may be some distinctions between bank-provided armored car services and the proposed full-service, for-hire armored car service, the nature of the customers served and the economic basis of the services provided do not fundamentally alter the nature of the services. It was therefore clear to the Board that the services then provided by the applicant as well as other banks and bank holding companies to themselves and their customers are sufficiently ‘‘operationally and functionally similar’’ to the proposed service as to equip banking organizations particularly well to perform the proposed service, and hence fulfill the second *National Courier* test.

The Board also noted that bank holding companies are permitted to provide courier services for unaffiliated parties under section 225.25(b)(10) of Regulation Y. The only essential difference between the two services relates to the intrinsic value of the materials transported. The Board concluded that the services themselves were certainly functionally and operationally similar, thereby lending additional support to its favorable finding under the second *National Courier* test.

The Board also found that the third *National Courier* test was met, that the applicant had demonstrated ‘‘the dependence of banks on a specialized form of the proposed services.’’ The Board found that the record amply demonstrated that banks are highly dependent upon the specialized transportation services provided by armored cars, which transport cash and valuables with a high degree of security. The applicant was proposing to engage in just those specialized services; it did not propose to start a general moving or trucking service. The record therefore supported a determination that the third *National Courier* test was also satisfied. Accordingly, the Board found, based on the record before it, that providing for-hire armored car services to the general public was an activity that is closely related to banking.

This determination, however, is only one of two steps needed for the Board to approve a nonbank activity for a bank holding company. The Board must also find that the activity is a ‘‘proper incident thereto.’’ On this issue, the ALJ declined to make any factual or legal determinations concerning the proper-incident test or state branching laws. However, under the Board's rules (12 C.F.R. 262.4 (1990)), the ALJ was required to provide a recommended decision with regard to *all* unresolved issues prior to a final Board determination (12 C.F.R. 263.11). A final disposition on the application therefore was not possible at that juncture, and the Board remanded the case to the ALJ for a recommended decision on the proper-incident standard and other unresolved issues (see 1990 FRB 676).

In accordance with the Board's remand order, a second formal hearing was held before the ALJ. Additional evidence and post-hearing briefs were submitted, including evidence on the proper-incident test, in support of this and other unresolved issues. The ALJ then issued his supplemental decision, which again recommended denial of the application. The ALJ found that, in this case, the applicant's record failed to provide a definitive proposal on which the Board could make a determination under the proper-incident test. The ALJ found that the applicant had offered only a skeletal structure and operation plan that was fleshed out only to a limited extent at the hearings. In addition, the ALJ found the application and other facts of record to be deficient with regard to possible public benefits and adverse effects. The ALJ further determined that the record had not shown that the proposed activity, as structured, would be lawful under the branch-banking laws of the states in which the applicant proposed to operate.

Based on its review of the ALJ's supplemental decision and the remainder of the record, the Board determined that the record failed to support a finding that the proposed armored car activities, in this particular instance, would be a ‘‘proper incident’’ to banking. The Board therefore adopted the ALJ's recommendation to deny the application, but only on the narrow grounds of inconsistency of the proposal, as then structured, with section 23B of the Federal Reserve Act.

In its order, the Board stressed that the burden of proof is upon an applicant to establish that the nonbanking activity it proposes to conduct—in this case the provision of armored car services—is *not only* closely related to banking, *but also* a ‘‘proper incident thereto.’’ The Board's review of the entire proceeding disclosed certain aspects of the application that appeared on its face to violate the arm's-length transaction requirement of section FRA 23B. In the Board's view, a proposal to engage in nonbanking activities pursuant to section 4(c)(8) will not produce net benefits to the public, as required under the public-benefit test, if it violates the kind of statutory requirement, such as section 23B, that was specifically intended to prevent unsafe or unsound banking practices when a bank affiliate engages in nonbanking activities.

The first potential violation would arise from the fact that the proposed service by the bank holding company's nonbank subsidiary to its bank affiliate would cost more than the bank was paying for similar armored car services provided by an unaffiliated provider. The Board noted that although there may be a justification for the higher pricing structure that would meet the standards set forth in section 23B, no justification appeared in the record. The Board could therefore only conclude that the bank may not be obtaining services from the nonbank provider ‘‘on terms . . . at least as favorable to such bank . . . as those prevailing for comparable transactions with or involving other nonaffiliated companies,’’ as required by section 23B.

The second potential violation of section 23B arose from the absence of a ‘‘precise breakdown of the services the nonbank subsidiary will purchase from the bank holding company's subsidiary bank and the projected cost of those services,’’ as called for in the Board's prior order in this matter. The applicant provided no detailed cost figures for the wide variety of services the applicant's banking subsidiary was to provide to the nonbank subsidiary. The bank holding company proposed to charge the bank subsidiary an ‘‘estimated’’ percentage (the fee was admitted to have had no ‘‘factual basis’’ reflected in the record) of the nonbank subsidiary's direct operating expenses to cover all of the services provided by the bank holding company's banking subsidiary to its nonbanking subsidiary. Under section 23B, the provision of services by a bank to an affiliate must be paid for on an arm's-length basis. This requires, where there are no comparable transactions between a bank and a nonaffiliate, that the bank's provision of services to its affiliate be on terms that in good faith would be offered to, or would apply to, nonaffiliated companies. The Board found that the banking subsidiary would not in good faith have provided back-office services to an unaffiliated armored car company by charging a flat fee that had no factual basis and without determining the relationship of the fee to the actual costs of providing the services. Therefore, the potential violations of section 23B, on their face, constrained the Board to deny the application as it was structured (see 1993 FRB 352).

The Board noted its denial did not affect the Board's prior ruling in the case that armored car services are closely related to banking, and was without prejudice to the filing of a new proposal from which a favorable proper-incident finding could be made.

Impermissible Activities (Computer Output Microfilm Service) Section 3700.11

The authority of bank holding companies under section 225.25(b) of the Board's Regulation Y to engage in data processing activities is intended to limit those activities to providing facilities that perform banking functions, such as check collection, or other similar functions for customers that are depository or other similar institutions, such as mortgage companies. With respect to this activity, the Board issued an interpretation that authorizes bank holding companies to provide the formatting for computer output microfilm only as an output option for data otherwise permissibly processed by the holding company system (1982 FRB 552).

A foreign banking organization subject to the BHC Act applied for the Board's approval under section 4(c)(8) to engage *de novo* through its subsidiary (Company), in the exchange and clearance of: (1) exchange traded securities options and other securities and (2) futures and options on futures that relate to financial instruments. The proposed customer base was comprised primarily of market makers and other professional floor traders dealing for their own accounts. Most of the professional traders were expected to be market makers and specialists, including individuals, small partnerships, or small corporations, that were to trade primarily on the Chicago Board of Options Exchange (CBOE).[1]

Previously, the Board approved the execution and clearance of financial instruments as a permissible nonbanking activity.[2] Under Board precedent, the nonbanking subsidiary engaged in such services has generally serviced a broad range of retail and/or institutional customers. Under this proposal, Company was to clear trades for a specialized customer base comprised primarily of professional floor traders that executed trades for their own accounts.

Nonbanking subsidiaries of BHCs, operating in accordance with prior Board approvals, have generally performed both execution and clearance services. By performing both services, the nonbank subsidiary is able to control risk because it executes the majority of the transactions that it clears. The nonbank subsidiary can refuse to execute an order that it deems inappropriate or it can require additional funds or collateral from the customer *in advance of* and as a condition to executing the transaction.

Unlike prior Board cases, Company plans to provide primarily clearing services. As a clearing agent, it would guarantee the financial performance of its customers to the clearing organization of the exchanges on which it operates.[3]

After the start of trading on any day, Company would be obligated to settle each trade entered into by its customers even when the customer may not have the financial resources to honor its obligation. Since the trades have already been executed by the time that they would be presented to Company by these professional floor traders, Company would be unable to decline transactions that posed unacceptable risk. On an intraday basis, professional traders, who are not employees of Company and who trade in relatively volatile instruments, could expose Company to financial risks beyond the trader's capacity to repay and beyond Company's own resources.

The applicants proposed to limit the risk exposure created by Company's activities through the establishment of risk guidelines and procedures that were intended to monitor the intraday trading activities of its floor traders. No such system had been developed for the industry for monitoring the intraday activities of floor traders on a real-time basis. Most of Company's traders would primarily operate on exchanges that used an open outcry system rather than an electronic trading system. As a result, Company may not know its real-time committed positions until the end of the trading day and therefore the possibility existed that a floor trader could exceed Company's risk limits and incur substantial losses before Company could act to mitigate its credit risk exposure. Professional floor traders generally operate with much higher levels of leverage than the average brokerage customer of a securities firm. Since most of Company's customers were to be market makers, such traders could at times take positions contrary to the market.

1. Market makers on the CBOE are floor traders that perform a dealer function by trading for their own accounts, at their own risk, and for their own profit. Market makers compete with other market makers assigned to the same class of options. In contrast, floor brokers on the CBOE generally act only as an agent, executing customer and firm proprietary orders.

2. Refer to sections 225.25(b)(3) (trust companies engaging in agency activities related to the clearing of securities); 225.25(b)(15) (securities brokerage activities); 225.25(b)(18) (execution and clearance of futures and options on futures) of the Board's Regulation Y.

3. With this arrangement clearing firms may also be liable for the obligations of other members of the exchange. Generally, losses of a failed member firm are covered in the following order:

1. by the assets of the failed firm;
2. by the excess capital of the clearing organization;
3. by the guarantee fund of the clearing organization; and
4. by direct assessments made on surviving member firms.

Since member clearing firms are the ultimate source of capital for both the clearing association and the guarantee fund, the surviving firms will bear the ultimate burden of any loss.

Such circumstances potentially expose the clearing firms to substantial losses. If the clearing firm exhausts all or most of its capital in funding the obligations of floor traders that have lost substantial amounts of money in trading, parent companies of the clearing firm may have to cover the firm's remaining contingent liabilities. Such risks may be acceptable for some nonbanking institutions currently providing these services, but they may be inappropriate for U.S. domiciled banking organizations.

The Board carefully considered the benefits of the proposal, including the Applicants entry into a concentrated market, its experience with similar activities on foreign exchanges, and Company's proposed risk management systems. The Board concluded that the proposal, as it was currently structured (including the absence of an effective means to monitor and limit the potential credit risk exposure to the parent bank holding company) involved potential adverse effects that outweighed the potential public benefits. The Board thus determined that the balance of public interest factors that it is required to consider under section 4(c)(8) of the BHC Act were not favorable. The application was denied by the Board on January 9, 1991 (1991 FRB 189).

The Gramm-Leach-Bliley Act (the GLB Act) became effective on March 11, 2000. The GLB Act authorized affiliations among banks, securities firms, insurance firms, and other financial companies. To further this goal, the GLB Act amended section 4 of the BHC Act to allow a bank holding company (BHC) or foreign bank that qualifies as a financial holding company (FHC) to engage in a broad range of activities that (1) the GLB Act defines as financial in nature or incidental to a financial activity, or (2) the Board, in consultation with the Secretary of the Treasury, determines to be financial in nature or incidental to a financial activity. Furthermore, section 4 of the BHC Act authorizes an FHC to engage in designated financial activities, including insurance and securities underwriting and agency activities, merchant banking, and insurance company portfolio investment activities.

The GLB Act includes conditions that must be met for a BHC or a foreign bank to be deemed a ''financial holding company'' and engage in expanded activities. The GLB Act also allows an FHC to seek Board approval to engage in any activity that the Board determines (1) is complementary to a financial activity and (2) does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. BHCs that do not qualify as FHCs are limited to engaging in those nonbanking activities that were permissible under section 4(c)(8) of the BHC Act before enactment of the GLB Act.

The GLB Act provides that, in most cases, an FHC may engage in or acquire the shares of a company that is engaged in financial activities without obtaining prior approval from the Board. An FHC is instead required to provide a *post-commencement* notice to the Board within 30 days after commencing a financial activity or acquiring a company. See section 4(k) of the BHC Act. Prior approval from the Board is required to acquire or engage in the activities of a savings association.

3900.0.1 FHC SUPERVISORY OVERSIGHT AUTHORITY

Under the GLB Act, the Federal Reserve has supervisory oversight authority and responsibility for BHCs, including BHCs that operate as FHCs. The GLB Act sets forth parameters for operating relationships between the Federal Reserve and other regulators. The statute differentiates between the Federal Reserve's relations with (1) depository institution regulators and (2) functional regulators, which include insurance, securities, and commodities regulators. There should be minimal, if any, noticeable change in the well-established relationships between the Federal Reserve as BHC (including FHC) supervisor and the bank and thrift supervisors (federal and state). The Federal Reserve's relationships with functional regulators will, in practice, depend on the extent to which an FHC is engaged in functionally regulated activities; those relationships will also be influenced by existing working arrangements.

The Federal Reserve's supervisory oversight role is that of an umbrella supervisor concentrating on a consolidated or group-wide analysis of an organization. Umbrella supervision is not an extension of more traditional bank-like supervision throughout an FHC. The FHC framework is consistent with and incorporates principles that are well established for BHCs. The FHC supervisory policy focuses on addressing supervisory practice for and relationships with FHCs, particularly those that are engaged in securities or insurance activities. See SR-00-13.

3900.0.2 ROLES OF SUPERVISORS

The Federal Reserve is responsible for the consolidated supervision of FHCs. In this regard, the Federal Reserve will assess the holding company on a consolidated or group-wide basis with the objective of ensuring that the holding company does not threaten the viability of its depository institution subsidiaries. The manner in which the Federal Reserve fulfills this role will likely evolve along with the activities and structure of FHCs, and it may differ depending on the mix of banking, securities, and insurance activities of an FHC.

Depository institution subsidiaries of FHCs are supervised by their appropriate primary bank or thrift supervisor (federal and state). The GLB Act did not alter the role of the Federal Reserve, as holding company supervisor, vis-a-vis the primary supervisors of FHC-associated bank and thrift subsidiaries. Traditionally, the Federal Reserve has relied to the fullest extent possible on those supervisors.

Nonbank (or nonthrift) subsidiaries engaged in securities, commodities, or insurance activities are supervised by their appropriate functional regulators. Such functionally regulated subsidiaries include a broker, dealer, investment adviser, and investment company registered with and regulated by the Securities and Exchange Commission (SEC) (or, in the case of an investment adviser, registered with any state); an insurance company or insurance agent subject to supervision by a state insurance regulator; and a nonbank subsidiary engaged in activities regulated by the Commodity Futures Trading Commission (CFTC).

3900.0.3 FHC SUPERVISION OBJECTIVES

The Federal Reserve, as umbrella supervisor, will seek to determine that FHCs are operated in a safe and sound manner so that their financial condition does not threaten the viability of affiliated depository institutions. Oversight of FHCs (particularly those engaged in a broad range of financial activities) at the consolidated level is important because the risks associated with those activities can cut across legal entities and business lines. The purpose of FHC supervision is to identify and evaluate, on a consolidated or group-wide basis, the significant risks that exist in a diversified holding company to assess how these risks might affect the safety and soundness of depository institution subsidiaries.

Accordingly, the Federal Reserve will focus on the financial strength and stability of FHCs, their consolidated risk-management processes, and overall capital adequacy. The Federal Reserve will review and assess the internal policies, reports, and procedures and the effectiveness of the FHC consolidated risk-management process. The appropriate bank, thrift, or functional regulator will continue to have primary responsibility for evaluating risks, hedging, and risk management at the legal-entity level for the entity or entities that it supervises.

FHC supervision is not intended to impose bank-like supervision on FHCs, nor is it intended to duplicate or replace supervision by the primary bank, thrift, or functional regulators of FHC subsidiaries. Rather, FHC supervision seeks to protect the depository institution subsidiaries of increasingly complex organizations with significant interrelated activities and risks, while not imposing an unduly duplicative or onerous burden on the subsidiaries of the organization. Effective financial holding company supervision requires—

1. strong, cooperative relationships between the Federal Reserve and primary bank, thrift, and functional regulators and foreign supervisors (these relationships respect the individual statutory authorities and responsibilities of the respective supervisors, but also allow for enhanced information flows and coordination so that individual responsibilities can be carried out effectively without creating duplication or excessive burden);
2. substantial reliance by the Federal Reserve on reports filed with or prepared by bank, thrift, and functional regulators, as well as on publicly available information for both regulated and nonregulated subsidiaries; and
3. continued reliance on the risk-focused supervision and examination process and on market discipline.

3900.0.4 FHC SUPERVISION IN PRACTICE

The supervisory activities of the Federal Reserve fall into three broad categories: (1) information gathering, assessments, and supervisory cooperation; (2) ongoing supervision; and (3) promotion of sound practices and improved disclosure.

3900.0.4.1 Information Gathering, Assessments, and Supervisory Cooperation

To fulfill its GLB Act responsibilities, the Federal Reserve needs to interact closely and exchange information with the primary bank, thrift, and functional regulators. The Federal Reserve will foster strong relationships with senior management and the boards of directors of FHCs, and have access to timely information from FHCs. These relationships will need to include heads of significant business lines and key internal-audit, control, and risk-management officials in order to understand how risk-management and internal-control policies and procedures established at the consolidated level are being implemented and assessed. To achieve these objectives, Federal Reserve supervisory staff will take the following actions:

1. *Regularly assess an FHC's centralized risk-management and control processes.* Such assessments are necessary to understand an organization's overall risk profile, identify

material contributions to core risks, and determine how such risks are being managed and controlled on a consolidated basis.
2. *Perform limited, targeted transaction testing.* The purpose of this transaction testing is to verify that the risk-management systems of the FHC are adequately and appropriately measuring and managing areas of risk for the organization, and to confirm that laws and regulations applicable to the FHC and within the jurisdiction of the Federal Reserve are being observed.
3. *Have periodic discussions with FHC senior management and boards of directors.* Such discussions will enable the Federal Reserve to build relationships with key personnel and to understand changing activities and the evolving risk profile of the consolidated organization. Periodic discussions also will provide a forum for supervisory staff to present any findings or concerns related to the activities of the group as a whole or to business lines that cut across legal entities.
4. *Have periodic discussions with key personnel.* Discussions will be held with the personnel responsible for corporate management and control functions, such as heads of business lines, risk management, internal audit, and internal control.

When performing the above tasks, Federal Reserve supervisory staff, to the extent possible, will coordinate their actions with those of the primary bank, thrift, and functional regulators of the FHC's subsidiaries. For example, to understand the risks and risk-management systems of an FHC at the consolidated level, the Federal Reserve will need information concerning assets or liabilities booked in significant bank, thrift, and functionally regulated subsidiaries within the FHC group. The primary bank, thrift, and functional regulators of such subsidiaries also may need information from the FHC to perform their respective statutory mandates. To assist in sharing needed information, Federal Reserve supervisory staff should do the following:

1. *Have periodic meetings with the primary bank, thrift, and functional regulators of an FHC's subsidiaries.* The purpose of these meetings is to develop an understanding of the risk profiles of the individual regulated legal entities and their relation to the FHC's overall risk profile. These meetings also should be used, when appropriate, to share information regarding supervisory plans and to coordinate supervisory activities and follow-up, as needed.
2. *Review the examination findings of primary bank, thrift, and functional regulators (and their self-regulatory organizations) together with other relevant information.* The purpose of this review is to develop a consolidated picture of the FHC's financial condition and risk profile, the effectiveness of risk-management and internal-control policies, and the implications for the affiliated depository institutions.
3. *Make available to primary bank, thrift, and functional regulators, to the extent permissible, pertinent information regarding the FHC.* Included is information on the financial condition, risk-management policies, and operations of an FHC that may have a material impact on individual regulated subsidiaries, as well as information concerning transactions or relationships between the regulated subsidiaries and other subsidiaries within the FHC group. This process will assist supervisors in performing their statutory and supervisory responsibilities over regulated subsidiaries.
4. *Participate in the sharing of information among international supervisors, consistent with applicable law.* The purpose of this exchange is to ensure that an FHC's global activities are supervised on a consolidated basis and to minimize material gaps in supervision.
5. *Review internal-audit and management reports and publicly available information (including market information on equity and debt prices of the consolidated organization), as well as reports and statistics collected by other regulators, including regulators of depository institution subsidiaries.* To limit regulatory burden, this information should be obtained, to the fullest extent possible, from (1) the parent organization; (2) primary bank, thrift, and functional regulators of the FHC's regulated subsidiaries; and (3) publicly available sources, such as externally audited financial statements.

3900.0.4.2 Ongoing Supervision

3900.0.4.2.1 FHC Structure, Management, and the Applications Process

The Federal Reserve is responsible for understanding the consolidated organization's legal, organizational, and risk-management structure; major business activities; and risk exposures and risk-management systems. The Federal Reserve needs to understand the nature and degree of involvement of the board of directors in overseeing their organization's risk-management and control process at the consolidated group level. The Federal Reserve, when considering any formal application, declaration, or notification at the FHC level, will coordinate, as appropriate, with primary bank, thrift, and functional regulators.

3900.0.4.2.2 Reporting and Examination

The Federal Reserve will rely, to the fullest extent possible, on reports that an FHC or its subsidiaries are required to file with federal or state authorities (or self-regulatory organizations) or on reports that are prepared by the federal or state authorities. The Federal Reserve will rely on routinely prepared management reports, publicly reported information, and externally audited financial statements. The Federal Reserve also will rely to the fullest extent possible on the examination of an FHC's bank and nonbank subsidiaries by their appropriate primary bank, thrift, and functional regulators (and their self-regulatory organizations).

If supervisory staff requires a specialized report from a functionally regulated subsidiary of an FHC, staff will first request it from the subsidiary's appropriate functional regulator. In the event that the report is not made available to the Federal Reserve, supervisory staff may obtain the report directly from the functionally regulated subsidiary if it is necessary to assess—

1. a material risk to the FHC or any of its depository institution subsidiaries;
2. compliance with any federal law that the Federal Reserve has specific jurisdiction to enforce against the FHC or a subsidiary; or
3. the FHC's systems for monitoring and controlling financial and operational risks that may pose a safety-and-soundness threat to a depository institution subsidiary.

The Federal Reserve may examine a functionally regulated subsidiary under certain circumstances. Before examining a functionally regulated subsidiary, supervisory staff should first seek to obtain the necessary information from the appropriate functional regulator. If an examination is determined to be necessary, the Federal Reserve should coordinate its actions with the appropriate functional regulator. An examination may be conducted when the Federal Reserve has reasonable cause to believe (or reasonably determines) that—

1. the subsidiary is engaged in an activity that poses a material risk to an affiliated depository institution,
2. the examination is necessary to be adequately informed about the FHC's systems for monitoring and controlling the financial and operational risks that may pose a safety-and-soundness risk to a depository institution subsidiary; or
3. the subsidiary is not in compliance with any federal law that the Board has specific jurisdiction to enforce (and the Board cannot determine compliance by examining the FHC or its affiliated depository institutions).

The Federal Reserve, consistent with its current practice, will continue relying to the fullest extent possible on the work performed by bank, thrift, and functional regulators to validate that material risks are measured and managed adequately at the regulated subsidiary level. Where necessary and appropriate, and consistent with (1) through (3) immediately above, the Federal Reserve may conduct or participate in reviews at banks, thrifts, or functionally regulated subsidiaries to validate that risk-management and internal-control policies established at the consolidated level are being implemented effectively.

For an FHC subsidiary that is not supervised by a bank, thrift, or functional regulator, the Federal Reserve will obtain information from the subsidiary, as appropriate and necessary, to assess the financial condition of the FHC as a whole. In addition, the Federal Reserve will conduct examinations of such subsidiaries, if necessary, to be informed about (1) the nature of the subsidiary's operations and financial condition, (2) the subsidiary's financial and operational risks that may pose a threat to the safety and soundness of any depository institution subsidiary of the FHC, and (3) the systems for monitoring and controlling such risks. Under the GLB Act, the Federal Reserve may not examine any subsidiary of an FHC that is an investment company registered with the SEC and that is not itself a BHC.

3900.0.4.2.3 Capital Adequacy

The Federal Reserve is responsible for assessing consolidated capital adequacy for FHCs, with the ultimate objective of protecting the insured depository subsidiaries from the effects of disruptions in the nonbank portions of the organization. Capital adequacy will be assessed in relation to the risk profile of the consolidated organization. The Federal Reserve will review the FHC's internal risk assessment and related capital-analysis process for determining the adequacy of its overall capital position. Such a review will include consideration of current and future economic conditions, business-development plans for the future, possible stress scenarios, and internal risk-control and audit procedures. As BHCs, FHCs are subject to the Federal Reserve's holding company capital guidelines, which set forth minimum capital ratios that serve as tripwires for additional supervisory scrutiny and corrective action. The Federal Reserve will review these requirements as they apply to FHCs and may, if warranted, adapt the manner in which they apply to FHCs that engage in a broad range of financial activities.

Although the Federal Reserve is responsible for assessing the consolidated capital adequacy of FHCs, the primary bank, thrift, or functional regulators of FHC subsidiaries will continue to set and enforce applicable capital requirements for the regulated entities within their jurisdiction. Under the GLB Act, the Federal Reserve may not establish separate capital adequacy requirements for an FHC subsidiary that is in compliance with the capital requirements of its functional regulator.

Consistent with current practice, the Federal Reserve will continue to place significant reliance on the primary bank, thrift, or functional regulator's analysis of the capital adequacy of a regulated subsidiary. That analysis will be a significant input in the Federal Reserve's assessment of an FHC's consolidated capital adequacy, especially when a securities broker-dealer or insurance company is a predominant part of an FHC.

Several issues become particularly important when assessing the consolidated capital adequacy of FHCs with functionally regulated subsidiaries. The capital adequacy requirements that have been established for banking, securities, and insurance entities by their respective regulators reflect varying definitions of the elements of capital and varying approaches to asset and liability valuations. Yet techniques for assessing capital adequacy must be able to identify situations such as double or multiple leverage or double-gearing. In such cases, the actual capital protection may be overstated.

3900.0.4.2.4 Intra-Group Exposures and Concentrations

Intra-group exposures, including servicing arrangements and risk concentrations, have the potential to threaten the condition of regulated entities. Intra-group exposures may be significant at large, complex FHCs, especially those that operate their businesses on global lines that cut across legal entities within the firm. The Federal Reserve's focus in this area is the potential impact of intra-group exposures and concentrations on insured depository institution subsidiaries of an FHC.

Risk concentrations can take many forms, including exposures to one or more counterparties or related entities, industry sectors, and geographic regions. For risk concentrations, the holding company supervisor is uniquely positioned to understand the combinations of exposures within an organization across all legal entities. This understanding is critical at the group level—risk concentrations that are prudent on a legal-entity basis may aggregate to an unsafe level for the consolidated organization. The Federal Reserve will monitor intra-group exposures and risk concentrations as follows:

1. The appropriate primary bank and thrift regulators will continue to monitor and enforce section 23A and 23B restrictions at the bank or thrift level. The Federal Reserve will focus on assessing whether the FHC monitors and ensures compliance with these statutory requirements. The Federal Reserve plans to begin collecting data from each depository institution subsidiary of BHCs, including FHCs, on their covered transactions with affiliates that are subject to sections 23A and 23B and will share that data with primary bank and thrift regulators.
2. Functional regulators will continue to monitor and enforce any intra-group exposure restrictions that may apply to the regulated entities under their jurisdictions.
3. The Federal Reserve will focus on understanding and monitoring related-party exposures at the group level (including areas such as servicing agreements, derivatives exposures, and payments-system exposures). An important emphasis will be the extent to which risk management in a group's subsidiary depository instutions depends on transactions with affiliates.
4. The Federal Reserve will focus on manage-

ment's effectiveness in monitoring and controlling intra-group exposures and risk concentrations. The Federal Reserve will consider how an organization's risk-management processes measure and manage group-wide risk concentrations.

3900.0.4.2.5 Enforcement Powers

The Federal Reserve is authorized generally to take enforcement action against FHCs and their nonbank subsidiaries. The primary bank and thrift supervisors have the authority to take enforcement action against the banks and thrifts under their respective jurisdictions. Under the GLB Act, the Federal Reserve may take enforcement action against a functionally regulated subsidiary of an FHC, but only when such action is necessary to prevent or redress an unsafe or unsound practice or breach of fiduciary duty that poses a material risk either to (1) the financial safety, soundness, or stability of an affiliated depository institution or (2) the domestic or international payments system. In such circumstances, the Federal Reserve may only take the action if it is not reasonably possible to protect effectively against the material risk through an action directed at or against an affiliated depository institution.

Under any circumstances, the Board may take enforcement action against a functionally regulated subsidiary to enforce compliance with any federal law that the Federal Reserve has specific jurisdiction to enforce against the subsidiary. If the Federal Reserve believes that an enforcement action against a functionally regulated entity is necessary, the Federal Reserve will notify the entity's appropriate functional regulator and, whenever practical, will coordinate such an action with any action taken by the functional regulator. It is expected that the Federal Reserve will not take an enforcement action against a functionally regulated subsidiary (or a person associated with the subsidiary) if the problem involves factors and statutes that are the primary responsibility of the functional regulator.

Under the existing bank holding company framework, the Federal Reserve coordinates enforcement actions with the primary bank and thrift regulators, possibly with some adaptation of the action for the holding company context (such as limitations on parent company debt or dividends). The Federal Reserve will continue to coordinate enforcement actions with these regulators. Similarly, the Federal Reserve will coordinate with functional regulators when formulating and issuing enforcement actions that involve or may have an impact on functionally regulated subsidiaries.

3900.0.4.3 Promotion of Sound Practices and Improved Disclosure

The Federal Reserve can promote sound practices in a number of ways, such as by monitoring trends in risk exposures and risk-management practices across the FHC population through a combination of efforts, including—

1. regular discussions, centered on specific issues and emerging risks, with FHC management;
2. regular meetings with primary bank, thrift, and functional regulators to explore and discuss issues of mutual interest or concern;
3. interagency working groups or specialty teams to gain early insight into risks that cut across the various entities of a conglomerate or groups of conglomerates; and
4. industry conferences on relevant topics of interest.

These initiatives will contribute to the development of sound practices that the Federal Reserve and the primary bank, thrift, and functional regulators can communicate to the senior management and boards of directors of the FHCs, as well as to the senior management of their bank and nonbank subsidiaries.

Improved transparency and public disclosure can meaningfully supplement the efforts of supervisors to monitor the increasingly complex and global activities of diversified banking organizations. Consistent with sound accounting principles, practices, and depository institution safety-and-soundness practices, the Federal Reserve will participate in efforts to enhance disclosures that will illuminate group-wide activities, risk exposures, risk management, controls, and intra-group exposures.

3900.0.4.4 Supervisory Response to Challenges Posed by FHCs

The Federal Reserve's response to the supervisory challenges of FHCs has been in the context of the consolidated supervision of BHCs.[1]

1. The Federal Reserve's framework for supervising large complex banking organizations (LCBOs) is described in SR-99-15. See section 2124.04.

Examples include greater reliance on risk-focused supervision; strengthening relationships with senior management; improving coordination with other federal, state, and international regulatory and supervisory authorities; greater reliance on specialty teams, sound-practices papers, and public disclosures; and simplification of the applications process.

The more diversified FHCs present new supervisory challenges. To address these challenges, the Federal Reserve will continue to strengthen—

1. cooperative arrangements with bank and thrift regulators, the SEC, the CFTC, state insurance and securities regulators, and foreign supervisors;
2. relationships with the FHC management and personnel responsible for significant risk-management functions and, when necessary, the management of the organization's nonbank subsidiaries;
3. information flows that provide supervisors with relevant, up-to-date information without imposing an unwarranted burden on financial organizations;
4. techniques for evaluating capital adequacy for FHCs engaged in an expanded range of nonbank financial activities;
5. public disclosures and market discipline;
6. techniques for assessing the overall risk profile of FHCs and the implications for affiliated depository institutions; and
7. incentives for FHCs to continually review and improve their risk-management processes, internal controls, and audit practices.

The Federal Reserve is committed to working constructively and cooperatively with all regulators involved in overseeing the activities of FHCs and their bank and nonbank subsidiaries.

To become a financial holding company (FHC), a domestic bank holding company (BHC) must file a written declaration with the appropriate Federal Reserve Bank. This declaration should contain the following information:

1. A statement that the BHC elects to be an FHC.
2. The name and head-office address of the company and each depository institution controlled by the company. For purposes of the election process for both domestic BHCs and foreign banks, the term "depository institution" here means any national bank, state-chartered bank, federal branch of a foreign bank, insured branch of a foreign bank, savings association, savings bank, and industrial bank. It also includes any trust company that engages in the business of receiving deposits other than trust funds. (See 12 U.S.C. 1813.) A depository institution does not have to have FDIC insurance.
3. A certification that all depository institutions controlled by the company are well capitalized as of the date the company files its declaration.
4. The capital ratios for all relevant capital measures (as defined in section 38 of the Federal Deposit Insurance Act), as of the close of the previous quarter, for each depository institution controlled by the company on the date the company files its declaration.
5. A certification that all depository institutions controlled by the company are well managed as of the date the company files its declaration. (See SR-00-1.)

A depository institution is well managed if, at the most recent inspection or examination or subsequent review by its appropriate federal banking agency, the institution received (1) at least a satisfactory composite rating and (2) at least a satisfactory rating for management, if such a rating is given. In the case of a depository institution that has not received an inspection or examination rating, a depository institution is well managed if the Board has determined, after a review of the depository institution's managerial and other resources and after consulting with the depository institution's appropriate federal and state banking agency, that the institution is well managed. In addition, a depository institution that results from the merger of two or more depository institutions that are well managed will be considered to be well managed unless the Board determines otherwise after consulting with the appropriate federal banking agency for each depository institution involved in the merger.

A depository institution that results from the merger of a depository institution that is well managed with one or more depository institutions that are not well managed or that have not been examined will be considered to be well managed, if the Board determines that the resulting institution is well managed. The Board makes this determination after a review of the managerial and other resources of the resulting institution and after consulting with the appropriate federal and state banking agencies for the institutions involved in the merger, as applicable.

The Gramm-Leach-Bliley Act (the GLB Act) also requires that all the insured depository institutions controlled by the FHC at the time of the declaration must be rated satisfactory or better under the Community Reinvestment Act (CRA). When determining whether the insured depository institutions controlled by a BHC meet the CRA requirement, the Federal Reserve excludes an institution that was acquired during the 12 months preceding the date the company filed its declaration. To qualify for this exception, (1) the company must have submitted the depository institution's affirmative correction plan to the appropriate federal banking agency, and (2) the agency must have accepted the plan.

A BHC must file its declaration to become an FHC with the appropriate responsible Reserve Bank. A BHC's election to become an FHC is effective on the thirty-first day after the date that a complete declaration was received, unless the Board notifies the company before that time that the election is ineffective. The Board or the appropriate Federal Reserve Bank also may notify a BHC in writing that its election to become an FHC is effective before the thirty-first day after the date that a complete declaration was filed.

When an FHC's declaration becomes effective, it may engage in the expanded financial activities available to such companies. If, however, the Board has timely notified a BHC that its declaration is ineffective, the BHC will not be considered an FHC and may not begin to engage in any expanded activities.

A company that is not a BHC may simultaneously submit an application under section 3(a)(1) of the Bank Holding Company Act (BHC

Act) to become a BHC and to request to become an FHC on consummation of that transaction. The company must (1) state that it seeks to become an FHC on consummation of its section 3 proposal to become a BHC and (2) certify that each depository institution that would be controlled by the company on consummation of the section 3 proposal will be both well capitalized and well managed on the date of consummation. To coordinate action on these two requests, the acceptance of the declaration as complete does not occur until the date the company lawfully consummates its section 3 proposal and becomes a BHC. A simultaneous declaration will not be effective if the Board notifies the company at any time before consummation that (1) any depository institution that would be controlled by the company on consummation will not be well capitalized and well managed or (2) any insured depository institution that would be controlled by the company on consummation has not achieved at least a satisfactory rating at its most recent CRA examination. An insured depository institution that is controlled or would be controlled by a company filing a simultaneous declaration and section 3(a)(1) application to become a BHC may not be excluded for the purposes of evaluating the CRA performance record under this provision or the general FHC certification requirements of section 225.82(d) of Regulation Y.

In most cases, an FHC may, without providing prior notice to or obtaining prior approval from the Board, conduct an activity that is financial in nature or incidental to a financial activity (a financial activity). (See section 225.85(a)(1) of Regulation Y.) An FHC may conduct a financial activity by engaging directly in the activity or by acquiring and retaining the shares of any company that is engaged exclusively in one or more financial activities. An FHC may conduct a financial activity at any location inside or outside of the United States, subject to the laws of the jurisdiction in which the activity is conducted. A company acquired or to be acquired by an FHC also may engage in other activities that are permissible for an FHC, in accordance with any applicable notice, approval, or other requirements.

An FHC may acquire more than 5 percent of the voting shares or control of a company that is not engaged exclusively in activities that are financial in nature, incidental to financial activities, or otherwise permissible for the acquiring FHC. (See section 225.85(a)(3) of Regulation Y.) To do so, the acquisition must meet three requirements:

1. The company to be acquired must be substantially engaged in activities that are financial in nature, incidental to a financial activity, or otherwise permissible for the FHC under section 4(c) of the BHC Act. A company is considered to be substantially engaged in permissible activities if at least 85 percent of the company's consolidated total annual gross revenues is derived from and at least 85 percent of the company's consolidated total assets is attributable to the conduct of activities that are financial in nature, incidental to a financial activity, or otherwise permissible for an FHC under section 4(c) of the BHC Act. An FHC's management should consult with Board staff if they are uncertain whether a proposed acquisition meets this standard.
2. The FHC must comply with the notice requirements of section 225.87 of Regulation Y. The acquired company must conform, terminate, or divest, within two years of the date the FHC acquires shares or control of the company, all activities that are not financial in nature, incidental to a financial activity, or otherwise permissible for the FHC under section 4(c) of the BHC Act. Although an FHC may acquire any percentage of shares or control of a company engaged in limited impermissible activities, the FHC needs only to provide a post-transaction notice if such an acquisition results in control of the company.
3. After being acquired by an FHC, the company engaged in impermissible activities may not engage in or acquire a company engaged in any activity that is not permissible for the FHC.

Section 225.85(c) of Regulation Y identifies two circumstances in which Board approval is still required to engage in financial activities. First, prior approval in accordance with section 4(j) of the BHC Act and section 225.24 of Regulation Y is required to acquire more than 5 percent of the voting shares or control of a savings association or any company that owns, operates, or controls a savings association. Second, the Board may, in the exercise of its supervisory authority, require an FHC to provide it with prior notice or obtain prior Board approval if circumstances warrant. The GLB Act did not change in any way the requirement that a company receive prior Board approval under section 3 of the BHC Act before acquiring shares or control of a bank.

Section 225.87(a) of Regulation Y requires an FHC that commences an activity, or that acquires control or shares of a company engaged in an activity under section 225.86 of Regulation Y, to provide written notice to the appropriate Reserve Bank within 30 calendar days after commencing the activities or consummating the acquisition. The notice must be provided on the FR Y-10 form, obtained from the Board or any Reserve Bank. This requirement also applies to an activity that the FHC may engage in under section 4(c)(8) of the BHC Act that is incorporated under section 4(k) of the act.

There are two circumstances in which notice to the Board is not required to engage in an activity: (1) when an FHC acquires shares of a company without acquiring control of the company, or (2) when an FHC is engaged in securities underwriting, dealing, or market-making activities described in section 4(k)(4)(E), merchant banking investment activities conducted pursuant to section 4(k)(4)(H), or insurance company investment activities conducted pursuant to section 4(k)(4)(I) of the BHC Act, and has provided the System with the appropriate notice regarding the relevant activity. (See section 225.87(b) of Regulation Y.) Under these circumstances, the FHC must provide written notice to the Board within 30 days after acquiring, as part of a merchant banking activity under section 4(k)(4)(H) or an insurance company investment activity under section 4(k)(4)(I) of the BHC Act, more than 5 percent of any company at a cost that exceeds 5 percent of the FHC's tier 1 capital or $200 million, whichever is less.

3901.0.1 SUPERVISORY CONCERNS

In some instances, a U.S. BHC or a foreign bank may meet the statutory requirements to be an FHC, but its capital strength and managerial resources are less than satisfactory on a consolidated basis. In this situation, the Federal Reserve may have supervisory concerns about the consolidated entity although it technically qualifies as an FHC. The Federal Reserve may, in the exercise of its supervisory authority, restrict or limit the conduct of new activities or future acquisitions of an FHC, or take other appropriate action, if it finds that the FHC does not have the financial or managerial resources to conduct the activity or make the acquisition. This supervisory action could be based, for example, on a determination that the company does not have adequate capital or risk-management systems to conduct a specific activity in a safe and sound manner and may involve the issuance of cease-and-desist orders, the execution of written agreements, or other appropriate supervisory action.

3901.0.2 HOLDING COMPANY FAILS TO CONTINUE MEETING FHC CAPITAL AND MANAGEMENT REQUIREMENTS

If a domestic bank holding company has made an effective election to be an FHC, and the Board finds that any depository institution subsidiary owned or controlled by the company ceases to be well capitalized or well managed, the company must execute an agreement acceptable to the Federal Reserve Board to comply with all applicable capital and management requirements. This agreement should be executed within 45 days after the Board notifies the company that it is not in compliance with the applicable requirements for an FHC. (See section 225.83 of Regulation Y.)

At the request of the bank holding company, the Federal Reserve Board may extend the 45-day period. The request should state why an extension is necessary. The agreement must explain the specific actions that the bank holding company will take to correct all areas of noncompliance, provide a schedule for all such actions, and provide any other information the Board may require, and be acceptable to the Board.

During the period of noncompliance, the Federal Reserve Board may impose limitations or conditions on the activities of the company. In addition, the company must obtain the Board's approval before conducting any of the activities that are newly authorized for FHCs by the GLB Act. Section 225.83 of Regulation Y also sets forth the consequences of failing to correct the noncompliance within a period of 180 days. Such consequences may include divestiture of ownership or control of any depository institution the company owns or controls, or the cessation of the expanded activities permitted for FHCs.

3901.0.3 DEPOSITORY INSTITUTION SUBSIDIARY FAILS TO MAINTAIN A SATISFACTORY OR BETTER CRA RATING

The Federal Reserve Board prohibits an FHC from engaging in any additional activity[1] or acquiring control of a company engaged in any activity under section 4(k) and 4(n) of the BHC Act if any insured depository institution controlled by the FHC fails to maintain a satisfactory or better CRA rating.

1. With respect to engaging in any additional activities, see section 225.84 of Regulation Y for the exceptions.

3901.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
BHCs and foreign banks that qualify as FHCs can engage in financial activities and those incidental thereto	1843			
Definition of an FHC		225.81	4-056	
Election to become an FHC		225.82	4-056.1	
Failure to meet applicable capital and management requirements		225.83	4-056.2	
Consequences of the failure to maintain at least a satisfactory CRA rating		225.84	4-056.3	
Notices or approvals for FHCs to engage in financial activities		225.85	4-056.4	
Activities permissible for FHCs		228.86	4-056.5	
Post-commencement notice for FHC to engage in a financial activity		225.87	4-056.6	
Board determination that an FHC activity is financial in nature or incidental thereto		225.88	4-056.7	
Board approval for an FHC to engage in an activity that is complementary to a financial activity		225.89	4-056.8	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

3903.0.1 FINANCIAL HOLDING COMPANY QUALIFICATION REQUIREMENTS FOR FOREIGN BANKS

A foreign bank that owns or controls a U.S. bank (and any company that controls the foreign bank) must comply with the same requirements as a domestic bank holding company (BHC) that elects to be treated as a financial holding company (FHC). Either entity is thus able to engage in authorized financial activities under the Gramm-Leach-Bliley Act (GLB Act). If a foreign bank does not own a subsidiary bank in the United States, but instead operates through a branch, agency, or commercial lending company located in the United States, the foreign bank (and any company that controls the foreign bank) is subject to the Bank Holding Company Act (BHC Act) as if the foreign bank or company were a BHC. Such foreign banks may, like U.S. BHCs, also elect to be treated as FHCs. Foreign banks electing to be treated as FHCs must meet ‘‘well-capitalized’’ and ‘‘well-managed’’ standards comparable to those that are applicable to U.S. depository institutions. Futher, any U.S. branches of the foreign bank that are FDIC-insured must be rated satisfactory or better under the Community Reinvestment Act (CRA).[1] (See section 225.90 of Regulation Y.)

To be treated as an FHC, a foreign bank (or a company that owns or controls a foreign bank) that operates in the United States only through U.S. branches, agencies, or commercial lending subsidiaries must file a written declaration with the appropriate Reserve Bank. This declaration must contain items 1 through 6 below. Foreign banks or companies that operate in the United States through U.S. branches, agencies, or commercial lending companies and through a U.S. subsidiary bank are not required to provide item 1, but they must provide the items domestic BHCs are to provide.

1. a statement that the foreign bank or company elects to be treated as an FHC
2. the risk-based capital ratios and the amounts of tier 1 capital and total assets of the foreign bank as of the close of the most recent quarter, and as of the close of the most recent audited reporting period
3. a certification that the foreign bank meets the standards to be well capitalized that are set out in section 225.90(b)(1)(i) and (ii) or section 225.90(b)(2) of Regulation Y, as of the date the foreign bank or company files its election
4. a certification that the foreign bank is well managed, as defined in section 225.90(c)(1) of Regulation Y, as of the date the foreign bank or company files its election
5. a certification that all U.S. depository institutions controlled by the foreign bank or company (including thrifts and nonbank trust companies) are well capitalized and well managed as of the date the foreign bank or company files its election
6. the capital ratios and all relevant capital measures (as defined in section 38 of the Federal Deposit Insurance Act) for all U.S. depository institution subsidiaries of the foreign bank or company as of the end of the previous quarter

The well-capitalized and well-managed tests in items 2, 3, and 4 above apply to each foreign bank that has U.S. operations in the form of a branch, agency, or commercial lending company subsidiary that is part of a foreign banking organization seeking certification as an FHC.

For those foreign banks whose home-country supervisors have adopted risk-based capital standards consistent with the Basel Accord, their tier 1 and total risk-based capital ratios, as calculated under the home-country standard, must be at least 6 percent and 10 percent, respectively. The Board will determine the comparability of the foreign bank's capital under the listed comparability factors in section 225.92(e) of Regulation Y. Among these factors are the composition of the foreign bank's capital, accounting standards, long-term debt ratings, the ratio of tier 1 capital to total assets, reliance on government support to meet capital requirements, the foreign bank's anti–money laundering procedures, whether the foreign bank is subject to comprehensive consolidated supervision, and other factors that may affect the analysis of capital and management.[2] For those foreign banks whose

1. Under the GLB Act, the capital and management standards the Board must apply to foreign banking organizations that elect to become FHCs should be comparable to the standards applied to domestic institutions, giving due regard to the principle of national treatment and equality of competitive opportunity.

2. The Board may consider whether the overall level of the foreign bank's capital and other factors indicate that addi-

home-country supervisors have not adopted the Basel Accord and for any other foreign banking organizations that otherwise do not meet the capital standards noted above, the foreign bank may be considered well capitalized by obtaining from the Board a prior determination that its capital is otherwise comparable to the capital that would be required of a U.S. banking organization to become an FHC. The pre-clearance process provided by section 225.91(c) of Regulation Y can be used to obtain this determination.

A foreign bank will be considered well managed if—

1. the branches, agencies, and commercial lending subsidiaries of the foreign bank have received at least a satisfactory composite rating at their most recent examination;[3]
2. the home-country supervisor of the foreign bank consents to the foreign bank expanding its activities in the United States to include FHC activities;[4] and
3. the Board determines that the management of the foreign bank meets standards comparable to those required of a U.S. bank owned by an FHC.

The Board believes that, as a general rule, the top tier foreign bank in a foreign banking group that requests an FHC determination should be subject to comprehensive consolidated supervision by the home-country supervisor.

As a general matter, a foreign bank will *not* be determined to be well capitalized and well managed when it is not subject to comprehensive consolidated supervision. When a foreign bank has not been determined by the Board to be subject to comprehensive consolidated supervision, and the Board has not deemed any other bank from the country where the foreign bank is chartered to be subject to comprehensive consolidated supervision, the foreign bank must use the pre-clearance process provided by section 225.91(c) of Regulation Y—even if it otherwise meets the objective screening criteria. The Board may review a foreign bank's home-country supervision through the pre-clearance process and make a comprehensive consolidated supervision determination in that context. The Board will try to make a determination on pre-clearance requests within 30 days of receipt.[5]

There may be limited situations when an exceptionally strong bank from a country that has not yet fully implemented comprehensive consolidated supervision should be considered for FHC status. Such a foreign bank can qualify for FHC status if (1) the home-country supervisor has made significant progress in adopting and implementing arrangements for the consolidated supervision of its banks, and (2) the foreign bank demonstrates significant financial strength, such as through high levels of capital or exceptional asset quality. The Board anticipates, however, that a foreign bank that is not subject to comprehensive consolidated supervision will be granted FHC status only in rare instances.

As in the case of domestic BHCs, each U.S. depository institution subsidiary of a foreign bank is required to meet all the well-capitalized and well-managed standards in order for the foreign bank or company to obtain FHC status in the same manner as required for U.S. BHCs. In addition, all the U.S. insured depository institutions controlled by the foreign bank or company must be rated satisfactory or better under the CRA. If the foreign bank operates a U.S. branch that is FDIC-insured, the branch must be rated satisfactory or better under the CRA.

tional analysis should be undertaken to assess comparability. The Board will not impose a specific standard for the foreign bank's ratio of tier 1 capital to total assets (the leverage ratio), but a foreign bank's leverage ratio may be among the factors taken into account in the comparability review.

3. The Federal Reserve's foreign bank examination process includes the assignment of a combined assessment (the combined ROCA rating) of a foreign banking organization's (FBO's) U.S. branch, agency, and commercial lending operations through the regular examination cycle. (See SR-00-14.) The combined ROCA rating will be factored into the FBO's overall combined U.S. operations rating, which will continue to be a single composite rating that reflects the U.S. supervisors' collective assessment of all operations (that is, banking and nonbanking) of the FBO in the United States. If a foreign bank wishes to obtain FHC status, but does not have the assignment of a combined U.S. banking assessment as part of the regular examination cycle, the foreign bank can contact its responsible Federal Reserve Bank or engage in the pre-clearance process. If a foreign banking group contains more than one foreign bank with U.S. banking offices, each such foreign bank in the group must have a satisfactory composite U.S. banking assessment in order for the foreign banking group or any of its subsidiaries to obtain FHC status.

4. The home-country supervisor should consider the FBO's consolidated capital and management before providing its consent to the expansion. If the home country has no formal consent process, the Board will consult with the supervisor to assure itself that the supervisor considers the capital and management of the bank to satisfy its home-country standards and that the supervisor has no objections to the expansion.

5. If the Board makes an affirmative comprehensive consolidated supervision determination through the FHC pre-clearance process, the determination will be relied on for the foreign bank to establish additional branches and agencies under the Foreign Bank Supervision Enhancement Act.

An election by a foreign bank or company to be treated as an FHC will become effective on the thirty-first day after the date that an election was received by the appropriate Reserve Bank, unless the Board notifies the foreign bank or company before that time that the election is ineffective or unless the period for the Board's determination is extended with the consent of the foreign bank or company making the election. The date the Federal Reserve Bank receives the declaration should be considered the first day of the 30-day review period. The Board or the Reserve Bank also may notify a foreign bank or company in writing that its election to become an FHC is effective before the thirty-first day after the election was filed. A foreign bank or company should file the declaration (or pre-clearance request) with the responsible Reserve Bank.

If the election is determined to be effective, the foreign bank or company may engage in the financial activities available to FHCs. The GLB Act requires that an FHC that engages in an activity, or that acquires control or shares of a company engaged in an activity, under section 4(k) of the BHC Act provide written notice to the appropriate Reserve Bank within 30 calendar days after commencing the activities or acquisition. The notice should describe the activity commenced or identify the name of the company acquired and describe its activities.

3903.0.2 FOREIGN BANK FAILS TO CONTINUE MEETING FHC CAPITAL AND MANAGEMENT REQUIREMENTS

If a foreign bank or company has made an effective election, and the Board finds that the foreign bank; any foreign bank that is controlled by the foreign bank and maintains a U.S. branch, agency, or commercial lending company; or any U.S. depository institution owned or controlled by the foreign bank or company ceases to be well capitalized or well managed, the foreign bank or company must execute an agreement acceptable to the Federal Reserve Board to comply with all applicable capital and management requirements. This agreement should be executed within 45 days after the Board notifies the foreign bank or company that it is not in compliance with the applicable requirements for an FHC. (See section 225.93 of Regulation Y.) At the request of the foreign bank or company, the Board may extend the 45-day period. (The request should state why an extension is necessary.) The agreement must explain the specific actions that the foreign bank or company will take to correct all areas of noncompliance, provide a schedule for all such actions, provide any other information the Board may require, and be acceptable to the Board. During the period of noncompliance, the Board also may impose limitations or conditions on the U.S. activities of the foreign bank or company. Section 225.93 of Regulation Y also sets forth the consequences of failing to correct the noncompliance within a period of 180 days. Such consequences may include termination of the foreign bank's U.S. branches and agencies and divestiture of its commercial lending company subsidiaries, or cessation of the expanded activities permitted for FHCs. The foreign bank may also choose to cease engaging in activities not permitted for a foreign bank under sections 2(h) and 4(c) of the BHC Act.

3903.0.3 INSURED BRANCH FAILS TO MAINTAIN A SATISFACTORY OR BETTER CRA RATING

When an insured branch of a foreign bank, or an insured depository institution controlled by a foreign bank, fails to maintain a satisfactory or better CRA rating, section 225.94 of Regulation Y applies the provisions of section 225.84 to the foreign bank and to any company that owns or controls the foreign bank. For these purposes, the insured branch is treated as an "insured depository institution." An FHC is thus prohibited by the Board from engaging in any additional activity or acquiring control of a company engaged in activities under section 4(k) or 4(n) of the BHC Act.(See section 225.84 of Regulation Y.)

3903.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
BHCs and foreign banks that qualify as FHCs can engage in financial activities and those incidental thereto	1841(h) 1843(c)			
Election of a foreign bank to become an FHC		225.91	4-057.2	
How elections by foreign banks to be an FHC become effective		225.92	4-057.3	
Foreign bank fails to satisfy capital and management requirements		225.93	4-057.4	
Foreign branch fails to retain a satisfactory CRA rating		225.94 225.84	4-057.7 4-056.5	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The Gramm-Leach-Bliley Act (GLB Act) amended the Bank Holding Company Act (BHC Act) to allow a BHC or foreign bank that qualifies as a financial holding company (FHC) to engage in a broad range of activities that the GLB Act defines as ‘‘financial in nature.’’ Section 4(k)(4)(A)–(E) of the BHC Act defines the following activities as financial in nature:

1. lending, exchanging, transferring, investing for others, or safeguarding money or securities
2. insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing, in any state
3. providing financial, investment, or economic advisory services, including advising an investment company (as defined in section 3 of the Investment Company Act of 1940)
4. issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly
5. underwriting, dealing in, or making a market in securities

These activities include activities that the Board had previously determined to be impermissible for BHCs, such as acting as principal, agent, or broker for purposes of insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, and issuing annuity products. Permissible insurance activities as principal include reinsuring insurance products.

An FHC acting under section 4(k)(4)(B) of the BHC Act may conduct insurance activities without regard to the restrictions on the insurance activities imposed on BHCs under section 4(c)(8).

Providing claims administration and risk-management services. Legal counsel representing an FHC sought an opinion as to whether an insurance agency owned by an FHC may engage in certain insurance claims activities, as described below, under section 4(k)(4)(B) of the BHC Act. In particular, it was asked whether such an insurance agency may engage in the following claims administration activities in connection with its insurance sales activities: (1) collecting insurance premiums, (2) holding insurance premiums in trust, (3) establishing an insurance-claims-paying account, (4) adjusting insurance claims (which would include obtaining facts about claims, investigating the veracity of claims, and estimating losses relating to claims), (5) negotiating with insureds and their representatives concerning insurance claims, and (6) paying and settling insurance claims. A representation was made that insurance agents typically perform these claims administration services for an insurance underwriter in connection with insurance policies sold by the agents on behalf of an insurance underwriter.

With respect to the insurance risk-management activities provided in connection with insurance sales activities, a legal opinion was requested as to whether an insurance agency or broker owned by an FHC could engage in the following activities: (1) assessing the risks of a client seeking insurance and identifying the client’s exposures to loss; (2) designing programs, policies, and systems (such as workplace safety programs) to reduce the client’s risks; (3) advising clients about risk-management alternatives to insurance (such as self-insurance, securitization, or derivatives); and (4) negotiating insurance coverages, deductibles, and premiums for an insurance client. It was represented that insurance agents and brokers provide these risk-management services to their customers in connection with the sale of insurance products, including, in particular, commercial property and casualty insurance, and other insurance activities. It also was understood that the proposed risk-management services would (1) be related to managing insurable risks, (2) be advisory in nature, and (3) not allow the risk manager to control or perform operations of its clients.

Board staff noted that most states require a person performing one or more of the insurance claims administration services listed above to be licensed by, or registered with, the appropriate insurance authority of the state either as an insurance company, an insurance agent, or a third-party administrator (TPA).[1] The legislative history of the GLB Act also suggests that Con-

1. For example, the Model Third Party Administrator Statute adopted by the National Association of Insurance Commissioners (NAIC) requires a person who collects premiums or adjusts or settles claims for an insurer in connection with the sale of life or health insurance policies or annuities to register with the relevant state insurance authority as a TPA if the person is not already registered with the state as an insurance company, agent, or broker. See the NAIC Model Third Party Administrator Statute, sections 1.A and 11 (1996).

The NAIC’s Model Managing General Agents Act also requires a person to register with the relevant state insurance authority if the person adjusts or pays claims for an insurer and engages in certain other activities on behalf of an insurer.

gress believed that insurance-related claims administration services are a necessary part of the insurance sales and underwriting activities authorized by section 4(k)(4)(B).[2]

State insurance laws generally do not require companies that provide insurance risk-management services to obtain a special insurance license. States generally do require a license of any person that negotiates insurance coverages, deductibles, and premiums for another.[3]

In a legal opinion dated July 10, 2002, Board staff opined that the specific insurance claims administration services listed above are encompassed within the insurance activities authorized by section 4(k)(4)(B) of the BHC Act, and that the services may be conducted by an FHC when they are provided by an insurance agent or broker in connection with its other insurance sales activities. In addition, Board staff believes that the specific insurance risk-management services listed above are encompassed within section 4(k)(4)(B) insurance activities, and the services may be conducted by an FHC if they (1) are provided by an insurance agent or broker in connection with its other insurance sales activities, (2) involve managing insurable risks, (3) are advisory in nature, and (4) do not allow the FHC to control, or perform operations of, the person to which the services are provided.[4]

Acting as a third-party administrator. Other legal counsel representing a BHC that had elected to become an FHC requested an opinion on whether acting as a TPA on behalf of an insurance company is an activity that is permissible for an FHC under the BHC Act. The BHC proposed to invest in a company that acts as a TPA for licensed insurance companies that underwrite and sell credit life insurance. A TPA provides one or more insurance companies with administrative and related services that support and assist the sale of insurance products by the insurance company. A TPA may provide some or all of the following services to an insurance company: (1) assisting the insurance company in designing its insurance programs (which would include policy and certificate development and issuance); (2) determining whether a prospective insured meets the insurance company's established underwriting guidelines; (3) collecting and processing insurance premiums; (4) processing, adjudicating, and paying claims on behalf of the insurance company; (5) investing excess cash and maintaining bank accounts for the insurance company; (6) establishing risk reserves for the insurance company; (7) advising on, and arranging for, reinsurance or stop-loss insurance for the insurance company; (8) preparing and filing tax returns and regulatory reports for the insurance company and providing other related services designed to ensure that the insurance company remains properly licensed and in compliance with applicable governmental regulations; (9) providing accounting and recordkeeping services to the insurance company in connection with its insurance activities; and (10) providing insurance-product sales training to employees of the insurance company. It was represented that the BHC may engage in some, but not all, of the activities in its capacity as a TPA.

The Board's staff noted that the activities listed above are directly related to the provision and sale of insurance by a third-party insurance company and constitute an integral part of the regulated insurance activities of the third-party insurance company. Most states consequently require a person performing one or more of these services for an insurance company to be licensed by, or registered with, the appropriate insurance authority of the state either as an insurance company or agent or as a TPA. In addition to the previously stated requirements, the Model Third Party Administrator Statute (Model TPA Statute) requires a person to register as a TPA if the person accepts insurance contracts for an insurer that meet the insurer's underwriting guidelines, assists an insurer in the overall planning and coordination of its insurance program, or collects premiums or adjusts claims for an insurer.[5]

See NAIC Model Managing General Agents Act, sections 2.C and 3 (1993).

2. See H.R. Rep. No. 106-74, part I, p. 122 (1999) ("Activities such as administering, marketing, advising or assisting with . . . claim administration or similar programs shall be deemed to be incidental to insurance activities as described in [section 4(k)(4)(B)].").

3. See NAIC Producer Licensing Model Act, sections 2. K and 3 (2000).

4. A BHC or an FHC may provide advice to customers concerning financial matters, including insurance, self-insurance, securitizations, and derivatives, under 12 C.F.R 225.28(b)(6) and may provide management consulting advice to customers regarding nonfinancial equity matters, such as workplace safety, subject to Regulation Y's limits and restrictions. See 12 C.F.R. 225.28(b)(9) (management consulting activities permissible for all bank holding companies) and 225.86(b)(1) (management consulting activities permissible for all FHCs).

5. See the NAIC Model TPA Statute, sections 1.A and 11 (1996). A person generally does not have to register as a TPA if the person is currently registered with the state as an insurer or as an insurance agent or broker. See Model TPA Statute, section 1.A.(3) and (4).

Similarly, the NAIC's Model Managing General Agents

In a legal opinion dated July 10, 2002, the Board staff opined that the above-listed services are encompassed within the insurance activities authorized by section 4(k)(4)(B) of the BHC Act when provided to, or on behalf of, an insurance company in connection with the sale or underwriting of insurance. Staff concluded that an FHC could, under section 4(k)(4)(B) of the BHC Act, provide these services to a third-party insurance company.

Section 4(k)(4)(F) of the BHC Act also defines as financial in nature any activity that the Board determined to be closely related to banking under section 4(c)(8) of the BHC Act by a regulation or order that was in effect on November 12, 1999. Section 225.86(a)(1) of Regulation Y cross-references the long-standing ''laundry list'' of nonbanking activities (at section 225.28(b)) permissible by regulation for BHCs. Section 225.86(a)(2) lists nonbanking activities approved for BHCs by Board order as of November 12, 1999.[6] All activities an FHC may engage in pursuant to section 225.86(a) must be conducted subject to the terms and conditions in Regulation Y and the Board orders authorizing those activities.

Section 4(k)(4)(G) of the BHC Act also defines ''financial in nature'' as any activity (1) in which a BHC may engage outside the United States, and (2) that the Board has determined, by regulation or interpretations issued under section (4)(c)(13) of the BHC Act that were in effect on November 11, 1999, to be usual in conducting banking or other financial services abroad.[7] Section 225.86(b) lists three activities that the Board has found to be usual in connection with the transaction of banking or other financial operations abroad. These activities are—

1. providing management consulting services, including services to any person with respect to nonfinancial matters, so long as the services are advisory and do not allow the FHC to control the person to whom the services are provided (these services go beyond the management consulting services that are allowed under section 225.28(b)(9) of Regulation Y and are incorporated by reference at section 225.86(a)(1));
2. operating a travel agency in connection with financial services offered by the FHC or others; and
3. organizing, sponsoring, and managing a mutual fund, so long as the fund does not exercise managerial control over the companies in which it invests and the FHC reduces its ownership, if any, of the fund to less than 25 percent of the equity of the fund within one year (or such longer time as the Board permits) after sponsoring the fund.

The activities that a BHC is authorized to engage in outside the United States under sections 211.8 and 211.10 of Regulation K have been either (1) authorized for FHCs in a broader form by the GLB Act (for example, underwriting, distributing, and dealing in securities and underwriting various types of insurance) or (2) authorized in the same or a broader form in Regulation Y (for example, data processing activities; real and personal property leasing; and acting as agent, broker, or adviser in leasing property).[8] The remaining activities authorized by section 4(k)(4) of the BHC Act are those activities that are defined to be ''financial in nature'' under section 4(k)(4)(H) and (I). These are merchant banking activities conducted under section 4(k)(4)(H) through a securities affiliate or an affiliate thereof, or through an affiliate of an insurance company (as defined in section 4(k)(4)(I)(ii)) when the affiliate is registered under the Investment Advisers Act of 1940 and provides investment advice to an insurance company or is an affiliate of such a registered company. Under section 4(k)(4)(I), these merchant banking activities may be conducted by an insurance company. These activities must be conducted in accordance with the restrictions and limitations under subpart J of Regulation Y, sections 225.170 through 225.177.

Section 4(k)(1)(A) of the BHC Act also allows FHCs to engage in activities that the Board, in coordination with the Secretary of the Treasury, determines to be financial in nature or incidental to such financial activity. Section 225.86(d) of

Act requires a person to register with the relevant state insurance authority, if the person manages all or part of the business of an insurer or, subject to certain conditions, accepts or rejects policies for the insurer and either adjusts or pays claims for the insurer or negotiates reinsurance for the insurer. See the NAIC Model Managing General Agents Act, sections 2.C and 3 (1993).

6. Section 20 company activities are not included in this list. Section 4(k)(4)(E) of the BHC Act authorizes FHCs to engage in securities underwriting, dealing, and market-making activities in a broader form than was previously authorized by Board order.

7. See sections 211.8 and 211.10 of Regulation K (12 C.F.R. 211.8 and 211.10).

8. The Board also has approved, under section 4(c)(13) of the BHC Act, activities in individual orders. Section 4(k)(4)(G) of the BHC Act does not authorize an FHC to engage in activities that the Board has authorized a BHC to provide in individual orders.

Regulation Y lists only one activity, acting as a finder, that has been authorized under this provision. (See section 3910.0 in this manual.) Section 4(k)(1)(B) of the BHC Act allows FHCs to seek Board approval to engage in any activity that the Board determines to be complementary to a financial activity and not to pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

Other permissible activities under section 4(k)(4)(E) of the BHC Act are underwriting and dealing in or making a market in securities without any limitation on revenues that can be derived from bank-ineligible securities. These activities must be conducted in accordance with applicable restrictions and limitations found in the BHC Act and any regulations or supervisory guidance adopted by the Board. The Board adopted an interim rule pertaining to these activities, effective March 11, 2000.[9] It imposed two restrictions on FHCs engaged in securities underwriting, dealing, or market-making activities. All intraday extensions of credit by a bank, thrift, or U.S. branch or agency of a foreign bank to an affiliated company engaged in these activities under section 4(k)(4)(E) must be on market terms consistent with section 23B of the Federal Reserve Act (FRA). In addition, a foreign bank that is an FHC must ensure that its U.S. branch or agency making a loan to or purchasing securities from such an affiliated company complies with sections 23A and 23B of the FRA as if the branch or agency were a member bank.

Section 4(k)(5) of the BHC Act requires the Board and the secretary of the Treasury to define three categories of activities as financial in nature, as well as the extent to which these activities are financial in nature or incidental to a financial activity. These three categories encompass a wide range of activities:

1. lending, exchanging, transferring, investing for others, or safeguarding financial assets other than money or securities
2. providing any device or other instrumentality for transferring money or other financial assets
3. arranging, effecting, or facilitating financial transactions for the account of third parties

The above categories include activities in which FHCs and national banks and their financial subsidiaries are already permitted to engage. For example, the categories include safe deposit services, electronic funds transfer activities, credit and stored-value card activities, and securities brokerage, as well as finder activities. The categories are intended to allow FHCs and financial subsidiaries to engage in activities that were not otherwise permitted for these companies. The procedure below allows an FHC or financial subsidiary to obtain a determination from the Board and the secretary of the Treasury that an activity is financial in nature or incidental to a financial activity pursuant to section 4(k)(5).

An FHC's request for the Board to determine whether an activity falls within one of the three categories listed above must be in writing. The request must—

1. identify and define the activity for which the determination is sought, specifically describing what the activity would be and how the activity would be conducted, and
2. provide information that supports the requested determination, including information on how the proposed activity falls into one of the three categories, as well as any other information the Board requires concerning the proposed activity.

9. This interim rule added paragraph (g) to section 225.4 of Regulation Y, which imposed the two restrictions.

In making its determination, the Board will take into account the same factors that it must consider when determining whether an activity is financial in nature or incidental to a financial activity. These factors include, among other things, changes in the marketplaces in which FHCs and banks compete, changes in technology for delivering financial services, and whether the activity is necessary or appropriate to allow FHCs and their affiliates, or banks and their subsidiaries, to compete effectively with any company seeking to provide financial services in the United States.

If an activity is listed in more than one provision of section 4 of the BHC Act, the FHC may choose to conduct the activity under any applicable provision. The FHC is subject only to the procedures and limitations that the chosen source of authority imposes on the activity.

3905.0.1 ACTIVITIES THAT ARE PERMISSIBLE FOR FHCs UNDER SECTION 225.86(a) OF REGULATION Y

Activities That Are Financial in Nature or That Are Incidental to a Financial Activity	*Manual Section 3600.*
1. Nonbanking activities listed in section 225.28(b) of Regulation Y that have been determined to be so closely related to banking as to be a proper incident thereto (see section 3000.0.2).	
2. Any nonbanking activity that the Board has determined by order (those in effect on November 12, 1999) to be so closely related to banking as to be a proper incident thereto. The activities are—	
a. providing administrative and other services to mutual funds;	27
b. owning shares of a securities exchange;	6
c. acting as a certification authority for digital signatures, and authenticating the identity of persons conducting financial and nonfinancial transactions (includes transactions abroad);	7
d. providing employment histories to third parties for use in making credit decisions and to depository institutions and their affiliates for use in the ordinary course of business;	29
e. check-cashing and wire-transmission services;[1]	
f. in connection with offering banking services, providing notary public services, selling postage stamps and postage-paid envelopes, providing vehicle-registration services, and selling public-transportation tickets and tokens; and	25
g. real estate title abstracting.	30

1. See 1990 FRB 860 and 1995 FRB 1130.

An FHC or other interested party may request that the Board, in consultation with the Secretary of the Treasury, determine that an additional activity is financial in nature or incidental to a financial activity. The written request should (1) identify and define the activity, specifically describing what the activity would involve and how the activity would be conducted; (2) explain in detail why the activity should be considered financial in nature or incidental to a financial activity; and (3) provide information supporting the request and any other information the Board requests concerning the proposed activity. (See section 225.88(b) of Regulation Y.)

An FHC may request an advisory opinion from the Board on whether a proposed specific activity falls within the scope of an activity already determined to be a financial activity and listed in section 225.86 of Regulation Y. The request must be in writing and provide (1) a detailed description of the activity, product, or service about which the company proposes to engage in or provide; (2) an explanation supporting an interpretation on the scope of the permissible financial activity; and (3) any other information the Board requests. (See section 225.88(e) of Regulation Y.)

An FHC may request approval to engage in an activity that is complementary to a financial activity. The written request must (1) identify the proposed complementary activity, specifically describing what the activity would involve and how it would be conducted; (2) identify the financial activity for which the proposed activity would be complementary and provide information to support a finding that the proposed activity should be considered complementary to the identified financial activity; (3) describe the scope and relative size of the proposed activity, as a percentage of projected FHC revenues and on the basis of assets associated with conducting the activity; (4) discuss the risks that conducting the proposed activity pose to the subsidiary depository institutions of the FHC and the financial system in general; (5) describe the potential adverse effects of conducting the activity and explain the proposed measures the FHC would take to address these potential effects; and (6) provide any other information the Board requests. (See section 225.89(a) of Regulation Y.)

3905.0.2 SECURITIES UNDERWRITING, DEALING, AND MARKET-MAKING ACTIVITIES

The GLB Act also authorizes securities underwriting, dealing, and market making without regard to whether such securities may be sold by a bank. This activity includes underwriting or distributing shares of open-end investment companies commonly referred to as mutual funds.

Securities underwriting activities conducted under section 4(k)(4)(E) of the BHC Act may be conducted without regard to the 25 percent revenue limitation that is applicable to section 20 nonbank subsidiaries of BHCs engaged in securities underwriting and dealing, as authorized by Board order under section 4(c)(8). In addition, dealing may be done without regard to the 5 percent limitation on ownership of voting securities.

The operating standards applicable to section 20 companies do not apply to FHCs that engage in securities underwriting, dealing, and market making under section 4(k)(4)(E) of the BHC Act, with two exceptions. First, intraday extensions of credit to a securities firm from an affiliated bank or thrift or U.S. branch or agency of a foreign bank must be on market terms consistent with section 23B of the FRA. Second, foreign banks that are FHCs or that are treated as FHCs are required to comply with the restrictions of sections 23A and 23B of the FRA with respect to lending and securities-purchase transactions between the U.S. branch or agency of a foreign bank and a U.S. securities affiliate. The operating standards and revenue limit continue to apply to BHCs that are not FHCs and to FHCs that continue to conduct securities activities pursuant to section 4(c)(8) of the BHC Act.

3905.0.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
BHCs and foreign banks that qualify as FHCs can engage in financial activities and those incidental thereto	1843			
Activities permissible for an FHC		225.86	4-056.5	
Notice requirement for FHCs engaging in a financial activity		225.87	4-056.6	
Requests for Board to determine whether an activity is financial in nature or incidental to a financial activity		225.88	4-056.7	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Request to engage in an activity that is complementary to a financial activity		225.89	4-056.8	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

3907.0.1 MERCHANT BANKING INVESTMENT AUTHORITY

The Gramm-Leach-Bliley Act (GLB Act) and the Board's Regulation Y permit financial holding companies (FHCs) (but not bank holding companies (BHCs) generally) to make investments as part of a bona fide securities underwriting or merchant or investment banking activity.[1] These investments may be made in any type of ownership interest in any type of nonfinancial entity (portfolio company), and they may include any amount up to all of the ownership interests in the company. The investments that may be made are substantially broader in scope than the investment activities that are otherwise permissible for BHCs.

The authority section 4(k)(4)(H) of the Bank Holding Company Act (BHC Act) grants to FHCs to make merchant banking investments (MBIs) is an alternative to any other authority that the FHC may have to make investments in nonfinancial companies under other provisions of the BHC Act, except as specifically noted in the rule. For example, the rule's provisions do not apply to investments acquired as part of securities underwriting, dealing, or market-making activities conducted under section 4(k)(4)(E) of the BHC Act; investments made by insurance underwriting subsidiaries of an FHC in accordance with section 4(k)(4)(I) of the BHC Act; investments made under section 4(c)(6) or (7) of the BHC Act; or investments made overseas under the Board's Regulation K (12 C.F.R. 211).[2] As described below, the BHC Act allows an FHC to make MBIs if it controls a securities affiliate or controls both an insurance underwriter and a registered investment adviser. The GLB Act does contain certain limitations on MBIs made by FHCs, and it provides a framework for MBIs that is designed to help maintain the separation between banking and commerce to ensure the safety and soundness of depository institutions. All MBIs made by an FHC under section 4(k)(4)(H) must comply with the Board's rule.

3907.0.2 PERMITTED INVESTMENTS

Under section 4(k)(4)(H) of the BHC Act and the Board's rule, an FHC may acquire or control *any* amount of shares, assets, or a full range of ownership interests in a company or other entity that is engaged in an activity that is *not* financial in nature, incidental to a financial activity, or otherwise permissible for the FHC under section 4 of the BHC Act. The interests an FHC may acquire include securities, warrants, partnership interests, trust certificates, other instruments representing an ownership interest in a company, and instruments convertible into a security or other ownership interest whether the interest is voting or nonvoting. An FHC can acquire *any amount* of ownership interests in the company or other entity, whether or not that amount results in control for purposes of the BHC Act. An FHC must file a notice with the Board under section 4(k)(6) of the BHC Act and section 225.87 of Regulation Y (12 C.F.R. 225.87) within 30 days after commencing MBI activities or acquiring any company that makes MBIs.[3]

An FHC also can acquire and control "assets" other than debt or equity securities or other ownership interests of a company. For example, assets acquired as an MBI may include real estate or the assets of a division of an operating company. To be permissible, the assets must be acquired through or promptly transferred to a portfolio company that has and maintains a separate corporate existence, management, and operations to the extent required by the rule. (See section 225.170(e)(3) of Regulation Y.)

3907.0.2.1 Securities Affiliate

A BHC may make MBIs only if it becomes an FHC.[4] The FHC must either (1) control or be a "securities affiliate" or (2) control both an insurance underwriter affiliate and an invest-

1. Unless stated otherwise in this section, the "merchant banking statutory provisions" refer to section 4(k)(4)(H) of the Bank Holding Company Act, and references to the "rule" or "regulatory provisions" pertain to Regulation Y and are found in sections 225.170 through 225.177.

2. Although the rule does not apply to investments held under section 4(c)(6) or (7) of the BHC Act or the Board's Regulation K, those authorities are only available if the FHC's aggregate investment in the relevant company under a combination of authorities, including any investment made under the merchant banking authority, is within the applicable investment limitations and restrictions set forth in section 4(c)(6) or (7) or Regulation K.

3. See section 4(k)(6)(A) of the BHC Act (12 U.S.C. 1843(k)(6)(A)) and section 225.87(a) of Regulation Y (12 C.F.R. 225.87(a)).

4. The Board's Regulation Y sets forth the procedures and qualification criteria applicable to BHCs that seek to elect to become an FHC. See section 225.81 et seq. of Regulation Y (12 C.F.R. 225.81 et seq.).

ment adviser affiliate registered under the Investment Advisers Act of 1940 that provides investment advice to an insurance company. The GLB Act and the rule, however, do *not* require that the FHC make its MBIs *through* such a securities, insurance underwriting, or investment adviser affiliate. Instead, an FHC may make MBIs directly or through any affiliate other than a depository institution or a subsidiary of a depository institution.

The rule defines a ''securities affiliate'' to include any broker or dealer registered with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (Exchange Act). The definition also includes an SEC-registered municipal securities dealer, including a separately identifiable division or department of a bank that is registered as a municipal securities dealer under the Exchange Act. An FHC may make MBIs if the holding company is itself a registered securities broker or dealer.

3907.0.2.2 Investments in Companies Engaged in Nonfinancial Activities

An FHC is authorized under section 4(k)(4)(H) of the BHC Act to acquire or control a company or entity ''engaged in any activity not authorized pursuant to [section 4 of the BHC Act].'' An FHC may not make MBIs in financial companies under section 4(k)(4)(H) or the rule. FHCs have separate authority under other provisions of the BHC Act to make investments in companies engaged in financial activities. However, a company held as an MBI may be engaged in both nonfinancial and financial activities, and an FHC may retain an MBI in a nonfinancial company even if the company subsequently commences a financial activity. An FHC also is not prohibited from using a combination of authorities to invest, through the same subsidiary or fund, in ownership interests of both nonfinancial and financial companies.

Investments in financial companies are not authorized in section 4(k)(4)(H) of the BHC Act. The rule's restrictions, such as those for holding periods and cross-marketing, therefore do not apply to FHC investments in financial companies that are made under other provisions of the BHC Act and the Board's Regulation Y—even if such investments are made for strategic reasons or for reselling the investment. An FHC may not, however, use the merchant banking authority to evade restrictions, such as consent or approval requirements or restrictions that address conflicts of interest or that govern the acquisition of financial companies.[5] In addition, nothing in section 4(k)(4)(H) or the rule overrides the prior-approval requirements of section 3 of the BHC Act, which governs the acquisition of shares of a bank or BHC, or the provisions of section 4(k)(6) and (j) of the BHC Act, which governs the acquisition of shares of a savings association or a company that controls a savings association.

3907.0.2.3 Bona Fide Underwriting or Merchant Banking or Investment Activity

An FHC may only make MBIs as part of a bona fide underwriting or merchant banking or investment banking activity.[6] An FHC is not authorized to make an investment in a nonfinancial company for the purpose of engaging in the activities of the nonfinancial company, such as real estate investment or development or other activities that have not been found to be financial in nature. This ''bona fide'' requirement thus preserves the financial nature of MBI activities and the separation of banking from commerce.

The bona fide requirement does not prohibit an FHC from specializing in making MBIs in particular industries or from making its first MBI in a company engaged in real estate investment or development. However, such investments should be made only for investment as part of an ongoing underwriting or investment or merchant banking activity, and they should be held in accordance with the Board's rules.[7]

3907.0.2.3.1 Investments Made Directly or Through Funds

An FHC may acquire or control MBIs directly or through any subsidiary *other than* a depository institution or subsidiary of a depository institution. An FHC also may *not* acquire or control MBIs on behalf of a depository institution or subsidiary of a depository institution. A

5. See section 4(*l*)(2) of the BHC Act (12 U.S.C. 1843(*l*)(2)) and section 225.84 of Regulation Y (12 C.F.R. 225.84).

6. See section 4(k)(4)(H) of the BHC Act (12 U.S.C. 1843(k)(4)(H)).

7. Concentration in particular industries or in individual investments may present supervisory concerns. The Board expects all FHCs that engage in MBI activities to establish policies governing portfolio diversification and to maintain capital that is adequate, considering the FHC's investment portfolio. See section 3900.0 of this manual and SR-00-9.

U.S. branch or agency of a foreign bank is considered a ''depository institution'' for purposes of the merchant banking rule and its related restrictions. Accordingly, a U.S. branch or agency of a foreign bank may not acquire or control MBIs, and MBIs may *not* be acquired or controlled on behalf of a U.S. branch or agency of a foreign bank.

An FHC is allowed to make MBIs through a private equity fund or other investment fund that, in turn, invests in nonfinancial companies. When an FHC makes such an investment, the holding company's investment in the fund is considered an MBI that must comply with the rule. Certain benefits for investments in or held through a qualifying private equity fund are provided, including an extended holding period and certain relief from the rule's cross-marketing restrictions. Investments in funds that do not qualify as private equity funds are treated as any other type of MBI.

3907.0.2.3.2 Definition of Portfolio Company and Financial Holding Company

Some of the rule's requirements—such as the restrictions on routine management and operation—apply only to portfolio companies. A ''portfolio company'' means any company or entity that is directly or indirectly held, owned, or controlled by an FHC that is using the merchant banking authority, and the company or entity is engaged in an activity that is not authorized for the FHC under section 4 of the BHC Act. (See section 225.177 of Regulation Y.)

The term ''financial holding company,'' as used in the rule, refers to the FHC and any direct or indirect subsidiary of the holding company (including a private equity fund or other fund controlled by the FHC). The term does not include—

1. a portfolio company that is controlled by the FHC or
2. any depository institution controlled by the FHC or any subsidiary of such a depository institution, unless otherwise provided in the rule.

3907.0.3 LIMITS ON MANAGING OR OPERATING A PORTFOLIO COMPANY HELD AS A MERCHANT BANKING INVESTMENT

The GLB Act prohibits an FHC from routinely managing or operating a portfolio company, except as may be necessary or required to obtain a reasonable return on the resale or disposition of the investment. (See section 225.171 of Regulation Y.)

3907.0.3.1 Relationships That Involve Routine Management or Operation

An FHC routinely manages or operates a portfolio company if any director, officer, or employee of the FHC serves as or has the responsibilities of an executive officer of the portfolio company. The term ''executive officer'' has the same meaning as used in the Board's Regulation O. This definition includes any person who participates or has the authority to participate (other than in the capacity of a director) in major policymaking functions of the portfolio company, whether or not the officer has an official title, the title designates the officer as an assistant, or the officer serves without salary or other compensation.[8] (See section 225.177(d) of Regulation Y and 12 C.F.R. 215.2(e)(1).) An FHC is also considered to routinely manage or operate a portfolio company if an executive officer of the parent FHC or certain of its major subsidiaries serves as (or has the responsibilities of) an officer or employee of the portfolio company. For the purposes of these restrictions, an FHC's major subsidiaries include any subsidiary that is (1) a depository institution, (2) an SEC-registered broker-dealer, (3) engaged in MBI activities or insurance company investment activities under section 4(k)(4)(H) or (I) of the BHC Act, (4) a small business investment company, or (5) engaged in significant equity investment activities that are subject to a special capital charge under the Board's capital guidelines (for example, a company engaged in investment activities under section 4(c)(6) or (7) of the BHC Act). An FHC also is considered to routinely manage or operate a portfolio company if

8. An executive officer does not include a person who may exercise a certain measure of discretion in the performance of his or her duties, including the discretion to make decisions in the ordinary course of business, but who does not participate in the determination of major policies of the company and whose decisions are limited by policy standards fixed by senior management. In addition, the term does not include any person who is excluded from participating (other than in the capacity of a director) in major policymaking functions of the company by resolution of the board of directors or by the bylaws of the company, provided the person does not in fact participate in such policymaking functions.

it restricts, by covenants, agreements, or otherwise, the portfolio company's ability to make routine business decisions. Covenants or agreements that involve routine business decisions include covenants that restrict the portfolio company's ability to enter into transactions in the ordinary course of business or to hire nonexecutive officers or employees. As described below, an FHC may have covenants and agreements that restrict actions that are outside the ordinary course of business.

In addition, an FHC is presumed to be involved in the day-to-day management or operations of a portfolio company if a director, officer, or employee of the FHC serves as a nonexecutive officer or employee of the portfolio company or if an officer or employee of the portfolio company is supervised by or reports to an officer or employee of the FHC. An FHC may rebut this presumption by presenting specific facts demonstrating that the junior-officer or employee interlock with the portfolio company would not involve the investing FHC in the routine management and operating of the company.[9] Any request to rebut a presumption must be made to the Board and should fully describe all the facts and circumstances related to the FHC's investment in and relationships with the portfolio company.

3907.0.3.2 Relationships That Do Not Constitute Routine Management or Operation

The rule identifies several relationships that an FHC may have with a portfolio company that would *not* involve the FHC in routinely managing or operating the portfolio company.[10] The following relationships allow the FHC to monitor and provide strategic and financial advice to a portfolio company without becoming involved in the day-to-day management or operations of the company:

1. *Director interlocks.* An FHC may have one or more representatives on the board of directors of a portfolio company. The Board considers the selection of the partners (including the general partner) of a partnership to be the equivalent of selecting the directors of a company. An FHC representative who serves as a director of a portfolio company may participate fully in those matters that are typically presented to directors of a company, whether the director participates in these matters at a meeting of the board, at meetings of committees of the board, through written votes, through meetings with officers or employees of the portfolio company, or in other ways. The FHC's director representatives, however, may not participate in the day-to-day operations of the portfolio company or in management decisions that are made in the ordinary course of business and that are not customarily presented to the directors of a company. The portfolio company also must have officers and employees that routinely manage and operate the company, and the FHC must not have other arrangements or relationships with the portfolio company that would involve the FHC in the routine management or operation of the portfolio company.
2. *Covenants concerning actions outside the ordinary course of business.* An FHC may restrict, by covenant or otherwise, the ability of a portfolio company to take actions that are outside the ordinary course of business. Some examples of actions that are outside the ordinary course of business and that may be subject to these types of covenants or agreements are—
   a. the acquisition of significant assets or control of another company by the portfolio company or any of its subsidiaries;
   b. the removal or selection of the portfolio company's independent accountant or investment banker;
   c. significant changes to the portfolio company's business plan or accounting methods or policies;
   d. the removal or replacement of any or all of the executive officers of the portfolio company;
   e. the redemption, authorization, or issuance of any equity or debt securities of the portfolio company;
   f. any borrowing by the portfolio company that is outside the ordinary course of business;
   g. the amendment of the portfolio company's articles of incorporation, bylaws, or similar governing documents; and
   h. the sale, merger, consolidation, spin-off, recapitalization, liquidation, dissolution, or sale of substantially all of the assets of the portfolio company or any of its significant subsidiaries.

9. See section 225.171(c) of Regulation Y (12 C.F.R. 225.171(c)).
10. See section 225.171(d) of Regulation Y (12 C.F.R. 225.171(d)).

3. *Providing advisory and underwriting services to and consulting with a portfolio company.* An FHC also may provide financial, investment, or management consulting advisory services to the portfolio company in accordance with applicable limitations under Regulation Y.[11] Any management consulting services provided to a portfolio company must remain solely advisory, and the FHC may not assume responsibility for decision making or for the day-to-day management or operations of the portfolio company.[12] An FHC may also underwrite or act as placement agent for the securities of a portfolio company and provide assistance to the portfolio company in connection with the underwriting or placement of its securities without being considered to be involved in routinely managing or operating the company. An FHC also may have regular or periodic meetings with the officers or employees of a portfolio company to monitor and provide advice regarding the portfolio company's performance or activities, so long as the FHC, through such meetings or otherwise, does not routinely manage or operate the portfolio company.

3907.0.3.2.1 Other Permissible Covenants Not Involving the FHC in Routinely Managing and Operating a Portfolio Company

Listed below are some additional examples of covenants that an FHC may have with a portfolio company without routinely managing or operating the portfolio company.[12a] In particular, an FHC may, consistent with the GLB Act and section 225.171(d) of Regulation Y, have covenants with a portfolio company that restrict the ability of the portfolio company to—

1. alter its capital structure through the issuance, redemption, authorization, or sale of any equity or debt securities of the portfolio company;[12b]
2. establish the general purpose for funds sought to be raised through the issuance or sale of any equity or debt securities of the portfolio company (for example, retirement of existing debt, acquisition of another company, or general corporate use);
3. amend the terms of any equity or debt securities issued by the company;
4. declare a dividend on any class of securities of the portfolio company or change the dividend-payment rate on any class of securities of the portfolio company;
5. engage in a public offering of securities of the portfolio company;
6. register a class of securities of the portfolio company under federal or state securities laws;
7. list (or de-list) any securities of the portfolio company on a securities exchange;
8. create, incur, assume, guarantee, refinance, or prepay any indebtedness outside the ordinary course of business of the portfolio company;
9. voluntarily file for bankruptcy, or consent to the appointment of a receiver, liquidator, assignee, custodian, or trustee of the portfolio company for purposes of winding up its affairs;
10. significantly alter the regulatory, tax, or liability status of the portfolio company (examples of actions that would significantly alter the regulatory, tax, or liability status of the portfolio company include the registration of the portfolio company as an investment company under the Investment Company Act of 1940, or the conversion of the portfolio company from a corporation to a partnership or limited-liability company);
11. make, or commit to make, any capital expenditure that is outside the ordinary course of business of the portfolio company, such as the purchase or lease of a significant manufacturing facility, an office building, an asset, or another company;
12. engage in, or commit to engage in, any purchase, sale, lease, transfer, or other transaction outside the ordinary course of business of the portfolio company, which may include for example—
    a. entering into a contractual arrangement (including a property lease or consulting agreement) that imposes significant financial obligations on the portfolio company;
    b. the sale of a significant asset of the portfolio company (for example, a signifi-

11. See sections 225.28(b)(6) and 225.86(b)(1) of Regulation Y (12 C.F.R. 225.28(b)(6) and 12 C.F.R. 225.86(b)(1)).

12. See sections 225.28(b)(9) and 225.86(b)(1) of Regulation Y (12 C.F.R. 225.28(b)(9) and 12 C.F.R. 225.86(b)(1)).

12a. See letter from Virgil Mattingly, the Federal Reserve Board's general counsel, to Peter T. Grauer, Credit Suisse First Boston, dated December 21, 2001.

12b. For these purposes, the phrase ''equity and debt securities'' includes options, warrants, obligations, or other instruments that give the holder the right to acquire securities of the portfolio company.

cant patent, manufacturing facility, or parcel of real estate);

c. the establishment of a significant new subsidiary by the portfolio company;
d. the transfer by the portfolio company of significant assets to a subsidiary or to a person affiliated with the portfolio company; or
e. the establishment by the portfolio company of a significant new joint venture with a third party;

13. hire, remove, or replace any or all of the executive officers of the portfolio company;[12c]
14. establish, accept, or modify the terms of an employment agreement with an executive officer of the portfolio company, including the terms setting forth the executive officer's salary, compensation, and severance;
15. adopt or significantly modify the portfolio company's policies or budget concerning the salary, compensation, or employment of the officers or employees of the portfolio company generally;
16. adopt or significantly modify any benefit plan covering officers or employees of the portfolio company, including defined benefit and defined contribution retirement plans, stock option plans, profit sharing, employee stock ownership plans, or stock appreciation rights plans;
17. alter significantly the business strategy or operations of the portfolio company, for example, by entering or discontinuing a significant line of business or by altering significantly the tax, cash-management, dividend, or hedging policies of the portfolio company; or
18. establish, dissolve, or materially alter the duties of a committee of the board of directors of the portfolio company.

Some of the above actions by their very nature are outside the ordinary course of business of a portfolio company and, thus, may be subject to a covenant with the portfolio company. For example, covenants restricting the ability of a portfolio company to issue or redeem its equity or debt securities or hire or fire its executive officers are unusual actions that typically are taken only by or in consultation with the company's board of directors.

12c. The term ''executive officer'' is defined in section 225.171 of Regulation Y.

Covenants concerning other types of actions may, or may not, involve the FHC in routine business decisions of the portfolio company, depending on the specific scope of actions covered by the covenant and the size and characteristics of the portfolio company. To provide FHCs maximum flexibility in structuring their relationships with portfolio companies to the extent permitted by the GLB Act, several of the examples included above permit an FHC to restrict the ability of a portfolio company to take certain actions whenever the actions are significant.

The measure of ''significant'' in this context would depend on the size, capital, condition, business, and other characteristics of the portfolio company. In determining what is significant for a particular portfolio company, one rule of thumb is that any action that would, under ordinary business practices, be presented to the board of directors of the portfolio company for approval or consideration may also be subject to a covenant that requires review and approval of the action by the financial holding company investor. In this way, the rule permits a financial holding company investor to exercise the same type of review and approval rights through a covenant that the FHC could exercise directly through representation on the board of directors of the portfolio company. As with a director representative, however, an FHC may not use a covenant as a means to become involved in routine business decisions made in the ordinary course of the portfolio company's day-to-day business activities.

There also may be situations in which a covenant is permissible even though the actions involved are ones that, under ordinary business practices, would not be considered by the board of directors of the portfolio company. It is expected that these situations would be unusual and the permissibility of such a covenant would likely depend on the particular facts and circumstances involved in the case.

3907.0.3.2.2 FHC May Routinely Manage or Operate a Portfolio Company in Special Circumstances

An FHC may routinely manage or operate a portfolio company only when such action is ''necessary or required to obtain a reasonable return on [the] investment upon resale or disposition.'' Examples of situations in which intervention may be needed would be when the portfolio company experiences a significant operating loss or when there is a loss of senior management. Once the FHC has taken appropriate action to obtain a reasonable return on the resale or disposition of the investment, the GLB Act requires the FHC to cease routinely managing or operating the portfolio company. The FHC may routinely manage or operate a portfolio company only for the period of time that may be necessary to address the cause of the holding company's involvement in the routine management or operations of the portfolio company, to obtain suitable management arrangements, to dispose of the investment, or to otherwise obtain a reasonable return on the resale or disposition of the investment. The determination of whether and how long FHC intervention is necessary or required will depend on the facts and circumstances of the particular investment.

Two requirements in the rule assist the Federal Reserve in monitoring the interventions of FHCs in the routine management or operations of portfolio companies. These requirements ensure that such actions are consistent with the GLB Act's limitations. First, FHCs are required to maintain and make available to the Board on request a written record describing the company's involvement in routinely managing or operating any portfolio company.[13] Second, an FHC is required to provide the Board with written notice if the company routinely manages or operates a portfolio company for more than nine months.[14] The notice may be in the form of a letter and should identify the portfolio company, the date on which the FHC first became involved in the routine management or operations of the portfolio company, the reasons for the involvement, and the actions that the FHC has taken to address the circumstances giving rise to the intervention, as well as provide an estimate of when the FHC anticipates it will cease routinely managing or operating the portfolio company.

3907.0.3.3 Depository Institutions Prohibited from Managing or Operating Portfolio Companies

A depository institution or a subsidiary of a depository institution may not routinely manage or operate a portfolio company held by an FHC. As noted above, U.S. branches and agencies of foreign banks are considered depository institutions for purposes of the rule. A director, officer, or employee of a depository institution or its subsidiary, as well as a U.S. branch or agency, however, is not prohibited from serving as a director of a portfolio company to the same extent as would be permitted for a director, officer, or employee of an FHC. Such director, officer, or employee is also not prohibited from taking other actions that the rule does not define to be routine management or operation. In addition, a depository institution is not prevented from having covenants or from taking actions pursuant to covenants that are typically found in credit agreements to ensure repayment of extensions of credit in the ordinary course of business, provided the covenant or action is not an attempt to evade the rule's restrictions.

The rule also does not apply the prohibition on a depository institution routinely managing or operating a portfolio company to a financial subsidiary of a bank that is held in accordance with section 5136A of the Revised Statutes (12 U.S.C. 24a) or section 46 of the Federal Deposit Insurance Act (FDI Act). The prohibition also does not apply to a small business investment company subsidiary of a bank held in accordance with the Small Business Investment Act of 1958. These subsidiaries may, however, exercise routine management or operation only in accordance with the limitations that apply to FHCs.

3907.0.4 HOLDING PERIODS FOR MERCHANT BANKING INVESTMENTS

The GLB Act requires that any shares, assets, and ownership interests acquired as an MBI be held only for a period of time that enables the sale or disposition of the interest on a reasonable basis, consistent with the financial viability of the FHC's merchant banking activity. The rule permits an FHC to hold any MBI for a period of up to 10 years. In addition, the rule allows an FHC to own or control an MBI in or through a private equity fund (as defined below) for the life of the fund, up to 15 years.[15]

An FHC may hold an MBI beyond the rule's specified time periods only with the Board's prior approval. A request by an FHC for an extension of the applicable holding period must be filed at least 90 days before the expiration of the holding period. An extension request must provide the reasons for the request (including

13. See section 225.171(e)(4) of Regulation Y (12 C.F.R. 225.171(e)(4)).

14. See section 225.171(e)(3) of Regulation Y (12 C.F.R. 225.171(e)(3)).

15. See section 225.172 of Regulation Y (12 C.F.R. 225.172).

the factors listed below), explain the FHC's plan for divesting the investment, and discuss the factors that the Board may consider in reviewing the request. Factors to be included in the extension request are the cost to the FHC of disposing of the investment within the applicable time period, the total exposure of the FHC to the portfolio company and the risks that disposing of the investment without an extension may pose to the FHC, market conditions, the nature of the portfolio company's business, the extent and history of the FHC's involvement in the management and operations of the portfolio company, and the average holding period of the FHC's MBIs. The Board may also consider any other relevant information related to the investment.

If an FHC receives permission to hold an MBI beyond the applicable holding period, a special capital charge applies to the investment. The Board must set this charge at a rate that is above the highest marginal tier 1 capital charge applicable under the Board's capital guidelines for MBIs held by that FHC, but the rate may not be below 25 percent of the adjusted carrying value of the investment as reflected on the FHC's balance sheet. The Board may also impose other restrictions it determines to be appropriate in connection with granting the extension request.

3907.0.4.1 Holding-Period Tacking Provisions

The rule includes special "tacking" provisions to prevent an FHC from circumventing the holding periods on MBIs by transferring an MBI from one company or fund to another.[16] The rule also provides that, for purposes of calculating compliance with the merchant banking holding periods, an investment the FHC acquires under another authority that imposes a restriction on the amount of time that the FHC may hold the investment is considered to have been acquired on the original acquisition date.

3907.0.5 PRIVATE EQUITY FUNDS

As noted above, the rule permits an FHC to make MBIs directly or through funds that pool the firm's capital with capital provided by third-party investors, such as investment companies, pension funds, endowments, financial institutions or corporations, and sophisticated individual investors who have a high net worth. Frequently, these pooled investment vehicles have characteristics (such as limited terms, manager-compensation arrangements, and the presence of third-party investors that monitor investments) that encourage the fund to dispose of its investments in a relatively short period of time. Considering such characteristics, and to

16. See section 225.172(b)(2) and (3) of Regulation Y (12 C.F.R. 225.172(b)(2) and (3)).

accommodate industry practice on investment funds, the rule includes several special provisions for MBI activities conducted through a qualifying "private equity fund." The provisions include a longer holding period for private equity fund investments, a higher aggregate investment threshold for review of an organization that makes investments in or through private equity funds, and streamlined reporting and recordkeeping provisions for investments in or held through private equity funds.

3907.0.5.1 Definition of Private Equity Fund

To qualify as a "private equity fund" under the rule, the fund must have a fixed duration of not more than 15 years including all potential extensions, and the FHC (including its officers, directors, employees, and principal shareholders) may not own more than 25 percent of the total equity of the fund. There are no limits on advisory fees or on the various types of incentive compensation that the FHC may receive for services rendered to the fund, provided such fees do not increase the FHC's equity stake in the fund above the 25 percent threshold.

A private equity fund also may not be an operating company and must be engaged exclusively in the business of investing in financial and nonfinancial companies for resale or other disposition. In addition, the fund may not be established or operated for the purpose of making investments that are inconsistent with section 4(k)(4)(H) of the BHC Act or evading the limitations of the GLB Act or the rule.

A private equity fund can be organized in any form, including a partnership, corporation, or limited-liability company. In addition, the fund may, but need not be, registered as an investment company under the federal securities laws.

3907.0.5.2 Permissible Holding Period for Private Equity Fund Investments

As noted above, an FHC, without Board approval, may own or control an investment in a private equity fund that makes MBIs for the duration of the fund, which may be up to 15 years. A qualifying private equity fund may therefore hold investments in portfolio companies for up to 15 years, and it is not required to dispose of its investments within the 10-year period applicable to other types of MBIs. In special circumstances, an FHC may seek the Board's approval to retain an investment in a qualifying private equity fund or to extend the duration of a private equity fund for a period longer than 15 years.[17] (See section 3907.0.5 of this manual for a discussion of how an FHC may request an extension of this holding period.)

3907.0.5.3 Routine Management and Operation Restrictions for Private Equity Funds

The GLB Act and the rule generally prohibit an FHC from routinely managing or operating any portfolio company—that is, any company engaged in nonfinancial activities.[18] These restrictions apply regardless of whether the FHC owns or controls its interest in the portfolio company directly or through a private equity fund. Accordingly, an FHC may not routinely manage or operate a portfolio company that is owned or controlled by a private equity fund in which the FHC owns or controls any ownership interest, except in the limited circumstances permitted by the rule.[19] In addition, if an FHC controls a private equity fund, the private equity fund is a subsidiary of the FHC and the *private equity fund* must abide by the rule's limits on routine management and operation of portfolio companies. An FHC, however, is not prohibited from routinely managing or operating the private equity fund itself.

An FHC is considered to control a private equity fund for the purpose of the rule if the FHC or any director, officer, employee or principal shareholder of the company (1) serves as a general partner, managing member, or trustee of the private equity fund; (2) owns or controls in the aggregate 25 percent or more of any class of voting shares or similar interests in the fund; (3) selects, controls, or constitutes a majority of the directors, trustees, or management of the fund; or (4) owns or controls more than 5 percent of any class of voting shares or similar ownership interests in the fund and serves as the fund's investment adviser.

17. The holding-period tacking rules in section 225.172(b)(2) and (3) of Regulation Y must be applied when a private equity fund investment has been held longer than the permitted time.

18. See sections 225.177(c) and 225.171(a) of Regulation Y (12 C.F.R. 225.177(c) and 225.171(a)).

19. See section 225.171(e) of Regulation Y (12 C.F.R. 225.171(e)).

3907.0.5.4 Other Matters Related to Private Equity Funds

When an FHC has a passive (that is, noncontrolling) investment in a private equity fund that is advised and controlled by an unaffiliated entity, any shares owned by the fund generally are not considered to be owned or controlled by the passive FHC investor.[20] Therefore, the rule's cross-marketing restrictions on the products or services of a portfolio company, the limitations of sections 23A and 23B of the FRA, and the rule's reporting and recordkeeping requirements *do not apply* to investments in portfolio companies that are held by a private equity fund and that are not controlled by the FHC. These restrictions and requirements (other than the cross-marketing restrictions) would, however, apply to the FHC's investment in the private equity fund and would govern the relationship of the FHC with the private equity fund.

3907.0.5.4.1 Funds That Are Not Qualifying Private Equity Funds

An FHC is permitted to invest in and control a fund that does not meet the private equity fund definition. If the FHC controls the nonqualifying fund, then the provisions of the rule, including the holding-period provisions for portfolio companies, the routine-management restrictions, the risk-management and recordkeeping requirements, the cross-marketing provisions, and the section 23A provisions, apply to investments made by the nonqualifying fund in the same manner as those provisions would apply if the investment in the portfolio company were held directly by the FHC. If the FHC owns a noncontrolling interest in the fund, then the fund is itself considered to be a portfolio company.

An FHC may thus own more than 25 percent of the equity of a fund that has an unlimited life (and, consequently, is not a qualifying private equity fund), so long as the fund does not hold investments in portfolio companies for more than 10 years, and the FHC and the fund comply with the routine management and other restrictions of the rule. Similarly, an FHC may invest in a fund that, in addition to making MBIs, engages in other businesses (and, consequently, is not a qualifying private equity fund), so long as the FHC does not control the fund, divests its interest in the fund within 10 years, and complies with the other provisions of the rule that apply to investments in a portfolio company.

20. See section 2(g)(1) of the BHC Act (12 U.S.C. 1841(g)(1)) and section 225.2(e)(2)(i) of Regulation Y (12 C.F.R. 225.2(e)(2)(i)).

3907.0.6 TEMPORARY AGGREGATE INVESTMENT THRESHOLDS FOR MBIs

To allow the Federal Reserve to review the risk-management policies, procedures, and systems of an FHC that seeks to devote a significant portion of its capital to MBIs, temporary investment thresholds on MBIs are included in the rule. An FHC may not, without the Board's prior approval, make additional MBIs if the aggregate carrying value of its existing MBIs exceeds either of the two thresholds. The first threshold prevents an FHC from making additional MBIs (including making additional capital contributions to a company held under the rule) if the aggregate carrying value of the FHC's MBIs exceeds 30 percent of the FHC's tier 1 capital. A second threshold applies if the aggregate carrying value of the FHC's MBIs, *excluding* investments in private equity funds, exceeds 20 percent of the FHC's tier 1 capital. An FHC may exceed either threshold with the prior approval of the Board.

The investment thresholds were adopted as sunset provisions until the Board adopts a final rule specifically addressing the regulatory capital treatment for MBIs and that rule becomes effective. In February 2001, the Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation jointly requested comment on proposed rules that would establish special capital requirements for MBIs and similar equity investments held by BHCs and banks. (See 66 *Federal Register* 10, 212 (February 14, 2001).)

The investment thresholds discussed above apply only to MBIs made by FHCs under section 4(k)(4)(H) of the BHC Act and under the rule. They do not apply to or restrict investments made by BHCs or FHCs under other authorities, such as investments made through small business investment companies (SBICs), investments made in less than 5 percent of the voting shares of a company under section 4(c)(6) or (7) of the BHC Act, or investments made overseas under Regulation K.

3907.0.7 RISK-MANAGEMENT, REPORTING, AND RECORDKEEPING POLICIES

3907.0.7.1 Policies, Procedures, Systems, and Reports

An FHC must maintain policies, procedures, and systems that are reasonably designed to manage the risks associated with making MBIs and to monitor compliance with the statutory and regulatory provisions governing such investments. The rule identifies the major areas that must be addressed by the internal policies and controls of an FHC engaged in making MBIs. In particular, an FHC engaged in merchant banking activities must have policies, procedures, records, and systems that are reasonably designed to—

1. monitor and assess the carrying value, market value, and performance of MBIs and of the company's aggregate MBI portfolio;
2. identify and manage the market, credit, concentration, and other risks associated with MBIs;
3. identify, monitor, and assess the terms, amounts, and risks arising from transactions and relationships (including contingent fees or contingent interests) with each company in which the FHC has an MBI;
4. ensure the maintenance of corporate separateness between the FHC and each company in which the FHC holds an interest under the rule, and protect the FHC and its depository institution subsidiaries from legal liability for the operations conducted and financial obligations of any such company; and
5. ensure compliance with the rule, including the rule's holding-period, routine management and operation, and cross-marketing restrictions, as well as with any other applicable provisions of law governing transactions and relationships with companies in which the FHC holds an interest under the rule, such as fiduciary principles and sections 23A and 23B of the FRA.

This list of policies, procedures, records, and systems identifies only some of the most important elements of a sound approach to monitoring MBI activities. The Board has issued supervisory guidance (see SR-00-9) that provides additional detail concerning the internal controls, policies, and systems that any BHC engaged in equity investment activities is expected to have and maintain to engage in such activities in a safe and sound manner. (See section 3900.0 of this manual for more detail on this guidance.)

If the FHC controls a private equity fund or other fund that makes MBIs, the FHC must ensure that the fund has the types of policies, procedures, and systems for making and monitoring MBIs that are required for FHCs. The FHC may satisfy these requirements by ensuring that the private equity fund or other fund is subject to the FHC's merchant banking policies, procedures, and systems. If an FHC does not control the fund, then the fund is not subject to the recordkeeping and risk-management provisions of the rule. Nevertheless, an FHC must apply its merchant banking policies, procedures, and systems to any investment made by the company in any fund that is controlled by an unaffiliated entity.

It is anticipated that FHCs will be able to satisfy the rule's recordkeeping requirements by using the internal reports and records it prepares in the ordinary course of making an MBI or controlling a private equity fund. Similarly, if an FHC makes a noncontrolling investment in a private equity fund, the FHC should be able to use information provided by the fund's adviser or sponsor to satisfy the rule's recordkeeping requirements.

3907.0.7.2 Notice of Commencement of Merchant Banking Activities

An FHC must notify the Board within 30 days of commencing merchant banking activities under section 4(k)(4)(H) of the BHC Act. (See section 225.87(a) of Regulation Y.) For a domestic FHC, this notice should be provided on the Federal Reserve's reporting form, the FR Y-6A (which is expected to be replaced by the FR Y-10). For qualifying foreign banking organizations, the notice should be provided on the FR Y-7 (which is expected to be replaced by the FR Y-10F).

The appropriate Reserve Bank, in coordination with Board staff, should schedule a review of the investment and risk-management policies, procedures, and systems of an FHC that files a notification indicating that it has commenced merchant banking activities. The review may be conducted either off- or on-site, depending on the expected level and complexity of the FHC's MBIs and the company's previous experience in making equity investments under other legal authorities. This review may be deferred until the next regularly scheduled inspection or examination, if the FHC has significant experience in making equity investments under preexisting authorities and if the Federal Reserve has recently reviewed the company's policies, procedures, and systems for managing and controlling the risks associated with equity investment activities.

3907.0.7.3 Quarterly and Annual Reporting Requirements

The Federal Reserve has instituted two periodic reporting requirements relating to MBIs. The first is a quarterly report (FR Y-12) that seeks aggregate information on the cost and carrying values of an FHC's MBIs. This report also collects information on nonfinancial equity investments made by BHCs and their subsidiaries under other legal authorities, including investments made through SBICs and investments made in less than 5 percent of the voting shares of a company under section 4(c)(6) or (7) of the BHC Act. This quarterly report assists the Federal Reserve in monitoring the exposure of BHCs to MBIs and similar types of equity investments. The second report is an annual report, the FR Y-12A, that will collect basic information on MBIs held by an FHC for an extended time period. The FR Y-12A annual report collects information on MBIs that are approaching the end of their applicable holding period.

3907.0.7.4 Notice of Large Merchant Banking Acquisitions

After an FHC has provided notice to the Federal Reserve that it has commenced merchant banking activities, the FHC generally is *not* required to file a notice after acquiring the shares of a company under its merchant banking investment authority. However, an FHC must file a post-transaction notice with the Federal Reserve within 30 days after making an MBI in a company if (1) the investment represents more than 5 percent of the voting shares, assets, or ownership interests of the company, and (2) the total cost of the investment to the FHC exceeds the lesser of 5 percent of the tier 1 capital of the FHC or $200 million. This notice must be provided on the forms discussed above.

3907.0.8 CROSS-MARKETING RESTRICTIONS

The GLB Act prohibits a depository institution subsidiary of an FHC from marketing or offering any product or service of a company in which the FHC has an MBI. Similarly, the GLB Act prohibits a company held by an FHC as an MBI from marketing or offering any product or service of a depository institution subsidiary of the FHC. U.S. branches and agencies of a foreign bank that conduct BHC activities in the United States or through a U.S. company are considered depository institutions under the rule. Thus, a U.S. branch or agency of a foreign bank may not cross-market the products or services of a company that is owned or controlled by the foreign bank or an affiliate of the foreign bank under section 4(k)(4)(H) of the BHC Act. In addition, the cross-marketing restrictions generally apply to any *subsidiary* of a depository institution controlled by an FHC.

The cross-marketing restrictions, however, do not apply to certain subsidiaries of a depository institution that Congress has expressly authorized the parent institution to own or control. In particular, the cross-marketing restrictions do *not* apply to (1) a financial subsidiary of a depository institution held in accordance with section 5136A of the Revised Statutes (12 U.S.C. 24a) or section 46 of the FDI Act, (2) any company held by an Edge Act or agreement subsidiary of the depository institution that is controlled pursuant to section 25 or 25A of the FRA, or (3) any company held by an SBIC subsidiary of the depository institution that is controlled in accordance with the Small Business Investment Act.

The cross-marketing restrictions of the GLB Act and the rule also do *not* apply to nondepository affiliates of FHCs. Accordingly, a nondepository holding company affiliate of an FHC may engage in cross-marketing activities with a portfolio company held by the FHC under section 4(k)(4)(H) of the BHC Act. In addition, these restrictions do not apply to (1) portfolio companies in which the FHC, either directly or indirectly, owns less than 5 percent of the voting shares or ownership interests; (2) portfolio companies that are held by a private equity fund the FHC does not control; and (3) interests in a private equity fund (whether or not the FHC controls the fund). Accordingly, a depository institution subsidiary of an FHC may engage in cross-marketing activities with such a company, or it may market the shares of a private equity fund.

3907.0.8.1 Marketing Products or Services Involving a Portfolio Company

As noted above, the GLB Act prohibits any depository institution controlled by an FHC from (1) marketing or offering any product or service of a portfolio company held by the FHC under section 4(k)(4)(H) of the BHC Act or (2) allowing any product or service of the depository institution to be offered or marketed by or through any portfolio company held by the FHC under that section. A depository institution or subsidiary of a depository institution is *not* prohibited from marketing its own products or services—such as deposit, lending, and advisory products or services—to a portfolio company so long as the portfolio company does not then market those products or services to its customers or others. A depository institution subsidiary of an FHC also may purchase the products or services of a portfolio company—such as data processing hardware, software, or services to support the depository institution's own operations—provided that the institution does not, directly, indirectly, or through any arrangement, market the portfolio company's products or services to the institution's customers or others. Likewise, the cross-marketing restrictions would not prohibit a depository institution controlled by an FHC from engaging in cross-marketing activities with a company that is a co-investor with the FHC in a portfolio company, so long as those activities do not involve products or services of the portfolio company.

3907.0.9 PRESUMPTION OF CONTROL UNDER SECTIONS 23A AND 23B OF THE FRA

Sections 23A and 23B of the FRA impose specific quantitative, qualitative, and collateral requirements on certain types of transactions between an insured depository institution and its affiliates, that is, companies that are under common control with the insured depository institution. Typically, a company owned by an FHC is considered to be an affiliate of the FHC's subsidiary insured depository institution for the purposes of sections 23A and 23B, if the FHC owns or controls 25 percent or more of any class of the company's voting securities. The GLB Act, however, includes a presumption that an FHC controls a company for purposes of sections 23A and 23B if the FHC directly or indirectly, or acting through one or more other persons, owns or controls 15 percent or more of the equity capital of the company under the merchant banking authority of section 4(k)(4)(H) of the BHC Act.[21] Thus, a company is presumed to be a section 23A affiliate of a subsidiary insured depository institution of an FHC if the FHC owns or controls more than 15 percent of the total equity of the company under section 4(k)(4)(H).

An FHC can rebut the presumption by providing information to the Board demonstrating that the FHC does not control the company.[22] In the three situations identified below, the presumption of control under the GLB Act will be considered rebutted. In each situation, the FHC is assumed to own more than 15 percent of the total equity of the portfolio company under section 4(k)(4)(H) of the BHC Act (thereby triggering the statutory presumption) and less than 25 percent of any class of voting securities of the portfolio company (thereby not meeting the statutory definition of control). In particular, absent evidence to the contrary, an FHC will *not* be presumed to control a portfolio company if—

1. no officer, director, or employee of the FHC serves as a director, trustee, or general partner (or as an individual exercising similar functions) of the portfolio company;
2. a person that is not affiliated or associated with the FHC owns or controls a greater percentage of the equity capital of the portfolio company than the FHC, and no more than one officer or employee of the holding company serves as a director or trustee (or as an individual exercising similar functions) of the portfolio company; or
3. a person that is not affiliated or associated with the FHC owns or controls more than 50 percent of the voting shares of the portfolio company, and officers and employees of the FHC do not constitute a majority of the directors or trustees (or of individuals exercising similar functions) of the portfolio company.

21. Equity capital includes voting and nonvoting shares, warrants, options, and other instruments convertible into equity capital.

22. The presumption applies only when an FHC owns or controls 15 percent or more of the total equity of a portfolio company under section 4(k)(4)(H) of the BHC Act and the rule. Under existing Board precedents, an FHC may not own any shares of a company in reliance on section 4(c)(6) or (7) of the BHC Act when the company owns or controls, in the aggregate under a combination of authorities, more than 5 percent of any class of voting securities of the company.

These safe harbors do not require Board review or approval under the provisions allowing rebuttal of the presumptions. An FHC also may request the Board's approval to rebut a presumption of control under other circumstances.

The rule's presumption of control is independent from the general definition of control in section 23A of the FRA.[23] A portfolio company, under the statute, is per se a section 23A affiliate of any insured depository institution subsidiary of an FHC if the FHC owns 25 percent or more of a class of voting securities of the portfolio company, even if the FHC owns or controls less than 15 percent of the portfolio company's *total equity* or is within one of the rule's safe harbors.

For the purpose of applying the presumption of control, an FHC that has an investment in a private equity fund will not be considered to indirectly own the equity capital of a portfolio company held by the fund *unless* the FHC controls the private equity fund. For example, if an FHC has a noncontrolling investment in a private equity fund that, in turn, owns 20 percent of the total equity of a portfolio company, the portfolio company is not presumed to be an affiliate of the insured depository institution subsidiaries of the FHC. On the other hand, if an FHC acts as general partner of a private equity fund and thus controls the fund, and if the private equity fund owns or controls more than 15 percent of the total equity of any portfolio company, the portfolio company is presumed to be an affiliate of the insured depository institution subsidiaries of the FHC.

To ensure competitive equity, the Board's rule applies sections 23A and 23B of the FRA to covered transactions between a U.S. branch or agency of a foreign bank and (1) any portfolio company controlled by the foreign bank or an affiliate of the foreign bank under the merchant banking authority of section 4(k)(4)(H) of the BHC Act, and (2) any company controlled by the foreign bank or an affiliate if the company is engaged in making MBIs under section 4(k)(4)(H) and the proceeds of the covered transaction are used for the purpose of funding the company's merchant banking activities. In determining if a portfolio company is controlled by a foreign bank or an affiliate of a foreign bank for these purposes, the rebuttable presumption of control and the three safe harbors discussed above apply to the foreign bank and affiliate in the same manner that the presumption and safe harbors apply to domestic FHCs. The rule does not restrict lending by a foreign bank's U.S. branches and agencies to parent companies or other affiliated companies unless the proceeds of such lending would be used by these companies to make or fund the making of MBIs.

23. See 12 U.S.C. 371c(3)(A).

3907.0.10 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Merchant banking investment activities	1843(k)(7)(A)			
Permitted investments		225.170	4-058	
Limitations on managing or operating a portfolio company held as an MBI		225.171	4-058.2	
MBI holding periods		225.172	4-058.3	
Investments in private equity fund		225.173	4-058.4	
Aggregate limits on MBIs		225.174	4-058.5	
Risk-management, reporting, and recordkeeping policies for MBIs		225.175	4-058.6	
Cross-marketing and FRA section 23A and 23B limitations for MBIs		225.176	4-058.7	
Definitions		225.177	4-058.8	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Investments in the equity of nonfinancial companies[1] as well as lending to private-equity-financed companies have emerged as important sources for earnings and business relationships at a number of banking organizations (BOs).[2] These equity investments in nonfinancial companies, however, can entail significant market, liquidity, and other risks. Equity investments can also give rise to increased volatility of both earnings and capital. Accordingly, sound investment and risk-management practices and strong capital positions are critical when conducting these activities.

In June 2000, the Board issued supervisory guidance on various sound practices related to the equity investment activities of B0s; this guidance merits the attention of management, examiners, and other supervisory staff. The guidance applies to the equity investment activities of financial holding companies (FHCs), bank holding companies (BHCs), state member banks, and their affiliates, regardless of the authority under which the investments are made. The major elements of this guidance, equity investments and the provision of traditional credit-based services to equity-funded companies, are highlighted below. For a more complete discussion, see SR-00-9.

3909.0.1 LEGAL AND REGULATORY AUTHORITY FOR EQUITY INVESTMENTS

FHCs, BHCs, and depository institutions are able to make equity investments under several statutory and regulatory authorities. Under section 4(c)(6) and (7) of the Bank Holding Company Act (BHC Act), BHCs may make passive investments in up to 5 percent of the outstanding voting shares of any company and up to 25 percent of the total equity of the company. Under this authority, there is no aggregate limit on the total dollar amount of equity investments that a BHC may hold.

BOs can make equity investments through a small business investment corporation (SBIC), which can be a subsidiary of a bank or BHC. Investments made by SBIC subsidiaries are allowed up to a total of 50 percent of a portfolio company's outstanding shares, but can only be made in companies defined as a small business, according to SBIC rules. A bank's aggregate investment in the stock of SBICs is limited to 5 percent of the bank's capital and surplus. In the case of BHCs, the aggregate investment is limited to 5 percent of the BHC's proportionate interest in the capital and surplus of its subsidiary banks.

Under Regulation K, which implements sections 25 and 25A of the Federal Reserve Act (FRA) and section 4(c)(13) of the BHC Act, BOs may, with Board approval, make portfolio investments in foreign companies that in the aggregate do not exceed 25 percent of the tier 1 capital of the BHC. In addition, individual investments must be less than 20 percent of a portfolio company's voting shares and must not exceed 40 percent of the portfolio company's total equity.[3]

FHCs are also permitted to acquire any amount of the shares, assets, or ownership interests of a nonfinancial company under the merchant banking investment authority of section 4(k)(4)(H) of the BHC Act, as amended by the Gram-Leach-Bliley Act (GLB Act). The GLB Act places certain limits on the holding period of merchant banking investments and on the ability of an FHC to routinely manage or operate a portfolio company held as a merchant banking investment. Subpart J of the Board's Regulation Y (12 C.F.R. 225.170–225.177) implements these and other restrictions applicable to merchant banking investments.

Equity investments made under any of the authorities described above may be in publicly

1. Unless otherwise noted, references to equity investments in this guidance are references to equity investments in nonfinancial companies. Nonfinancial companies include companies that engage in activities other than financial activities that a financial holding company may conduct pursuant to section 4 of the Bank Holding Company Act (12 U.S.C. 1843), as amended by the Gramm-Leach-Bliley Act, and the regulations and interpretations thereunder. Equity investments include merchant banking investments made by financial holding companies under the regulations adopted by the Board of Governors (12 C.F.R. 225, subpart J, sections 225.170 through 225.177) and the Treasury Department (12 C.F.R., chapter XV, part 1500, sections 1500.1 through 1500.8) that became effective on February 15, 2001.

2. The term ''private equity,'' as used in this guidance, refers to shared-risk investments outside of publicly quoted securities and also activities such as venture capital, leveraged buyouts, mezzanine financing, and holdings of publicly quoted securities obtained through these activities.

3. Also included in calculating a BO's investment are shares of the corporation held in trading or dealing accounts or under any other authority. The 25 percent of tier 1 capital limitation increases to 100 percent of tier 1 capital for certain non-BHC investors. See Regulation K for more detailed information.

traded securities or privately held equity interests. The investment may be made as a direct investment in a specific portfolio company, or it may be made indirectly through a pooled investment vehicle, such as a private equity fund. In general, private equity funds are investment companies, typically organized as limited partnerships, that pool capital from third-party investors to invest in shares, assets, and ownership interests in companies for resale or other disposition.[4] Private equity fund investments may provide seed or early-stage investment funds to start-up companies, or they may finance changes in ownership, middle-market business expansions, and mergers and acquisitions.

The supervisory guidance applies to all equity investments a BHC or FHC holds in nonfinancial companies, public or private, regardless of the authority under which such investments are made. FHCs and BHCs are expected to control aggregate risk exposures on a consolidated basis, while recognizing legal distinctions and possible obstacles to cash movements among subsidiaries and affiliates. Also, the basic principles set forth in this guidance should be incorporated into the U.S. operations of foreign BOs, with appropriate adaptations to reflect the fact that (1) those operations are an integral part of a foreign bank, which should be managing its risks on a consolidated basis, and (2) the foreign bank is subject to overall supervision by its home authorities.

3909.0.2 SOUND PRACTICES FOR EQUITY INVESTMENTS

High returns in both equity investments and lending to private-equity-financed companies can spur an increased flow of funds into this market segment. As in other rapidly expanding and highly profitable business lines, business and competitive pressures can lead to compromises in due diligence, the use of overly optimistic assumptions, and breakdowns in internal controls. Sound investment and risk-management practices are crucial to the success of equity investment activities. As with any financial activity, sound management practices for these activities involve—

1. active involvement and oversight by the board of directors and senior management;
2. appropriate policies, limits, procedures, and management information systems that govern all elements of the investment decision-making and management process; and
3. adequate internal controls.

As with all financial activities, institutions should ensure that they have sufficient capital for conducting equity investment activities. BOs that are conducting material equity investment activities are expected to have an internal capital-allocation system that meaningfully links the identification, monitoring, and evaluation of the risks of the institution's equity investment activities to the determination of its needs for economic capital. (See SR-99-18.) A review of these systems should be an important part of the investment-management process, as well as an integral element of ongoing supervisory review and monitoring of this business line. The federal banking agencies have recognized that equity investment activities entail greater risks than traditional banking activities, and they have requested comment on proposed amendments to their regulatory capital guidelines that would establish special capital requirements for equity investments.[5]

Supervisory approach. Examiners and other supervisors (and a BO's management) should review each of the three areas listed above to identify any deficiencies in the management of FHCs and BHCs. The supervisory efforts should be targeted appropriately in accordance with Federal Reserve policies on risk-focused supervision, taking into account both (1) the findings of internal audit and other independent reviews and (2) the materiality of equity investment activities to the banking organization. Consistent with the Federal Reserve's role as umbrella supervisor, reviews of the merchant banking activities of FHCs and the equity investment activities of BHCs should focus on the potential exposure these activities may pose to insured depository affiliates and should, where appropriate and available, use the findings of primary bank supervisors and functional regulators of holding company affiliates. At the same time, supervisory and examination staff should ensure that they continue to conduct sufficient and targeted transaction testing across legal-entity lines if necessary to fully assess the adequacy of business-line risk management. Transaction testing should be consistent with the risk profile of the institution and the materiality of the activity to the institution's financial condition.

4. For a detailed definition of "private equity funds," see the merchant banking rule (12 C.F.R. 225.170 et seq.).

5. See 66 *Federal Register* 10, 212 (Feb. 14, 2001).

3909.0.2.1 Oversight by the Board of Directors and Senior Management

Equity investment activities require the active oversight of the board of directors and senior management of the institution that is conducting the activities. The board should approve portfolio objectives, overall investment strategies, and general investment policies that are consistent with the institution's financial condition, risk profile, and risk tolerance. Portfolio objectives should address the types of investments, expected business returns, desired holding periods, diversification parameters, and other elements of sound investment-management oversight. Board-approved objectives, strategies, policies, and procedures should be documented and clearly communicated to all the personnel involved in their implementation. The board should actively monitor the performance and risk profile of equity investment business lines in light of the established objectives, strategies, and policies.

The board of directors should also ensure that there is an effective management structure for conducting the institution's equity activities, including adequate systems for measuring, monitoring, controlling, and reporting on the risks of equity investments. The board should approve policies that specify lines of authority and responsibility for both acquisitions and sales of investments. The board should also approve limits on aggregate investment and exposure amounts, the types of investments (for example, direct and indirect, mezzanine financing, start-ups, or seed financing) and appropriate diversification-related aspects of equity investments such as industry, sector, and geographic concentrations.

For its part, senior management must ensure that adequate policies, procedures, and management information systems are in place for managing equity investment activities on a day-to-day and longer-term basis. Management should set clear lines of authority and responsibility for making and monitoring investments and for managing risk. Management should ensure that competent staff conduct the institution's equity investment activities. The staff's technical knowledge and experience should be consistent with the scope of the institution's activities.

3909.0.2.2 Management of the Investment Process

Institutions engaging in equity investment activities should have a sound process for executing all elements of investment management, including initial due diligence, periodic reviews of holdings, investment valuation, and realization of returns. This process requires appropriate policies, procedures, and management information systems, the formality of which should be commensurate with the scope, complexity, and nature of an institution's equity investment activities. A sound investment process should be applied to all equity investment activities, regardless of the legal entity in which investments are booked.

Supervisory approach. Any supervisory reviews of equity investment activities should be risk-focused. The review should take into account the institution's stated tolerance for risk, the ability of senior management to govern these activities effectively, the materiality of activities in light of the institution's risk profile, and its capital position.

3909.0.2.2.1 Equity Investment Policies and Limits

Institutions engaging in equity investment activities require effective policies that—

1. govern the types and amounts of investments that may be made,
2. provide guidelines on appropriate holding periods for different types of investments, and
3. establish parameters for portfolio diversification.

Investment strategies and permissible types of investments should be clearly identified. Portfolio-diversification policies should identify factors pertinent to the risk profile of the investments being made, such as industry, sector, geographic, and market factors. Policies establishing expected holding periods should specify the general criteria for liquidation of investments, as well as guidelines for the divestiture of underperforming investments. Decisions to liquidate underperforming investments are necessarily made on a case-by-case basis, considering all relevant factors. However, policies and procedures that stipulate more frequent review and analysis are generally used to address investments that are performing poorly or that have been in portfolio for a considerable length of time.

Policies should identify the aggregate exposure that the institution is willing to accept by the type and nature of investment (for example, direct or indirect, industry sectors). When adhering to those limits, institutions should consider unfunded and funded commitments. Where hedging activities are conducted, formal and clearly articulated hedging policies and strategies should identify limits on hedged exposures and permissible hedging instruments.

Management and staff compensation play a critical role in providing incentives and controlling risks within a private equity business line. Clear policies should govern compensation arrangements, including co-investment structures and sales of portfolio company interests by employees of the BO.

3909.0.2.2.2 Equity Investment Procedures

As they do with investment policies, many institutions have different procedures for assessing, approving, and reviewing investments based on their size, nature, and risk profile. Often, procedures used for direct investments are different than those used for indirect investments made through private equity funds. For example, different levels of due diligence and senior management approvals may be required. The management infrastructures that have been constructed for conducting these activities should ensure that operating procedures and internal controls appropriately reflect the diversity of investments.

Supervisory approach. Supervisors should recognize the potential diversity of practice when conducting reviews of the equity investment process. They should focus on the appropriateness of the process employed relative to the risk of the investments made and the materiality of this business line to the overall soundness of the BO and the potential impact on affiliated depository institutions.

3909.0.2.2.2.1 Investment Analysis and Approvals

Well-founded analytical assessments of investment opportunities and formal processes for approving investments are critical in conducting equity investment activities. While analyses and approval processes may differ by individual investments and across institutions, the methods and types of analyses conducted should be appropriately structured to adequately assess the specific risk profile, industry dynamics, management, and specific terms and conditions of the investment opportunity, as well as other relevant factors. All elements of the analytical and approval processes, from initial review through the formal investment decision, should be documented and clearly understood by the staff who are conducting these activities. An institution's evaluation of potential investments in private equity funds, as well as its reviews of existing fund investments, should assess the adequacy of a fund's structure, with due consideration given to the following:

1. management fees
2. carried interest[6] and its computation on an aggregate portfolio basis
3. the sufficiency of the general partners' capital commitments in providing management incentives
4. contingent liabilities of the general partner
5. distribution policies and wind-down provisions
6. performance benchmarks and return-calculation methodologies

3909.0.2.2.2.2 Investment-Risk Ratings

It is a sound practice to establish a system of internal risk-ratings for equity investments. The system should assign each investment a rating based on factors such as the nature of the company, strength of management, industry dynamics, financial condition, operating results, expected exit strategies, market conditions, and other pertinent factors. Different rating factors may be appropriate for indirect investments and direct investments. For example, rating factors for investments in private equity funds could include an assessment of the fund's diversification, management experience, liquidity, and actual and expected performance. Rating systems should be used for assessments of both new investment opportunities and existing portfolio investments.

3909.0.2.2.2.3 Periodic Reviews

Management should ensure the periodic and timely review of the institution's equity investments. Reviews should be conducted at both

6. The carried interest is the share of a partnership's return that is received by general partners or investment advisers.

individual investment and portfolio levels. Depending on the size, complexity, and risk profile of the investment, reviews should, where appropriate, include factors such as—

1. the history of the investment, including the total funds approved;
2. commitment amounts, principal-cash-investment amounts, cost basis, carrying value, major-investment cash flows, and supporting information, including valuation rationales and methodologies;
3. the current actual percentage of ownership in the portfolio company on both a diluted and undiluted basis;
4. a summary of recent events and current outlook;
5. the recent financial performance of portfolio companies, including summary compilations of performance and forecasts, historical financial results, current and future plans, key performance metrics, and other relevant items;
6. internal investment-risk ratings and rating-change triggers;
7. exit strategies, both primary and contingent, and expected internal rates of return on exit; and
8. other pertinent information for assessing the appropriateness, performance, and expected returns of investments.

Portfolio reviews should include an aggregation of individual investment-risk and performance ratings; an analysis of appropriate industry, sector, geographic, and other pertinent concentrations, and total portfolio valuations. Portfolio reports containing the cost basis, carrying values, estimated fair values, valuation discounts, and other factors summarizing the status of individual investments are integral tools for conducting effective portfolio reviews. Reports containing the results of all reviews should be available to supervisors for their inspection.

Given the inherent uncertainties in equity investment activities, institutions should include in their periodic review consideration of best case, worst case, and probable case assessments of investment performance. The reviews should evaluate changes in market conditions and alternative assumptions used to value investments—including expected and contingent exit strategies. Major assumptions used in valuing investments and forecasting performance should be identified. The assessments need not be confined to quantitative analyses of potential losses, but may also include qualitative analyses. The formality and sophistication of investment reviews should be appropriate for the overall level of risk the BO incurs from this business line.

3909.0.2.2.2.4 Valuation and Accounting

Valuation and accounting policies and procedures can have a significant impact on the earnings of institutions engaged in equity investment activities. Many equity investments are made in privately held companies, for which independent price quotations are either unavailable or not available in sufficient volume to provide meaningful liquidity or a market valuation. Valuations of some equity investments may involve a high degree of judgment on the part of management or require the skillful use of peer comparisons. Similar circumstances may exist for publicly traded securities that are thinly traded or subject to resale and holding-period restrictions, or when the institution holds a significant block of a company's shares. Accordingly, clearly articulated policies and procedures on the accounting and valuation methodologies used for equity investments are of paramount importance.

Several methods are used in accounting for equity investments. Under generally accepted accounting principles (GAAP), equity investments held by investment companies, held by broker-dealers, or maintained in the trading account[7] are reported at fair value, with any unrealized appreciation or depreciation included in earnings and flowing to tier 1 capital. For some holdings, fair value may reflect adjustments for liquidity and other factors.

Equity investments not held in investment companies, by broker-dealers, or in the trading account and that have a readily determinable fair value (quoted market price) are generally reported as available-for-sale (AFS). They are marked to market with unrealized appreciation or depreciation recognized in GAAP-defined "comprehensive income," but not earnings. Appreciation or depreciation flows to equity but, for regulatory capital purposes only, depreciation is included in tier 1 capital.[8] Equity investments without readily determinable fair

7. Equity investments in nonfinancial companies held under the authorities discussed previously would not normally be held in the trading account, as they are not intended to be traded actively.

8. Under regulatory capital rules, tier 2 capital may include up to 45 percent of the unrealized appreciation of AFS equity investments with readily determinable fair values.

values generally are held at cost, subject to write-downs due to impairments in the value of the asset. As is the case with all assets, impairments in value should be promptly addressed. Institutions should ensure that they have taken write-downs in a timely manner and in an appropriate amount.

In determining fair value, the valuation methodology is critical. Clearly articulated methods for valuing investments are critical to the effective management of equity investments. Formal valuation and accounting policies should be established for investments in public companies; direct private investments; indirect fund investments; and, where appropriate, other types of investments with special characteristics. In establishing valuation policies, institutions should consider market conditions, taking account of lockout provisions, the restrictions of Securities and Exchange Commission Rule 144, liquidity features, the dilutive effects of warrants and options, and industry characteristics and dynamics.

For institutions acting as general partners of private equity funds, ''clawback,'' or ''lookback,'' provisions of partnership agreements can pose additional challenges when accounting for and valuing the distributions received from funds managed by the institution. Clawback provisions are promises general partners make to repay limited partners at the end of the term of a fund, if the general partner has received more than its contractually defined compensation or ''carried interest'' over the life of the fund. Clawback provisions can come into play when the liquidation and associated disposition of both limited-partner and general-partner returns on well-performing investments in a fund occur before the liquidation of poorer-performing investments. Often, escrow accounts are established to hold a portion of the general partners' carried interest during the life of the fund. When applicable, institutions should appropriately recognize the estimated impact of these provisions in accounting for and valuing general-partner activities, including the earnings derived from those activities.

The accounting and valuation of equity investments should be subject to regular periodic reviews. In all cases, valuation reviews should produce documented audit trails that are available to supervisors and auditors. These reviews should assess the consistency of the methodologies used to estimate fair value.

Accounting and valuation treatments should be assessed in light of their potential for abuse through the inappropriate management or manipulation of reported earnings on equity investments. For example, high valuations may produce overstatements of earnings through gains and losses on investments reported at ''fair value.'' On the other hand, inappropriately understated valuations can be vehicles for ''smoothing earnings'' by recognizing gains on profitable investments when an institution's earnings are otherwise under stress. While reasonable people may disagree on the valuations given to illiquid private equity investments, institutions should have rigorous valuation procedures that are applied consistently.

Given the uncertainties in valuation methodologies and the relatively high volatility of the equity market, equity investments that are reported at fair value can contribute to earnings volatility in the institutions where they play a major role. Equity investments are increasingly contributing to the earnings of some BOs. Therefore, the potential impact of these investments on the composition, quality, and sustainability of overall earnings should be appropriately recognized and assessed by both management and supervisors.

3909.0.2.2.2.5 Exit Strategies

Returns and reported earnings on equity investments are highly affected by assumed and actual exit strategies. The principal means of exiting an equity investment in a privately held company include initial public stock offerings, sales to other investors, and share repurchases. An institution's assumptions regarding exit strategies can significantly affect the valuation of the investment. The importance of reasonable and comprehensive primary and contingent take-out strategies for equity investments should be emphasized. Management should periodically review investment exit strategies, particularly focusing on larger or less liquid investments.

3909.0.2.2.2.6 Disposition of Investments

Policies and procedures should be established to govern the sale, exchange, transfer, or other disposition of the institution's investments. These policies and procedures should state clearly the levels of management or board approval required for the disposition of investments, and, in the case of investments held under the merchant banking provisions of the GLB Act, should take into account and comply with the time limits for holding merchant banking investments.[9]

3909.0.2.2.2.7 Capital

Given the potential volatility of returns on equity investments, the risks associated with private equity investment and merchant banking business lines can exceed those of many more traditional banking activities. BOs that are conducting material equity investment activities should have internal methods for allocating economic capital based on the risk inherent in those activities.[10] These methods should identify all material risks and their potential impact on the safety and soundness of the institution. The amount and percentage of capital that is dedicated to this business line should be appropriate to the size, complexity, and financial condition of the BO. Organizations substantially engaged in equity investment and merchant banking activities should have strong capital positions supporting their equity investments, and they should allocate economic capital to them that is well in excess of the current regulatory minimums applied to lending activities.

Supervisory approach. Assessments of capital adequacy (by supervisors and the BO's management) should include not only the institution's compliance with regulatory capital requirements and the quality of regulatory capital, but also its methodologies for internally allocating economic capital to this business line.

3909.0.2.3 Internal Controls

An adequate system of internal controls, with appropriate checks and balances and clear audit trails, is critical to conducting equity investment activities effectively. Appropriate internal controls should address all of the elements of the investment-management process, and they should focus on the appropriateness of existing policies and procedures; adherence to policies and procedures; and the integrity and adequacy of investment valuations, risk identification, regulatory compliance, and management reporting. Departures from policies and procedures should be documented and reviewed by senior management. This documentation should be available for examiner review.

Assessments of an institution's compliance with both written and implied policies and procedures should be independent of line decision-making functions to the fullest extent possible. Large complex banking institutions with material equity investment activities should have internal auditors or independent outside parties conduct periodic independent reviews of their investment process and valuation methodologies. In smaller, less complex institutions, where limited resources may preclude independent review, alternative checks and balances should be established. These checks and balances may include random internal audits, reviews by senior management who are independent of the function, or the use of outside third parties.

3909.0.2.3.1 Documentation of the Investment Process

Documentation of key elements of the investment process, including initial due diligence, approval reviews, valuations, and dispositions, is an integral part of any private equity investment internal-control system. Accordingly, institutions should appropriately document their policies, procedures, and investment activities, and they should make this documentation accessible to supervisors.

Institutions should be aware that the statutory and regulatory authority under which some equity investment activities are conducted may impose specific documentation and recordkeeping requirements. For example, merchant banking regulations require an FHC to maintain a written record any time it becomes involved in the routine management or operation of a portfolio company and to notify the Board if it routinely manages or operates a portfolio company for more than nine months.

Supervisory approach. Review the documentation of the internal controls over the key elements of the equity investment process. If senior management has authorized and reviewed any departures from policies and procedures, review the documentation for those departures.

3909.0.2.3.2 Legal Compliance

Compliance with all federal laws and regulations that are applicable to the institution's investment activities should be a focus of an

9. See 12 C.F.R. 225.172.
10. The internal methods for allocating economic capital should be consistent with the general guidance in SR-99-18.

institution's system of internal controls. Regulatory compliance requirements, in particular, should be incorporated into internal controls so managers outside of the compliance or legal functions understand the parameters of permissible investment activities.

It is important to recognize that private equity and merchant banking activities are subject to different laws and regulations, depending on the authority under which the activities are conducted. For example, the merchant banking investments an FHC makes are subject to holding-period limits and restrictions on the FHC's involvement in the routine management or operation of the portfolio company. Accordingly, management should have a system in place, consistent with applicable laws and regulations, to ensure that impermissible control is not exercised over portfolio companies held under this authority and that merchant banking investments are disposed of within the time periods required by the rule. Limiting involvement in the portfolio company's day-to-day management and operation is also important to protect the institution from lender-liability claims.

Likewise, certain cross-marketing restrictions apply to subsidiary depository institutions of FHCs and to portfolio companies controlled by the FHC under statutory merchant banking authority. Management should ensure that these limits are observed. When a banking organization owns or controls a significant percentage of a company's voting securities, the company may be an affiliate of the organization's depository institution subsidiaries for the purposes of the affiliate transaction limits of sections 23A and 23B of the FRA. Also, the section 23A and 23B limitations on transactions between a depository institution and its affiliates are presumed by the GLB Act to apply to certain transactions between a depository institution subsidiary of an FHC and any portfolio company in which the FHC owns at least a 15 percent equity interest under the merchant banking authority. This ownership threshold is lower than the ordinary definition of an affiliate for section 23A purposes, which is typically 25 percent.

Moreover, to ensure compliance with federal securities laws, institutions should establish policies, procedures, and other controls addressing insider trading. A restricted list of securities for which the institution has inside information is one widely used mechanism for controlling the risk of insider trading. In addition, the institution should have control procedures in place to ensure that appropriate reports are filed with functional regulators.

3909.0.2.3.3 Compensation

Often, key employees in the private equity investment units of BOs may co-invest in the direct or fund investments made by the unit. The return on this co-investment, which the FHC may underwrite, may constitute a significant portion of the compensation of these employees. These co-investment arrangements can be an important incentive mechanism and risk-control technique and can help to attract and retain qualified management. However, "cherry picking," or selecting only certain investments for employee participation while excluding others, should be discouraged.

In many cases, the employees' co-investment may be funded through loans from affiliates of the BO, which, in turn, hold a lien against the employees' interests. The administration of the compensation plan should be appropriately governed pursuant to formal agreements, policies, and procedures. Among other matters, policies and procedures should address the terms and conditions of employee loans and sales of participants' interests before the release of the lien.

3909.0.3 DISCLOSURE OF EQUITY INVESTMENT ACTIVITIES

Given the important role that market discipline plays in controlling risk, institutions should ensure that they adequately disclose the information necessary for the markets to assess the institution's risk profiles and performance in the equity investment business line. Indeed, it is in the institution's interest, as well as that of its creditors and shareholders, to disclose publicly information about earnings and risk profiles. Institutions are encouraged to disclose in public filings information on the type and nature of investments, portfolio concentrations, returns, and their contributions to reported earnings and capital. The following topics are relevant for public disclosure, though disclosures of each of these topics may not be appropriate, relevant, or sufficient in every case:

1. the size of the portfolio
2. the types and nature of investments (for example, direct or indirect, domestic or international, public or private, equity or debt with conversion rights)

3. the initial cost, carrying value, and fair value of investments, and, where applicable, comparisons to publicly quoted share values of portfolio companies
4. the accounting techniques and valuation methodologies, including key assumptions and practices affecting valuation and changes in those practices
5. the realized gains (or losses) arising from sales and unrealized gains (or losses)
6. insights regarding the potential performance of equity investments under alternative market conditions

Supervisory approach. Supervisors should fully use the disclosures in public filings, as well as the periodic regulatory reports filed by publicly held BOs, as part of the information that they review routinely. Supervisors should encourage BOs to make adequate disclosures or to improve their public disclosures of equity investment and merchant banking activities (these disclosures should include the items listed above).

3909.0.4 INSTITUTIONS LENDING TO OR ENGAGING IN OTHER TRANSACTIONS WITH PORTFOLIO COMPANIES

Additional risk-management issues may arise when a banking institution or an affiliate lends to or has other business relationships with (1) a company in which the banking institution or an affiliate has invested (that is, a portfolio company); (2) the general partner or manager of a private equity fund that has also invested in a portfolio company; or (3) a private-equity-financed company in which the banking institution does not hold a direct or indirect ownership interest, but which is an investment or portfolio company of a general partner or fund manager with which the BO has other investments. Given the potentially higher than normal risk attributes of these lending relationships, institutions should devote special attention to ensuring that the terms and conditions of these relationships are at arm's length and are consistent with the lending policies and procedures of the institution. Similar issues may arise in the context of derivatives transactions with or guaranteed by portfolio companies and general partners.

Lending and other business transactions between an insured depository institution and a portfolio company that meets the definition of an affiliate must be negotiated on an arm's-length basis, in accordance with section 23B of the FRA. The holding company also should have systems and policies in place to monitor transactions between the holding company, or a nondepository institution subsidiary of the holding company, and a portfolio company. (These transactions are not typically governed by section 23B.) A holding company should ensure that the risks of these transactions, including exposures of the holding company on a consolidated basis to a single portfolio company, are reasonably limited and that all transactions are on reasonable terms. Special attention should be paid to transactions that are not on market terms.

A BO may lend to a private-equity-financed company in which it has no equity interest. When the borrowing company is a portfolio investment of private equity fund managers or general partners with which the institution may have other private-equity-related relationships, the extension of credit should be conducted on reasonable terms. In some cases, supervisors have found that lenders may wrongly assume that the general partners or another third party implicitly guarantees or stands behind such credits. Reliance on implicit guarantees or comfort letters should not substitute for reliance on a sound borrower that is expected to service its debt with its own resources. As with any type of credit extension, absent a written contractual guarantee, the credit quality of a private equity fund manager, general partner, or other third party should not be used to upgrade the internal credit-risk rating of the borrower company or to prevent the classification or special mention of a loan. Any tendency to relax this requirement when the general partners or sponsors of private-equity-financed companies have significant business dealings with the BO should be strictly avoided.

When an institution lends to a portfolio company in which it has a direct or indirect interest, implications arise under sections 23A and 23B of the FRA, which govern credit-related transactions and asset purchases between a depository institution and its affiliates. Section 23A applies to transactions between a depository institution and any company when the institution's holding company or shareholders own at least 25 percent of the company's voting shares. The GLB Act extends this coverage by establishing a presumption that a portfolio company is an affiliate of a depository institution subsidiary of an FHC if the FHC uses the merchant banking authority of the GLB Act to own or control more than 15 percent of the total equity of the company. Institutions should obtain the assistance of counsel to determine whether such issues exist or would exist if loans were extended to a portfolio company, general partner, or manager.

In addition to limiting and monitoring the exposure to portfolio companies that arises from traditional banking transactions, BHCs should adopt policies and practices that limit their legal liability, and that of their affiliates, for the financial obligations and liabilities of portfolio companies. These policies and practices include, for example, the use of limited-liability corporations or special-purpose vehicles to hold certain types of investments, the insertion of corporations that insulate liability between the BHC and a partnership controlled by the BHC, and contractual limits on liability. BHCs that extend credit to companies in which the BHC has made an equity investment should also be aware of the potential for equitable subordination of the lending arrangements.

Supervisory approach. Supervisors should ensure that the institution has conducted a proper review of section 23A and 23B compliance issues to avoid violations of law or regulations. Ascertain that internal controls limit and monitor the exposures to portfolio companies in which the institution has a direct or indirect interest. Determine if the BHC has adopted policies and practices that limit its legal liability and that of its affiliates for the financial obligations and liabilities of the portfolio companies.

3909.0.5 SUPERVISORY OBJECTIVES

1. To ensure that any risk assessment, supervisory strategies, and on-site and targeted reviews of the banking organization adequately and appropriately consider its equity investment and merchant banking activities.
2. To ascertain that the board of directors and senior management are taking the necessary actions to ensure that the risks associated with private equity investments and merchant banking activities are properly identified and managed, and that these activities do not adversely affect the soundness of the banking organization and its affiliated federally insured depository institutions.
3. To encourage the banking organization's board of directors and management to make the necessary and adequate public disclosures of its equity investment activities.
4. When the banking organization is engaged in material equity investment and merchant banking activities, to ascertain (1) that the board of directors and management have taken the necessary actions to ensure that the organization has a strong capital position that is adequate to support its activities, and (2) that the banking organization has robust internal methods for allocating capital that fully reflect the inherent risks of those activities.
5. To assess the existence, adequacy, maintenance, and documentation of the institution's system of internal controls over the key elements of the equity investment and merchant banking process.
6. To review compliance with limits on transactions governed by sections 23A and 23B of the FRA.

3909.0.6 SUPERVISORY PROCEDURES

1. Identify the organization's deficiencies and the material risks that are involved in the management of its equity investment and merchant banking activities. Also identify those activities that pose potential risks to the financial condition of state member banks and other federally insured depository institutions affiliated with FHCs and BHCs. Fully use the findings of primary bank supervisors and the functional regulators of holding company affiliates to review and assess the potential risks of the equity investment activities.
2. Assess the ability of senior management to govern equity investment activities effectively, particularly the—
   a. involvement and oversight by the board of directors and senior management;
   b. implementation and maintenance of appropriate policies, limits, procedures, and management information systems; and
   c. system of internal controls.
3. Target supervisory efforts to assess the compliance of the board of directors and management with the Federal Reserve's risk-focused management and supervision policies, considering—
   a. the BO's stated tolerance for risk,
   b. the findings of internal audit and other independent reviews, and
   c. the materiality of the activities, considering the BO's risk profile.

4. Focus and assess the impact of the equity investment activities on insured depository affiliates, considering the potential risks and returns associated with the activities and the potential volatility in some segments of the equity markets.
5. Conduct sufficient, targeted transaction testing across legal-entity lines, if necessary, to fully assess the adequacy of risk management in the equity investment business lines. The transaction testing should be consistent with the institution's risk profile, the materiality of the business line's activity, and the overall soundness of the BO's financial condition.
6. Assess the adequacy and quality of the BO's capital position in relation to the risk that is associated with its equity investment activities and the potential impact on affiliated depository institutions. If the organization is substantially engaged in equity investment activities, determine that it has a strong capital position with capital backing that is well above regulatory minimums for traditional banking activities. Also evaluate the adequacy and quality of the methods used to internally allocate economic capital to the business line (or lines) involving equity investment activities.
7. Recognize, as a supervisor, that many institutions have diverse practices and procedures for assessing, approving, and reviewing investments based on the size, nature, and risk profile of an investment. Focus on and assess the appropriateness, adequacy, and quality of the process employed relative to the—
   a. risk of the investments made,
   b. materiality of this business line in relation to the overall soundness of the BO, and
   c. the potential impact on affiliated depository institutions.
8. Review and determine the adequacy of senior management's documentation of the internal controls over the key elements of the equity investment process, including its documentation for any authorized departures from any of these controls.
9. Use the disclosures the institution has made in public filings and period regulatory reports, and review and assess their adequacy and quality. Encourage the BO to improve any deficient public disclosures involving equity investment and merchant banking activities.
10. Ascertain that—
    a. the institution maintains and monitors proper internal controls, and that it conducts adequate periodic reviews of the controls to ensure its and its affiliate's compliance with sections 23A and 23B of the FRA;
    b. the internal controls are designed to limit and monitor the institution's exposure to portfolio companies in which it has a direct or indirect ownership interest; and
    c. the BHC has adopted policies and practices that limit its legal liability and that of its affiliates for the financial obligations of the portfolio companies.
11. Communicate to the management of the banking organization and other appropriate supervisors any concerns about deficiencies found in reviewing equity investment and merchant banking activities.

A finder brings together one or more buyers and sellers of any product or service for transactions that the parties themselves negotiate and consummate. National banks and state banks have been permitted to act and have acted as a finder in nonfinancial transactions for many years. Banking organizations have served as a finder by providing enclosures (or "statement stuffers") and other marketing materials from sellers of various products and services. Banking organizations have also helped to identify service providers as an accommodation to their customers. Financial holding companies (FHCs) have argued that acting as a finder, particularly in an electronic form, offers them increased opportunities to cross-sell financial products and services or to enhance the attractiveness of their electronic web site to customers. BHCs and foreign banks that qualify as FHCs may engage in finder activities (as authorized by section 225.86(d)(1) of Regulation Y) by providing the post-transaction notice stipulated in section 225.87(a) of Regulation Y.

An FHC may act as a finder for financial and nonfinancial products or services.[1] A finder includes providing any or all of the following services:

1. identifying potential parties, making inquiries as to their interest, introducing and referring potential parties to each other, and arranging contacts between and meetings of interested parties
2. conveying between interested parties expressions of interest, bids, offers, orders, and confirmations relating to a transaction
3. transmitting information concerning products and services to potential parties in connection with the activities described in this section

Some examples of finder services that may be provided by a finder, in accordance with section 225.86(d) of the rule, include—

1. hosting an electronic marketplace on the FHC's Internet web site by providing hypertext or similar links to the web sites of third-party buyers or sellers;
2. hosting, on the FHC's servers, the Internet web site of—
   - a buyer (or seller) that provides information concerning the buyer (or seller) and the products or services it seeks to buy (or sell) and allows sellers (or buyers) to submit expressions of interest, bids, offers, orders, and confirmations relating to those products or services; or
   - a government or government agency that provides information concerning its services or benefits, assists persons in completing applications to receive such government or agency services or benefits, and allows persons to transmit their applications for services or benefits to the government or agency;
3. operating an Internet web site that allows multiple buyers and sellers to (1) exchange information concerning the products and services that they are willing to purchase or sell, (2) locate potential counterparties for transactions, (3) aggregate orders for goods or services with those made by other parties, and (4) enter into transactions between themselves; or
4. operating a telephone call center that provides permissible finder services.

An FHC that acts as a finder for a buyer or seller may also provide the buyer or seller with any combination of other services that are permissible under Regulation Y, so long as the finder and other services are provided in accordance with any applicable limitations under the finder provisions of Regulation Y. For example, a finder for a merchant may, in addition to acting as a finder, make, acquire, broker, or service loans or other extensions of credit to or for the merchant or merchant's customers; provide the merchant with check-verification, check-guaranty, collection agency, and credit bureau services; provide financial investment advice to the merchant or its customers (within the parameters of Regulation Y); act as a certification authority for digital signatures and thereby authenticate the identity of persons conducting business with the merchant over electronic networks; and process and transmit financial, economic, and banking data on behalf of the merchant, such as processing the merchant's accounts receivable and debit and credit card transactions. The FHC may also provide the merchant

1. An FHC is permitted to act as a finder for financial products and services as part of other permissible financial activities. For example, an FHC may act as a finder (1) in the purchase and sale of securities under authority to act as a securities broker under section 225.86(a) of Regulation Y or (2) in the purchase or sale of insurance products as an insurance agent under section 225.86(c) of Regulation Y.

with bill-payment and billing services, as well as processing order, distribution, accounting, settlement, collection, and payment information for the merchant's transactions.

Furthermore, an FHC may market and provide its own financial products and services in conjunction with acting as a finder for buyers and sellers of nonfinancial products and services. For example, an FHC may use its finder services to promote a company's products and services and, in connection with that activity, may negotiate on its own behalf and bind itself to transactions.

3910.0.1 LIMITATIONS ON AN FHC THAT ACTS AS A FINDER

A finder cannot serve as a principal in the underlying transaction. A finder may act only as an intermediary between a buyer and a seller. A finder may not negotiate for or bind any buyer or seller to the terms of a specific transaction or negotiate the terms of a specific transaction on behalf of a buyer or seller. However, a finder may—

1. arrange for buyers to receive preferred terms from sellers so long as the terms are not negotiated as part of any individual transaction, are provided generally to customers or broad categories of customers, and are made available by the seller (and not by the FHC), and
2. establish rules of general applicability governing the use and operation of the finder service, including rules that—
   - govern the submission of bids and offers by buyers and sellers that use the finder service and the circumstances under which the finder service will match bids and offers submitted by buyers and sellers, and
   - govern the manner in which buyers and sellers may bind themselves to the terms of a specific transaction.

A finder may not (1) take title to or acquire or hold an ownership interest in any product or service offered or sold through the finder service; (2) provide distribution services for physical products or services offered or sold through the finder service; (3) own or operate any real or personal property that is used for the purpose of manufacturing, storing, transporting, or assembling physical products offered or sold by third parties; or (4) own or operate any real or personal property that serves as a physical location for the physical purchase, sale, or distribution of products or services offered or sold by third parties. Further, a finder cannot engage in any activity that would require the company to register or obtain a license as a real estate agent or broker under applicable law.

3910.0.2 REQUIRED DISCLOSURES

A finder is required to distinguish the products and services offered by the FHC from those offered by a third party through the finder service. Because an FHC may act as a finder for third parties through varied technological means and in a wide variety of circumstances, FHCs are not required to provide specific disclosures. The Board expects FHCs to provide disclosures that, given the medium employed and type of buyers and sellers using the service (for example, consumers or corporations), are reasonably designed to ensure that users are not led to believe that the FHC is providing the products or services offered or sold by third parties through the finder service. An FHC could provide such notice by identifying those products or services that are offered or sold by the FHC (with a corresponding notice that all other products or services are provided by third parties), or by identifying those products or services that are offered and sold by third parties and not by the FHC.

Physical Commodity Trading Activities on a Limited Basis (Section 4(k) of the BHC Act) Section 3920.0

A financial holding company (FHC) requested the Board's approval under section 4(k) of the Bank Holding Company Act (the BHC Act) to retain all of the shares of a company that engaged in a variety of commodity-related activities in the United States, including trading in physical commodities, an activity not previously approved under the BHC Act.

Regulation Y authorizes bank holding companies (BHCs) to engage as principal in forward contracts, options, futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on a rate, price, financial asset, nonfinancial asset, or group of assets (other than a bank-ineligible security) (commodity derivatives). A BHC may conduct commodity derivatives activities under Regulation Y subject to certain restrictions that are designed to limit the BHC's activity to trading and investing in financial instruments rather than dealing directly in physical commodities. Under these restrictions, a BHC may take and make delivery of physically settled derivatives involving commodities that a state member bank is permitted to own.[1] For all other types of physically settled derivatives,[2] a BHC must make reasonable efforts to avoid delivery on such derivatives or must take and make delivery only on an instantaneous, pass-through basis. (See section 3260.0.4.6.) Other than in the limited circumstances described above in connection with commodity derivatives, Regulation Y generally does not permit BHCs to take or make delivery of nonfinancial commodities.

The FHC requested that the Board expand the authority of FHCs to purchase and sell commodities in the spot market and to take and make delivery of physical commodities to settle commodity derivatives (commodity trading activities). Commodity trading activities substantially involve the commercial activities of physically owning and disposing of assets such as oil, natural gas, agricultural products, and other nonfinancial commodities. Moreover, the risks associated with conducting these activities are commercial risks not traditionally incurred or managed to a material extent by banking organizations. Accordingly, the Board did not believe that commodity trading activities could be construed as incidental to a financial activity within the meaning of the Gramm-Leach-Bliley Act (the GLB Act). The Board concluded, however, for the reasons set forth below, that there was a reasonable basis for construing these activities as complementary to a financial activity within the meaning of the GLB Act.

A number of considerations supported a Board determination that commodity trading activities are complementary to a financial activity. First, commodity trading activities flow from the existing financial activities of FHCs. In particular, commodity trading activities provide FHCs with an alternative method of fulfilling their obligations under otherwise BHC-permissible commodity derivatives. For example, if warranted by market conditions, an FHC would be able to use commodity trading activity authority to take a commodity derivative to physical settlement rather than terminating, assigning, offsetting, or otherwise cash-settling the contract.

The Board also noted that the applicant contended that the existing restrictions of Regulation Y place FHCs at a significant bargaining disadvantage when operating in physically settled over-the-counter (OTC) derivatives markets. According to the applicant, counterparties to FHCs in these markets are aware of the regulatory impediments that inhibit FHCs from taking derivative contracts to physical settlement. As a consequence, FHCs that participate in these markets can be forced to terminate or offset their derivative contracts on uneconomic terms. Allowing FHCs to engage in commodity trading activities would permit FHCs to compete in physically settled OTC derivatives markets more economically.

The Board concluded that commodity trading activities involving a particular commodity complement the financial activity of engaging regularly as principal in BHC-permissible commodity derivatives based on that commodity.[3] In order to authorize FHCs to engage in commodity trading activities as a complementary activity under the GLB Act, the Board also must determine that those activities do not pose a substantial risk to the safety or soundness of depository institutions or the U.S. financial sys-

1. State member banks may own, for example, investment-grade corporate debt securities, U.S. government and municipal securities, foreign exchange, and certain precious metals.

2. These derivative contracts would include instruments based on, for example, energy-related and agricultural commodities.

3. For example, commodity trading activities involving all types of crude oil would be complementary to engaging regularly as principal in BHC-permissible commodity derivatives based on Brent crude oil.

tem generally.[4] To limit the potential safety-and-soundness risks of commodity trading activities, the applicant proposed to engage in only a limited amount of commodity trading activities. As a condition of the Board's order, the market value of commodities held by the applicant as a result of commodity trading activities must not exceed 5 percent of the applicant's consolidated tier 1 capital.[5] The applicant also must notify its designated supervising Federal Reserve Bank if the market value of commodities held by the applicant as a result of its Commodity trading activities exceeds 4 percent of its tier 1 capital.

In addition, the Board's order permitted the applicant to take and make delivery only of physical commodities for which derivative contracts have been approved for trading on a U.S. futures exchange by the Commodity Futures Trading Commission (CFTC) (unless specifically excluded by the Board) or that have been specifically approved by the Board.[6] This requirement is designed to prevent the applicant from becoming involved in dealing in finished goods and other items, such as real estate, that lack the fungibility and liquidity of exchange-traded commodities.

The Board concluded that permitting the applicant to engage in the limited amount and types of commodity trading activities described above would not appear to pose a substantial risk to it, its subsidiary depository institutions, or the U.S. financial system generally. The Board also concluded that permitting the applicant to buy and sell commodities in the spot market or physically settle commodity derivatives would not appear to increase significantly the organization's potential exposure to commodity-price risk.

4. 12 U.S.C. 1843(k)(1)(B).

5. The applicant is required to include in this 5 percent limit the market value of any commodities it holds as a result of a failure of its reasonable efforts to avoid taking delivery under section 225.28(b)(8)(ii)(B) of Regulation Y.

6. The particular commodity derivative contract that the applicant takes to physical settlement need not be exchange-traded, but (in the absence of specific Board approval) futures or options on futures on the commodity underlying the derivative contract must have been approved for exchange trading by the CFTC. The CFTC publishes annually a list of the CFTC-approved commodity contracts. See, for example, Commodity Futures Trading Commission, *FY 2002 Annual Report to Congress* 124.

With respect to granularity, the Board intends this requirement to permit commodity trading activities involving all types of a listed commodity. For example, commodity trading activities involving any type of coal or coal derivative contract would be permitted, even though the CFTC list specifically approves only Central Appalachian coal.

The Board's order acknowledged that adding commodity trading activities would expose the applicant to additional risks, including, but not limited to, storage risk, transportation risk, and legal and environmental risks. To minimize these risks, the applicant was not authorized to (1) own, operate, or invest in facilities for the extraction, transportation, storage, or distribution of commodities or (2) process, refine, or otherwise alter commodities. In conducting its commodity trading activities, the applicant was expected to use appropriate storage and transportation facilities owned and operated by third parties.[7]

The applicant indicated that it will mandate that the commodity storage facilities it uses have all required governmental permits and provide the applicant with a certificate to that effect. The applicant further stated that all commodity storage facilities will be inspected by or on its behalf before use and that it will physically inspect any commodity in storage every six months.

The applicant also stated that it would adopt additional standards for commodity trading activities that involve environmentally sensitive products, such as oil or natural gas. For example, the applicant will require that the owner of every vessel that carries oil on its behalf be a member of a protection and indemnity club and carry the maximum insurance for oil pollution available from the club. Every such vessel will be required to carry substantial amounts of additional oil pollution insurance from creditworthy insurance companies. The applicant will place age limitations on vessels and will require vessels to be approved by a major international oil company and have appropriate response plans and equipment for oil spills. The applicant will also have a comprehensive backup plan in the event any vessel owner fails to respond adequately to an oil spill and will hire inspectors to monitor the loading and discharging of vessels.

The applicant also represented that it will have in place specific policies and procedures for the storage of oil. In addition, the applicant will require all oil storage facilities it uses to carry a significant amount of oil pollution insurance from a creditworthy insurance company and to have appropriate spill response plans and equipment. The applicant will also follow a

7. The Board's approval of commodity trading activities as a complementary activity, subject to the limits and conditions, did not restrict the existing authority of the applicant to deal in foreign exchange, precious metals, or any other bank-eligible commodity.

comprehensive backup plan in the event the storage facility owner fails to respond adequately to an oil spill.

The Board determined that the applicant had the managerial expertise and internal control framework to manage the risks of taking and making delivery of physical commodities. It also concluded that the applicant had the expertise and internal controls to integrate effectively the risk management of commodity trading activities into its overall risk-management framework, which includes managing on a consolidated basis the overall exposure arising from the applicant's commodity-related activities.

For these reasons, and based on the applicant's policies and procedures for monitoring and controlling the risks of commodity trading activities, the Board concluded that consummation of the proposal did not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally and could reasonably be expected to produce benefits to the public that outweighed any potential adverse effects. (See 2003 FRB 508.)

Banking organizations have long been engaged in the sale of insurance products and annuities, although these activities historically have been subject to several restrictions. For example, until recently, national banks could sell most types of insurance, but only through an agency located in a small town. Bank holding companies were also permitted to engage in only limited insurance agency activities under the Bank Holding Company Act. State-chartered banks, on the other hand, generally have been permitted to engage in insurance sales activities as agent to the extent permitted by state law.

The Gramm-Leach-Bliley Act of 1999 (the GLB Act), however, authorized bank holding companies that make an effective election to become a financial holding company (FHC) to *underwrite* and *sell* any type of insurance nationwide. In addition, the GLB Act authorized national banks and state-chartered member banks to sell all types of insurance products through a financial subsidiary. *The GLB Act generally did not change the powers of banks to sell insurance directly.* As a result of the GLB Act and marketplace developments, many banking organizations are increasing the range and volume of their insurance and annuities sales activities.

To the extent permitted by applicable law, banking organizations may conduct insurance and annuity sales activities through a variety of structures and delivery channels, including ownership of an insurance underwriter or an insurance agency or broker, the employment by a bank of licensed agents, a joint marketing arrangement with a producer,[1] independent agents located at a bank's office, direct mail, telemarketing, and Internet marketing.

A banking organization may also conduct insurance or annuity sales activities through a managing general agent (MGA). An MGA is a wholesaler of insurance products and services to insurance agents. The MGA has a contractual agreement with an insurance carrier to assume functions for the carrier, which may include marketing, accounting, data processing, policy recordkeeping, and monitoring or processing claims. The MGA may rely on various local agents or agencies to sell the carrier's products. Most states require an MGA to be licensed.

3950.0.1 OVERVIEW AND SCOPE

The following guidance pertains to bank holding companies (BHCs) (including FHCs) and state member banks that are either directly or indirectly engaged in the sale of insurance or annuity products as agents. As noted above, the GLB Act amended the BHC Act to allow a BHC or foreign bank that qualifies as an FHC to engage in a broad range of insurance activities, including underwriting or selling (as agent or broker) any type of insurance and issuing and selling annuities, in any state.

BHCs that are not FHCs may sell or underwrite insurance as a principal, agent, or broker only to the limited extent authorized, before the GLB Act, under section 4(c)(8) of the BHC Act and section 225.28(b)(11) of Regulation Y. For example, a BHC that is not an FHC may underwrite and sell insurance (including home mortgage redemption insurance) that is directly related to an extension of credit by the BHC or any of its subsidiaries and that is limited to ensuring repayment of the outstanding balance due on the extension of credit in the event of the death, disability, or involuntary unemployment of the debtor. A BHC that is not an FHC can also sell any type of insurance as agent in a town if the town has a population of 5,000 or less and the BHC or a subsidiary has a lending office in the small town. (See section 3170.0.)

The GLB Act permits state member banks that are not authorized by applicable state law to sell insurance directly through a financial subsidiary.[2] A financial subsidiary engaged in insurance sales may be located wherever state law permits the establishment and operation of an insurance agency. Such subsidiaries, however, would be subject to state licensing and other requirements. The examination guidance found in this section is limited to insurance and annu-

1. The term "producer" refers broadly to persons, partnerships, associations, limited liability corporations, etc., that hold a license to sell or solicit contracts of insurance to the public. Insurance agents and agencies are producers who, through a written contractual arrangement known as a direct appointment, represent one or more insurance underwriters. Independent agents and agencies are those producers that sell products underwritten by one or more insurance underwriters. Captive agents and agencies represent a specific underwriter and sell only its products. Brokers are producers that represent the purchaser of insurance and obtain bids from competing underwriters on behalf of their clients. State insurance laws and regulations often distinguish between an insurance agent and a broker; in practice, the terms are often used interchangeably.

2. Rules pertaining to state member bank financial subsidiaries are found in the Board's Regulation H (12 C.F.R. 208.71–77).

ity *sales* activities. Because this section focuses only on insurance sales activities, it does *not* address insurance underwriting (that is, as principal) activities of FHCs or the limited insurance-underwriting powers of BHCs or state member banks. Examiner guidance on performing appropriate risk assessments for insurance and annuity sales activities of BHCs (including FHCs) and state member banks is included.[3]

Additionally, guidance is provided for examining a state member bank for compliance with the consumer protection rules relating to insurance and annuities sales activities that are contained in the Board's December 2000 revisions to Regulation H (subpart H) (12 C.F.R. 208.81–86), ''Consumer Protection in Sales of Insurance'' (CPSI). Subpart H, which became effective October 1, 2001, implements the insurance consumer protection requirements of the GLB Act, which are codified at 12 U.S.C. 1831x. (See 65 *Fed. Reg.* 75841 (December 4, 2000)). The regulation applies not only to the sale of insurance products or annuities by the state member bank but also to activities of any person engaged in insurance product or annuity sales on behalf of the state member bank, as discussed in this guidance. The guidance is generally not applicable to debt-cancellation contracts and debt-suspension agreements, unless these products are considered to be insurance products by the state in which the sales activities are conducted.

The Federal Reserve is responsible for evaluating the consolidated risk profile of a BHC or state member bank, including determining the risks posed to the BHC or state member bank from the insurance sales activities it conducts, directly or indirectly, and determining the effectiveness of its risk-management systems. The GLB Act also established a regulatory framework that is designed to ensure that the Federal Reserve coordinates with, and relies to the extent possible on information from, the state insurance authorities when it is supervising the insurance activities conducted by a BHC or state member bank through a functionally regulated subsidiary.

3. The term ''risk assessment'' denotes the work product described in SR-97-24, ''Risk-Focused Framework for Supervision of Large Complex Institutions,'' and entails an analysis of (1) the level of inherent risk by type of risk (operational, legal, market, liquidity, credit, and reputation risk) for a business line or business function, (2) the adequacy of management controls over that business line or business function, and (3) the direction of the risk (increasing, decreasing, or stable).

Consistent with the Federal Reserve's risk-focused framework for supervising banking organizations, resources allocated to the review of insurance sales activities should be commensurate with the significance of the activities and the risk they pose to the banking organization. The scope of the review depends on the significance of the activity to the BHC or state member bank and on the extent to which the bank is directly involved in the activity. Examiner judgment is required to tailor the reviews, as appropriate, on the basis of the legal, organizational, and risk-management structure of the BHC's or state member bank's insurance sales activities and on other relevant factors.[4]

3950.0.2 SUPERVISORY APPROACH FOR THE REVIEW OF INSURANCE AND ANNUITY SALES ACTIVITIES

3950.0.2.1 Supervisory Objective

The primary objective of the review is to determine the level and direction of risk to a BHC or state member bank from its insurance sales activities, including insurance sales activities conducted directly, by or in conjunction with a subsidiary or affiliate, or through a third-party arrangement. Primary risks that may arise from insurance sales activities include operational, legal, and reputational risk. If the BHC or state member bank does not adequately manage these risks, they could have an adverse impact on a BHC's or state member bank's earnings and capital. The examiner should produce (1) a risk assessment that summarizes the level of inherent risk to the BHC or state member bank by risk category and (2) an assessment of the adequacy of board of directors and management oversight of the activity, including the activity's internal control framework. For those state member banks selling insurance or annuity products, or that enter into arrangements under which another party sells insurance or annuity products at the bank's offices or on behalf of the bank, a second objective of the review is to determine the bank's compliance with the consumer protection provisions of the GLB Act and the CPSI regulation.

4. See SR-02-01, ''Revisions to Bank Holding Company Supervision Procedures for Organizations with Total Consolidated Assets of $5 Billion or Less,'' and section 1000.1 of the *Commercial Bank Examination Manual* for a discussion of the Federal Reserve's risked-focused examinations and the risk-focused supervision program for community banking organizations. See also SR-97-24.

3950.0.2.2 State Regulation of Insurance Activities

Historically, insurance activities have primarily been regulated by the states. In 1945, Congress passed the McCarran-Ferguson Act, which granted states the power to regulate most aspects of the insurance business. The McCarran-Ferguson Act states that ''no act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any state for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, provided the Act shall be applicable to the business of insurance to the extent that such business is not regulated by State law'' (15 U.S.C. 1012(b)).

State regulation of insurance producers is centered on the protection of the consumer and consists primarily of licensing and continuing education requirements for producers. A producer generally must obtain a license from each state in which it sells insurance and for each product sold. Each state in which a producer sells insurance has regulatory authority over the producer's activities in the state.

The GLB Act does include several provisions that are designed to keep states from (1) unfairly regulating a BHC or bank to prevent it from engaging in authorized insurance activities or (2) otherwise discriminating against BHCs and banks engaged in insurance activities. These provisions are complex and beyond the scope of this guidance. It should be noted, however, that the GLB Act generally does not prohibit a state from requiring a BHC or bank, or its employees engaged in insurance sales, solicitation, or cross-marketing activities, to be licensed within the state.

State insurance regulatory authorities do not conduct routine, periodic examinations of an insurance producer. A state examination of an insurance producer is generally conducted only on an ad hoc basis and is primarily based on the volume and severity of consumer complaints. The state examination may also be based in part on the producer's market share and on previous examination findings. Additionally, a review of a producer would typically not assess its financial condition.

State market conduct examinations of *insurance sales practices* are focused at the insurance-underwriter level.[5] The insurance underwriter is generally held accountable for compliance with state insurance laws to protect the consumer from the unfair sales practices of any producer that markets the insurance underwriter's products. Market conduct examinations of an insurance underwriter may potentially uncover a concern about a particular producer, such as a bank-affiliated producer.[6] However, in the past, a state insurance regulatory authority has not typically examined a producer unless the insurance underwriter owns the producer.

Generally, market conduct examinations include reviews of insurance underwriters' complaint handling, producer licensing, policyholder service, and marketing and sales practices. Typically, a state authority will direct a corrective action for insurance sales activity at the underwriter. The states generally have specific guidance for their market conduct examinations of life, health, and property/casualty[7] lines of business guidance that corresponds to regulations related to advertising, misrepresentations, and disclosures for these different business lines. The reports of examination issued by the state insurance departments are usually available to the public.

Because the underwriter, not the producer, is liable to the insured, the failure of an insurance producer generally would not result in financial loss to consumers or state guarantee funds. Consequently, there are no regulatory capital requirements for insurance producers, nor do states require regulatory reporting of financial statement data on insurance producers. While the underwriter is ultimately liable to the insured, in some instances a producer and its owner may be held liable for misrepresentations, as well as for violations of laws and regulations.

5. Generally, market conduct reviews of *insurance underwriters* are conducted on an ad hoc basis, triggered primarily by the volume and severity of consumer complaints, and are based on the underwriter's market share or on previous examination findings. In some states, however, market conduct reviews of insurance underwriters are conducted on a periodic, three- to five-year schedule.

6. The terms ''insurance underwriter,'' ''insurer,'' ''insurance carrier,'' and ''insurance company'' are industry terms that apply similarly to the party to an insurance arrangement who undertakes to indemnify for losses, that is, the party that assumes the principal risk under the contract.

7. Property insurance indemnifies a person who has an interest in a physical property for loss of the property or the loss of its income-producing abilities. Casualty insurance is primarily concerned with the legal liability for losses caused by injury to persons or damage to the property of others. It may also include such diverse forms of insurance as crime insurance, boiler and machinery insurance, and aviation insurance. Many casualty insurers also underwrite surety bonds.

3950.0.2.3 Functional Regulation

Under the GLB Act, reviews by banking supervisors of insurance or securities activities conducted in a BHC's or bank's functionally regulated subsidiary are not to be extensions of more traditional bank-like supervision. Rather, to the extent possible, bank supervisors are to rely on the functional regulators to appropriately supervise the insurance and securities activities of a functionally regulated subsidiary. A functionally regulated subsidiary includes any subsidiary of a BHC or bank that (1) is engaged in insurance activities and subject to supervision by a state insurance regulator or (2) is registered as a broker-dealer with the Securities and Exchange Commission. The GLB Act does *not* limit the Federal Reserve's supervisory authority with respect to a BHC or state member bank or the insurance activities conducted by either of them. The functional regulators for insurance sales activities, including the activities of insurance producers, consist of the insurance departments in each of the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, American Samoa, and Guam.

The GLB Act places certain limits on the ability of the Federal Reserve to examine, obtain reports from, or take enforcement action against a functionally regulated nondepository subsidiary of a BHC or state member bank. For purposes of these limitations, a subsidiary licensed by a state insurance department to conduct insurance sales activities is considered functionally regulated only with respect to its insurance activities and any activities incidental to those activities.[8]

The GLB Act indicates that the Federal Reserve must rely, to the fullest extent possible, on information obtained by the appropriate state insurance authority of a nondepository insurance agency subsidiary of a BHC or state member bank. In addition, the Federal Reserve may examine a functionally regulated subsidiary of a BHC or state member bank only in the following situations:

1. The Federal Reserve has reasonable cause to believe that the subsidiary is engaged in activities that pose a material risk to an affiliated depository institution, as determined by the responsible Reserve Bank and Board staff.
2. After reviewing relevant information available at the BHC or state member bank level (including information obtained from the appropriate functional regulator), it is determined that an inspection or examination is necessary to adequately understand and assess the banking organization's systems for monitoring and controlling the financial and operational risks that may pose a threat to the safety and soundness of an affiliated depository institution.
3. On the basis of reports and other available information (including information obtained from the appropriate functional regulator), there is reasonable cause to believe that the subsidiary is not in compliance with a federal law that the Federal Reserve has specific jurisdiction to enforce with respect to the subsidiary (including limits relating to transactions with affiliated depository institutions), and the Federal Reserve cannot assess such compliance by examining the BHC or state member bank or other affiliated depository institution.

Other similar restrictions limit the ability of the Federal Reserve to obtain a report directly from, or take enforcement action against, a functionally regulated nonbank subsidiary of a BHC or state member bank. As noted above, these GLB Act limitations do *not* apply to a BHC parent company or state member bank even if the BHC parent company or state member bank is itself licensed by a state insurance regulatory authority to conduct insurance sales activities.

Staff who are conducting reviews of BHC or state member bank insurance or annuity sales activities should be thoroughly familiar with SR-00-13, which provides guidance on reviews of functionally regulated BHC or state member bank subsidiaries. Reserve Bank staff may conduct an examination of a functionally regulated subsidiary, or request a specialized report from a functionally regulated subsidiary, only after obtaining approvals from the appropriate staff of the Board's Division of Banking Supervision and Regulation.

When preparing or updating the risk assessment of a BHC's or state member bank's insurance or annuity sales activities, Federal Reserve staff, when appropriate, should coordinate their activities with the appropriate state insurance authorities. The Federal Reserve's supervision of BHCs or state member banks engaged in insurance sales activities is not intended to replace or duplicate the regulation of insurance

8. For example, if a BHC's nonbank subsidiary engages in mortgage lending and is also licensed as an insurance agency, it would be considered a functionally regulated subsidiary only to the extent of its insurance sales activities.

activities by the appropriate state insurance authorities.

3950.0.2.4 Information Sharing with the Functional Regulator

The Federal Reserve and the National Association of Insurance Commissioners (NAIC) approved a model memorandum of understanding (MOU) on the sharing of confidential information between the Federal Reserve and individual state insurance departments.[9] The Board also approved the delegation of authority to the Board's general counsel to execute agreements with individual states, based on this MOU. Examiners should follow required Board administrative procedures before sharing any confidential information with a state insurance regulator. (These procedures generally require Federal Reserve staff to identify and forward to Board staff for review any confidential information that may be appropriate to share with the applicable state insurance regulator concerning insurance sales activities conducted by BHCs or state member banks.) The Board's Division of Consumer and Community Affairs' CP Letter 2001-11 outlines the procedures for sharing consumer complaint information with state insurance regulators.

3950.0.3 STATUTORY AND REGULATORY REQUIREMENTS AND POLICY GUIDANCE

3950.0.3.1 Privacy Rule and the Fair Credit Reporting Act

BHCs, state member banks, and the subsidiaries of both (other than subsidiaries that are subject to the privacy rules of another financial regulator such as a broker-dealer or insurance company) that sell insurance to consumers must comply with the privacy provisions under title V of the GLB Act (12 U.S.C. 6801–6809), as implemented by the Board's Regulation P (12 C.F.R. 216) (the privacy rule). Functionally regulated BHC and state member bank nonbank insurance agency subsidiaries are not covered by the Federal Reserve's privacy rule; however, they must comply with the privacy regulations (if any) issued by their relevant state insurance regulator.

The privacy rule regulates a BHC's or state member bank's treatment of nonpublic personal information about a "consumer," that is, an individual that obtains a financial product or service (such as insurance) from the institution for personal, family, or household purposes. The privacy rule generally requires a BHC or bank to provide a notice to each of its customers that describes the privacy policies and practices of the BHC or bank no later than when the BHC or bank establishes a business relationship with the customer. The privacy rule also generally prohibits a BHC or bank from disclosing any nonpublic personal information about a consumer to any nonaffiliated third party, unless the BHC or bank first provides to the consumer a privacy notice and a reasonable opportunity to prevent (or "opt out" of) the disclosure, and the consumer does not opt out. The privacy rule permits a BHC or bank to provide a joint notice with one or more of its affiliates or other financial institutions, as identified in the privacy notice itself, provided that the notice is accurate with respect to the institution and the other institutions.

While the privacy rule applies to the sharing of nonpublic personal information by a BHC or bank with nonaffiliated third parties, the sharing of certain consumer information with affiliates or nonaffiliates may be subject to the Fair Credit Reporting Act (FCRA) as well. For example, under the FCRA, if a BHC or bank wants to share with its insurance subsidiary information from a credit report or from a consumer application for credit (such as the consumer's assets, income, or marital status), the BHC or bank must first notify the consumer about the intended sharing and give the consumer an opportunity to opt out. The same rules would apply to an insurance company that wants to share information from credit reports or from applications for insurance with an affiliate or a third party.

3950.0.3.2 Anti-Tying Prohibitions

Federal law (section 106(b) of the BHC Act Amendments of 1970 (12 U.S.C. 1972(b)) generally prohibits a bank from requiring that a customer purchase a product or service from the bank or an affiliate as a prerequisite to obtaining another product or service (or a discount on the other product or service) from the bank. This prohibition applies whether the customer is retail or institutional, or whether the transaction is on bank premises or off premises. For example, a

9. The NAIC is the organization of insurance regulators from the 50 states, the District of Columbia, and the four U. S. territories. The NAIC provides a forum for the development of uniform policy among the states and territories. The NAIC is not a governmental or regulatory body.

state member bank may not require that a customer purchase insurance from the bank or a subsidiary or an affiliate of the bank in order to obtain a loan from the bank (or a reduced interest rate on the loan).[10] The special anti-tying rules in section 106 do not apply to tying arrangements imposed by a BHC or a nonbank affiliate of a BHC.

3950.0.3.3 Policy Statement on Income from Sale of Credit Life Insurance

This Federal Reserve Board policy statement (see the *Federal Reserve Regulatory Service* at 3-1556) sets forth the principles and standards that apply to a bank's sales of credit life insurance and the limitations that apply to the receipt of income from those sales by certain individuals and entities associated with the bank. (See section 3170.0.4.1 and the inspection procedure related to this policy statement in section 3170.0.6.)

3950.0.4 RISK-MANAGEMENT PROGRAM

3950.0.4.1 Elements of a Sound Insurance or Annuity Sales Program

A BHC or state member bank engaged in insurance or annuity sales activities should—

1. conduct insurance sales programs in a safe and sound manner;
2. have appropriate written policies and procedures in place that are commensurate with the volume and complexity of its insurance sales activities;
3. obtain its board of directors' approval of the scope of the insurance and annuity sales program and of written policies and procedures for the program;
4. effectively oversee the sales program activities, including third-party arrangements;
5. have an effective, independent internal audit and compliance program;
6. appropriately train and supervise the employees conducting insurance and annuity sales activities;
7. take reasonable precautions to ensure that disclosures to customers for insurance and annuity sales and solicitations are complete and accurate and are in compliance with applicable laws and regulations;
8. ensure compliance with all applicable federal, state, or other jurisdiction regulations, including compliance with sections 23A and 23B of the Federal Reserve Act as that act applies to affiliate transactions; and
9. have controls in place to ensure accurate and timely financial reporting.

Every banking organization conducting insurance or annuity sales activities should have appropriate, board-approved policies, procedures, and controls in place to monitor and ensure that it complies with both federal and state regulatory requirements. Consistent with the principle of functional regulation, the Federal Reserve will rely primarily on the appropriate state insurance authorities to monitor and enforce compliance with applicable state insurance laws and regulations, including state consumer protection laws and regulations governing insurance sales.

3950.0.4.1.1 Sales Practices and Handling of Customer Complaints

Every component of a banking organization that engages in insurance or annuity sales activities should have board-approved policies and procedures for handling customer complaints related to these sales. The customer complaint process should provide for the recording and tracking of all complaints and require periodic reviews of complaints by compliance personnel. A BHC's or state member bank's board of directors and senior management should also review complaints if the complaints involve significant compliance issues that may pose a risk to the organization.

3950.0.4.1.2 Third-Party Arrangements

BHCs and state member banks, to the extent permitted by applicable law, may enter into agreements with third parties, including unaffiliated agents or agencies, to sell insurance or annuities or provide expertise and services that otherwise would have to be developed in-house. Many banks hire third parties to assist in establishing an insurance program or to train their own insurance staff. A bank may also find it advantageous to offer more specialized insurance products through a third-party arrangement.

A BHC's or state member bank's management should conduct a comprehensive review of an unaffiliated third party before entering into

10. See section 3500.0.

any arrangement to conduct insurance or annuity sales with the third party. The review should include an assessment of the third party's financial condition, management experience, reputation, and ability to fulfill its contractual obligations to the BHC or state member bank, which includes compliance with applicable consumer protection laws and regulations.

The BHC's or state member bank's board of directors or its designated committee should approve any agreements with third parties. Agreements should outline the duties and responsibilities of each party; describe the third-party activities permitted on the institution's premises; address the sharing or use of confidential customer information; and define the terms for use of the BHC's or state member bank's office space, equipment, and personnel. If an arrangement includes dual employees (for example, bank employees who are also employed by an independent third party), the agreement must provide for written employment contracts that specify the duties of these employees and their compensation arrangements.

In addition, a third-party agreement should specify that the third party will comply with all applicable laws and regulations and will conduct its activities in a manner consistent with the CPSI regulation, if applicable. The agreement should authorize the banking organization to monitor the third party's compliance with its agreement, as well as authorize the banking organization to have access to third-party records considered necessary to evaluate compliance. A BHC or state member bank that contracts with a functionally regulated third party should obtain from and review, as appropriate, any relevant, publicly available regulatory reports of examination of the third party.[11] Finally, the agreement should provide for indemnification of the institution by the unaffiliated third party for any losses caused by the conduct of the third party's employees in connection with its sales activities.

A BHC or state member bank is responsible for ensuring that any third party or dual employee selling insurance at or on behalf of the organization is appropriately trained either by the banking organization or the third party with respect to compliance with the minimum disclosures and other requirements of the CPSI regulation and applicable state regulations. The banking organization should obtain and review copies of third-party training and compliance materials to monitor the third party's performance on its disclosure and training obligations.

3950.0.4.1.3 Designation, Training, and Supervision of Personnel

A banking organization hiring personnel to sell insurance or annuities should investigate the backgrounds of the prospective employees. When a candidate for employment has previous insurance industry experience, the banking organization should have procedures to determine whether the individual has been the subject of any disciplinary actions by state insurance regulators.[12]

The banking organization should require its own insurance or annuity sales personnel or third-party sales personnel selling at or on behalf of the bank to receive appropriate training and licensing. Training should cover appropriate policies and procedures for the organization's sales of insurance and annuity products. Personnel who are referring potential or established customers to a licensed insurance producer should also be trained to ensure that referrals are made in conformance with the CPSI regulation, if applicable. The training should also include procedures and guidance to ensure that an unlicensed or referring individual cannot be deemed to be acting as an insurance agent that is subject to licensing requirements.

When insurance or annuities are sold by a banking organization or by third parties at an office of, or on behalf of, the organization, the institution should have policies and procedures to designate, by title or name, the individuals responsible for supervising insurance sales activities, as well as for supervising the referral activities of bank employees not authorized to sell these products. A banking organization also should designate supervisory personnel responsible for monitoring compliance with any third-party agreement, as well as a state member bank's compliance with the CPSI regulation, if applicable.

3950.0.4.1.4 Compliance

Banking organizations should have policies and procedures to ensure that insurance or annuity

11. The reports of examination issued by state insurance regulators are generally public documents. Many states do not conduct periodic examinations of insurance sales activities.

12. Information from the states on the issuance and termination of producer licenses and on producers' compliance with continuing education requirements is available from the NAIC database known as the National Insurance Producer Registry (NIPR).

sales activities are conducted in compliance with applicable laws and regulations (including the CPSI regulation for sales conducted by or on behalf of a state member bank) and the institution's internal policies and procedures. Compliance procedures should identify any potential conflicts of interest and how such conflicts should be addressed. For example, sales-compensation programs should be conducted in a manner that would not expose the BHC or state member bank to undue legal or reputation risks. The compliance procedures should also provide for a system to monitor customer complaints and their resolution. Where applicable, compliance procedures also should call for verification that third-party sales are being conducted in a manner consistent with the governing agreement with the banking organization.

The compliance function should be conducted independently of the insurance and annuity product sales and management activities. Compliance personnel should determine the scope and frequency of their reviews, and findings of compliance reviews should be reported directly to the banking organization's board of directors or to its designated board committee.

3950.0.5 RISK ASSESSMENT OF INSURANCE AND ANNUITY SALES ACTIVITIES

A risk assessment of insurance activities may be accomplished (1) in the course of conducting a regularly scheduled BHC inspection or state member bank examination or (2) as a targeted review. The purpose of preparing the risk assessment is to determine the level and direction of risk to the BHC or bank arising from its insurance and annuity sales activity. The risks to banking organizations engaged in insurance sales programs consist primarily of legal, reputational, and operational risk, all of which may lead to financial loss. After completing the risk assessment, if material concerns remain, the Board's Division of Banking Supervision and Regulation staff should be consulted for further guidance.

Legal and reputational risk may arise from a variety of sources, such as fraud; noncompliance with statutory or regulatory requirements, including those pertaining to the handling of premiums collected on behalf of the underwriter; claims processing; insurance and annuity sales practices; and the handling of "errors and omissions" claims.[13] Other sources of legal and reputational risk may arise from failing to safeguard nonpublic customer information; a high volume of customer complaints; or public regulatory sanctions against a producer.

Legal and reputational risks may also arise from an agent's obligation to provide a customer with products that are suited to the customer's particular needs and are priced and sold in accordance with state regulations. Additionally, an agent or agency may be liable for failing to carry out the appropriate paperwork to bind a policy that it has sold to a customer, or for making an error in binding the policy. State insurance departments generally are permitted by law to suspend or revoke a producer's license and assess monetary penalties against a producer if warranted.

Operational risk may arise from errors in processing sales-related information or from lack of appropriate controls over systems or staff responsible for carrying out the insurance or annuity sales activities. Additionally, banking organizations that have recently commenced insurance or annuity sales activities, or that are expanding their insurance sales business, are exposed to risk arising from inadequate strategic and financial planning associated with the activities, which could result in financial loss. Examiners should be attuned to risks that may arise from inadequate controls over insurance activities, a rapid expansion of the insurance or annuity sales programs offered by banking organizations, the introduction of new products or delivery channels, and legal and regulatory developments.

Operational risk may arise from inadequate premium-payment procedures and trust-account-balance administration by an agency. When the insurance agency bills the insured, the agent must comply with requirements for forwarding the payments to the insurer and for safekeeping the funds. Inadequate internal controls over this activity may result in the inappropriate use of these funds by the agent or agency. The banking organization should ensure that appropriate controls are in place to verify that all funds that are owed to the insurer or the insured are identified in the trust account and that the account is in balance.

When conducting a risk assessment, the examiner should first obtain relevant information to determine the existence and scale of

13. Errors and omissions insurance indemnifies the insured against loss sustained because of an error or oversight by the insured. For instance, an insurance agency generally purchases this type of coverage to protect itself against such things as failing to issue a policy.

insurance or annuity sales activity. Such information is available in the BHC's Bank Holding Company Performance Report or the state member bank's Uniform Bank Performance Report (UBPR) and in other System reports on insurance activities. Relevant reports, including applicable balance sheets and income statements for the insurance and annuity sales activities, may also be obtained from the BHC or state member bank. When preparing a risk assessment for an insurance or annuity sales activity that is conducted by a functionally regulated nonbank subsidiary of a BHC or state member bank, examiners should rely, to the fullest extent possible, on information available from the BHC or state member bank and the appropriate state insurance regulator for the subsidiary. If information that is needed to assess the risk cannot be obtained from the BHC or state member bank, or from the applicable functional regulator, the examiner should consult with the appropriate designated Board staff. Requests should not be made directly to a functionally regulated nonbank insurance and annuity sales subsidiary of a BHC or state member bank without first obtaining approval from the appropriate Board staff.

3950.0.6 CONSUMER PROTECTION IN SALES OF INSURANCE RULES

3950.0.6.1 Overview of the CPSI Regulation

The CPSI regulation is only applicable to all insured depository institutions, including state member banks.[14] The regulation, however, generally *does not* apply to nonbank affiliates or subsidiaries of a state member bank unless the company engages in the retail sale of insurance products or annuities at an office of, or on behalf of, an insured depository institution. Interpretations of the regulation, issued by the federal banking agencies, are found in appendix A of this section. Federal Reserve examiners are responsible for reviewing state member banks' compliance with the regulation. A BHC's board of directors and senior management are responsible for overseeing its depository institution subsidiaries' compliance with the CPSI regulation.

The regulation applies to the retail sale of insurance products and annuities by banks or by any other person at an office of a bank, or acting on behalf of a bank. For purposes of the CPSI regulation, "office" means the premises of the bank where retail deposits are accepted. The regulation applies only to the retail sale of insurance or annuity products—that is, when the insurance is sold or marketed to an individual primarily for personal, family, or household purposes.

14. The CPSI regulation applies to all federally insured depository institutions, including all federally chartered U.S. branches and state-chartered insured U.S. branches of foreign banking organizations.

3950.0.6.2 Misrepresentations Prohibited

The regulation prohibits a bank or other covered person from engaging in any practice or using any advertisement at any office of, or on behalf of, the bank or a subsidiary of the bank if the practice or advertisement could mislead any person or otherwise cause a reasonable person to erroneously believe—

1. that the insurance product or annuity is backed by the federal government or the bank, or is insured by the Federal Deposit Insurance Corporation (FDIC);
2. that an insurance product or annuity does not have investment risk, including the potential that principal may be lost and the product may decline in value, when in fact the product or annuity does have such risks; or
3. in the case of a bank or subsidiary of the bank at which insurance products or annuities are sold or offered for sale, that (1) the bank may condition approval of an extension of credit to a consumer by the bank or subsidiary on the purchase of an insurance product or annuity from the bank or a subsidiary of the bank and (2) the consumer is not free to purchase the insurance product or annuity from another source.

The regulation also incorporates the antitying provisions of section 106(b) of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972). Additionally, banks are prohibited from selling life or health insurance products if the status of the applicant or insured as a victim of domestic violence or as a provider of services to domestic violence victims is considered as a factor in decision making on the product, except as expressly authorized by state law.

3950.0.6.3 Insurance Disclosures

The regulation also requires that a bank or a person selling insurance at an office of, or on behalf of, a bank make the following affirmative disclosures (to the extent accurate), both orally and in writing, before the completion of the initial sale of an insurance product or an annuity to a consumer. However, sales by mail or, if the consumer consents, via electronic media (such as the Internet) do not require oral disclosure.

1. The insurance product or annuity is not a deposit or other obligation of, or guaranteed by, the bank or an affiliate of the bank.
2. The insurance product or annuity is not insured by the FDIC or any other U.S. government agency, the bank, or (if applicable) an affiliate of the bank.
3. The insurance product or annuity, if applicable, has investment risk, including the possible loss of value.

For telephone sales, written disclosures must be mailed within three business days. The above disclosures must be included in advertisements and promotional materials for insurance products and annuities, unless the advertisements or promotional materials are of a general nature and describe or list the nature of services or products offered by the bank. Disclosures must be conspicuous and readily understandable.

3950.0.6.4 Credit Disclosures

When an application for credit is made in connection with the solicitation, offer, or sale of an insurance product or annuity, the consumer must be notified that the bank may not condition the extension of credit on either (1) the consumer's purchase of an insurance product or annuity from the bank or any of its affiliates or (2) the consumer's agreement not to obtain, or a prohibition on the consumer from obtaining, an insurance product or annuity from an unaffiliated entity. These disclosures must be made both orally and in writing; however, applications taken by mail or, if the consumer consents, via electronic media do not require oral disclosure. For telephone applications, the written disclosure must be mailed within three business days. The disclosures must be conspicuous and readily understandable.

3950.0.6.5 Consumer Acknowledgment

The bank must obtain written or electronic acknowledgments of the consumer's receipt of the disclosures described above at the time they are made or at the completion of the initial purchase. For telephone sales, the bank must receive an oral acknowledgment and make a reasonable effort to obtain a subsequent written or electronic acknowledgment.

3950.0.6.6 Location

Insurance and annuity sales activities must take place, to the extent practicable, in an area physically segregated from one where retail deposits are routinely accepted from the general public (such as teller windows). The bank must clearly identify and delineate areas where insurance and annuity sales activities occur.

3950.0.6.7 Referrals

Any person who accepts deposits from the public in an area where deposits are routinely accepted may refer a consumer to a qualified person who sells insurance products or annuities only if the person making the referral receives no more than a one-time, nominal fee of a fixed dollar amount for the referral. The amount of the referral fee may not depend on whether a sale results from the referral.

3950.0.6.8 Qualifications

A bank may not permit any person to sell or offer insurance products or annuities at its office or on its behalf, unless that person is at all times properly qualified and licensed under applicable state law for the specific products being sold or recommended.

3950.0.6.9 Relationship of the CPSI Regulation to State Regulation

The GLB Act contains a legal framework for determining the effect of the CPSI regulation on state laws governing the sale of insurance, including state consumer protection standards. In general, if a state has legal requirements that are inconsistent with, or contrary to, the CPSI regulation, initially the federal regulation does not apply in the state. However, the federal banking agencies may, after consulting with the state involved, decide to preempt any inconsistent or contrary state laws if the agencies find that the CPSI regulation provides greater protections than the state laws. It is not expected that there will be significant conflict between state and federal laws in this area. If the consumer protection laws of a particular state appear to be inconsistent with and less stringent (that is, provide less consumer protection) than the CPSI regulation, examiners should inform the staff of the Board's Division of Banking Supervision and Regulation.

3950.0.6.10 Relationship to Federal Reserve Guidance on the Sale of Nondeposit Investment Products

When a bank sells insurance products or annuities that also are securities (such as variable life insurance annuities), it must conform with the applicable Federal Reserve and interagency guidance pertaining to a bank's retail sales of nondeposit investment products (NDIPs).[15] If the CPSI regulation and the guidance pertaining to NDIPs conflict, the CPSI regulation prevails.

3950.0.6.11 Examining a State Member Bank for Compliance with the CPSI Regulation

Examinations for compliance with the CPSI regulation should be conducted consistent with the risk-focused supervisory approach when a state member bank sells insurance products or annuities directly, or when a third party sells insurance or annuities at or on behalf of a state member bank. To the extent practicable, the examiner should conduct the review at the state member bank. In certain instances, however, the examiner's review at the state member bank may identify potential supervisory concerns about the state member bank's compliance with the CPSI regulation as it pertains to insurance or annuities sales conducted by a functionally regulated nonbank affiliate or subsidiary of the state member bank that is selling insurance products or annuities at or on behalf of the state member bank.

If the examiner determines that an on-site review of a functionally regulated nonbank affiliate or subsidiary of the state member bank is appropriate to adequately assess the state member bank's compliance with the CPSI regulation, the examiner should discuss the situation with staff of the Board's Division of Banking Supervision and Regulation. The approval of the Division of Banking Supervision and Regulation's officer that is responsible for the supervisory policy and examination guidance pertaining to insurance and annuity sales activities should be obtained before examining or requesting any information directly from a functionally regulated nonbank affiliate or subsidiary of the state member bank that is selling insurance or annuity products at or on behalf of the state member bank.

The state member bank examination procedures described in section 3950.0.10.2 apply to retail sales, solicitations, advertisements, or offers of insurance products and annuities by any state member bank or any other person that is engaged in such activities at an office of the bank, or on behalf of the state member bank. For purposes of the CPSI regulation, activities "on behalf of a state member bank" include activities in which a person, whether at an office of the bank or at another location, sells, solicits, advertises, or offers an insurance product or annuity and in which at least one of the following applies:

1. The person represents to a consumer that the sale, solicitation, advertisement, or offer of any insurance product or annuity is by or on behalf of the bank.
2. The bank refers a consumer to a seller of insurance products or annuities, and the bank has a contractual arrangement to receive commissions or fees derived from the sale of an insurance product or annuity resulting from the bank's referral.
3. Documents evidencing the sale, solicitation, advertising, or offer of an insurance product or annuity identify or refer to the bank.

3950.0.7 APPENDIX A—JOINT INTERPRETATIONS OF THE CONSUMER PROTECTION IN SALES OF INSURANCE REGULATION

In response to a banking association's inquiries, the federal banking agencies jointly issued interpretations regarding the Consumer Protection in Sales of Insurance (CPSI) regulation.[16] A joint statement, issued on August 17, 2001, contains responses to a set of questions relating to disclosure and acknowledgment, the scope of applicability of the regulation, and compliance. Additionally, a February 28, 2003, joint statement

15. Interagency Statement on Retail Sales of Nondeposit Investment Products, February 17, 1994. See SR-94-11.

16. These letters, issued jointly by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, may be accessed on these agencies' web sites.

responded to a request to clarify whether the disclosure requirements apply to renewals of pre-existing insurance policies sold before October 1, 2001, the effective date of the regulation. The issues raised and the banking agencies' responses are summarized below.

3950.0.7.1 Disclosures

3950.0.7.1.1 Credit Disclosures

A bank or other person who engages in insurance sales activities at an office of, or on behalf of, a bank (''a covered person'') must make the credit disclosures set forth in the regulation if a consumer is solicited to purchase insurance while the consumer's loan application is pending. A consumer's application for credit is still ''pending'' for purposes of the regulation if the depository institution has approved the consumer's loan application but not yet notified the consumer. Until the consumer is notified of the loan approval, the covered person must provide the credit disclosures if the consumer is solicited, offered, or sold insurance.

3950.0.7.1.2 Disclosures for Sales by Mail and Telephone

The regulation requires a covered person to provide oral disclosures and to obtain an oral acknowledgment of these disclosures when sales activities are conducted by telephone. This requirement applies regardless of whether the consumer will also receive and acknowledge written disclosures in person, through the mail, or electronically.

3950.0.7.1.3 Use of Short-Form Insurance Disclosures

There is no short form for the credit disclosures. A depository institution, however, may use the short-form insurance disclosures set forth below in visual media (such as television broadcasting, ATM screens, billboards, signs, posters, and written advertisements and promotional materials):

- NOT A DEPOSIT
- NOT FDIC-INSURED
- NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY
- NOT GUARANTEED BY THE BANK
- MAY GO DOWN IN VALUE

3950.0.7.2. Acknowledgment of Disclosures

3950.0.7.2.1 Reasonable Efforts to Obtain Written Acknowledgment

The banking agencies have not prescribed any steps that must be taken for a depository institution's efforts to obtain a written acknowledgment to be deemed ''reasonable'' in a transaction conducted by telephone. Examples of reasonable efforts, however, include:

1. providing the consumer with a return-addressed envelope or similar means to facilitate the consumer's return of the written acknowledgment,
2. making a follow-up phone call or contact,
3. sending a second mailing, or
4. similar actions.

The covered person should (1) maintain documentation that the written disclosures and the request for written acknowledgment of those disclosures were mailed to the consumer and (2) record his or her efforts to obtain the signed acknowledgment. The ''reasonable efforts'' policy exception for telephone sales does not apply to other types of transactions, such as mail solicitations, in which a covered person must obtain from the consumer a written (in electronic or paper form) acknowledgment.

3950.0.7.2.2 Appropriate Form or Format for Acknowledgment Provided Electronically

Electronic acknowledgments are not required to be in a specific format but must be consistent with the provisions of the CPSI regulation applicable to acknowledgments. That is, the electronic acknowledgment must establish that the consumer has acknowledged receipt of the credit and insurance disclosures, as applicable.

3950.0.7.2.3 Retention of Acknowledgments by an Insurance Company

If an insurance company provides the disclosures and obtains the acknowledgment on behalf of a depository institution, the insurance company may retain the acknowledgment. The depository institution is responsible for ensuring that sales made "on behalf of" the depository institution are in compliance with the CPSI regulation. An insurance company may maintain documentation showing compliance with the CPSI regulation, but the depository institution should have access to such records and the records should be readily available for review by examiners.

3950.0.7.2.4 Form of Written Acknowledgment

There is no prescribed form for the written acknowledgment. The regulation requires, however, that a covered person obtain the consumer's acknowledgment of receipt of the complete insurance and credit disclosures.

3950.0.7.2.5 Timing of Acknowledgment Receipt

A covered person must obtain the consumer's acknowledgment either at the time a consumer receives disclosures *or* at the time of the initial purchase of an insurance product. The CPSI regulation does not prescribe any specific wording for an oral acknowledgment. However, if a covered person has made the insurance and credit disclosures orally, an affirmative response to the question "Do you acknowledge that you received this disclosure?" is acceptable.

3950.0.7.3 Scope of the CPSI Regulation

3950.0.7.3.1 Applicability to Private Mortgage Insurance

Depending on the nature of a depository institution's involvement in an insurance sales transaction, the CPSI regulation may cover sales of private mortgage insurance. If the depository institution itself purchases the insurance to protect its interest in mortgage loans it has issued and merely passes the costs of the insurance on to the mortgage borrowers, then the transaction is not covered by the regulation. If, however, a consumer has the option of purchasing the private mortgage insurance and (1) the depository institution offers the private mortgage insurance to a consumer or (2) any other person offers the private mortgage insurance to a consumer at an office of a depository institution, or on behalf of a depository institution, the transaction would be covered by the regulation.

3950.0.7.3.2 Applicability to Federal Crop Insurance

The CPSI regulation does not apply to federal crop insurance that is sold for commercial or business purposes. However, if the crop insurance is purchased by an individual primarily for family, personal, or household purposes, it would be covered.

3950.0.7.3.3 Solicitations and Applications Distributed Before, but Returned After, the Effective Date of the CPSI Regulation

Direct-mail solicitations and "take-one" applications that are distributed on or after October 1, 2001, must comply with the CPSI regulation. If a consumer seeks to purchase insurance after the effective date of the regulation in response to a solicitation or advertisement that was distributed *before* that date, the depository institution would be in compliance with the regulation if the institution provides the consumer, before the initial sale, with the disclosures required by the regulation. These disclosures must be both written and oral, except that oral disclosures are not required if the consumer mails in the application.

3950.0.7.4 Renewals of Insurance

Renewals of insurance are not subject to the disclosure requirements (see the 3950.0.7.1 sections above), but are subject to other requirements of the CPSI regulation. A "renewal" of insurance means continuation of coverage involving the same type of insurance for a consumer as issued by the same carrier. A renewal need not be on the same terms and conditions as the original policy, provided that the renewal does not involve a different type of insurance and the consumer has previously received the disclosures required by the regulation at the time of the initial sale. An upgrade in coverage at a time when a policy is not up for renewal would be treated as a renewal, provided that the solicitation and sale of the upgrade do not involve a different type of insurance and the consumer has previously received the disclosures required by the regulation at the initial sale.

3950.0.7.4.1 Disclosures Required with Renewals of Insurance Coverage

The banking agencies' interpretations clarified that the CPSI regulation does not *mandate* disclosures for renewals of policies sold before October 1, 2001. Accordingly, the CPSI regulation does not require the disclosures to be furnished at the time of renewal of a policy, including a pre-existing policy. However, renewals are subject to the other provisions of the CPSI regulation. Moreover, the banking agencies would expect that, consistent with applicable safety-and-soundness requirements, depository institutions would take reasonable steps to avoid customer confusion in connection with renewals of pre-existing policies.

3950.0.7.4.2 ''On-Behalf-of'' Test and Use of Corporate Name or Logo

Under the CPSI regulation, an affiliate of a bank is not considered to be acting ''on behalf of'' a bank simply because the affiliate's marketing or other materials use a corporate name or logo that is common to the bank and the affiliate. In general, this exclusion applies even if a bank and its parent holding company have a similar, but not identical, name. For example, if the names of all of the affiliates of a bank holding company share the words ''First National,'' an affiliate would not be considered to be engaged in an activity ''on behalf of'' an affiliated bank simply by using the terms ''First National'' as part of a corporate logo or identity. The affiliate would, however, be considered to be acting ''on behalf of'' an affiliated bank if the name of the bank (for example, ''First National Bank'') appears in a document as the seller, solicitor, advertiser, or offeror of insurance. A transaction also would be covered if it occurs on the premises of a depository institution or if one of the other prongs of the ''on-behalf-of'' test is met.

3950.0.7.5 Compliance

3950.0.7.5.1 Appropriate Documentation of an Oral Disclosure or Oral Acknowledgment

There is no specific documentation requirement for oral disclosures or acknowledgments. However, other applicable regulatory reporting standards would apply. Appropriate documentation of an oral disclosure would clearly show that the covered person made the credit and insurance disclosures to a consumer. Similarly, appropriate documentation of an oral acknowledgment would clearly show that the consumer acknowledged receiving the credit and insurance disclosures. For example, a tape recording of the conversation (where permitted by applicable laws) in which the covered person made the oral disclosures and received the oral acknowledgment would be acceptable. Another example would be a contemporaneous checklist completed by the covered person to indicate that he or she made the oral disclosures and received the oral acknowledgment. A contemporaneous note to the consumer's file would also be adequate. The documentation should be maintained in the consumer's file so that it is accessible to examiners.

3950.0.7.5.2 Setting for Insurance Sales

A depository institution must identify the areas where insurance sales occur and must clearly delineate and distinguish those areas from areas where the depository institution's retail deposit-taking activities occur. Although the banking agencies did not define how depository institutions could ''clearly delineate and distinguish'' insurance areas, signage or other means may be used.

3950.0.8 APPENDIX B—GLOSSARY

See section 4040.1 of the Commercial Bank Examination Manual *for additional definitions of insurance terms.*

Accident and health insurance. A type of coverage that pays benefits in case of sickness, accidental injury, or accidental death. This coverage may provide for loss of income when the insured becomes disabled and provides reimbursement for medical expenses when the insured is ill. The insurance can provide for debt payment if it is taken out in conjunction with a loan. (See *Credit life insurance*.)

Actuary. A professional whose function is to calculate statistically various estimates for the field of insurance, including the estimated risk of loss on an insurable interest and the appropriate level for premiums and reserves.

Admitted insurer. An insurance company licensed by a state insurance department to underwrite insurance products in that state.

Agency contract (or agreement). An agreement that establishes the contractual relationship between an agent and an insurer.

Agent. A licensed insurance company representative under contract to one or more insurance companies. Depending on the line of insurance represented, an agent's power may include soliciting, advertising, and selling insurance; collecting premiums; claims processing; and effecting insurance coverage on behalf of an insurance underwriter. Agents are generally compensated by commissions on policies sold, although some may receive salaries.

1. *Captive or exclusive agent.* An agent who represents a single insurer.
2. *General agents.* An agent who is contractually awarded a specific geographic territory for an individual insurance company. General agents are responsible for building their own agency and usually represent only one insurer. Unlike exclusive agents, who usually receive a salary in addition to commissions, general agents are typically compensated on a commission basis only.
3. *Independent agent.* An agent who is under contractual agreements with at least two different insurers. Typically, all of the independent's agent's compensation originates from commissions.

Aggregate excess-of-loss reinsurance. A form of ''excess-of-loss'' reinsurance that indemnifies the ceding company against the amount by which all of the ceding company's losses incurred during a specific period (usually 12 months) exceed either (1) a predetermined dollar amount or (2) a percentage of the company's subject premiums. This type of contract is also commonly referred to as stop-loss reinsurance or excess-of-loss ratio reinsurance.

Allied lines. Various insurance coverages for additional types of losses and against losses by additional perils. The coverages are closely associated with and usually sold with fire insurance. Examples include coverage against loss by perils other than fire, coverage for sprinkler-leakage damage, and business-interruption coverage.

Annuity. A contract that provides for a series of payments payable over an individual's life span or other term, on the basis of an initial lump-sum contribution or series of payments made by the annuitant into the annuity during the accumulation phase of the contract.

1. *Fixed-annuity contracts* provide for payments to annuitants at fixed, guaranteed minimum rates of interests.
2. *Variable-annuity contracts* provide for payments based on the performance of annuity investments. Variable-annuity contracts are usually sold based on a series of payments and offer a range of investment or funding options such as stocks, bonds, and money market fund investments. The annuity principal and the investment return are not guaranteed as they depend on the performance of the underlying funding option.

Annuity payments may commence with the execution of the annuity contract (*immediate annuity*) or may be deferred until some future date (*deferred annuity*).

Assigned risk. A risk that is not usually acceptable to insurers and is therefore assigned to a group of insurers who are required to share in the premium income and losses, in accordance with state requirements, in order for the insurer to sell insurance in the state.

Assignment. The legal transfer of one person's interest in an insurance policy to another person or business.

Bank-owned life insurance (BOLI). Life insurance purchased and owned by a BHC or bank to fund its exposure arising from employee compensation and benefit programs. In a typical BOLI program, a BHC or bank insures a group of employees; pays the life insurance policy premiums; owns the cash values of the policies, which are booked on the BHC's or bank's balance sheet as ''other assets''; and is the beneficiary of the policies upon the death of any insured employee or former employee.

Beneficiary. The person or entity named in an insurance policy as the recipient of insurance proceeds upon the policyholder's death or when an endorsement matures. A revocable beneficiary can be changed by the policyholder at any time. An irrevocable beneficiary can be changed by the policyholder only with the written permission of the beneficiary.

Binder. A written or oral agreement, typically issued by an insurer, agent, or broker for property and casualty insurance, to indicate acceptance of a person's application for insurance and to provide interim coverage pending the insurance company's issuance of a binding policy.

Blanket bond. Coverage for an employer for loss incurred as a result of employee dishonesty.

Boiler and machinery insurance. Insurance against the sudden and accidental breakdown of boilers, machinery, and electrical equipment, including coverage for damage to the equipment and property damage, including the property of others. Coverage can be extended to cover consequential losses, including loss from interruption of business.

Broker. A person who represents the insurance buyer in the purchase of insurance. Brokers do not have the power to bind an insurance company to an insurance contract. Once a contract is accepted, the broker is compensated for the transaction through a commission from the insurance company. An individual may be licensed as both a broker and an agent.

Bulk reinsurance. A transaction sometimes defined by statute as any quota-share, surplus aid, or portfolio reinsurance agreement through which an insurer assumes all or a substantial portion of the liability of the reinsured company.

Captive insurer. An insurance company established by a parent firm to insure or reinsure its own risks or the risks of affiliated companies. A captive may also underwrite insurable risks of unaffiliated companies, typically the risks of its customers or employees. For example, a BHC or bank may form a captive insurance company to underwrite its own directors' and officers' risks or to underwrite credit life or private mortgage insurance (third-party risks) related to its lending activities.

Cash surrender value of life insurance. The amount of cash available to a life insurance policyholder upon the voluntary termination of a life insurance policy before it becomes payable by death or maturity.

Casualty insurance. Coverage for the liability arising from third-party claims against the insured for negligent acts or omissions causing bodily injury or property damage.

Cede. To transfer to a reinsurer all or part of the insurance or reinsurance risk underwritten by an insurance company.

Ceding commission. The fee paid to a reinsurance company for assuming the risk of a primary insurance company.

Ceding company (also cedant, reinsured, reassured). The insurer that transfers all or part of the insurance or reinsurance risk it has underwritten to another insurer or reinsurer via a reinsurance agreement.

Cession. The amount of insurance risk transferred to the reinsurer by the ceding company.

Churning. The illegal practice wherein a customer is persuaded to unnecessarily cancel one insurance policy in favor of buying a purportedly superior policy, often using the cash surrender value of the existing policy to pay the early premiums of the new policy. In such a transaction, the salesperson benefits from the additional commission awarded for booking a new policy.

Claim. A request for payment of a loss under the terms of a policy. Claims are payable in the manner suited to the insured risk. Life, property, casualty, health, and liability claims generally are paid in a lump sum after the loss is incurred. Disability and loss-of-time claims are paid periodically during the period of disability or through a discounted lump-sum payment.

Coinsurance. A provision in property and casualty insurance that requires the insured to maintain a specified amount of insurance based on the value of the property insured. Coinsurance clauses are also found in health insurance and require the insured to share a percentage of the loss.

Combination-plan reinsurance. A reinsurance agreement that combines the excess-of-loss and the quota-share forms of coverage within one contract, with the reinsurance premium established as a fixed percentage of the ceding company's subject premium. After deducting the excess recovery on any one loss for one risk, the reinsurer indemnifies the ceding company on the basis of a fixed quota-share percentage. If a loss does not exceed the excess-of-loss retention level, only the quota-share coverage applies.

Commission. The remuneration paid by insurance carriers to insurance agents and brokers for the sale of insurance and annuity products.

Comprehensive personal liability insurance. A type of insurance that reimburses the policyholder if he or she becomes liable to pay money for damage or injury he or she has caused to others. This coverage does not include automobile liability but does include almost every activity of the policyholder, except business operations.

Contractholder. The person, entity, or group to whom an annuity is issued.

Credit for reinsurance. A statutory accounting procedure, set forth under state insurance regulations, that permits a ceding company to treat amounts due from reinsurers as assets, or as offsets to liabilities, on the basis of the reinsurer's status.

Credit life insurance. A term insurance product issued on the life of a debtor that is tied to repayment of a specific loan or indebtedness. Proceeds of a credit life insurance policy are used to extinguish remaining indebtedness at the time of the borrower's death. The term is applied broadly to other forms of credit-related insurance that provide for debt satisfaction in the event of a borrower's disability, accident or illness, and unemployment. Credit life insurance has historically been among the most common BHC and bank insurance products.

Credit score. A number that is based on an analysis of an individual's credit history and that insurers may consider as an indicator of risk for purposes of underwriting insurance. Where not prohibited by state law, insurers may consider a person's credit history when underwriting personal lines.

Debt-cancellation contract/debt-suspension agreement. A loan term or contract between a lender and borrower whereby, for a fee, the lender agrees to cancel or suspend payment on the borrower's loan in the event of the borrower's death, serious injury, unemployment, or other specified events. The Office of the Comptroller of the Currency considers these products to be banking products. State law determines whether these products are bank or insurance products for state-chartered banks and insurance companies.

Deductible. The amount a policyholder agrees to pay toward the total amount of insurance loss. The deductible may apply to each claim for a loss occurrence, such as each automobile accident, or to all claims made during a specified period, as with health insurance.

Directors' and officers' liability insurance. Liability insurance covering a corporation's obligation to reimburse its directors or officers for claims made against them for alleged wrongful acts. It also provides direct coverage for company directors and officers themselves in instances when corporate indemnification is not available.

Direct premiums written. Premiums received by an underwriter for all policies written during a given time period by the insurer, excluding those received through reinsurance assumed.

Direct writer. An insurance company that deals directly with the insured through a salaried representative, as opposed to those insurers that use agents. This term refers to insurers that operate through exclusive agents. In reinsurance, a direct writer is the company that originally underwrites the insurance policies ceded.

Disability income insurance. An insurance product that provides income payment to the insured when his or her income is interrupted or terminated because of illness or accident.

Endowment insurance. A type of life insurance contract under which the insured receives the face value of the policy if he or she survives the endowment period. Otherwise, the beneficiary receives the face value of the policy upon the death of the insured.

Errors and omissions (E&O) liability insurance. Professional liability insurance that covers negligent acts or omissions resulting in loss. Insurance agents are continually exposed to the claim that inadequate or inappropriate coverage was recommended resulting in a lack of coverage for losses incurred. The agent or the carrier may be responsible for coverage for legitimate claims.

Excess-of-loss reinsurance. A form of reinsurance whereby an insurer pays the amount of each claim for each risk up to a limit determined in advance, and the reinsurer pays the amount of the claim above that limit up to a specific sum. It includes various types of reinsurance, such as catastrophe reinsurance, per-risk reinsurance, per-occurrence reinsurance, and aggregate excess-of-loss reinsurance.

Excess-per-risk reinsurance. A form of excess-of-loss reinsurance that, subject to a specified limit, indemnifies the ceding company against the amount of loss in excess of a specified retention for each risk involved in each occurrence.

Excess and surplus lines. Property/casualty coverage that is unavailable from insurers licensed by the state (admitted insurers) and must be purchased from a nonadmitted underwriter.

Exposure. The aggregate of all policyholder limits of liability arising from policies written.

Face amount. The amount stated on the face of the insurance policy to be paid, depending on the type of coverage, upon death or maturity. It does not include dividend additions or additional amounts payable under accidental death or other special provisions.

Facultative reinsurance. Reinsurance of individual risks by offer and acceptance wherein the reinsurer retains the faculty to accept or reject each risk offered by the ceding company.

Financial guarantee insurance. Financial guarantee insurance is provided for a wide array of financial risks. Typically, coverage is provided for the fulfillment of a specific financial obligation originated in a business transaction. The insurer, in effect, is lending the debtor its own credit rating to enhance the debtor's creditworthiness.

Financial strength rating. Opinion as to an insurance company's ability to meet its senior policyholder obligations and claims. For many years, the principal rating agency for property and casualty insurers and life insurers has been A.M. Best. Other rating agencies, such as Fitch, Moody's, Standard and Poor's, and Weiss, also rate insurers.

Fixed annuity. See annuity.

Flood insurance. A special insurance policy to protect against the risk of loss or damage to property caused by flooding. Regular homeowners' policies do not pay for damages caused by flooding.

General liability insurance. A broad commercial policy that covers all business liability exposures, such as product liability, completed operations, premises and operations, independent contractors, and other exposures that are not specifically excluded.

Gross premiums written. Total premiums for insurance written during a given period, before deduction for reinsurance ceded.

Group insurance. Insurance coverage typically issued to an employer under a master policy for the benefit of employees. The insurer usually does not condition coverage of the people that make up the group upon satisfactory medical examinations or other requirements. The individual members of the group hold certificates as evidence of their insurance.

Health insurance. An insurance product that provides benefits for medical expenses incurred as a result of sickness or accident. This product may be in the form of traditional indemnity insurance or managed-care plans and may be underwritten on an individual or group basis.

Incurred but not reported (IBNR). The loss-reserve value established by insurance and reinsurance companies in recognition of their liability for future payments on losses that have occurred but have not yet been reported to them. This definition is often erroneously expanded to include adverse loss development on reported claims. The term incurred but not enough reported (IBNER) is being increasingly used to reflect more accurately the adverse development on inadequately reserved reported claims.

Inland marine insurance. A broad field of insurance that covers cargo being shipped by air, truck, or rail. It includes coverage for most property involved in transporting cargo as well as for bridges, tunnels, and communications systems.

Key person life insurance. Life insurance designed to cover the key employees of an employer. It may be written on a group- or an individual-policy basis.

Lapse. The termination or discontinuance of a policy resulting from the insured's failure to pay the premium due.

Liability insurance. Protects policyholders from financial loss due to liability resulting from injuries to other persons or damage to their property.

Lines. A term used in insurance to denote insurance business lines, as in "commercial lines" and "personal lines."

Long-term care insurance. Health insurance designed to supplement the cost of nursing home care or other care facilities in the event of a long-term illness or permanent disability or incapacity.

Managing general agent. A managing general agent (MGA) is a wholesaler of insurance products and services to insurance agents. An MGA receives contractual authority from an insurer to assume many of the insurance company's functions. The MGA may provide insurance products to the public through local insurance agents as well as provide services to an insurance company, including marketing, accounting, data processing, policy maintenance, and claims-monitoring and -processing services. Many insurance companies prefer the MGA distribution and management system for their insurance products because it avoids the high cost of establishing branch offices. Most states require that an MGA be licensed.

Manuscript policy. A policy written to include specific coverage or conditions not provided in a standard policy.

Morbidity. The incidence and severity of illness and disease in a defined class of insured persons.

Mortality. The rate at which members of a group die in a specified period of time or die from a specific illness.

Mortgage guarantee insurance. A product that insures lenders against nonpayment by borrowers. The policies are issued for a specified time period. Lenders who finance more than 80 percent of the property's fair value generally require such insurance.

Mortgage insurance. Life insurance that pays the balance of a mortgage even if the borrower dies. Coverage typically is in the form of term life insurance, with the coverage declining as the debt is paid off.

Multiperil insurance. An insurance contract providing coverage against many perils, usually combining liability and physical damage coverage.

Net premiums written. The amount of gross premiums written, after deduction for premiums ceded to reinsurers.

Ninety-day loss rule. A state requirement for an insurer to establish a loss provision for reinsurance recoverables over 90 days past due.

Obligatory treaty. A reinsurance contract under which business must be ceded in accordance with contract terms and must be accepted by the reinsurer.

Policyholder. The person or entity who owns an insurance policy. This is usually the insured person, but it may also be a relative of the insured, a partnership, or a corporation.

Premium. The payment, or one of the periodic payments, a policyholder agrees to make for insurance coverage.

Private mortgage insurance (PMI). Coverage for a mortgage lender against losses due to a collateral shortfall on a defaulted residential real estate loan. Most BHCs and banks require borrowers to take out a PMI policy if a downpayment of less than 20 percent of a home's value is made at the time the loan is originated. PMI does not directly benefit a borrower, although its existence provides the opportunity to purchase a home to many people who otherwise would not qualify for a loan.

Producer. A person licensed to sell, solicit, or negotiate insurance.

Professional designations and organizations. Three of the most common insurance professional designations are Chartered Life Underwriter (CLU), Chartered Property Casualty Underwriter (CPCU), and Chartered Financial Consultant (ChFC). Insurance agents also join professional organizations such as the American Society of Chartered Life Underwriters, the International Association of Financial Planning, the National Association of Life Underwriters, the National Association of Health Underwriters, the American Council of Life Insurance, the Life Insurance Marketing and Research Association, the Life Underwriter Training Council, and the Million Dollar Round Table.

Property insurance. Coverage for physical damage or destruction of real property (building, fixtures, and permanently attached equipment) and personal property (movable items that are not attached to land) that occurs during the policy period as a result of, for example, fire, windstorm, explosion, and vandalism.

Pro rata reinsurance. A generic term describing all forms of ''quota-share'' and ''surplus reinsurance,'' in which the reinsurer shares a pro rata portion of the losses and premiums of the ceding company.

Protected cell. A structure available to captive insurers underwriting risks of unaffiliated companies whereby the assets associated with the self-insurance program of one organization are segregated to provide legal-recourse protection from creditors of protected cells providing insurance coverage to other organizations.

Quota-share reinsurance. A form of pro rata reinsurance indemnifying the ceding company for a fixed percent of loss on each risk covered in the contract in consideration of the same percentage of the premium paid to the ceding company.

Rebating. Directly or indirectly giving or offering to give any portion of the premium or any other consideration to an insurance buyer as an inducement to purchase or renew the insurance. Rebates are forbidden under most state insurance codes.

Reinsurance. Insurance placed by an underwriter (the ceding company or reinsured) in another company to transfer or reduce the amount of the risk assumed under the original insurance policy (or group of policies).

Reinsurance premium. The consideration paid by a ceding company to a reinsurer for the coverage provided by the reinsurer.

Residual market. Also known as the shared market, it covers applications for insurance that were rejected by underwriters in the voluntary market that is covered by agency direct-marketing systems, perhaps because of high loss experience by the insured party. The residual market includes government insurance programs, specialty pools, and shared market mechanisms such as assigned-risk plans.

Retrocession. A reinsurance transaction whereby a reinsurer (the retrocedant) cedes all or part of the reinsurance risks it has assumed to another reinsurer (the retrocessionaire).

Retrospective rating. An insurance plan in which the current year's premium is based on the insured's own loss experience for that same period, subject to a maximum and minimum.

Rider. A written attachment, also known as an endorsement, to an insurance policy that changes the original policy to meet specific requirements, such as increasing or decreasing benefits or providing coverage for specific property items beyond that provided for under the insurance company's standard contract terms.

Self-insured retention (SIR). The percentage of a risk or potential loss assumed by an insured, whether in the form of a deductible, self-insurance, or no insurance at all.

Separate accounts. Certain life insurance assets and related liabilities that are segregated and maintained to meet specific investment objectives of contract holders, particularly those assets and liabilities associated with pension plans and variable products offered by life insurers, wherein the customer and not the insurer retains most of the investment and interest-rate risk.

Split-dollar life insurance. An arrangement that typically involves an agreement between an employer and an employee whereby the premium payment, cash values, policy ownership, and death benefits may be split. There are many variations of split-dollar arrangements, including arrangements in which a trust is created to facilitate estate planning. Split-dollar life insurance is designed to serve as a supplemental benefit to a particular company executive. The arrangement typically involves the payment of the insurance premium by the employer, with the death benefit accruing to the employee.

Subrogation. An insurance carrier may reserve the ''right of subrogation'' in the event of a loss. This means that the company may choose to take action to recover the amount of a claim paid to a covered insured if a third party caused the loss. After expenses, the amount recovered must be divided proportionately with the insured to cover any deductible for which the insured was responsible.

Term life insurance. An insurance product that provides, for a specified period of time, death coverage only. Typically, it has no savings component and, therefore, no cash value. Because term insurance provides only mortality protection, it generally provides the most coverage per premium dollar. Most term life insurance policies are renewable for one or more time periods up to a stipulated maximum age; however, premiums generally increase with the age of the policyholder.

Title insurance. Insurance that protects BHCs, banks, and mortgagees against unknown encumbrances against real estate by indemnifying the mortgagor and property owner in the event that clear ownership of the property is clouded by the discovery of faults in the title. Title insurance policies may be issued to either the mortgagor or the mortgagee or both. Title insurance is written largely only by companies specializing in this class of insurance.

Treaty reinsurance. A reinsurance contract under which the reinsured company agrees to cede, and the reinsurer agrees to assume, risks of a particular class or classes of business.

Twisting. In insurance, twisting involves making misrepresentations to a policyholder to induce the policyholder to terminate one policy and to take out another policy with another company, when it is not to the insured's benefit. Twisting is a violation of the Unfair Trade Practices Act. Twisting is similar to the ''churning'' concept in securities sales, and it results in increased commissions for the inducing agent.

Umbrella liability insurance. This type of liability insurance provides excess liability protection over the ''underlying'' liability insurance coverage to supplement underlying policies that have been reduced or exhausted by loss.

Underwriting. The process by which a company determines whether it can accept an application for insurance and by which it may charge an appropriate premium for those applications selected. For example, the underwriting process for life insurance classifies applicants by identifying such characteristics as age, sex, health, and occupation.

Unearned reinsurance premium. The part of the reinsurance premium that is applicable to the unexpired portion of the policies reinsured.

Universal life insurance. A form of permanent insurance designed to provide flexibility in premium payments and death benefit protection. The policyholder can pay maximum premiums and maintain a high cash surrender value. Alternatively, the policyholder can make minimal payments in an amount only large enough to cover mortality and other expense charges.

Variable annuity. See Annuity.

Variable life insurance. A form of whole life, or universal life, insurance in which the policyholder's cash value is invested in ''separate accounts'' of the insurer. These accounts are segregated from the insurance carrier's other asset holdings. Such separate account investments are generally not available to a carrier's general creditors in the event of the carrier's insolvency. The policyholder assumes the investment and price risk. Because variable life policies have investment features, life insurance agents selling these policies must be registered representatives of a broker-dealer licensed by the National Association of Securities Dealers and registered with the Securities and Exchange Commission.

Vendors' single-interest insurance. A form of force-placed insurance that is typically purchased by the BHC or bank to protect against loss or damage to loan collateral in which the BHC or bank has a security interest. The banking organization passes its expense for this insurance on to the consumer who has either refused or is unable to obtain property insurance.

Viatical settlement. The cashing in of a life insurance policy at a discount from face amount by policyholders who are often terminally ill and need the money for medical care. The purchaser becomes the policyholder as well as the beneficiary and assumes the premium payments of the policy.

Whole life insurance. A fixed-rate insurance product, with premiums and death benefits guaranteed over the duration of the policy. There is a cash value (essentially a savings account) that accrues to the policyholder tax deferred. A policyholder receives the cash value in lieu of death benefits if the policy matures or lapses before the insured's death. A policyholder also may borrow against the policy's accumulated cash value or use it to pay future premiums. For most whole life insurance policies, premiums are constant for the life of the insured's contract.

3950.0.9 INSPECTION OBJECTIVES

1. To understand the volume and complexity of the banking organization's insurance or annuity program and insurance sales strategy.
2. To assess the financial results of the activity compared with planned results.
3. To determine if the insurance and annuity sales activities are effectively integrated into

the banking organization's risk-management, audit, and compliance functions and if the control environment is adequate.
4. To assess the adequacy of the banking organization's controls to ensure compliance with the applicable state and federal laws and regulations.
5. To assess the level and direction of operational, legal, and reputational risks to the consolidated banking organization and the bank from the insurance or annuity sales activity.

The following objectives apply if insurance products or annuities are sold by another person at an office of, or on behalf of, a state member bank subsidiary of the BHC.

6. To assess the adequacy of the BHC's oversight program for ensuring a state member bank's compliance with the Consumer Protection in Sales of Insurance (CPSI) regulation. (See section 3950.0.1.)
7. To assess the effectiveness of the BHC's oversight of a state member bank's compliance and audit programs with respect to the CPSI regulation.
8. To assess the BHC's oversight of a state member bank's compliance with the CPSI regulation.
9. To obtain commitments for a BHC's oversight for needed corrective action when a state member bank is in violation of the CPSI regulation or when applicable policies, procedures, practices, or management oversight to protect against violations is deficient.

3950.0.10 INSPECTION PROCEDURES

3950.0.10.1 Risk Assessment of Insurance and Annuity Sales Activities

The examiner should consider the following procedures, as appropriate, when conducting a risk assessment to determine the level and direction of risk exposure to the BHC that is attributable to insurance or annuity sales activity. If there are specific areas of concern, the examiner should focus primarily on those areas.

1. *Scope of activities and strategies.* Assess the significance and complexity of the insurance or annuity sales program.
   a. Obtain a general overview of the scope of the BHC's insurance or annuity sales activities and any anticipated or recent change in or expansion of such activities.
   b. Determine the BHC's strategy for insurance or annuity sales, including strategies for cross-selling and referrals of insurance and banking products. Determine the institution's experience with any cross-marketing programs for both insurance business generated by the BHC and business generated by insurance producers.
   c. Obtain two years' worth of income statements, balance sheets, and budget documents for the agency's activities. Compare the expected budget items with their actual results.
   d. Determine the volume and type of insurance or annuity products and services sold or solicited.
   e. Determine what other related services the BHC provides in connection with its insurance or annuity sales activities, such as providing risk-management services to clients seeking advice on appropriate insurance coverages, claims processing, and other activities.
   f. If the BHC is not an FHC, confirm that any insurance sales activities conducted by the BHC or a nonbank subsidiary are within the limited scope of activities permissible for BHCs that are not FHCs.
2. *Insurance sales products and concentrations.*
   a. Determine the composition of sales—
      - by line of business, such as property/casualty insurance, life insurance including annuities, and health insurance;
      - by the proportion of sales to commercial and retail customers; and
      - by the portion of sales that is credit related, such as credit life and credit health insurance.
   b. Determine any sales concentrations to particular entities, industries, or BHC customers.
   c. Note any concentrations to large commercial accounts.
   d. Determine what insurance services are provided to the BHC, its employees, and BHC or bank affiliates.
3. *Legal-entity and the risk-management structure for insurance or annuity sales.*
   a. Obtain an organizational chart for the legal-entity and risk-management structure for the insurance or annuity sales activities.
   b. Determine—

- whether the insurance or annuity sales activity is conducted in an affiliated producer, by the BHC itself, through another distribution arrangement, or by a combination of these entities;
- the names of any affiliated insurance agencies and the states where the affiliated insurance agencies are licensed; and
- the locations outside of the United States where insurance or annuities are sold or solicited.

c. Determine if the insurance or annuity producer is acting as a managing general agent (MGA).[17] If so, determine —
- the scope of the MGA activities;
- the BHC management's assessment of the risk associated with the MGA activity; and
- what risk controls are in place to protect the BHC from potential loss that may arise from the MGA's activities, such as loss arising from legal liability.

4. *Strategic and financial plans.* Assess management controls over the insurance annuity sales activities.
   a. Ascertain the BHC management's strategic and financial plans and goals for the insurance or annuity sales activity.
   b. Review the BHC's due-diligence process for acquiring and pricing agencies, if applicable.
   c. Review the BHC's financial budgets and forecasts for the activity, particularly plans for new products, marketing strategies, and marketing arrangements, and the rate of actual and expected growth for the activity.
   d. Determine the cause for significant deviations from the plan.
   e. Determine if any agency acquired by the state member bank is providing the expected return on investment and if the agency's revenues are covering the debt servicing associated with the purchase, if applicable.
5. *Review of board and committee records and reports.*
   a. Review the reports of any significant BHC oversight committees, including relevant board of directors' and board committees' minutes and risk-management reports.
   b. Determine if the BHC's board of directors, a board committee, or senior management reviews reports pertaining to consumer complaints and complaint resolution, information pertaining to litigation and associated losses, and performance compared with the organization's plan for the insurance and annuity sales activities.
6. *Policies and procedures.*
   a. Determine—
      - the adequacy of the BHC's policies and procedures for conducting and monitoring insurance or annuity sales activities, including those policies designed to ensure adherence with federal and state laws and regulations pertaining to consumer protection;
      - whether there are appropriate policies and procedures for the handling of customer funds collected on behalf of the underwriter; accurate and timely financial reporting; complaint monitoring and resolution; effective system security and disaster-recovery plans; and policy-exception tracking and reporting, and
      - if the board of directors or a designated committee of the board has formally approved the policies.
   b. Obtain a detailed balance sheet for agency subsidiaries, and determine if the assets held by insurance or annuity agency subsidiaries of BHCs and banks are all eligible investments.
   c. Determine the independence of the BHC's audit program applicable to the insurance and annuity sales activity. Ascertain if the audit program's scope, frequency, and resources are commensurate with the insurance and annuity activities conducted.
   d. Determine how the BHC selects insurance underwriters with whom to do business, as well as how the banking organization monitors the continuing performance of the underwriters.
   e. Determine the adequacy of the BHC board of directors' oversight of the insurance management team's qualifications, the training and licensing of personnel, and general compliance with state insurance regulations.

17. MGAs do not assume underwriting risk. Through contractual arrangements with an insurer, MGAs have the authority to write policies on behalf of the insurer in certain instances, thereby binding the insurer to the policy. Certain minimum provisions governing MGA agreements are delineated in the applicable National Association of Insurance Commissioners (NAIC) model law.

f. Review the internal controls of the BHC related to third-party arrangements, including arrangements for sales, processing, and auditing of insurance and annuity activities.

7. *Claims, litigation, and functional regulator supervision.* Assess legal and reputational risk.
   a. Identify any significant litigation against the BHC arising from its insurance or annuity sales activity and the likely impact of the litigation on the BHC.
   b. Obtain the insurance agency's errors and omissions claims records for the past several years, including a listing of claims it has made and the amount of claims, the claim status, and the amount of claim payments.
   c. Review the BHC's policies and procedures for tracking and resolving claims. Determine if the policies and procedures appear adequate and if they are adhered to.
   d. Determine if the applicable functional regulator has any outstanding supervisory issues with the insurance agency.
8. *Consumer complaints.*
   a. Determine if the BHC's management has policies and procedures in place to assess whether consumer complaints received are likely to expose the BHC to regulatory action, litigation, reputational damage, or other significant risk.
   b. Obtain applicable consumer complaint files, and evaluate internal control procedures to ensure the complaints are being adequately addressed.
9. *Audit and compliance functions.*
   a. Determine the date of the most recent review of the insurance or annuity sales activities by the audit and compliance functions.
   b. Determine the adequacy of the BHC's management policies and procedures for ensuring that any deficiencies noted in such reviews are corrected, and ascertain whether any such deficiencies are being adequately addressed.[18]
10. *Insurance underwriter oversight of agent/agency activities.*
   a. Determine if the banking organization has adequate policies and procedures to review and resolve any issues or concerns raised by an insurance underwriter regarding the producers used by, or affiliated with, the BHC.[19]
   b. Determine whether any of the insurance underwriters conducted a periodic review of producers that they engaged to sell insurance.
11. *State supervisory insurance authorities.*
   a. During discussions with the BHC's management, determine whether state insurance regulators have raised any issues or concerns in correspondence or reports.
   b. Consult with the state insurance regulator (or regulators), as appropriate, to determine any significant supervisory issues, actions, or investigations. (For multistate agencies, contacts with states may be prioritized on basis of the location of the agency's head office or by a determination of the significance of sales by state. Both financial examinations and market conduct examinations conducted by the state insurance departments are targeted at insurance underwriters, not agencies. Therefore, information available from the states pertaining to agencies may be very limited.)
12. *Operational risk assessment.* Ascertain from BHC management whether there are—
   a. any significant operational problems or concerns relating to insurance or annuity sales activities;
   b. policies and procedures in place to ensure accurate and timely reporting to the BHC's management of insurance or annuity sales activity plans, financial results, and significant consumer complaints or lawsuits or compliance issues, such as errors and omissions claims;[20]
   c. appropriate policies and procedures at the BHC to ensure accurate reporting of

18. Enforcement of the privacy provisions of the GLB Act as they relate to state member banks is the responsibility of the Board's Division of Consumer and Community Affairs. However, enforcement of the privacy provisions of the GLB Act with respect to the insurance activities of nondepository subsidiaries of a state member bank is the responsibility of the state insurance regulators.

19. Insurance underwriters generally have procedures to determine whether individual producers affiliated with agencies are selling the underwriters' products in conformance with applicable laws and regulations. These reviews' findings and conclusions should be available to the state member bank's management.

20. Errors and omissions insurance should be in place to protect the state member bank against loss sustained because of an error or oversight, such as failure to issue an insurance policy. A tracking system to monitor errors and omission claims should be in place and monitored by the state member bank, as appropriate. See section 4040.1, "Management of Insurable Risks," of the *Commercial Bank Examination Manual*.

insurance or annuity sales activity on Federal Reserve regulatory reports (Determine from applicable Board or Reserve Bank contacts if there are any outstanding issues with respect to potential reporting errors on submitted Federal Reserve reports, BHC and bank call reports, or other applicable reports. If so, seek resolution of the issues); and

d. adequate disaster-recovery plans and procedures to protect the BHC from loss of data related to insurance or annuity sales activities.

3950.0.10.2 Consumer Protection in Sales of Insurance Regulation

These examination procedures apply only to the examination of state member banks. The procedures are provided for the BHC examiner's information only.

The following procedures should be risk-focused in accordance with the Federal Reserve's risk-focused framework for supervising banking organizations. The procedures should be carried out as necessary to adequately assess the state member bank's compliance with the Consumer Protection in Sales of Insurance (CPSI) regulation.

1. Determine the role of the state member bank's board of directors and management in ensuring compliance with the CPSI regulation and applicable state consumer regulations.
2. Evaluate the management information system (MIS) reports the state member bank's board or designated committee relies on to monitor compliance with the consumer regulations and to track complaints and complaint resolution.
3. Review the state member bank's policies and procedures to ensure they are consistent with the CPSI regulation, and conduct transaction testing, as necessary, in the following areas:[21]
   a. disclosures, advertising, and promotional materials
   b. consumer acknowledgments
   c. physical separation from areas of deposit-taking activities
   d. qualifications and licensing for insurance personnel
   e. compliance programs and internal audits
   f. hiring, training, and supervision of insurance or annuity sales personnel employed directly by the state member bank, or of third parties selling insurance or annuity products at a state member bank office or on behalf of the state member bank
   g. compensation practices and training for personnel making referrals
4. If a third party sells insurance or annuities at the state member bank's offices or on behalf of the state member bank, review the state member bank's policies and procedures for ensuring that the third party complies with the CPSI regulation and other relevant policies and procedures of the bank.
5. Review the state member bank's process for identifying and resolving consumer complaints related to the sale of insurance products and annuities.
6. Obtain and review the record of consumer complaints related to the CPSI regulation. These records are available from the Board's Division of Consumer and Community Affairs' database. (See CP letter 2001-11.)
7. Include examination findings, as appropriate, in the commercial bank examination report or in other communications to the bank, as appropriate, that pertain to safety-and-soundness reviews of the bank.

21. If the examiner determines that transaction testing of a functionally regulated nonbank affiliate of the state member bank is appropriate in order to determine the state member bank's compliance with the CPSI regulation, the examiner should first consult with and obtain approval from appropriate staff of the Board's Division of Banking Supervision and Regulation.

3950.0.11 INTERNAL CONTROL QUESTIONNAIRE

3950.0.11.1 Risk Assessment of Insurance and Annuity Sales Activities

3950.0.11.1.1 Program Management

1. Does the BHC have a comprehensive program to ensure that its insurance and annuity sales activities are conducted in a safe and sound manner?
2. Does the BHC have appropriate written policies and procedures commensurate with the volume and complexity of the insurance or annuity sales activities?
3. Has management obtained the approval of the board of directors for the program scope and the associated policies and procedures?
4. Have reasonable precautions been taken to ensure that disclosures to customers for

insurance or annuity sales and solicitations are complete and accurate and are in compliance with applicable laws and regulations?
5. Does the BHC's management effectively oversee the insurance or annuity sales activities, including those involving third parties?
6. Does the BHC have an effective independent internal audit and compliance program in place to monitor retail sales of insurance or annuity products?
7. Does the BHC appropriately train and supervise employees conducting insurance or annuity sales activities?

3950.0.11.1.2 Management Information Systems

8. Does the BHC's insurance program management plan establish the appropriate management information systems (MIS) necessary for the banking organization's board of directors to properly oversee the insurance or annuity sales activities?
9. Does the MIS provide sufficient information to allow for the evaluation and measurement of the effect of actions taken to identify, track, and resolve any issues relative to compliance with the CPSI regulation?
10. Does the MIS include sales volumes and trends, profitability, policy exceptions and associated controls, customer complaints, and other information providing evidence of compliance with laws and established policies?

3950.0.11.1.3 Compliance Programs and Internal Audits

11. Are there policies and procedures in place to ensure that insurance or annuity sales activities are conducted in compliance with applicable laws and regulations?
12. Do compliance procedures identify potential conflicts of interest and how such conflicts should be addressed?
13. Do the compliance procedures provide a system to monitor customer complaints and track their resolution?
14. When applicable, do compliance procedures call for verification that third-party sales are being conducted in a manner consistent with the agreement governing the third party's arrangement with the BHC?
15. Is the compliance function conducted independently of the insurance or annuity sales and management activities?
16. Do compliance personnel determine the scope and frequency of the insurance-product review?
17. Are findings of insurance or annuity sales activity compliance reviews periodically reported directly to the BHC's board of directors or a designated committee thereof?

3950.0.11.2 Consumer Protection in Sales of Insurance Regulation

This internal control questionnaire applies only to the examination of state member banks. It is provided for the BHC examiner's information only.

If applicable, review the state member bank's internal controls, policies, practices, and procedures for retail insurance or annuity sales activities conducted by the bank on bank premises or on behalf of the bank. The bank's program management for such activities should be well documented and should include appropriate personnel training, as well as compliance and audit-function coverage of all efforts to ensure compliance with the provisions of the Board's CPSI regulation.

3950.0.11.2.1 Advertising and Promotional Materials

1. Do advertising materials associated with the insurance or annuity sales program create an erroneous belief that—
   a. an insurance product or annuity sold or offered for sale by the state member bank, or on behalf of the bank, is backed by the federal government or the bank, or that the product is insured by the FDIC?
   b. an insurance product or annuity that involves investment risk does not, in fact, have investment risk, including the potential that principal may be lost and the product may decline in value?
2. Does a review of advertising for insurance products or annuities sold or offered for sale create an erroneous impression that—
   a. the state member bank or an affiliate or subsidiary may condition the grant of an extension of credit to a consumer on the purchase of an insurance product or

annuity by the consumer from the bank or an affiliate or subsidiary of the bank?
b. the consumer is not free to purchase an insurance product or annuity from another source?

3950.0.11.2.2 Disclosures

3. In connection with the initial purchase of an insurance product or annuity by a consumer, does the initial disclosure to the consumer, except to the extent the disclosure would not be accurate, state that—
   a. the insurance product or annuity is not a deposit or other obligation of, or is not guaranteed by, the state member bank or an affiliate of the bank?
   b. the insurance product or annuity is not insured by the FDIC or any other agency of the United States, the state member bank, or (if applicable) an affiliate of the bank?
   c. in the case of an insurance product or annuity that involves an investment risk, there is risk associated with the product, including the possible loss of value?
4. In the case of an application for credit, in connection with which an insurance product or annuity is solicited, offered, or sold, is a disclosure made that the state member bank may not condition an extension of credit on either—
   a. the consumer's purchase of an insurance product or annuity from the bank or any of its affiliates?
   b. the consumer's agreement not to obtain, or a prohibition on the consumer's obtaining, an insurance product or annuity from an unaffiliated entity?
5. Are the disclosures under question 3 above provided orally and in writing before the completion of the initial face-to-face sale of an insurance product or annuity to a consumer?
6. Are the disclosures under question 4 above made orally and in writing at the time the consumer applies in a face-to-face interaction for an extension of credit in connection with which insurance is solicited, offered, or sold?
7. If a sale of an insurance product or annuity is conducted by telephone, are the disclosures under question 3 above provided in writing, by mail, within three business days?
8. If an application for credit is made by telephone, are the disclosures under question 4 above provided by mail to the consumer within three business days?
9. Are the disclosures under questions 3 and 4 above provided through electronic media instead of on paper, only if the consumer affirmatively consents to receiving the disclosures electronically, and only if the disclosures are provided in a format that the consumer may retain or obtain later?
10. Are disclosures made through electronic media, for which paper or oral disclosures are not required, presented in a meaningful form and format?
11. Are disclosures conspicuous, simple, direct, readily understandable, and designed to call attention to the nature and significance of the information provided?
12. Are required disclosures presented in a meaningful form and format?

3950.0.11.2.3 Consumer Acknowledgment

13. At the time a consumer receives the required disclosures, or at the time of the consumer's initial purchase of an insurance product or annuity, is a written acknowledgment from the consumer that affirms receipt of the disclosures obtained?
14. If the required disclosures are provided in connection with a transaction that is conducted by telephone—
    a. has an oral acknowledgment of receipt of the disclosures been obtained and is sufficient documentation maintained to show that the acknowledgment was given?
    b. have reasonable efforts to obtain a written acknowledgment from the consumer been made?

3950.0.11.2.4 Physical Separation from Deposit Activities

15. Does the state member bank, to the extent practicable—
    a. keep the area where the bank conducts transactions involving the retail sale of insurance products or annuities physically segregated from the areas where retail deposits are routinely accepted from the general public?
    b. identify the areas where insurance product or annuity sales activities occur?
    c. clearly delineate and distinguish insurance and annuity sales areas from the

areas where the bank's retail deposit-taking activities occur?

3950.0.11.2.5 Qualifications and Licensing

16. Does the state member bank permit any person to sell or offer for sale any insurance product or annuity in any part of its office or on its behalf, only if the person is at all times appropriately qualified and licensed under applicable state insurance licensing standards for the specific products being sold or recommended?

3950.0.11.2.6 Hiring, Training, and Supervision

17. Have background investigations of prospective employees that will sell insurance products or annuities been completed?
18. When a candidate for employment has previous insurance experience, has a review to determine whether the individual has been the subject of any disciplinary actions by state insurance regulators been completed?
19. Do all insurance or annuity sales personnel or third-party sales personnel conducting sales activities at or on behalf of the state member bank receive appropriate training and continue to meet licensing requirements?
20. Does training address policies and procedures for sales of insurance and annuity products, and does it cover personnel making referrals to a licensed insurance producer?
21. Does training ensure that personnel making referrals about insurance products or annuities are properly handling all inquiries so as not to be deemed to be acting as unlicensed insurance agents or registered (or equivalently trained) securities sales representatives (for insurance products that are also securities) if they are not qualified?
22. When insurance products or annuities are sold by the bank or third parties at an office of, or on behalf of, the organization, does the institution have policies and procedures to designate, by title or name, the individuals responsible for supervising insurance sales activities, as well as the referral activities of bank employees not authorized to sell these products?
23. Does the bank designate supervisory personnel responsible for monitoring compliance with any third-party agreement, as well as with the CPSI regulation?

3950.0.11.2.7 Referrals

24. Are fees paid to nonlicensed personnel who are making referrals to qualified insurance or annuity salespersons limited to a one-time, nominal fee of a fixed dollar amount for each referral, and is the fee unrelated to whether the referral results in a sales transaction?

3950.0.11.2.8 Third-Party Agreements

25. Does the state member bank's management conduct a comprehensive review of a third party before entering into any arrangement to conduct insurance or annuity sales activities through the third party?
26. Does the review include an assessment of the third party's financial condition, management experience, reputation, and ability to fulfill its contractual obligations to the bank, including compliance with applicable consumer protection laws and regulations?
27. Does the board of directors or a designated committee thereof approve any agreement with the third party?
28. Does the agreement outline the duties and responsibilities of each party; describe the third-party activities permitted on the institution's premises; address the sharing or use of confidential customer information; and define the terms for use of the bank's office space, equipment, and personnel?
29. Does the third-party agreement specify that the third party will comply with all applicable laws and regulations and will conduct its activities in a manner consistent with the CPSI regulation, if applicable?
30. Does the agreement authorize the bank to monitor a third party's compliance with the agreement, as well as to have access to third-party records considered necessary to evaluate compliance?
31. Does the agreement provide for indemnification of the institution by the third party for any losses caused by the conduct of the third party's employees in connection with its insurance or annuity sales activities?
32. If an arrangement includes dual employees, does the agreement provide for written employment contracts that specify the duties of these employees and their compensation arrangements?

33. If the bank contracts with a functionally regulated third party, does the bank obtain, as appropriate, any relevant regulatory reports of examination of the third party?
34. How does the bank ensure that a third party selling insurance or annuity products at or on behalf of the bank complies with all applicable regulations, including the CPSI regulation?
35. How does the bank ensure that any third party or dual employee selling insurance or annuity products at or on behalf of the bank is appropriately trained to comply with the minimum disclosures and other requirements of the Board's CPSI regulation and applicable state regulations?
36. Does the bank obtain and review copies of third-party training and compliance materials to monitor the third party's performance regarding its disclosure and training obligations?

3950.0.11.2.9 Consumer Complaints

37. Does the state member bank have policies and procedures for handling customer complaints related to insurance and annuity sales?
38. Does the customer complaint process provide for the recording and tracking of all complaints?
39. Does the state member bank require periodic reviews of complaints by compliance personnel? Is a review by the state member bank's board and senior management required for significant compliance issues that may pose risk to the bank?

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The analysis of financial factors should be conducted in four primary parts, namely: (1) parent only, (2) banking subsidiary(ies), (3) nonbank subsidiary(ies), and (4) consolidated organization. In view of the fact that all BHCs are not structured in the same organizational and financial manner, it is important that examiners be flexible in their approach and be judicious in their use of ratio analysis and peer group comparisons. There is no substitute for using sound judgment and creativity while performing an analysis, providing all of the pertinent information is available. The summary and conclusions should follow from the information presented in the analysis.

The analysis is intended to determine the financial strengths and weaknesses of an organization and the impact of conditions at the parent company and nonbank subsidiary which could adversely affect the condition of the banking subsidiary. As a regulatory agency, a goal of the Federal Reserve System is to safeguard and protect the soundness of commercial banks. The System oversees holding company banking and nonbanking activities to assure the continued safety and soundness of individual banks and the industry as a whole.

The analysis of financial factors resulting from the inspection of a bank holding company is essentially a finding of facts and an expression of judgment. In conducting an appraisal of a holding company's condition, the financial analysis of the organization, based on a ''building block'' or ''component'' approach, should provide the examiner with a solid foundation from which to proceed. In order to complete the analysis it is first necessary to accumulate sufficient information concerning the parent company, bank and nonbanking subsidiary(ies) and the consolidated organization. A final analysis should not be attempted until these integral parts have been thoroughly reviewed.

The completion of the financial analysis will culminate with the preparation of a rating for the bank holding company. Manual section 4070.0, entitled ''Bank Holding Company Rating System,'' presents the rating system in its entirety.

4010.0.1 INTRODUCTION AND SCOPE OF THE ANALYSIS

The cash flow analysis is *applicable to all bank holding companies with consolidated assets in excess of $1 billion, those that have substantive fixed charges or debt outstanding,* as well as select others at the option of the Reserve Bank. Key parts of the analysis involve the use of:

1. A standardized ''Cash Flow Statement (Parent)'' page (refer to manual sections 5010.23 and 5020.13 for the illustrated pages) which includes computation of the cash earnings coverage ratios and analyses; regarding the results;
2. Earnings cash flow coverage ratios to measure the parent company's ability:
   a. To pay its fixed charges, including interest costs, lease expense, income taxes, retirement of long-term debt (including sinking fund provisions), and preferred stock cash dividends, and
   b. To pay common stock cash dividends.
3. Guidelines for supervisory determination of parent company debt servicing capacity.

The cash flow statement page of the inspection report presents the cash earnings and the cash expenditures of the parent company. Within the statement are the key components to be used in the ''Fixed Charge Coverage Ratio,'' which measures the parent company's ability to meet its fixed obligations, and a ''Common Stock Cash Dividend Coverage Ratio'' which measures the ability of the remaining, or residual, earnings to cover common stock dividends.

4010.0.2 CASH FLOW STATEMENT

The cash flow statement is an effective tool used in understanding how a particular bank holding company operates. Its primary objective is to summarize the financing and investing activities of the holding company, including the extent to which the entity has generated funds (externally and internally) during the period. The cash flow statement is related to both the income statement and the balance sheet and provides information that otherwise can be obtained only partially by interpreting each of those statements.

An analysis of past cash flow statements can supply important information regarding the uses of funds, such as internal asset growth or acquisitions, as well as data on the sources of funds used and the financing needs of management. A projected cash flow statement will focus on the need for future funds, its applications, and the sources from which they are likely to be available.

Specifically, the analysis of the cash flow statement is necessary for a thorough understanding of a bank holding company and the nature of its operations to the extent that it provides information on such areas as:

1. Utilization of funds provided by operations;
2. Use of funds from a new debt issue or sale of stock;
3. Source of funds used for acquisitions or additional capital contributions;
4. Means of payment of a dividend in the face of an operating loss;
5. Means of debt repayment and stock redemption.

While the cash flow statement provides an overall perspective of a holding company's utilization of available funds, it does not, by itself, indicate possible or actual difficulties the parent company may have in meeting its fixed obligations from internally generated funds. Fixed obligations or fixed charges are those recurring expenses which must be paid as they fall due, which includes interest expense, lease expense, sinking fund requirements, scheduled debt repayments and preferred dividends.

One ratio that may be used to calculate the strength of a parent company's earnings to meet its fixed charges or obligations is the *Fixed Charge Coverage Ratio* (FCCR). The components of the ratio are included on the ''Cash Flow Statement (Parent)'' page. The Fixed Charge Coverage Ratio (FCCR) measures the parent company's ability to pay for *fixed* contractual obligations if management is to *retain control of the organization,* thereby satisfying the expectation of creditors and preferred stockholders. Net income *after taxes* is used in the formula. Interest and lease expenses are already deducted to arrive at the net income figure and must be added back to obtain the earnings available to pay such charges. Interest expense is usually the largest component among all ''fixed charges,'' and the ability to pay this expense from earnings cash flow is critical to an assurance of continued refunding of the parent company's debt. It measures not only the extent to which net cash operating earnings covers the debt servicing requirements of the parent company, but the capacity to pay income taxes and preferred stock cash dividends as well, thereby meeting the expectations that creditors and preferred shareholders have for the protection of their respective interests. The need for *better than a 1:1* coverage is therefore critical.

Another important formula, required to be calculated is the *Common Stock Cash Dividend Coverage Ratio* (CSCDCR) which measures the ability of the parent company to pay common stock cash dividends. The CSCDCR will show, in turn, whether the residual cash earnings of the parent company are sufficient to pay the common stock cash dividend and, if not, the amount that must be provided from other sources of cash, such as the liquidation of assets or additional borrowings, to cover the shortfall.

Significant shortfalls in the CSCDCR are to be scrutinized in light of the Board's November 1985 Policy Statement on ''Cash Dividends Not Fully Covered by Earnings.'' According to the statement, a bank holding company should not maintain its existing rate of cash dividends on common stock unless:

1. The holding company's net income available to common stockholders over the past year has been sufficient to fully fund the dividends; *and*
2. The prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality, and overall financial condition.

A bank holding company whose cash dividends are inconsistent with the above criteria is to give serious consideration to cutting or eliminating its dividends. The need for *at least a 1:1 coverage* is therefore critical.

The two ratios[1] are calculated as follows:

$$\text{FCCR} = \frac{\text{After tax cash income (1)} + \text{interest expense (2)} + \text{lease \& rental expense (3)}}{\text{interest expense (2)} + \text{lease \& rental expense (3)} + \text{contractual long-term debt retired (4)} + \text{preferred stock dividend payments (5)}}$$

$$\text{CSCDCR} = \frac{\text{After tax cash income (1)} - [\text{Contractual long-term debt retired (4)} + \text{preferred stock dividend payments (5)}]}{\text{Common Stock Dividend Payments (6)}}$$

Note that the Cash Flow Statement (Parent) page presents only cash items included in the parent's income and therefore the analyst can use its income figures without any need to adjust for noncash items.

Both the Fixed Charge Coverage and the Common Stock Cash Dividends Coverage ratios are considered inadequate at less than 1:1. If a holding company is generating funds which provide at least dollar-for-dollar coverage, no criticism need be made. However, the examiner should be aware that these ratios, as well as others, are merely guidelines and good judgment must prevail. A ratio of 1.02:1 may pass the test, but it is only barely adequate. No criticism may necessarily be warranted for the period covered by the 1.02:1 ratio, but it may be indicative of a deteriorating trend over the past few years. Accordingly, an appropriate comment concerning the trend may be warranted.

When reviewing these ratios, it should be kept in mind that certain components in the numerator can to some degree be altered at the discretion of management. For example, by altering the dividends paid by bank subsidiaries, the amount of funds available to the parent to cover fixed charges can be increased or decreased. For this reason, the fixed charge and funds flow ratios should be analyzed in conjunction with a review of the dividend payout ratios of the subsidiary banks. Cash flow ratios that otherwise appear adequate may be a cause for concern if the banks are paying out dividends that are too high in relation to capital or overall condition. Analysts should evaluate the bank dividend payout ratios in light of the bank's capital and financial condition. Only in this way can the analyst gain a better understanding of the quality of the parent's cash flow and its potential effect on bank subsidiaries.

Ratios of less than 1:1 coverage show that internally generated funds are not sufficient to meet a parent company's needs. In many cases, the examiner may find low coverage ratios yet all fixed charges were paid as agreed. Had they not been, the company would have incurred severe financial difficulties long before the start of the inspection. Therefore, when less than adequate ratios appear and obligations are paid

1. The numbered ( ) items correspond to the numbered lines on the ''Cash Flow Statement (Parent)'' page.

on time, the examiner must determine what other source of funds was utilized to make up the shortfall and to permit the timely payment of obligations.

4010.0.3 SUPERVISORY DETERMINATION AS TO ADEQUACY OF PARENT COMPANY CASH FLOW

A supervisory determination about the adequacy of parent company cash flow, and its use as a measure of parent company debt servicing capacity, requires more information than just the results of the Fixed Charge Coverage and Common Stock Cash Dividend Coverage Ratios. The typical major parent company does not generate an earnings cash flow by conducting banking operations itself, although it nevertheless may incur a heavy external debt on behalf of its operating subsidiaries which are the generators of the actual earnings cash flow. Therefore, the parent company earnings cash flow may not be indicative of the *actual* earnings power of the entire banking organization. For example, the cash earnings of the parent company may be kept low by management to avoid State or local income tax liability and/or to increase leveraged lending volumes at the subsidiary level. Conversely, cash earnings may be forced to the parent company through imprudent levels of upstream cash dividend payments which eventually will endanger the operating subsidiaries and the parent itself.

A supervisory determination about the adequacy of parent company cash flow must take place at *two levels:* (1) by analyzing the results of the two coverage ratios using the net earnings cash flow *realized* by the parent company, *and* (2) by analyzing the effect that upstream cash flow to the parent company has had, and can be expected to have, on the financial condition of the bank subsidiaries and the significant nonbank subsidiaries. The latter focus should be on significant nonbank subsidiaries whose capital and dividend policies are subject to separate regulation—such as thrifts—or subsidiaries with significant external funding, whose creditors presumably monitor capital and dividend policies of the subsidiary.

4010.0.4 SPECIFIC GUIDELINES FOR DEBT SERVICING CAPACITY

The specific guidelines for debt servicing capacity are as follows:

1. The adequacy or inadequacy of parent company cash flow, and thereby the capacity to sustain the parent company's debt, is determined ultimately from the results of the Fixed Charge and Common Stock Cash Dividend Coverage Ratios, and the related analysis of the effects of upstream cash flow on the financial condition of the key subsidiaries.

2. For those parent companies with material amounts of long-term debt, coverage ratios in excess of 1:1 will not necessarily be considered sufficient to sustain the parent company's leverage *unless: first,* the Tier 1 capital positions of the bank subsidiaries are considered adequate; *second,* that the bank holding company's consolidated Tier 1 capital position is considered adequate; and *third,* the parent's liquidity is judged adequate. If that is not the case, then a critical comment on the ''Examiner's Comments'' page should be made regarding the potentially excessive leverage of the parent, as well as that of its subsidiaries. A specific period of time should be established for the management of the bank holding company to submit a capital improvement program acceptable to the System. *Moreover,* where the capital positions, bank and consolidated, are considered adequate but the dividend payout ratios are excessive, it is indicative of a potential future debt servicing problem and should be brought to management's attention. Since the earnings level may not be sustainable, corrective action must be taken within a specified period of time.

3. For coverage ratios of less than 1:1, there is a presumption of a critical comment on the ''Examiner's Comments'' page of the inspection report *unless* the shortfall is prudently planned,[2] insignificant in amount and/or the trend of earnings cash flow and dividend policies clearly point toward a return to sufficient parent company earnings cash flow coverage.

    a. In circumstances where the Tier 1 capital position of *any bank subsidiary* is considered inadequate, a written program of corrective action should be required, including the steps necessary to reestablish positive earnings cash flow coverage at the parent company.

    b. In circumstances where the Tier 1 *consolidated* capital position of the holding company is considered inadequate, a written pro-

2. A planned cash flow shortfall might typically occur when the parent elects to reduce (or not increase) dividends from subsidiaries because it anticipated an excess cash or liquid asset position from certain *external sources* (i.e., stock or debt issuance, dividend reinvestment plans, or tax refunds) sufficient to cover the deficiency.

gram of corrective action should be required, including the steps necessary to reestablish positive earnings cash flow coverage at the parent company.

c. In circumstances where the Tier 1 capital position of *each bank subsidiary* and the consolidated Tier 1 capital position of the bank holding company is considered adequate, but there is a developed trend of inadequate earnings cash flow coverage at the parent company level or excessive dividend payouts from the subsidiaries, a written program of corrective action should be required to reestablish and maintain a positive earnings cash flow at the parent company.

4010.0.5 SOURCES OF FUNDS TO MAKE UP SHORTFALLS

Basically, there are three source categories, other than current earnings, that could be used to make up any deficit: (1) liquidation of assets, (2) proceeds from a stock offering, or (3) borrowed funds. These sources must be thoroughly analyzed to determine the extent they were and could still be utilized. It must be kept in mind that the use of these sources cannot permanently eliminate a shortfall in the flow of funds from current operations. These alternative sources only alleviate temporarily the effects of a shortfall. Nevertheless, a deficit could have been intentionally allowed to occur because the holding company knew of funds coming from these alternate sources. For example, the parent knew of an impending stock sale and cut dividends from subsidiaries significantly. In future years, dividends from subsidiaries could be restored to normal proportions, bringing the ratios up to adequate levels.

At this point, it must be determined what, if any, criticism is necessary when an unplanned shortfall is made up by any of these alternate sources. The necessity of liquidating assets to meet cash needs may warrant a critical comment. The parent's advances to subsidiaries and its investment in marketable securities are considered temporary investments. That is, the holding company may reasonably expect to sell its securities and be repaid on its advances to subsidiaries within a reasonably short period of time. In the case of advances to a problem subsidiary, repayments may not be forthcoming. Nevertheless, if the parent does receive partial payments, such funds are available to meet cash needs. The concern to the examiner is the extent to which such temporary investments can be relied upon before they are fully exhausted. If the continued liquidation of those investments to meet cash needs has fully exhausted the assets or will do so in the near future, then appropriate critical comments are warranted. Such comments should stress that the liquidation of the investment portfolio and the advances to subsidiaries can no longer be considered a reliable source of funds.

Another method which may be used by a holding company to overcome a flow of funds deficiency is the sale of capital stock which is an effective source for generating permanent funds for the parent. However, it must be recognized that the primary reason for the stock offering was something other than covering the shortfall (i.e., debt repayment, capital contributions to subsidiaries, acquisitions). Therefore, it cannot be relied upon as a consistent annual source to supplement internally generated funds from operations. Also, it should be realized that the sale of stock will increase future funding requirements as additional dividends will have to be paid. Consequently, where no significant improvement in internal operations is contemplated in future periods, an appropriate comment is warranted indicating the potential problem.

Holding companies also compensate for inadequate funds flow with borrowed money. Although not a permanent source of funds, long-term debt is a source similar to the sale of stock. Its main purpose, however, was not to cover the shortfall. Long-term debt cannot be considered as a reliable, consistent annual source, and moreover, its existence creates new funding requirements.

Short-term debt is perhaps the most commonly used source to cover a deficit cash flow from operations and its use is of serious concern from a supervisory viewpoint. Unlike long-term debt and equity issues, short-term borrowings (i.e., bank loans, commercial paper) are readily available to holding companies which can and do rely on this source year after year for support. As a consequence, this indebtedness increases fixed charges and where material improvement in earnings does not develop, the shortfall could increase in subsequent periods thereby necessitating even larger borrowing requirements. This practice may jeopardize the parent's liquidity position since short-term liabilities rise without a corresponding increase in liquid assets as the borrowed funds are used to pay expenses. Here, an appropriate comment is warranted indicating the problems.

4010.0.6 REPORTING THE RESULTS

If the coverage ratios are less than 1:1, then appropriate comments are necessary to explain the external source utilized to make up the shortfall. The supporting details may be shown within the comments section of the Cash Flow Statement. More significant comments should be included on the ''Analysis of Financial Factors'' page or the ''Examiner's Comments'' page. The examiner may include prior years' results for comparative purposes.

4010.0.7 INSPECTION OBJECTIVES

1. To determine the ability of the parent to manage its cash position and operate within debt service and funding requirements.
2. To measure the parent's ability to meet its fixed obligations and its dependency on borrowed funds to meet its cash needs.
3. To determine if the parent company's dividends to stockholders are covered by residual cash earnings.
4. To analyze any cash flow transaction which may adversely affect the financial stability of the parent.
5. To discuss with parent company management:

   a. Deficit cash flows arising from internal operations;

   b. Steps management has taken, or plans to take, to restore adequate cash earnings coverage for fixed charges and dividend payments and whether such plans should be commensurate with the maintenance of adequate loan loss reserves and Tier 1 capital levels in the bank and major nonbank subsidiaries.

   c. Any parent company borrowings or restructurings needed to sustain dividend payments to shareholders; and

   d. The need to increase cash flow although there may be no deficit in current cash flow coverage.

4010.0.8 INSPECTION PROCEDURES

1. Prepare the ''Cash Flow Statement (Parent)'' FR 1225.

   a. Analyze each item of the parent company's comparative balance sheet and income statement. Since accrual figures may be used for all accounts except tax and dividend payments, adjustment to the figures may be necessary for the difference between accrual and cash basis accounting.

   b. Examine the underlying nature of period increases or decreases for the balances listed on the financial statements, particularly any material transactions that aided in averting coverage ratio shortfalls.

   c. Note contractual long-term debt retired (net decrease in borrowed funds, including sinking fund provisions) as a memo item on the bottom of the page, where indicated.

   d. Compute the fixed charge and common stock cash dividend coverage ratios as illustrated on the page. *The numbered items in the formula correspond with the numbered items on the ''Cash Flow Statement (Parent)'' page.*

   e. Answer the six questions on the ''Cash Flow Statement (Parent)'' page that prompt an analysis.
2. Analyze the Results.

   a. If there is full coverage, no problem should be assumed. However, *the underlying assets and transactions that provided for the coverage should be examined to make certain that ''no problem'' does, in fact, exist.*

   b. If a shortfall exists, provide guidelines to the parent company's management for developing a workable contingency plan, using your ''good examiner judgement'', considering the viability of all sources in resolving the shortfall.

   - Review the *sources* for making up shortfalls:
     - — Liquidation or sale of assets, *giving full consideration to external market concerns and losses that may result from the sales.*
     - — Proceeds from stock offerings.
     - — Increase in borrowed funds, including a restructuring of short term debt to long term debt.
     - — Sale of capital stock.
     - — Payments from subsidiaries on advances in the form of amortization or interest.
     - — Short term debt.
3. Report the Results.

   a. *When an ''engineered'' (planned) shortfall exists,* indicate that one does exist, the reasons therefore, and the degree of severity to which it should be addressed, either as part of the answers to the questions on the ''Cash Flow Statement (Parent)'', the ''Analysis of Financial Factors'' page, or the ''Examiner's Comments'' page. Provide management's assessment as to whether planned short falls will occur in the future.

b. When an *unplanned shortfall exists,* determine the extent of criticism that is to be made when short falls are lessened or corrected by an imprudent use of *alternative sources.* Based on the severity of the situation, determine whether the comments will be provided in the inspection report as answers to the questions on the Cash Flow Statement, or within the content of the ''Analysis of Financial Factors'' page, or the ''Examiner's Comments'' page.

BHC financial leverage is the use of debt to supplement the equity in a company's capital structure. It is anticipated that funds generated through borrowings will be invested and earn a rate of return above their cost so that the net interest margin generated will improve the company's net income, providing a higher rate of return on stockholders' equity which has otherwise remained constant. Since no creditor or lender would be willing to extend credit without the cushion and safety provided by the stockholders' equity, this borrowing process is also referred to as "trading on equity." That is, utilizing the existence of a given amount of equity capital as a borrowing base. Stockholders and management often view leveraging as a favorable financial alternative because if owners have provided only a small portion of total financing, much of the financial risk will be borne by the lenders, alleviating the need of the stockholders to assume the total risk. In addition, by raising funds through long-term debt, the owners gain the benefits of maintaining control of the firm with a limited investment rather than diluting existing ownership via the sale of additional capital stock.

There are, however, some unfavorable aspects in this type of financing. As a holding company substitutes debt for equity, keeping its asset size constant, its leverage ratio will increase. The increase in leverage increases the probability that a company may go into default since a larger portion of the income stream generated by earning assets must then be used to meet increased fixed charges (interest expense). (This assumes that increases in future earnings are not anticipated. While earnings may be sufficient to meet fixed interest expenses at the time the debt is issued, it is possible that future earnings will not be sufficient to meet the increased expenses.) In addition, utilization of leverage reduces management flexibility in making future decisions because lenders impose restrictive covenants that may limit future debt issues, limit dividend payments, or impose constraints on specific operating ratios. However, not all of the effects of increased leverage are unfavorable. Additional long-term debt may have the favorable effect of extending maturities on obligations and may improve liquidity.

Leverage ratios measure the contribution of owners compared with the financing provided by lenders. Companies with low leverage ratios generally have less exposure to loss when the economy is in a recession, but they may also have lower expected returns when the economy booms. Firms with high leverage ratios run the risk of large losses but also have a chance of earning high rates of return on equity and assets. Thus, if a company earns more on the borrowed funds than it pays in interest, the return to the owners is increased. For example, if the company earns 10 percent on assets and debt costs 8 percent, there is a 2 percent differential accruing to the stockholders. However, if the return on assets falls to 7 percent, the differential between that figure and the cost of debt must be made up from total profits.

A bank holding company is composed of at least two tiers, parent and subsidiary, and each tier may issue long-term debt in its own name. Several different types of long-term debt instruments are utilized by holding companies. Corporations make use of instruments such as debentures, convertible debentures, term loans, capital notes and mortgage notes. (See Manual section 2080.0—"Funding"). While most issues are generally sold to the public, in some cases, issues of subsidiaries have been placed directly with another subsidiary, the parent company, or perhaps with an unaffiliated banking institution. Alternatively, issues presently held on the books of the parent may have been originally issued by one of the subsidiaries and later transferred to the parent. These transfers have often occurred at the time of the formation of the holding company when debt of the subsidiaries was assumed by the parent.

The proceeds of parent company long-term debt may be advanced to banking subsidiaries as debt or invested in banking subsidiaries as equity. When parent debt is issued, and the proceeds are advanced to subsidiaries as debt, a condition of "***simple leverage***" exists. When such proceeds are invested in subsidiaries as equity, a condition of "***double leverage***" is said to exist since the increase in the subsidiary bank's capital base will allow the bank to increase its own borrowings.[1] In effect, the

1. Parent company "***total leverage***" may be defined as the relationship between equity at the parent level and the total assets of the parent company. Such assets typically consist of investments in bank and nonbank subsidiaries, advances to affiliates, deposits with bank affiliates and securities. A useful related measure of parent company leverage is "***investment leverage***" which may be defined as the relationship between parent equity and its equity investments in subsidiaries. Since the equity which has been invested in subsidiaries can, and often is, further leveraged by external borrowings of such subsidiaries, this type of parent company investment leverage can lead to what is referred to as "***double leverage***."

parent's capital injection which was funded by debt, provides the bank with greater debt capacity, thereby allowing the bank to borrow additional funds on its own. Therefore, the original borrowing by the parent has, in effect, been compounded when the bank borrows based on its newly injected equity.

If the parent debt is reinvested as equity in a bank, the servicing of interest and principal is usually provided by dividends paid to the parent by the bank subsidiaries. The bank dividends, however, may become restricted based on the bank's earning power which may not provide for sufficient retention of earnings to support its asset growth. Problems may be less severe when parent debt is downstreamed as debt to the bank subsidiary. When the terms and maturities of the indentures match, the obligation of a bank to meet its interest and principal payments to the parent are contractual and represent fixed charges (interest is tax deductible) which will continue up to the maturity of the note. When funds are downstreamed as equity and the bank typically issues dividends to its parent, it is easier to restrict the flow of funds from the bank than if the funds were downstreamed as debt which results in bank payments of interest expense. Bank dividend declarations are subject to limitations imposed by sections 5199(b) (12 U.S.C. 60) and 5204 (12 U.S.C. 56) of the United States Revised Statutes, while interest payments are not subject to such restrictions.

4010.1.1 ACQUISITION DEBT

Some holding companies use debt for the acquisition of subsidiary banks. The Board believes that a high level of acquisition debt can impair the holding company's ability to act as a source of strength to its bank subsidiaries, and thus does not favor the use of a substantial amount of acquisition debt in bank holding company formations. However, the Board recognizes that the use of acquisition debt in the formation of certain holding companies may be necessary, particularly when transferring the ownership of small community banks (approximately $150 million or less), and the maintenance of local ownership in those banks. To this end, and in the interest of maintaining a safe and sound banking system, the Board has adopted a policy for assessing financial factors in the formation of small one-bank holding companies. (see Manual section 2090.2)

4010.1.2 INSPECTION CONSIDERATIONS

Generally, it is not the examiner's responsibility to criticize the method of term financing used by a bank holding company. The examiner, however, should be familiar with the various types of leveraging and the possible ramifications that they may have on a holding company structure. While the use of ratios may show an excessive leverage position, indicating vulnerability, it is primarily the corporation's earning power that dictates the acceptable level of debt. Accordingly, the examiner should compute a holding company's ability to meet its fixed charges (as detailed in the preceding section) to determine the appropriateness of the leverage position. If the company's earnings do not support the present fixed charge requirements, or if a declining trend is noted, appropriate comments are warranted.

4010.2.1 INTRODUCTION

Liquidity is generally defined as the ability of a company to meet its short-term obligations, to convert assets into cash or to obtain cash, or to roll-over or issue new short-term debt. Short-term is generally viewed as a time span up to a year. Since a bank holding company does not have the full range of asset and liability management options available to it that a bank does in managing its liquidity position, it therefore, needs to have a sufficient cushion of liquid assets to support maturing liabilities. Certain assets which normally would not be considered current may be readily sold to avert a liquidity squeeze. For example, a holding company may be participating in long-term loans originated by a Small Business Investment Company (S.B.I.C.) subsidiary. If these loans are of good quality, the parent's share may be sold at little or no discount to that S.B.I.C. subsidiary, another subsidiary, or an unaffiliated company to obtain the needed cash. Consequently, the breakdown of assets segregating those that are current would not necessarily be indicative of liquid assets, given the nature of bank holding company investments. Therefore, liquid assets are defined as those assets which are readily available as cash or which can be converted into cash on an ''arm's-length'' basis without considerable loss.

Liquidity problems are usually a matter of degree of severity. A less serious liquidity problem may mean that the company is unable to take advantage of profitable business opportunities. A more serious lack of liquidity may mean that a company is unable to pay its short-term obligations and is in default. This can lead to the forced sale of long-term investments and assets and, in its most severe form, to insolvency and bankruptcy.

4010.2.2 SUPERVISORY APPROACH TO ANALYZING PARENT COMPANY LIQUIDITY

For bank holding companies with consolidated assets in excess of $1 billion or material amounts of debt outstanding, or others, at the option of the Reserve Bank, the analytical approach to parent company liquidity will include the following key elements:

1. Beginning an evaluation of parent liquidity with an analysis of the *contractual* maturity structure of assets and liabilities, extended to consider the underlying liquidity of its intercompany advances and deposits. Any judgment of *adequate* parent company liquidity must be keyed to a finding that the parent has adequate liquid assets, on an underlying basis, to meet its short-term debt obligations.
2. Estimating the underlying liquidity of parent liabilities and assets, giving particular attention to interest bearing deposits in and advances to subsidiaries. Emphasis should be placed on asset quality and the liquidity profile of the bank and key nonbank subsidiaries. The estimates are to be reflected in a statement of ''Parent Company Liquidity Position'' as restated data with appropriate explanations as to the basis for the restatement.
3. Using the statement of ''Parent Company Liquidity Position'' which includes five contractual and estimated underlying maturity categories into which data is to be slotted. They are:
   a. Up to 30 days;
   b. Up to 90 days;
   c. Up to 1 year;
   d. One to two years; and
   e. Beyond two years.

   The schedule provides for the use of effective remaining maturity categories for the parent company's short-term assets and liabilities, highlighting funding surpluses or deficits at key specified periods of times. *Examiners have the option of including the statement in the inspection report to substantiate or clarify particular judgments.*
4. Using the conclusions drawn from the statement of parent company liquidity position as a basis for discussions with management. Examiners will also comment on their findings in detail on the ''Analysis of Financial Factors'' page in the inspection report.
5. Ascertaining that an organization with significant funding activities has in place:
   a. Internal parent liquidity management policies which address and limit the use of short-term funding sources to support various subsidiaries; and
   b. An internal *Contingency Plan* for maintaining parent liquidity under adverse situations.

4010.2.3 STATEMENT OF PARENT COMPANY LIQUIDITY POSITION

The purpose of the statement of ''Parent Company Liquidity Position'' is to provide a consistent method for analyzing parent liquidity. The schedule is *not* intended to address the issue of interest sensitivity. While only conclusions drawn from the schedule of estimated, effective maturities are to appear in the inspection report, examiners should also collect data on contractual (remaining life) maturities of parent assets and liabilities. Examiners will treat all externally funded nonbank entities of the parent company in a similar fashion.

The maturity categories appearing on the schedule represent a basic analytical framework for looking at funding mismatches and are not necessarily appropriate for all organizations. As such, categories can be adjusted to fit particular circumstances. On a conceptual basis, the 30 day period corresponds to a period during which markets might be in temporary disarray due to an external shock. For the largest companies with substantial overnight and very short term funding operations, an additional one-to-seven-day category may be needed. The 31 to 90 day period allows for gauging the parent's ability to withstand internal adversity and demonstrate a return to ''normal'' business operations. The 91 to one year period is a reasonable planning horizon over which an organization might be able to readjust its internal funding policies substantially. In addition, the up to one year categories, as a group, complement the cash flow analysis of debt servicing capacity by specifically addressing maturing debt that must be either paid or rolled over at prevailing rates. The one to two year category provides an early indication of any funding imbalances that would have to be addressed by management in the reasonably near term. As a practical matter, the over two year category has limited analytical value in most cases and is included principally to make certain that all deposits and advances are accounted for.

Using these categories, funding surpluses or deficits can be identified for specific maturity intervals. Guidelines on acceptable practices for funding surpluses and shortfalls are set for the examiners in evaluating gaps based on estimated ''underlying'' maturities. Examiners would be expected to place particular emphasis on the up to 30 day period, where a net liquidity surplus would be expected to provide at least that much time for a parent to ride out a shock. Similarly, the up to 90 day period would be viewed as the relevant time to demonstrate to the market that problems are being addressed appropriately and are being brought under control. Imbalances in the 91 day to one year categories would generally have less significance, due to greater uncertainty regarding the assumptions that would go into any adjustments.

A logical point for assessing parent liquidity is an assessment of the contractual maturity structure of the holding company's balance sheet. Contractual maturities of assets and normal run-off of liabilities are to be slotted into the five maturity categories depicted. Once completed, the examiner is provided with an initial indication of whether the parent has an adequate cushion of short-term liquid assets within the 0 to 30 day and the 0 to 90 day categories to cover short-term liabilities or whether a pattern of significant short-term funding gaps exists. Certainly, the identification of such gaps gives guidance on obvious areas for further analysis. However, the absence of short-term funding shortfalls on a strictly contractual basis gives only limited comfort as the parent's underlying liquidity still must be analyzed more deeply.

4010.2.4 ANALYSIS OF UNDERLYING SOURCES TO FUND DEBT AND TO MEET OTHER OBLIGATIONS

Adjustments to the schedule that better reflect the parent's liquidity position will be made as the next step in the analysis. These adjustments require the examiner's judgment on the underlying liquidity of the parent's assets and liabilities with particular emphasis placed on interest bearing deposits with bank subsidiaries and advances to both bank and nonbank subsidiaries.

4010.2.4.1 Interest Bearing Deposits With Subsidiary Banks

The parent's interest bearing deposits[1] with the subsidiary bank(s) may represent either the temporary placement of idle funds or a more permanent source of bank funding. Temporary deposits typically are structured to mature in 90 days or less, are generally not substantial in relation to the overall size of the bank, are usually supported by substantial holdings of highly liquid bank assets, and could be repaid without triggering marketplace concerns regarding the organization's overall funding needs. Therefore, if this pattern exists, the temporary deposits may

1. In concept, the parent could also have advances to bank subsidiaries. Such advances are either booked as deposits (typically off-shore time deposits to avoid reserve requirements) or as instruments qualifying as Tier 1 or Tier 2 capital. To the extent that advances to banks are encountered, the analysis follows the same approach as with deposits.

be considered highly liquid and slotted in the 0 to 30 day (or 0 to 7 day) period on the schedule, regardless of their contractual maturity dates.

Interest bearing deposits with the subsidiary bank(s) that serve as a permanent source of bank funds are typically substantial in relation to the size of the bank and are usually placed to fund bank expansion without additional bank borrowings. Here, judgments regarding underlying liquidity should be keyed to the CAMELS ratings on the bank's liquidity and asset quality as well as reasoned judgments on the bank's ability to liquidate assets and/or replace the funds in the marketplace through additional borrowings. Asset quality is regarded as critical as it is a leading indicator of bad news that will ultimately pull down earnings and undermine market confidence. As a general principle, the liquidity of the parent's deposits in bank(s) should be no better than the liquidity of the bank(s), and subject to downgrading if bank asset quality is suspect. If bank asset quality is worse than fair, the liquidity of these funds should be downgraded. For banks with asset quality rated fair, the parent's deposits might still be considered liquid, but a closer analysis of the particular situation would be warranted.

Under the assumption that the bank's asset quality and liquidity positions do not negatively impact the bank's ability to liquidate or replace these funds, such deposits may be slotted in the 0 to 30 day (or 0 to 7 day for large institutions) period on the schedule regardless of the contractual maturity. However, if these deposits are substantial, their replacement may trigger market concerns. At this point, the examiner's judgment is necessary regarding an acceptable level at which a portion of the deposits could be replaced in the marketplace without triggering such concerns. A starting point for the examiner should be to evaluate the funding gaps appearing on the contractual maturity schedule with particular attention paid to the 0 to 90 day period (0 to 30 days for large institutions). While it may be impossible for the bank(s) to replace all the parent's deposits without triggering concerns, the bank(s) may be able to replace only the portion necessary to eliminate the negative cumulative funding gap in the given time period. If even this amount is deemed to be substantial, the examiner may have no other alternative but to treat the deposits in accordance with the contractual maturity. For clarification purposes, the following example is provided:

The contractual maturity schedule of a large holding company reflects a negative cumulative gap of $400 million in the 0 to 30 day time frame. The company's balance sheet includes $2.5 billion in interest bearing deposits at the subsidiary bank(s), with $1 billion maturing in 30 days and $1.5 billion in 31 to 90 days.

In the examiner's judgment, the entire $1.5 billion due in over 30 days qualify to be slotted in the under 30 day category,[2] but the bank would face liquidity pressures to replace this amount prior to its original maturity. However, $400 million, the amount needed to eliminate the negative cumulative gap position, could be replaced by the bank without undue market concern. Therefore, $400 million from the 31 to 90 day period should be reslotted in the appropriate under 30 day period.

4010.2.5 ADVANCES TO SUBSIDIARIES

Given the typical composition of bank holding company assets, the examiner is likely to encounter difficulty in determining the degree of liquidity inherent in advances to subsidiaries.

For those subsidiaries with satisfactory asset quality, the examiner can usually assume the subsidiary could sell qualifying assets to affiliate bank(s) up to the quantitative limitations of section 23A, as long as the affiliated bank(s) are judged to have adequate liquidity. The examiner can also assume that the subsidiary, with an established program of secondary market asset sales, could at least continue or even modestly expand the scope of the program. For subsidiaries without a program of asset sales, but whose assets are of the type that are readily marketable in the secondary market, a *limited* asset sale program could be considered to provide some asset liquidity. However, caution should be used in estimating the magnitude of such sales, particularly because large transactions could not be accomplished quickly without risking market visibility and broadcasting concerns regarding the corporation's funding.

When nonbank advances are substantial, the parent has little or no practical access to the funds advanced. While an arm's-length sale of such a subsidiary or a large portion of its assets to a bank affiliate may not generate a loss, the funding requirements for a large transaction at the bank level would probably initiate market-

2. Subject to early withdrawal penalties which will be eliminated in consolidation.

place concerns.[3] Similarly, significantly above normal asset sales to an unaffiliated party would not only trigger market concerns, but would probably also result in a significant discount. Furthermore, although it is possible that another nonbank subsidiary may act as the funding vehicle, the subsidiary's ability to generate the required funds may be restricted at best. Such restrictions may include marketplace concerns as well as limitations on the maximum leverage positions or creation of senior debt imbedded in debt covenants.

Advances to a subsidiary may be either short-term or long-term and are made for a variety of reasons, including providing a temporary source of income for the parent, enhancing a subsidiary's liquidity position, and supporting a subsidiary's operations. Therefore, the purpose of the loan, its maturity, as well as the degree to which high quality assets of a subsidiary cover the amount due to the parent, should also be considered in order to properly categorize advances.

4010.2.6. LIQUIDITY AND LIABILITIES OF THE PARENT

In regard to liabilities of the parent, the policy presumption should be that their contractual maturity reflects the underlying availability of funds. Exceptions will reflect special circumstances, such as funding from foreign ownership interests or partners in joint ventures who have equity interests and an ongoing business relationship. The presence of back-up lines of credit for commercial paper, while especially desirable in the case of regional companies, should not, by itself, cause an examiner to assume that the underlying maturity of a parent's short-term debt is materially longer than its contractual term, or that these lines will always be readily available. In fact, organizations experiencing considerable problems, particularly asset quality and liquidity, have found that these facilities are no longer available.

The examiner should thus review back-up lines on a case-by-case basis and be aware of any escape clauses in interbank agreements. Specifically, for companies with a composite "3" or worse BOPEC rating *or* lead banks with asset quality of a declining "3" or worse *or* where asset quality *and* liquidity are rated "3" or worse, it is recommended that back-up lines with "material adverse change" or similar escape clauses *not* be regarded as satisfactory support to an imbalanced parent company funding position.

Furthermore, certain holding companies' liabilities may often include unamortizing debt instruments. The company's ability to retire or replace such issues at maturity should be evaluated as part or the organization's overall liquidity analysis. If it is the intention of management to roll over the maturing issues, the evaluation should be based on the company's ability to do so. In cases where debt retirement is the route chosen by management, the examiner's evaluation and judgment should focus on the company's ability to generate the necessary funds either through asset liquidation or the issuance of equity instruments.

The unamortizing portion of debt issues is to be slotted in the appropriate maturity column of long-term debt. If the maturity of such issues falls due within the 0 to 90 day time frame, the examiner should comment on the organization's ability to replace the maturing issues or retire them by the deployment of funds from other sources in a footnote on the schedule. If the maturity of such debt is longer, the replacement or retirement should be addressed in the corporation's funding plan.

4010.2.7 ANALYZING FUNDING MISMATCHES

After adjustments for the underlying liquidity of the parent's interest bearing deposits and advances to subsidiaries and the underlying maturity of its liabilities, the resulting schedule should provide the examiner with the framework for looking at funding mismatches as a tool for assessing the parent's overall liquidity position. The position may be evaluated by the analysis of the underlying liquidity gaps (appearing on the bottom of the schedule). In the 0 to 30 day time frame, a net positive gap is expected and reflects the parent's ability to ride out a temporary market disarray. Although a negative gap in the 8 to 30 day period may be evident in larger organizations, the overall 30 day interval is expected to be positive. Similarly, for most organizations, the 0 to 90 day period is expected to reflect a positive position, regardless of a shortfall in the 31 to 90 day period. Failure to meet these conditions requires appropriate examiner comments on the "Examiner's Comments" page of the report.

The 91 day to 1 year time frame (as well as

3. Underlying liquidity estimates should follow the same approach previously stated for deposits.

the 31 to 90 day period for certain larger organizations) is less critical, and negative cumulative funding positions of modest size may be tolerated if the organization has demonstrated an ability to tap the funding markets, has readily available backup lines of credit, has a reasonable earnings retention policy, adequate funds flow coverage and other fund generating programs such as a dividend reinvestment plan. Judgments on the reasonableness of any imbalances in these longer term categories should be weighed against the examiners' estimates as to the adequacy of these sources. In addition, the examiner should view these longer periods as a reasonable planning horizon over which the organization should be able to readjust its funding policies as well as provide an early indication of how funding imbalances, that may develop, are to be addressed by management.

A significant shortfall in the 91 day to 1 year period is expected to be covered by a contingency funding plan. While no single formula for such plans is recommended or possible, each organization needs to address its own particular situation and the options it faces. At minimum, the organization needs to address possible market shocks whether caused by its own actions or by external events. Funding markets should be addressed individually and as a group both as to their likely resiliency and the particular organization's position within each market. Contingency sources should be tested periodically as to their viability. The examiner should review the reasonableness of assumptions and adequacy of alternative courses as part of the company's liquidity analysis. Where no plan exists, a plan acceptable to the corporation's directors should be required. Even if there are no specific concerns, the existence or lack of a plan should be taken into account when assessing management.

In analyzing liquidity, the examiner will encounter the least difficulty when liquid assets equal or exceed short-term liabilities. In those instances, the liquidity position is considered adequate. If the examiner notes a declining trend in the liquidity position, an appropriate comment may be warranted, even though sufficient liquidity exists at that time.

Conversely, the examiner will encounter the most difficulty in analyzing liquidity when liquid assets are not sufficient to cover short-term obligations. When this situation exists, it is not necessarily indicative of an inadequate liquidity position. At that point, the examiner must consider other readily available sources of cash not shown on the balance sheet (e.g., unused bank lines, dividends from subsidiaries).

Footnotes to financial statements may also play an important role in such an analysis. One such footnote may be indenture restrictions on long-term debt. While a company may temporarily alleviate a liquidity bind by paying off its commercial paper with short-term bank loans, it may be faced with the problem of paying off the bank debt if it is precluded from issuing additional long-term debt.

4010.2.8 REPORTING THE RESULTS OF THE ANALYSIS

In the normal course of the inspection, the examiner should present his conclusions concerning liquidity to management. Where there is an indication of some vulnerability, the examiner should solicit management's opinion and any corrective action plans being considered. If it appears that management has not addressed itself to the vulnerable or inadequate situation, an appropriate comment should be made. The results of this analysis should be discussed in the parent company section on the ''Analysis of Financial Factors'' page in the inspection report. In addition, the examiner has the option of incorporating the liquidity schedule in the report to substantiate or clarify particular judgments. Criticism with respect to a liquidity shortfall anywhere within the 0 to 90 day time frame or, in most cases, the absence of a Contingency Plan to cover shortfalls in the under 1 year time frame, should be carried forward to the ''Examiner's Comments'' page, the transmittal letter, and be included in discussions with management.

4010.2.9 INSPECTION OBJECTIVES

1. To analyze the contractual maturity structure of assets and liabilities, and then extend the analysis to the underlying liquidity of intercompany advances and deposits, considering whether the underlying liquidity is short-term or long-term in nature.

2. *To estimate the underlying liquidity of parent liabilities and assets,* with particular attention to interest bearing deposits in, and advances to, subsidiaries. Place emphasis on:

a. Asset quality; and

b. The liquidity profile of the bank and key nonbank subsidiaries.

3. To restate the estimates on the analysis of

''Parent Company Liquidity Position'' using the suggested *5 broad contractual and underlying maturity categories.*

4. *To judge the adequacy of parent company liquidity,* keying it to a finding as to whether the parent has adequate liquid assets, on an underlying liquidity basis, to meet its short term debt obligations.

5. For *BHC's that have significant funding activities* at the parent level, to determine if the parent company has in place:

a. *Internal parent liquidity management policies* which address and limit the use of short term funding sources to support subsidiaries.

b. An internal *Contingency Plan* for maintaining parent liquidity in the face of adversity.

6. To draw conclusions from the estimated remaining effective maturities that appear in the report.

4010.2.10 INSPECTION PROCEDURES

1. Assess the contractual maturities of the parent company's balance sheet.

2. Slot the contractual maturities of assets and normal runoff of liabilities into the five categories on the ''Parent Company Liquidity Position'' page.

3. On the schedule, make adjustments, as to the underlying maturity of the parent company's assets and liabilities.

4. Review funding mismatches.

5. *Review the reasonableness of the Contingency Plan's assumptions and adequacy of alternative sources*.

a. If no plan exists, a plan acceptable to the corporation's directors should be required.

b. Even if there are no specific concerns, the existence or lack of a plan should be taken into account when assessing management.

6. Discuss the results in the parent company section of the ''*Analysis of Financial Factors*'' page in the inspection report.

7. Include in the ''*Examiner's Comments*,'' page 1, *criticism of liquidity shortfalls within the 0 to 90 day period or the absence of a contingency plan to cover shortfalls in the under one year time frame*, that were discussed with management.

In making the determination as to the condition of the holding company under inspection, an examiner must, as part of his examining procedure, focus his efforts on analyzing the financial condition of the bank(s) owned by the holding company. Such an appraisal is obviously of paramount importance when one considers that the bulk of the consolidated assets and earnings of a holding company are represented by the bank(s). The examiner must incorporate in the analysis, results of the most recent commercial examination of the subsidiary bank(s).

Therefore, for meaningful results, the analysis of the subsidiary bank(s) should commence after the results of the latest examination of the bank(s) have been obtained. The examiner in his analysis of the bank must consider and determine whether certain key facets of a bank's operations meet minimum standards and conform, where required, to bank regulatory restrictions. Areas of principal concern are: capital adequacy, asset quality, earnings, liquidity, and quality of management. The examiner should be especially alert to any exceptions or violations of applicable statutes or regulations that could have a materially adverse effect upon the financial condition of the organization. In addition, the examiner should also consider the conclusions drawn as to the extent of compliance and the adequacy of internal bank policies that contribute to the overall analysis of the bank's condition.

Inspection personnel should use the examination ratings of the other federal agencies (where appropriate) when completing the inspection report. However, if substantive differences of opinion exist as to the bank's composite rating, adjustments to the rating may be made and footnoted to indicate the change.

One area of vital importance in the evaluation of a bank's condition is capital adequacy. Consideration should be given by the examiner whether the bank has sufficient capital to provide an adequate base for growth and a cushion to absorb possible losses, thereby providing protection to depositors. In that regard, the Board, has adopted capital adequacy guidelines, that include risk-based and leverage measures which apply to state member banks. The examiner should refer to section 303.1 of the *Commercial Bank Examination Manual* for guidance on evaluating the capital adequacy of state member banks.

The quality of a bank's assets is another area of major supervisory concern. Indeed, supervisors consider the appraisal and evaluation of a bank's assets to be one of the most important examination procedures. It will be established by the bank examiner during the examination of a subsidiary bank to what degree its funds have been invested in assets of good quality that afford reasonable assurance of ultimate collectibility and regularity of income. The examiner should have further determined that a subsidiary bank's asset composition is compatible with the nature of the business conducted by the bank, the type of customer served, and the locality. The holding company examiner is expected to comment upon the total classifications determined by the bank examiner in relation to the bank's capital. Consideration should also be given to the severity of the classifications. If the classified assets are considered not to possess a significant loss potential, favorable consideration should be accorded this factor.

Past due ratios should also be evaluated. In this respect, it is essential that trends be observed. Although a particular lending department's delinquent outstandings or an institution's overall past due percentage is presently considered reasonable, a noticeable upward trend may be worthy of comment to management. Excessive arrearages in any area warrant an examiner's comment in the inspection report. It behooves management to take appropriate action to improve any undesirable past due levels.

In determining an organization's asset quality, one effective yardstick employed by examiners is the ''weighted average'' of classifications, which takes into consideration the severity of a bank's classified assets. In rating asset quality, the ''weighted average'' of classifications system is designed to distinguish the degree of risk inherent in classified assets by ascribing weights to each category of classification thereby providing a more reliable measure of the impact of risk on bank capital.

The following weights are to be used:

Classification	*Weights*
Substandard	20%
Doubtful	50%
Loss	100%

The ratio of weighted classifications to Tier 1 capital is the primary criterion to be used in determining the quality of assets. However, examiners should also evaluate the adequacy of loan loss valuation reserves as compared to weighted classifications. Loss potential inherent in weighted classified assets must be offset by valuation reserves and equity capital or appropriate comments should be made.

Another tool that should be considered in evaluating asset quality is the bank's internal classification list, if the bank's lending procedures and management are adequate. Additional information on rating a bank's asset quality is available in the Uniform Interagency Bank Rating System.

Comparison of earnings trends with other banks of similar size, along with an analysis of the quality of those earnings, is probably the best initial approach in determining whether or not a bank's earnings are satisfactory. Comprehensive surveys of bank earnings by peer group size are tabulated by the Board and many of the Reserve Banks. The results are sufficiently detailed to permit various methods of comparison of the earnings of a specific bank with those in its peer group.

One ratio used as a means of measuring the quality of a bank's earnings is its return on average assets (net income after taxes divided by average total assets). If the ratio is low or declining rapidly, it could signal, among other things, that the bank's net interest income or margin is declining or that the bank is experiencing increased loan losses.

A bank's current earnings should be sufficient to allow for ample provisions to offset anticipated normal losses. Various factors to be considered in the determination of such losses include a bank's historic loss experience, the adequacy of the valuation reserve, the quality and strength of its existing loans and investments and the soundness of the loan and administrative policies of management.

In assessing a bank's earnings performance capabilities and the quality of those earnings, an examiner should give consideration to any special factors that may affect a particular bank's earnings. For example, a bank located in an urban area of a large city may find it difficult to earn as much as a bank of similar size located in a rural community or a small city. The urban bank is usually subjected to a higher level of operating expenses, particularly in salaries and local taxes. Moreover, its proximity to the large city and the competition afforded by bigger banks may necessitate lower rates of interest on loans as well as higher rates of interest on time deposits. Consideration should also be given to the adequacy of the loan loss provisions as referred to above, the inclusion of any capitalized accrued interest into interest income, or the nature of any large nonoperating gains when analyzing earnings. Further consideration should be given to the general nature of a bank's business or management's mode of operation. A bank's deposit structure and its resulting average interest paid per dollar of deposits may differ widely from that of other banks of a similar size and consequently, its earnings may be substantially below average as a direct result of the difference. For example, the maintenance of a high volume of interest bearing time accounts in relation to total deposits is a major expense and is quite often the cause for certain banks falling below the average earnings of comparably sized banks.

A bank's earnings should also be adequate in relation to its current dividend rate. The percentage that should be retained in the capital accounts is not clearly established. One thing is certain, the need for retained earnings to augment capital will depend on the adequacy of the existing capital structure as well as the bank's asset growth rate. Dividend payout rates may be regarded as exceeding prudent banking practices if capital growth does not keep pace with asset growth. Prudent management dictates that a curtailment of the dividend rate be considered if capital inadequacy is obvious and greater earnings retention is required. Apparently excessive dividend payouts or a record of recent operating losses should lead the bank or BHC examiner to refer to sections 5199(b) and 5204 of the United States Revised Statutes and section 208.19 of Regulation H which restrict state member bank dividends.

Analysis of net interest margins is of growing importance. A comparison should be made of a bank's ability to generate interest income on earning assets relative to the interest expenses associated with the funds used to finance the earning assets.

Additional information on rating bank earnings is available in the Uniform Interagency Bank Rating System.

Liquidity is generally defined as the ability to meet short-term obligations, to convert assets into cash or obtain cash, or to roll over or issue new short-term debt. Various techniques are employed to measure a bank's (depository institution) liquidity position. The bank examiner considers the bank's location and the nature of its operations. For example, a small rural bank has far different needs than a multibillion dollar money market institution.

In addition to cash assets, a bank will hold for liquidity purposes a portion of its investment portfolio of securities that are readily convertible into cash. Loan and investment maturities are generally matched to certain deposit or other liability maturities. However, the individual responsible for a bank's money management must be extremely flexible and have alternate means to meet unanticipated changes in liquidity needs. To offset these needs, other means of increasing liquidity may be needed, which might include increasing temporary short-term borrowings, selling longer-term assets, or a combination of both. Factors that the ''money management'' officer will consider include the availability of funds, the market value of the saleable assets, prevailing interest rates and the susceptibility to interest-rate risk, and the bank's earnings position and related tax considerations. Although most small banks do not have a ''money manager,'' they too must monitor their liquidity carefully.

One of the most common methods used by large banks to increase liquidity is to use additional borrowings. Some of the other basic means of improving liquidity include the use of direct short-term credit available through the discount window from Reserve Banks, the use of Federal funds purchases, and the use of loans from correspondent banks.

4020.4.1 SOUND LIQUIDITY-RISK MANAGEMENT

All banks are affected by changes in the economic climate, and the monitoring of economic and money market trends is crucial to liquidity planning. Sound financial management can minimize the negative effects of these trends while accentuating the positive ones. Sound liquidity-risk-management requires the following four elements:[1]

1. Well-established strategies, policies, and procedures for managing both the sources and uses of an institution's funds across various tenors or time frames. This includes assessing and planning for short-term, intermediate-term, and long-term liquidity needs.
2. Liquidity-risk measurement systems that are appropriate for the size and complexity of the institution. Depending on the institution, such measurement systems can range from simple gap-derived cash-flow measures to very sophisticated cash-flow simulation models.
3. Adequate internal controls and internal audit processes designed to ensure compliance with internal liquidity-management policies and procedures.
4. Comprehensive liquidity contingency plans that are well designed, span a broad range of potential liquidity events, and are tailored to an institution's specific business lines and liquidity-risk profile.

Information that a bank's management should consider in liquidity planning includes—

1. internal costs of funds,
2. maturity and repricing mismatches in the balance sheet,
3. anticipated funding needs, and
4. economic and market forecasts.

In addition, bank management must have an effective contingency plan that identifies minimum and maximum liquidity needs and weighs alternative courses of action designed to meet those needs. Some factors that may affect a bank's liquidity include—

1. a decline in earnings,
2. an increase in nonperforming assets,
3. deposit concentrations,
4. a downgrading by a rating agency,
5. expanded business opportunities,
6. acquisitions,
7. new tax initiatives, and
8. the need to maintain a plan that ensures adequate access to a diversified array of readily accessible confirmed funding sources,

1. See the July 23, 2003, Interagency Advisory on the Use of the Federal Reserve's Primary Credit Program in Effective Liquidity Management, issued by the federal financial institution regulatory agencies. The interagency advisory supplements and does not replace existing agency guidance or policy.

including liquid assets such as high-grade investment securities and a diversified mix of wholesale and retail borrowings.

Adequate liquidity contingency planning is critical to the ongoing maintenance of the safety and soundness of any depository institution. Contingency planning starts with 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 or systemic market or operational circumstances. Responses to these events should be assessed in the context of their implications for an institution's short-term, intermediate-term, and long-term liquidity profile. A fundamental principle in designing contingency plans for each of these liquidity tenors is to ensure adequate diversification in the potential sources of funds that could be used to provide liquidity under a variety of circumstances. Such diversification should focus not only on the number of potential funds providers but also on the underlying stability, availability, and flexibility of funds sources in the context of the type of liquidity event these sources are expected to address.

4020.4.2 LIQUIDITY-RISK MANAGEMENT USING THE FEDERAL RESERVE'S PRIMARY CREDIT PROGRAM

The Federal Reserve's primary credit program (a type of discount window lending) offers generally sound depository institutions an additional source of available funds, although such funds are lent for managing short-term liquidity risks (at a rate above the target federal funds rate).[2] Management should fully assess the potential role that the Federal Reserve's primary credit program might play in managing the institution's liquidity. The primary credit program can be a viable source of very short-term backup funds. Management may find it appropriate to incorporate the availability of the primary credit program into their institution's diversified liquidity-management policies, procedures, and contingency plans. The primary credit program has the following attributes that make it a viable source of backup or contingency funding for short-term purposes:

1. Primary credit is extended, with minimal administrative burden, to eligible discount window participants.
2. Primary credit is available only to financially sound depository institutions, as determined by the lending Federal Reserve Bank.
3. Primary credit can enhance diversification in short-term funding contingency plans.
4. Borrowings can be secured with an array of collateral that is acceptable to the lending Federal Reserve Bank, including consumer and commercial loans.
5. Requests for primary credit advances can be made anytime during the day.[3]
6. There are generally no restrictions on the use of short-term primary credit.

If an institution incorporates primary credit into its contingency plans, the institution should ensure that it has in place with the appropriate Reserve Bank the necessary borrowing documentation and collateral arrangements. This is particularly important when the intended collateral consists of loans or other assets that may involve significant processing or lead time for pledging to the Reserve Bank.

It is a long-established sound practice for institutions to periodically test all sources of contingency funding. Accordingly, if an institution includes the Federal Reserve's primary and other credit programs, along with borrowing from other lenders, in its contingency plans, management should occasionally test the institution's ability to borrow from all the funding sources covered by the plan. The goal of such testing is to ensure that there are no unexpected impediments or complications in the case that such contingency lines need to be used.

Institutions should ensure that any planned use of primary credit is consistent with the stated purposes and objectives of the program. Under the primary credit program, the Federal Reserve generally expects to extend funds on a very short-term basis, usually overnight. Therefore, as with any other type of short-term contingency funding, institutions should ensure that

2. The Federal Reserve's secondary credit program provides loans to qualifying depository institutions (for example, those depository institutions that are not eligible for the primary credit program) at an interest rate that is above the primary credit program's interest rate. See section 3010.1 of the *Commercial Bank Examination Manual* for a further discussion of the Federal Reserve's credit programs.

3. Advances generally are booked at the end of the business day.

any use of primary credit facilities for short-term liquidity contingencies is accompanied by viable take-out or exit strategies to replace this funding expeditiously with other sources of funding. Institutions should factor into their contingency plans an analysis of their eligibility for primary credit under various scenarios, recognizing that if their financial condition were to deteriorate, primary credit may not be available. Under those scenarios, secondary credit may be available.

Secondary credit is available at a rate above that of primary credit. Secondary credit is available to meet short-term needs (when the borrowing is constant and there is a prompt return to market funding sources) or to resolve financial difficulties. The preparations made by a bank to access primary credit (the documentation and collateral requirements) will also support the borrowing of secondary credit.

Another critical element of liquidity management is an appropriate assessment of the costs and benefits of various sources of potential liquidity. This assessment is particularly important in managing short-term and day-to-day sources and uses of funds. Given the above-market rates charged on primary credit, institutions should ensure that they adequately assess the higher costs of this form of credit relative to other available sources. Extended use of any type of relatively expensive source of funds can give rise to significant earnings implications which, in turn, may lead to supervisory concerns.

It is also important to note that the Federal Reserve's primary credit facility is only one of many tools institutions may use in managing their liquidity-risk profiles. An institution's management should ensure that the institution maintains adequate access to a diversified array of readily available and confirmed funding sources, including liquid assets such as high-grade investment securities and a diversified mix of wholesale and retail borrowings. (See SR-03-15.)

4020.4.2.1 Supervisory and Examiner Considerations

Because primary credit can serve as a viable source of backup, short-term funds, supervisors and examiners should view the occasional use of primary credit as appropriate and unexceptional. At the same time, however, supervisors and examiners should be cognizant of the implications that too-frequent use of this source of relatively expensive funds may have for the earnings, financial condition, and overall safety and soundness of the institution. Overreliance on primary credit borrowings, or any other single source of short-term contingency funds, regardless of the relative costs, may be symptomatic of deeper operational or financial difficulties. Importantly, the use of primary credit, as with the use of any potential sources of contingency funding, is a management decision that must be made in the context of safe and sound banking practices.

4020.4.3 ANALYSIS OF LIQUIDITY

A bank's liquidity must be evaluated on the basis of the bank's capacity to satisfy promptly its financial obligations and its ability to fulfill the reasonable borrowing needs of the communities it serves. An examiner's assessment of a bank's liquidity management should not be restricted to its liquidity position on any particular date. Indeed, the examiner should also focus his efforts towards determining the bank's average liquidity over a specific time period. The examiner's evaluation should also encompass the overall effectiveness of the institution's asset-liability management and liquidity risk-management strategies. Factors such as the nature, volume, and anticipated takedown of a bank's credit commitments should also be considered in arriving at an overall rating for liquidity.

If the bank examiner has commented on a liquidity deficiency at a subsidiary bank, the holding company examiner should consider these findings in the overall analysis of financial factors. Additional information on rating a bank's liquidity is available in the Uniform Interagency Bank Rating System.

The condition of a bank provides important insight regarding the quality of bank management. An appraisal of management's performance should be measured in terms of long-term profitability, risk exposure, liquidity, and solvency; all geared toward assuring the bank's continued profitability and overall sound financial condition. Management must meet the bank's challenges and position in the market place among its competitors. It must make plans which will achieve the objectives established by the bank's directors. Management must be constantly alert to the need for continued upgrading and expanding of services and facilities to advance, support, and encourage the bank's growth.

Just as sound management decision making will generally produce banks that are free from serious problems, ineffective management has invariably been a prominent factor in almost every serious problem bank situation. An examiner must consider the degree and severity of problems that exist in the bank under examination and attempt to establish the responsibility for such. The examiner should seek to determine to what degree the bank's problems are attributable to questionable management judgment as opposed to outside factors, such as unfavorable economic conditions.

As indicated at the beginning of Part IV, the major portion of the holding company's consolidated assets are held in the bank subsidiaries. Furthermore, at the parent level, the major asset is generally the investment in subsidiaries, the principal portion of which is the investment in the bank(s). Therefore, with few exceptions, it is the overall condition of the bank subsidiaries that reflects the condition of the parent company. As the holding company examiner reviews the examination report(s) for each bank subsidiary, a decision must be made with respect to the general condition of each bank. When all the bank subsidiaries have been reviewed, the examiner must put these findings within their proper perspective. For example, if four of five bank subsidiaries comprise less than 10 percent of the combined banking assets, it is the condition of the fifth bank subsidiary that will weigh heavily in the analysis. In other words, if the fifth bank comprises 90 percent of the combined banking assets, the parent's investment in that bank also comprises most of the holding company's assets. Thus, the quality of the parent's assets would be reflected in the general condition of that bank and appropriate comments are warranted. It should be noted, however, that regardless of relative size, a bank experiencing problems should be commented upon in the summary analysis.

4020.9.1 DEFINITION AND SCOPE OF THE DE NOVO BANK SUPERVISION POLICY

The term ‘‘de novo bank’’ refers to a state member bank that has been in operation for five years or less. The application and supervision standards for de novo state member banks are found in SR-91-17. De novo state member bank subsidiaries of bank holding companies are subject to those policies. The standards discussed in this section are limited to a de novo subsidiary bank's financial performance.

The de novo policy also extends to commercial banks that have been in existence for less than five years and subsequently convert to membership. Because thrifts, Edge Act companies, and industrial banks that are converting to membership (‘‘converted banks’’) have not demonstrated operating stability as commercial banks, they also are subject to the de novo policy, regardless of how long they existed before the conversion.

The policy applies to de novo banks through the fifth year of operations. Experience has shown that pronounced problems often surface during a new bank's fourth and fifth years of operation, frequently as a result of inexperienced management, management and director changes, dissension among directors, directors' lack of involvement, and poor lending practices during the early years.

4020.9.2 CAPITAL STANDARDS FOR SUBSIDIARY BANKS OF BHCs

De novo subsidiary banks of bank holding companies are expected to maintain capital in conformance with the de novo policy guidelines of SR-91-17. Initial capital in a de novo state member bank should be reasonable in relation to state law, the bank's location and business plan, and the competitive environment. At a minimum, a de novo bank must maintain a tangible Tier 1 leverage ratio of 9 percent for the first three years of operation.[1] The applicant's (that is, the proposed state member bank's or the bank holding company's) initial projections of asset growth and earnings performances should be reasonably in line with the bank's ability to maintain this ratio without relying on additional capital injections. The de novo policy also applies to newly converted commercial banks through the third year of existence and to other types of institutions that become Federal Reserve members for a three-year period beginning from the date following consummation. Any exceptions to this policy that are being considered for converted banks should be discussed with Board staff. Although a 9 percent tangible leverage ratio is not required after year three, de novo banks are expected to maintain capital ratios commensurate with safety-and-soundness concerns and, generally, well in excess of regulatory minimums.

4020.9.3 CASH FLOWS TO A BHC PARENT

Under the current policy on small one-bank holding companies (see section 2090.2.3), de novo banks may not provide funds for servicing the parent's debt until the bank receives two consecutive CAMELS ratings of 1 or 2 based on full-scope examinations and, in the judgment of the Reserve Bank, can be expected to continue operating soundly. An exception to this prohibition is the tax payments that are made in accordance with the Board's policy under Regulation Y (see section 2070.0 and *FRRS* 4–870).

1. Although this policy applies to a bank holding company's acquisition of a de novo state member bank, the Federal Reserve also encourages bank holding companies' nonmember bank subsidiaries to adhere to the same standards.

4030.0.1 INTRODUCTION

Generally, a subsidiary of a bank holding company is not liable for debts of any other subsidiary of the holding company unless it is contractually obligated through guarantees, endorsements, or other similar instruments. This apparent legal separation may induce false confidence that banks are insulated from problems that may befall other subsidiaries of the holding company. If a nonbank subsidiary of a bank holding company finds itself in serious financial trouble, several results are possible. The holding company may work as it was intended, in that debts of the failing subsidiary are isolated and not transferred to other subsidiaries so that at worst, the subsidiary and the parent (the holding company) fail. In this instance, other subsidiaries, including bank subsidiaries, are unharmed, and after a change in management or ownership, they continue in operation. There is no loss of confidence in the bank by its depositors. However, this is not necessarily the result.

Failure of a nonbank subsidiary may lead to a lack of confidence in the affiliated bank's ability to continue in business, which might precipitate a run on the bank's deposits. The failure of a major nonbank subsidiary then may place its affiliated bank in serious financial trouble. The examiner should assess the impact that the failure or the potential failure of a nonbank subsidiary may have on an affiliated bank with a similar name.

Usually, a financially distressed nonbank subsidiary is aided by the holding company, which will do everything in its power to rescue it from failure. At a minimum, refusal to do so would undermine confidence in the strength of the holding company. Refusal to aid its nonbank subsidiary might even result in a rise in the interest cost of the holding company's future debt in the capital markets and, more than likely, preclude issuance of commercial paper.

A holding company has considerable discretion in choosing how to assist one of its troubled subsidiaries. Because the bank is usually the largest subsidiary, the holding company may attempt to draw upon the resources of the bank to aid the nonbank subsidiary. The bank can transfer a substantial portion of its capital through dividends to the parent company, which may pass these funds on to the troubled nonbank subsidiary. Also, the nonbank may attempt to sell part of its portfolio to the bank subsidiary to improve liquidity. The Board's Interpretation 12 C.F.R. 250.250 (at FRRS 3–1133) limits the sale of nonbank subsidiary loans to the bank affiliate unless the bank had an opportunity to appraise the credit at the inception of the loan. Therefore, the examiner should closely analyze the off-balance-sheet activity of the nonbank subsidiary, particularly activity relating to the sale of loans shortly after they are made. Reference should also be made to section 2020.7, regarding the transfer of low-quality loans or other assets to avoid classification.

4030.0.2 ANALYSIS OF FINANCIAL CONDITION AND RISK ASSESSMENT

Because of the potentially damaging effect on the parent company or its bank subsidiary, the examiner should conduct a detailed analysis of the financial condition and perform a risk assessment of the nonbank subsidiaries. The loss to the holding company may not be confined to the equity in and advances to the subsidiary. The contingent liabilities arising from the nonbank subsidiary's external borrowings are quite often a large multiple of the parent's investment. Particular attention should be directed to holding companies that have made massive capital injections in order to rescue a failing subsidiary or to satisfy the external debt obligations of the subsidiary.

For each bank holding company with nonbank activities, examiners should prepare a written risk assessment of each active nonbank subsidiary, addressing the financial and managerial concerns outlined below.[1] This assessment should be performed with the same frequency required for full-scope inspections. The purpose of this assessment is to identify subsidiaries with a risk profile that warrants an on-site presence, even if the subsidiary does not meet the minimum criteria set forth in section 5000.0.4.4.1, "On-site Reviews of Nonbank Subsidiaries." In formulating this assessment, the examiner should consider all available sources of information including, but not limited to—

- findings, scope, and recency of previous inspections;

1. The assessment of nonbank activities in large, complex organizations may be focused on an intermediate-tier company with oversight responsibility for multiple nonbank subsidiaries.

- ongoing monitoring efforts of surveillance and financial analysis units;
- information received through first-day letters or other pre-inspection communications;
- regulatory reports and published financial information; and,
- reports of internal and external auditors.

The risk assessment should address each nonbank subsidiary's funding risk, earnings exposure, operational risks, asset quality, capital adequacy, contingent liabilities and other off-balance-sheet exposures, management information systems and controls, transactions with affiliates, growth in assets, and the quality of oversight provided by the management of the bank holding company and nonbank subsidiary. The examiner should give particular attention to appraising the quality of a nonbank subsidiary's assets because asset problems therein may lead to other financial problems in the nonbank subsidiary and the parent company or bank affiliates. Examiners are expected to document in the inspection workpapers their assessment of the overall risk posed by each nonbank subsidiary and to summarize their assessment of nonbank activities in the bank holding company inspection report.

The examiner has four alternatives with respect to asset classifications. An appraisal of the degree of risk involved in a given asset leads to a selection. The examiner can either ''pass'' the asset or adversely classify the asset ''substandard,'' ''doubtful'' or ''loss,'' depending on the severity of deterioration noted.

Since the preponderance of all loans are subject to some degree of risk, the following question arises: To what point, or degree, must a given credit deteriorate to warrant a scheduled criticism in the report of inspection? Generally, a passed credit has those characteristics which are recognized as being part of a normal risk asset; the degree of risk is not unreasonable, the loan is being properly serviced, and is either adequately secured or repayment is reasonably assured from a specific source.

Classification units are designated as ''substandard,'' ''doubtful,'' and ''loss.'' 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 nonbank subsidiary will sustain some loss if the deficiencies are not corrected. 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. Assets classified loss are considered uncollectible and of such little value that their continuance as recordable 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 reserving against this basically worthless asset even though partial recovery may be effected in the future.

Although the System does not apply bank standards when classifying nonbank assets, the classification categories are the same. Examiners of BHC nonbank subsidiaries must appraise the assets in light of industry standards and conditions inherent in the market.

For information on classifying a parent's investment in and advances to a noncredit-extending subsidiary, see Manual section 4070.0, BHC Rating System.

For information on the sufficiency of nonbank valuation reserves, see Manual section 4030.4.

Nonbanks: Credit Extending (Earnings)

When analyzing the earnings of a nonbank subsidiary, the examiner should address two primary questions: (1) Is the return on assets commensurate with the risk associated with the assets? (2) What is the impact of earnings and trends on the parent company and affiliate banks? While a nonbank subsidiary operating at a loss may be in less than satisfactory condition, the loss may not necessarily result in a major adverse impact on the consolidated earnings. The nonbank subsidiary's total assets may be insignificant in relation to the consolidated assets of the BHC, but operating losses may result in a significant reduction in its consolidated earnings position.

In some cases, industry statistics will be available for comparative purposes. However, a favorable comparison should not necessarily be taken as depicting a satisfactory earnings condition. Actions by the parent company could influence the earnings of its subsidiaries. For example, management and/or service fees can be adjusted in order to alter the subsidiary's earnings to desired levels. Also, if the parent company is funding the subsidiary, the cost of funds to the subsidiary can be adjusted above or below the parent's cost of funds thus affecting net income. In addition, an undercapitalized subsidiary with only a marginal return on assets could show a better return on equity than the adequately capitalized independent counterpart experiencing a good return on its assets. As important as return on equity is as a measure of performance, for nonbank subsidiaries, particularly those that are thinly capitalized, absolute level of earnings or return on assets provide a more meaningful measure of earnings performance.

The cash return to the parent from its investment in and advances to a subsidiary less its costs to carry the assets and related expenses should exceed the cash return available from an investment of a similar amount in securities in order to justify retaining the subsidiary. If it seems that an alternative employment of funds would be more rational, the examiner should inquire as to management's plans to improve subsidiary earnings.

Questions to be answered in analyzing the earnings of credit-extending nonbank subsidiaries include:

1. What is the impact on the parent company and affiliate banks of a nonbank subsidiary operating at a loss?
2. Is the return on assets commensurate with the risk inherent in the asset portfolios for those nonbank subsidiaries operating profitably?
3. Are intercompany management/service fees appropriate? From a supervisory perspective, management and service fees should have a direct relationship to and be based solely upon the fair value of goods and services received.
4. Is the subsidiary required to reimburse the parent for the parent's interest expense on borrowed funds, the proceeds of which have been treated as ''advances to subsidiaries?''
5. Is the quality of the subsidiary's earnings sound? For example, is the company understating the provision for loan losses, relying upon nonoperating gains or capitalization of accrued interest?

Special attention should be directed by the examiner to the computation of the company's net interest margin (interest income–interest expense, divided by average earning assets). A study of company yields on investments should provide a measure of the company's ability to invest its funds in earning assets that provide a rate of return above the company's cost of funds. As net interest margins narrow, the company may find it more difficult to generate sufficient income to meet operating expenses.

When discussing growth in earnings, the examiner should clearly differentiate between increases due to increased net interest income on a constant base of earning assets as compared to an increase in the earning asset base with a concurrent proportional increase in net interest income. Any improvement in net interest income as a percentage of earning assets may reflect favorably on management's ability to invest its funds at favorable yields or its ability to find less expensive sources of funds.

Nonbanks: Credit Extending (Leverage) Section 4030.3

As a general rule, credit-extending nonbank subsidiaries are funded by the proceeds of parent company borrowings through instruments such as commercial paper or medium to long-term debt or a combination thereof. Equity generally represents only a small portion of funding resources. There are instances, however, where the nonbank subsidiary will arrange direct funding from external sources. This is especially true in certain States where there are tax advantages associated with direct external funding.

Heavy reliance on borrowed funds by a nonbank subsidiary together with its limited capital position often results in a highly leveraged financial condition that is quite sensitive to changes in money market cost of funds. An examiner should consider what a change in the company's cost of funds might do to its net interest margin and earnings.

Many BHCs operate on the premise that a nonbank subsidiary needs little capital of its own as long as the parent company is adequately capitalized. Implicit in this operating practice is management's belief that the parent could act as a source of financial strength to its subsidiary in the event of difficulty at the subsidiary level. However, experience has indicated that in many cases, once trouble has developed in the subsidiary, the parent is hesitant to direct additional funds to the subsidiary, arguing that it is best to limit losses and exposure and it is imprudent for the parent to inject additional capital at this time. Given this experience, it is often considered appropriate for an examiner to comment on a subsidiary's extended leveraged position, indicating to management that the company has little, if any, capital ‘‘cushion’’ with which to absorb any asset ‘‘shrinkage’’ or loss. The examiner may then conclude and possibly recommend that additional capital be provided for the credit-extending nonbank subsidiary so that its leverage may be reduced and its capital structure altered to reflect more closely an independent organization in the same or similar industry.

Funding should be reviewed to determine that the subsidiary (or the parent) is not mismatching maturities by borrowing short-term funds and applying them to long-term assets that are not readily convertible into cash. A mismatch of maturities can lead to serious liquidity problems.

A primary concern of the holding company examiner is to determine whether the nonbank subsidiary has the capacity to service its debt in an orderly manner. Does the credit-extending nonbank subsidiary have sufficient liquidity and how much will it have to rely on the parent company for funds to retire debt to unaffiliated parties? Factors to be considered include:

1. The subsidiary's asset quality and its ability to convert assets into cash at or near current carrying value. Consider the maturities of borrowings and whether they align with the scheduled assets that will be converted to cash.
2. The subsidiary's and the parent's back-up bank lines of credit available in the event commercial paper cannot be refinanced.
3. The parent company's ability to require its bank or other nonbank subsidiaries to upstream extra dividends to support the illiquid position of one or more of its nonbank subsidiaries.

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3. The parent company's ability to require its bank or other nonbank subsidiaries to upstream extra dividends to support the illiquid position of one or more of its nonbank subsidiaries.

Nonbanks: Credit Extending (Reserves) Section 4030.4

The purpose of a credit-extending nonbank subsidiary's reserve for bad debts is to provide for known and potential losses in its assets. Although there is no specific formula for measuring the adequacy of a reserve for bad debts, prudence dictates that the reserve account should be maintained at a ''reasonable'' level. What is reasonable depends on the quality of the subsidiary's assets, its collection history and other facts. However, from a supervisory perspective, the reserve for bad debts should at least provide total coverage for all assets classified ''loss'' and still be sufficient to absorb future, unidentified, ''normal'' losses, that are estimated based on the ''doubtful'' and ''substandard'' classifications and the company's historic experience. Valuation reserves for a going concern are not considered adequate unless they can absorb 100 percent of identified losses and still have a balance sufficient to absorb future losses from continued operations.

Examiners should recommend the maintenance of valuation reserves sufficient to offset classified losses and may recommend (as opposed to require) that management charge-off the losses to the reserve account. The charge-off of classified losses is considered appropriate in order to assure that financial statements accurately reflect the company's financial condition. The Federal Reserve System has the responsibility to monitor the bank holding company's nonbank subsidiary statements for accuracy and completeness. Failure by management to reflect accurately the financial condition of the subsidiary and/or parent company could result in a formal corrective action to require charge-offs or other adjustments to financial statements.

For additional information, see Manual section 4030.1, ''Classifications.''

The noncredit-extending nonbank subsidiaries provide services or financial products other than extensions of credit. Some of these companies are insurance agencies, credit life and credit accident and health insurance underwriting companies, electronic data processing centers, management consulting firms and advisory companies.

The operations of some insurance agencies are conducted on the premises of the bank subsidiary(ies) by personnel who often serve as officers or employees of the bank. These companies usually incur little or no liabilities and require only nominal capitalization because risk is limited. However, their commission income is often substantial and a steady source of funds for the parent company. Nevertheless, insurance ''underwriters'' typically have strong capital bases, good liquidity and profitable operations. Furthermore, their operating risks are generally stable and predictable.

Electronic data processing centers are often established under section 4(c)(8) of the Act, which permits them to sell their services to affiliated and unaffiliated customers. Section 4050.0 of this Manual cites examples of how an EDP servicer can have an unfavorable impact on the parent company or its affiliates. Management consulting firms and advisory companies usually require little capitalization and no funding and generate favorable earnings. Of the noncredit-extending subsidiaries, insurance underwriters and EDP servicers are generally the only companies requiring capital and funding in significant amounts.

However, all subsidiaries are subject to some level of risk, which could impact on the BHC. In the case of insurance underwriters, insurance benefits paid could exceed actuarial estimates. Such a situation, however rare, could necessitate financial support from the parent company. EDP servicers could, as a result of excessive computer down-time or equipment obsolescence, impact on consolidated earnings or require additional capital contributions. In addition, contingent liabilities, resulting from legal actions or failure to perform, could be a large multiple of a subsidiary's capital and may affect the parent.

4040.0.1 EARNINGS

In analyzing these subsidiaries, the examiner should consider the following:

1. Are any noncredit-extending subsidiaries operating at a loss or incurring low levels of earnings? If so, what is the cause and does it have a material impact on consolidated earnings?
2. Does the loss result in the subsidiary's reliance on the parent company or bank subsidiary(ies) for financial support? If so, in what form is the support provided?
3. If a loss has been incurred, has management initiated corrective measures? If not, why not?
4. Are the fees charged by the parent for services rendered limited to their *fair market value*? The answer to this question will almost always depend on information supplied by management. Management should be aware of the fair market rates charged by their competitors for similar services rendered.
5. Are the rates charged affiliates commensurate with the services provided and similar to rates charged nonaffiliated customers?

4040.0.2 RISK EXPOSURE

In noncredit-extending subsidiaries, risk exposure, of any meaningful magnitude, is often related to possible losses arising from legal actions for failure to perform services as contracted. The examiner should determine that the subsidiaries are being operated effectively by experienced and competent personnel under the direction of satisfactory management. The examiner should further determine that parent company management exercises appropriate controls over the activities of the subsidiary. Because of potential liability, the examiner should ascertain whether the subsidiaries have adequate insurance coverage (i.e., errors and omissions, public liability, etc.). The examiner should be alert to any contingent liabilities that would have a significant impact of the parent company. For example, the parent company might guarantee the payment of debt or leases for the subsidiary.

The internal services subsidiaries generally derive their business only from the parent company and its affiliates. Examples of such companies include forms printing firms, owners and operators of banking premises, and EDP servicing companies. Banking premises subsidiaries are established to hold or operate properties used wholly or substantially by the parent's subsidiary for its banking business. Generally, their operations do not impact unfavorably on the parent company. However, in instances where the banking premises are not wholly occupied by a banking subsidiary, the examiner should ascertain that the excess space is fully leased/rented. A high vacancy level could result in unprofitable operations or result in an abnormal rental charge to the banking subsidiary in order to operate the subsidiary on a profitable, or break even, basis.

EDP service centers provide bookkeeping or data processing services for the internal operations of the holding company and its subsidiaries, and store and process other banking, financial or related economic data. Generally, these service centers do not have a material effect on consolidated earnings performance as they provide essential services at costs comparable or below their independent counterparts. They usually operate on a break-even basis or at a nominal profit. However, there are some subsidiaries, including EDP servicers, which also provide services indirectly to unaffiliated concerns. EDP servicers operating under section 4(c)(1)(C) of the Act, may provide services to customers of its bank affiliates, provided that the service contract is between the bank and the customer. EDP servicers that operate as independent subsidiaries under section 4(c)(8) of the Act are not similarly restricted and are not considered ''not for profit'' organizations.

A financial analysis of a ''not for profit'' service subsidiary should concentrate on the organization's ability to control its expenses and its ability to provide its services to its affiliates at fair market value. Failure to control expenses may result in excessive charges to affiliates to the detriment of the affiliate.

For purposes of an analysis of earnings, analysts of bank holding companies have placed considerable weight on consolidated BHC financial data. Consolidated data, however, can be very misleading since bank assets and revenues are large in relation to their profit margins. On the other hand, the volume of nonbank assets is generally not nearly as large, but profit margins (or losses) tend to be much more substantial. The organizational structure of a holding company is of prime importance and must first be taken into consideration before attempting to analyze consolidated earnings. As an example, in the case of nonoperating shell bank holding companies with no nonbank subsidiaries, the earnings of the bank subsidiary should be nearly identical with consolidated earnings for the organization. Therefore, in these instances, the views and ratings of the applicable bank regulatory agency would normally be accepted and would apply to consolidated earnings of the BHC. This treatment would not apply to one-bank and multi-bank holding companies with substantial credit-extending nonbank subsidiaries. These holding companies require an in-depth analysis of earnings because of the adverse impact that a poorly operated subsidiary can have upon the consolidated earnings of the BHC.

In order to properly analyze consolidated earnings, it is best to review and study a consolidating statement of income and expense for the purpose of determining each entity's contribution to earnings. It is important to recognize that there need be no direct correlation between the asset size of a subsidiary and its relative contribution to total consolidated earnings. For example, a subsidiary accounting for a minute portion of consolidated assets could substantially negate satisfactory earnings of its larger asset base affiliates because of poor operations and sizeable losses.

When evaluating consolidated earnings, it is important to review the component parts of earnings for prior interim or fiscal periods for comparative purposes in order to determine trends. Considerable attention is to be focused on the various income and expense categories. The net interest income (difference between interest income and interest expense) of a company is highly revealing as it will give an indication of management's ability to borrow at attractive rates and employ those funds with maximum profitable results.

Items having a significant impact on earnings include the noncash charge, "provisions for loan losses" and the volume of nonaccrual and renegotiated or restructured credits. A large provision for loan losses is made necessary by poor quality assets which result in large charge-offs to valuation reserves. In order to replenish the reserve for loan losses to adequate levels to provide ample coverage against known and potential losses, large amounts of revenues must be "set aside." Nonperforming and renegotiated credits either provide no income or provide a reduced rate of income to the extent that the assets are no longer profitable relative to the cost of funds and the cost of doing business. In situations where earnings are below average or unsatisfactory, a comment concerning the amount of provision for loan losses and volume of nonperforming loans is warranted in the financial analysis.

Other items of significance include taxes, particularly where tax credits are indicative of loss operations, and extraordinary or nonrecurring items. Extraordinary gains or losses are not the result of the normal operations of a company and should be analyzed independently from operating earnings. Generally, extraordinary items result from the sale of current or fixed assets. When significant amounts are involved, examiners should determine the underlying reasons behind such transactions.

After an analysis has been made of the pertinent components of earnings, analyze the "bottom line" or net income of the consolidated company. Generally, analysts relate net income to several benchmarks in order to evaluate performance. The ratios of earnings as a percentage of average equity capital or average assets are most widely used. Conclude the analysis with a comparison of a company's ratios in relation to its peer group.

Comparatively low earnings relative to its peer group may be a reflection of problems and weaknesses such as lax or speculative credit practices (resulting in nonearning assets or loan losses), high interest costs resulting from excessive debt, or rapid expansion into competitive industries subject to wide variations in income potential.

Earnings on a consolidated basis are the best measure of performance. Moreover, while the earnings of individual subsidiaries must not be ignored, the ability of holding company management to control the level of reported earnings in any one subsidiary reaffirms the practicality of using the consolidated approach to analyze holding company profitability.

Essentially, the following points summarize areas which should be considered when analyzing consolidated earnings:

1. The return on consolidated assets and equity capital, as well as historical trends and peer group comparisons.

2. The ability of earnings to provide for capital growth, especially when taking into consideration recent and planned asset and deposit growth.

3. The ''quality'' of earnings is affected by the sufficiency of the provision to loan loss reserves and the asset quality of the organization. A high level of earnings that did not include sufficient provisions to the loan loss reserve during a period of high charge-offs may result in reductions in the reserve balance and thereby call to question the merits of high earnings in the face of declining reserve balances.

4. The ability of management to prepare realistic earnings projections in light of the risk structure and quality of assets.

The evaluation of asset quality based on classifications of "substandard, doubtful and loss," is one of the most important elements to be taken into consideration when performing a financial analysis of a holding company because of the severe impact that poor quality assets can have on the overall condition of the organization. Procedures to measure asset quality of banks involve the use of the relationship of weighted classified assets to Tier 1 capital funds and total classifications to total capital funds. Accordingly, consolidated asset quality could be based on the relationship of aggregate weighted classified assets of the parent company, bank subsidiary(ies) and nonbank subsidiary(ies), to Tier 1 capital.

However, a problem encountered when viewing asset quality on a consolidated basis is the fact that in multi-bank holding companies there is usually a large timing difference between the dates of examinations of the banking subsidiaries. Therefore, the aggregating of classified bank assets from reports prepared at different times, reduces the currentness and validity of conclusions drawn. This problem can only be eliminated by using common examination and inspection dates which are not generally available.

Despite the shortcoming of using classification information from different dates, an examiner may determine that there is a sufficient measure of validity in using the data and may present an analysis based on consolidated weighted classifications. For example, if there are a small number of bank subsidiaries and if the examination dates are near a common point in time, timing differences may be inconsequential. Or, if a review of several years of a bank's examinations reveals a relatively constant or stable level of classifications, then the timing of the most recent examination would not invalidate use of the analytical tool. As such, the technique may be employed when circumstances permit.

Other factors to be considered in determining asset quality include the levels of nonaccrual and renegotiated loans, other real estate owned and past due loans. While these assets may not be subject to classification, they usually represent former or emerging problem loans. Moreover, in the aggregate, they may represent a significant proportion of the asset portfolio. If such is the case, they should be taken into consideration when the examiner determines his overall rating of asset quality.

It is difficult to rely on the adequacy of consolidated reserves because they are "fractured" and protect portfolios in different organizations and may not be interchangeable or transferable. The reserve of each entity in the corporate structure must be reviewed or analyzed individually. For example, if consolidated reserves appear inadequate, there is no consolidated reserve account per se that could be increased to adequate proportions. Consequently, the inadequacy would have to be identified at the parent or subsidiary level. Conversely, if consolidated reserves appear to adequately cover the aggregate of all "loss" and a certain portion of "doubtful," it does not insure that all subsidiaries have adequate reserves. Nevertheless, despite the shortcomings of using consolidated reserves, the analyst should not hesitate to calculate and present a measure of the relationship of consolidated reserves to consolidated loans.

4060.3.1 INTRODUCTION TO EXAMINER GUIDELINES FOR RISK-BASED CAPITAL

To assist in assessing the capital adequacy of bank holding companies, the Board has established two measures of capital adequacy, the risk-based capital measure and the tier 1 leverage measure. The tier 1 leverage measure is discussed in section 4060.4.

4060.3.2 OVERVIEW OF RISK-BASED CAPITAL GUIDELINES

The Board's risk-based capital guidelines (the guidelines) focus principally on the credit risks associated with the nature of banking organizations' on- and off-balance-sheet assets and on the type and quality of their capital. The information provided in this section should be used in conjunction with the risk-based capital guidelines in verifying the bank holding company's risk-based capital. Examiners must refer to Regulation Y (12 C.F.R. 225), appendix A, for a complete description of the risk-based capital adequacy guidelines for bank holding companies.

The guidelines do not incorporate other factors that may also affect the financial condition of banking organizations. These factors include overall interest-rate exposure; liquidity, funding, and market risks; the quality and level of earnings; the effectiveness of loan and investment policies on operational results and the quality of assets; and management's ability to monitor and control financial and operating risks.

The major objectives of the guidelines are to make regulatory capital requirements more sensitive to differences in credit-risk profiles among banking organizations; to factor off-balance-sheet exposures into the assessment of capital adequacy; to minimize disincentives to holding liquid, low-risk assets; and to achieve greater consistency in the evaluation of the capital adequacy of major banking organizations worldwide.

The guidelines set forth *minimum* supervisory capital standards for banking organizations. Therefore, banking organizations are expected to operate with capital levels above the minimum ratios. This is particularly true for banking organizations that are undertaking significant expansion or that are exposed to high or unusual levels of risk. The guidelines generally apply to those bank holding companies that have $150 million or more in assets on a consolidated basis.

At year-end 1992 and thereafter, the risk-based capital guidelines require banking organizations to meet a standard: a minimum ratio of total capital to risk-weighted assets of 8.0 percent and a minimum ratio of tier 1 capital to risk-weighted assets of 4.0 percent.

The risk-based capital guidelines are intended to better reflect the differences in credit-risk profiles among banking organizations and explicitly factor off-balance-sheet exposures into the assessment of capital adequacy by weighting on- and off-balance-sheet items by perceived degrees of credit risk. The basic elements of the framework include definitions of capital that include core elements and supplementary elements, assignment of on- and off-balance-sheet items to broad categories of credit risk, and the methodology for computing risk-based capital ratios for banking organizations on an interim and final basis.

In addition, examiners should be aware that when certain organizations that engage in trading activities calculate their risk-based capital ratio under appendix A, they must also refer to appendix E of Regulation Y, which incorporates capital charges for certain market risks into the risk-based capital ratio. Examiners should also refer to the *Trading and Capital-Markets Activities Manual* for more detailed supervisory guidance. When calculating their risk-based capital ratio under appendix A, such organizations are required to refer to appendix E for supplemental rules to determine qualifying and excess capital, calculate risk-weighted assets, calculate market-risk-equivalent assets, and calculate risk-based capital ratios adjusted for market risk.

4060.3.2.1 Definition of Capital

For the purposes of the risk-based capital guidelines, a banking organization's total capital will consist of two types of components: core capital elements and supplementary capital elements. To qualify as an element of tier 1 or tier 2 capital, a capital instrument must be unsecured and may not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices.

4060.3.2.1.1 Tier 1 Capital

Tier 1 capital will consist of permanent core capital elements (common stockholders' equity, noncumulative perpetual preferred stock, a limited amount of qualifying cumulative perpetual preferred stock, and minority interest in the equity of consolidated subsidiaries) less any amounts of goodwill and other intangible assets, credit-enhancing interest-only strips receivables, and nonfinancial equity investments that are required to be deducted. Common stockholders' equity is limited to common stock; related surplus; and retained earnings, including capital reserves and adjustments for the cumulative effect of foreign-currency translation, net of any treasury stock, less net unrealized holding losses on available-for-sale equity securities with readily determinable fair values. For this purpose, net unrealized holding gains on such equity securities and net unrealized gains (losses) on available-for-sale debt securities are not included in common stockholders' equity.

4060.3.2.1.1.1 Common Stock Considerations

A capital instrument that is not permanent, or that has preference with regard to liquidation or the payment of dividends, is not deemed to be common stock, regardless of whether it is called common stock. Other preferences may also call into question whether the capital instrument is common stock. Close scrutiny should be paid to the terms of common stock issues that have issued more than one class of common stock. Preference features may be found in one of the classes and, if so, that class generally should not be treated as common stock.

From a supervisory standpoint, it is desirable that voting common stockholders' equity remain the dominant form of tier 1 capital. Accordingly, the risk-based capital guidelines state that bank holding companies should avoid overreliance on nonvoting equity elements in tier 1 capital. Nonvoting equity elements can arise in connection with common stockholders' equity in cases when a bank holding company has two classes of common stock, one voting and the other nonvoting. Alternatively, one class may have so-called super-voting rights entitling the holder to substantially more votes per share than the other class. In this case, the so-called super-voting shares may have so many votes per share that the voting power of the other shares is effectively overwhelmed.

Although no formal limit is placed on the amount of noncumulative perpetual preferred stock that may be included in tier 1 capital, the guidelines state that bank holding companies should avoid overreliance on preferred stock and other nonvoting equity elements in tier 1 capital.[1] Bank holding companies that have nonvoting, or effectively nonvoting, common equity and tier 1 perpetual preferred stock in excess of their voting common stock are clearly overrelying on nonvoting equity elements in tier 1 capital. In such cases, it may be appropriate to reallocate some of the nonvoting equity elements from tier 1 capital to tier 2 capital.

4060.3.2.1.1.2 Perpetual Preferred Stock Considerations

Traditional convertible perpetual preferred stock, which the holder can convert into a fixed number of common shares at a preset price, ordinarily does not raise supervisory concerns and generally qualifies as tier 1 capital. However, forms of preferred stock that the holder must or can convert into common stock at the market price prevailing at the time of conversion do raise supervisory concerns. Such preferred stock may be converted into an increasing number of common shares as the banking organization's condition deteriorates, for example, as the market price of the common stock falls. The potential conversion of such preferred stock into common stock could pose a threat of dilution to the existing common shareholders. The threat of dilution could make the issuer reluctant to sell new common stock, or it could place the issuer under strong market pressure to redeem or repurchase the convertible preferred stock. Such convertible preferred stock generally should be excluded from tier 1 capital.

Perpetual preferred stock issues may include other provisions or pricing mechanisms that would provide significant incentives or pressures for the issuer to redeem the stock for cash, especially at a time when the issuer is in a weakened financial condition. As a general matter, an issue that contains such features would be ineligible for tier 1 treatment.

1. A noncumulative issue may not permit the accruing or payment of unpaid dividends in any form, including the form of dividends payable in common stock. Perpetual preferred stock that calls for the accumulation and future payment of unpaid dividends is deemed to be cumulative, regardless of whether it is called noncumulative, and is generally includable in tier 2 capital.

4060.3.2.1.1.3 Considerations Regarding Minority Interest in Equity Accounts of Consolidated Subsidiaries

Minority interest in equity accounts of consolidated subsidiaries is included in tier 1 capital because, as a general rule, it represents equity that is freely available to absorb losses in operating subsidiaries. Banking organizations are expected to avoid using minority interest as an avenue for introducing elements that do not otherwise qualify as tier 1 capital (such as cumulative or auction-rate perpetual preferred stock) or that would, in effect, result in an excessive reliance on preferred stock within tier 1 capital. If a banking organization uses its minority interest in these ways, supervisory concerns may warrant reallocating some of the minority interest in equity accounts of consolidated subsidiaries from tier 1 to tier 2 capital.

Whenever a banking organization has included perpetual preferred stock of an operating subsidiary in minority interest, a possibility exists that such capital has been issued in excess of the subsidiary's needs, for the purpose of raising cheaper capital. Stock issued under these circumstances may, in substance if not in legal form, be secured by the subsidiary's assets. If the subsidiary fails, the outside preferred investors would have a claim on the subsidiary's assets that is senior to the claim that the banking organization, as a common shareholder, has on those assets. Therefore, as a general rule, issuances in excess of a subsidiary's needs do not qualify for inclusion in capital. The possibility that a secured arrangement exists should be considered if the subsidiary lends significant amounts of funds to the parent banking organization, is unusually well capitalized, has cash flow in excess of its operating needs, holds a significant amount of assets with minimal credit risk (for example, U.S. Treasury securities) that are not consistent with the subsidiary's operations, or has issued preferred stock at a significantly lower rate than the parent could obtain for a direct issue.

Some bank holding companies may use a nonoperating subsidiary or special-purpose entity (SPE) to issue perpetual preferred stock to outside investors. Such a subsidiary may be set up offshore so that it can receive favorable tax treatment for the dividends paid on the stock. In such arrangements, a strong presumption exists that the stock is, in effect, secured by the assets of the subsidiary. It has been agreed upon internationally that a banking organization may not include in its tier 1 capital minority interest in the perpetual preferred stock of nonoperating subsidiaries. Furthermore, such minority interest may not be included in tier 2 capital unless it can conclusively be proven that the stock is unsecured. Even if the banking organization's accountants have permitted it to account for perpetual preferred stock issued through an SPE as stock of the banking organization, rather than as minority interest in the equity accounts of a consolidated subsidiary, the stock may not be included in tier 1 capital and most likely is not includable in tier 2 capital.

Banking organizations may also use operating or nonoperating subsidiaries to issue subordinated debt. As with perpetual preferred stock issued through such subsidiaries, it is possible that such debt is in effect secured and therefore not includable in capital.

4060.3.2.1.1.4 Minority Interests in Small Business Investment Companies

Minority interests in small business investment companies (SBICs), investment funds that hold nonfinancial equity investments, and subsidiaries engaged in nonfinancial activities are not included in the banking organization's tier 1 or total capital base if the banking organization's interest in the company or fund is held under the legal authorities listed in section II.B.5.b. of the capital guidelines (12 C.F.R. 225, appendix A).

4060.3.2.1.1.5 Certain Tier 1 Cumulative Preferred Stock

On October 21, 1996, the Board approved the use of certain cumulative preferred stock instruments in tier 1 capital for bank holding companies. These instruments, which are marketed under a variety of proprietary names, such as MIPS and TOPRS, are issued out of a special-purpose subsidiary that is wholly owned by the parent company. The proceeds are lent to the parent in the form of a very long-term, deeply subordinated note.

Bank holding companies seeking to issue such securities should consult with their District Federal Reserve Bank. Such arrangements, which give rise to minority interest upon consolidation of the subsidiary with the parent holding company, normally will be accorded tier 1 capital status.

To be eligible as tier 1 capital, such instruments must provide for a minimum five-year consecutive deferral period on distributions to preferred shareholders. In addition, the intercompany loan must be subordinated to all subordinated debt and have the longest feasible maturity.

The amount of these instruments, together with other cumulative preferred stock a bank holding company may include in tier 1 capital, is limited to 25 percent of tier 1 capital. Like other preferred stock includable in capital, these instruments require Federal Reserve approval before they may be redeemed.

4060.3.2.1.1.6 Trust Preferred Stock

In order for trust preferred stock to be included in tier 1 capital, the issuing bank holding company must have the ability to defer payments for at least 20 consecutive quarters without giving rise to an event of default.[2] Such a deferral feature, which typically is cumulative in trust preferred stock, is essential in a tier 1 instrument because it allows the issuer to conserve its cash resources at a time when its financial condition is deteriorating.

When a banking organization hedges trust preferred stock through an interest-rate swap with a deferral feature, the deferral terms on the swap must be symmetrical for both the organization and its counterparty and must not have the effect of draining the organization's resources in a time of stress. The swap contract, for example, must not provide that the counterparty can defer, on a cumulative basis, its swap payments due to the banking organization during a trust preferred deferral period when the banking organization must continue to make payments to the counterparty. A plain-vanilla swap, when neither the banking organization nor its counterparty may defer payments, generally is an acceptable instrument for hedging the interest-rate risk on trust preferred stock included in tier 1 capital. Trust preferred stock issues may not be included in tier 1 capital if they are covered by an interest-rate derivative contract with asymmetrical deferral terms. (See SR-02-10.)

4060.3.2.1.1.7 Forward Equity Transactions

Banking organizations have engaged in various types of forward transactions relating to the repurchase of their common stock. In these transactions, the banking organization enters into an arrangement with a counterparty, usually an investment bank or another commercial bank, under which the counterparty purchases common shares of the banking organization, either in the open market or directly from the institution. The banking organization agrees that it will repurchase those shares at an agreed-on forward price at a later date (typically three years or less from the execution date of the agreement). These transactions are used to lock in stock repurchases at price levels that are perceived to be advantageous and are also a means of managing regulatory capital ratios.

Banking organizations have generally continued to treat shares under forward equity arrangements as tier 1 capital. However, these transactions can impair the permanence of the shares and typically have certain features that are undesirable from a supervisory point of view. For these reasons, shares covered by these arrangements have qualities that are inconsistent with tier 1 capital status.[3] Accordingly, any common stock covered by forward equity transactions entered into after the issuance of SR-01-27 (November 9, 2001) will be excluded from the tier 1 capital of a bank holding company (or a state member bank), other than those transactions specified for deferred compensation or other employee benefit plans. This exclusion applies even if the transactions were executed under a currently existing master agreement. The amount to be excluded is equal to the common stock, surplus, and retained earnings associated with the shares. This guidance does not apply to shares covered under traditional stock buyback programs that do not involve forward agreements.

4060.3.2.1.2 Tier 2 Capital

Tier 2 capital consists of (1) a limited amount of the allowance for loan and lease losses;[4] (2) cumulative perpetual preferred stock (original term of 20 years or more) including related

2. The inclusion of trust preferred stock in tier 1 capital was authorized in an October 21, 1996, Board release.

3. Section 4060.3.2.1.1.1 states that "a capital instrument that is not permanent...is not deemed to be common stock, regardless of whether it is called common stock." See also section 3020.1 of the *Commercial Bank Examination Manual.*

4. This allowance is limited to 1.25 percent of risk-weighted assets.

surplus (also includes cumulative perpetual preferred stock exceeding its tier 1 limitation, including auction-rate preferred stock, or any other perpetual preferred stock in which the dividend rate is reset periodically, in whole or in part, based on the holding company's financial condition); (3) hybrid capital instruments, perpetual debt, mandatory convertible debt securities; (4) limited amounts (50 percent of tier 1 capital) of term subordinated debt, intermediate-term preferred stock, including related surplus, and unsecured long-term debt issued before March 12, 1988, that qualified as secondary capital when issued; and (5) limited unrealized holding gains on equity securities. Tier 2 capital may not exceed tier 1 capital (net of goodwill, other intangible assets, and interest-only receivables and nonfinancial equity investments that are required to be deducted in accordance with section II.B. of the risk-based capital adequacy guidelines).

The amount of mandatory convertible securities that have the proceeds of common or perpetual preferred stock dedicated to retire or redeem them, and a maximum maturity of 12 years, should be treated as term subordinated debt. Mandatory convertible securities, net of the stock dedicated to redeem or retire the issues, are included within tier 2 on an unlimited basis.

There is a limit on the amount of unrealized holding gains on equity securities and the unrealized gains (losses) on other assets. Up to 45 percent of pretax net unrealized holding gains (that is, the excess, if any, of the fair value over historical cost) on available-for-sale equity securities, with readily determinable fair values, may be included in supplementary capital. However, the Federal Reserve may exclude all or a portion of these unrealized gains from tier 2 capital if it determines that the equity securities are not prudently valued. Unrealized gains (losses) on other types of assets, such as bank premises and available-for-sale-debt securities, are not included in supplementary capital. The Federal Reserve may take these unrealized gains (losses) into account as additional factors when assessing an institution's overall capital adequacy.

4060.3.2.1.3 Deductions from Tier 1 and Tier 2 Capital

The risk-based capital guidelines require that 50 percent of the aggregate amount of capital investments in unconsolidated banking and finance subsidiaries should be deducted from the bank holding company's tier 1 capital and 50 percent from its tier 2 capital. If the amount of tier 2 capital is insufficient for the required deduction, the additional amount needed would be deducted from tier 1 capital. Reciprocal holdings of other banking organizations' capital instruments are to be deducted from the sum of tier 1 and tier 2 capital.

4060.3.2.2 Procedures for Risk-Weighting of On- and Off-Balance-Sheet Items

The risk-based capital guidelines establish four general categories of credit risk. These categories of credit risk reflect the nature and quality of collateral, guarantees, and organizations issuing or backing obligations. Assets and credit-equivalent amounts of off-balance-sheet items are allocated to the various categories, which are assigned weights of 0 percent, 20 percent, 50 percent, and 100 percent depending on the perceived level of credit risk to the banking organization. (See 12 C.F.R. 225, appendix A, section III (and its attachment III), for a more detailed listing of the assets assigned to each risk-weight category.)

The majority of the items will fall in the 100 percent risk-weight category. A brief explanation of the components of each category follows. For more detailed information, see the capital adequacy guidelines.

4060.3.2.2.1 Risk Categories

4060.3.2.2.1.1 Category 1: Zero Percent

Category 1 includes cash (domestic and foreign) owned and held in all offices of the bank or in transit, as well as gold bullion held in the bank's own vaults or in another bank's vaults on an allocated basis to the extent it is offset by gold bullion liabilities. The category also includes all direct claims on (including securities, loans, and leases), and the portions of claims that are directly and unconditionally guaranteed by, the central governments of the Organization for Economic Cooperation and Development (OECD) countries and U.S. government agencies, as well as all direct local currency claims on, and the portions of local currency claims that are directly and unconditionally guaranteed by, the central governments of non-OECD countries, to the extent that the bank has liabilities booked in that currency. A claim is not considered to be unconditionally guaranteed by a central government if the validity of the guarantee depends on some affirmative action by the holder or a third party. Generally, securities guaranteed by the U.S. government or its agencies that are actively traded in financial markets, such as Government National Mortgage Association (GNMA) securities, are considered to be unconditionally guaranteed. This zero percent category also includes claims collateralized (1) by cash on deposit in the bank or (2) by securities issued or guaranteed by OECD central governments or U.S. government agencies for which a positive margin of collateral is maintained on a daily basis, fully taking into account any change in the bank's exposure to the obligor or counterparty under a claim in relation to the market value of the collateral held in support of that claim.

4060.3.2.2.1.2 Category 2: 20 percent

Category 2 includes cash items in the process of collection, both foreign and domestic; short-term claims on (including demand deposits), and the portions of short-term claims that are guaranteed by, U.S. depository institutions and foreign banks; and long-term claims on, and the portions of long-term claims that are guaranteed by, U.S. depository institutions and OECD banks. This category also includes the portions of claims that are conditionally guaranteed by OECD central governments and U.S. government agencies, as well as the portions of local currency claims that are conditionally guaranteed by non-OECD central governments, to the extent that the bank has liabilities booked in that currency. In addition, this category includes claims on, and the portions of claims that are guaranteed by, U.S. government–sponsored agencies and claims on, and the portions of claims guaranteed by, the International Bank for Reconstruction and Development (the World Bank), the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Investment Bank, the European Bank for Reconstruction and Development, the Nordic Investment Bank, and other multilateral lending institutions or regional development banks in which the U.S. government is a shareholder or contributing member. General obligation claims on, or portions of claims guaranteed by the full faith and credit of, states or other political subdivisions of the United States or other countries of the OECD-based group are also assigned to this category. Category 2 also includes the portions of claims (including repurchase transactions) that are (1) collateralized by cash on deposit in the bank or by securities issued or guaranteed by OECD central governments or U.S. government agencies that do not qualify for the zero percent risk-weight category; (2) collateralized by securities issued or guaranteed by U.S. government–sponsored agencies; or (3) collateralized by securities issued by multilateral lending institutions or regional development banks in which the U.S. government is a shareholder or contributing member.

This risk category also includes claims[5] on, and claims guaranteed by, a qualifying securities firm[6] incorporated in the United States or other member of the OECD-based group of countries provided that (1) the qualifying securities firm has a long-term issuer credit rating, or a rating on at least one issue of long-term debt, in one of the three highest investment-grade rating categories from a nationally recognized statistical rating organization, and (2) the claim is guaranteed by the firm's parent company, and the parent company has such a rating. If ratings are available from more than one rating agency, the lowest rating will be used to determine whether the rating requirement has been met. This category also includes certain collateralized claims on, or guaranteed by, a qualifying securities firm in such a country, without regard to satisfaction of the rating standard, provided that the claim arises under a contract that (1) is a reverse-repurchase/repurchase agreement or securities-lending/borrowing transaction executed using standard industry documentation; (2) is collateralized by debt or equity securities that are liquid and readily marketable; (3) is marked to market daily; (4) is subject to a daily margin-maintenance requirement under the standard industry documentation; and (5) can

5. Claims on a qualifying securities firm that the firm, or its parent company, uses to satisfy its applicable capital requirements are not eligible for this risk weight.

6. With regard to securities firms incorporated in the United States, qualifying securities firms are those securities firms that are broker-dealers registered with the Securities and Exchange Commission (SEC) and that are in compliance with the SEC's net capital rule, 17 C.F.R. 240.15c3-1.With regard to securities firms incorporated in other countries in the OECD-based group of countries, qualifying securities firms are those securities firms that a banking organization is able to demonstrate are subject to consolidated supervision and regulation (covering their direct and indirect subsidiaries, but not necessarily their parent organizations) comparable to that imposed on banks in OECD countries. Such regulation must include risk-based capital requirements comparable to those applied to banks under the Basel Accord.

be liquidated, terminated, or accelerated immediately in bankruptcy or a similar proceeding, and the security or collateral agreement will not be stayed or avoided, under applicable law of the relevant jurisdiction.[7]

4060.3.2.2.1.3 Category 3: 50 percent

Category 3 includes loans fully secured by first liens on one- to four-family residential properties (either owner-occupied or rented), or on multifamily residential properties, that meet certain criteria. To be included in category 3, loans must have been made in accordance with prudent underwriting standards, be performing in accordance with their original terms, and not be 90 days or more past due or carried in nonaccrual status. The following additional criteria must be applied to a loan secured by a multifamily residential property that is included in this category: (1) All principal and interest payments on the loan must have been made on time for at least the year preceding placement in this category, or, in the case of an existing property owner who is refinancing a loan on that property, all principal and interest payments on the loan being refinanced must have been made on time for at least the year preceding placement in this category; (2) amortization of the principal and interest must occur over a period of not more that 30 years, and the minimum original maturity for repayment of principal must not be less than seven years; and (3) the annual net operating income (before debt service) generated by the property during its most recent fiscal year must not be less than 120 percent of the loan's current annual debt service (115 percent if the loan is based on a floating interest rate) or, in the case of a cooperative or other not-for-profit housing project, the property must generate sufficient cash flow to provide comparable protection to the institution.

Also included in category 3 are privately issued mortgage-backed securities, provided that (1) the structure of the security meets the criteria described in section III.B.3. of the risk-based capital guidelines (12 C.F.R. 225, appendix A); (2) if the security is backed by a pool of conventional mortgages on one- to four-family residential or multifamily residential properties, each underlying mortgage meets the criteria described above for eligibility for the 50 percent risk category at the time the pool is originated; (3) if the security is backed by privately issued mortgage-backed securities, each underlying security qualifies for the 50 percent risk category; and (4) if the security is backed by a pool of multifamily residential mortgages, principal and interest payments on the security are not 30 days or more past due. Privately issued mortgage-backed securities that do not meet these criteria or that do not qualify for a lower risk weight are generally assigned to the 100 percent risk category. Also assigned to category 3 are revenue (nongeneral obligation) bonds or similar obligations, including loans and leases, that are obligations of states or other political subdivisions of the United States (for example, municipal revenue bonds) or other countries of the OECD-based group, but for which the government entity is committed to repay the debt with revenues from the specific projects financed, rather than from general tax funds. Credit-equivalent amounts of derivative contracts involving standard risk obligors (that is, obligors whose loans or debt securities would be assigned to the 100 percent risk category) are included in the 50 percent category, unless they are backed by collateral or guarantees that allow them to be placed in a lower risk category.

4060.3.2.2.1.4 Category 4: 100 percent

All assets not included in the categories above are assigned to category 4, which comprises standard risk assets. The bulk of the assets typically found in a loan portfolio would be assigned to the 100 percent category.

Category 4 includes long-term claims on, and the portions of long-term claims that are guaranteed by, non-OECD banks, and all claims on non-OECD central governments that entail some degree of transfer risk. This category includes all claims on foreign and domestic private-sector obligors not included in the categories above (including loans to nondepository financial institutions and bank holding companies); claims on commercial firms owned by the public sector; customer liabilities to the bank on acceptances outstanding that involve standard risk claims, investments in fixed assets, premises, and other real estate owned; common and preferred stock of corporations, including stock

7. For example, a claim is exempt from the automatic stay in bankruptcy in the United States if it arises under a securities contract or a repurchase agreement subject to section 555 or 559 of the Bankruptcy Code, respectively (11 U.S.C. 555 or 559); a qualified financial contract under section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)); or a netting contract between financial institutions under sections 401–407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401–4407) or the Board's Regulation EE (12 C.F.R. 231).

acquired for debts previously contracted; all stripped mortgage-backed securities and similar instruments; and commercial and consumer loans (except those assigned to lower risk categories due to recognized guarantees or collateral and loans secured by residential property that qualify for a lower risk weight).

This category also includes industrial-development bonds and similar obligations issued under the auspices of states or political subdivisions of the OECD-based group of countries for the benefit of a private party or enterprise when that party or enterprise, not the government entity, is obligated to pay the principal and interest. All obligations of states or political subdivisions of countries that do not belong to the OECD-based group are also assigned to category 4. The following assets are assigned a risk weight of 100 percent if they have not been deducted from capital: investments in unconsolidated companies, joint ventures, or associated companies; instruments that qualify as capital that are issued by other banking organizations; and any intangibles, including those that may have been grandfathered into capital.

4060.3.2.2.2 Application of the Risk Weights

The appropriate aggregate dollar value of the amount in each category is multiplied by the risk weight associated with that category. The resulting weighted values for each of the risk categories are added together.

Off-balance-sheet items are incorporated into the risk-based capital ratio through a two-step process. First, a credit-equivalent amount[8] for the item, except for direct-credit substitutes and recourse obligations, is calculated by multiplying the item by a credit-conversion factor. Second, the credit-equivalent amount of the off-balance-sheet item is then categorized in the same manner as on-balance-sheet items, that is, by credit risk, according to the obligor or, if relevant, the guarantor or nature of the collateral. The credit-conversion factors, that is, factors ranging from 0 to 100 percent,[9] are intended to reflect the risk characteristics of the activity in terms of an on-balance-sheet equivalent. The resulting sum of the risk-adjusted on- and off-balance-sheet items is the bank holding company's total risk-weighted assets, which comprises the denominator of the risk-based capital ratio. Generally, if an item may be assigned to more than one risk category, that item should be assigned to the category that has the lowest risk weight.

Collateral guarantees and other considerations. Under the guidelines, the primary determinant of the risk category of a particular on- or off-balance-sheet item is the obligor or, if relevant, the guarantor or nature of the collateral. To a limited extent, collateral or guarantees securing some obligations may be used to place an item or items in lower risk weights than would be available to the obligor. The forms of collateral that are formally recognized and available for this purpose are cash on deposit in subsidiary lending institutions;[10] securities issued or guaranteed by the central governments of the OECD-based group of countries, U.S. government agencies, or U.S. government–sponsored agencies; and securities issued by multilateral lending institutions or regional development banks. Obligations that are fully secured by such collateral are assigned to the 20 percent risk category.

In order for a claim to be considered collateralized for risk-based capital purposes, the underlying arrangements must provide that the claim will be secured by recognized collateral throughout its term. A commitment may be considered collateralized for risk-based capital purposes to the extent that its terms provide that advances made under the commitment will be secured throughout their term.

The market value of eligible securities used as collateral should be used to determine whether an obligation is partially or fully secured. For partially secured obligations, the secured portion is assigned a 20 percent risk weight. Any unsecured portion is assigned the risk weight appropriate for the obligor or guarantor, if any.

8. For interest-rate and foreign-exchange contracts, the credit-equivalent amount is determined by multiplying the notional amount by a conversion factor (which is different for contracts maturing in one year or less and those maturing in over a year) and adding the resulting amount to the positive mark-to-market values of the contracts. The maximum risk weight applied to interest-rate and exchange-rate contracts is 50 percent.

9. Interest-rate and exchange-rate contracts use conversion factors significantly below those used for other off-balance-sheet activities. These factors are assigned by remaining maturity, one year or less or more than one year, and range from 0 to 5 percent.

10. With regard to syndicated credits secured by cash on deposit in the lead institution, there is a limited exception to the rule that cash must be on deposit in the lending institution to be recognized as collateral. A lending institution participating in the syndication may treat its pro rata share of the credit as collateralized if it has a perfected interest in its pro rata share of the collateral.

The extent to which an off-balance-sheet item is secured by collateral is determined by the degree to which the collateral covers the face amount of the item before it is converted to a credit-equivalent amount and assigned to a risk category.

Certain guarantees are recognized for risk-based capital purposes as follows: guarantees of the OECD and non-OECD central governments; U.S. government agencies and U.S. government–sponsored agencies; state and local governments of the OECD-based group of countries; multilateral lending institutions and regional development banks; and U.S. depository institutions and foreign banks. If an obligation is partially guaranteed, the portion that is not fully covered is assigned the risk weight appropriate for the obligor or collateral, if any. An obligation that is covered by two types of guarantees having different risk weights is apportioned between the two risk categories appropriate for the guarantors. Direct-credit substitutes, assets transferred with recourse, and securities issued in connection with asset securitizations and structured financings are treated as described in section 4060.3.5.3.

4060.3.3 IMPLEMENTATION

The guidelines apply to those bank holding companies having $150 million or more in assets on a consolidated basis. For bank holding companies having *less than* $150 million in assets on a consolidated basis, the guidelines will apply only to their subsidiary banks unless (1) the parent bank holding company is engaged in a nonbank activity involving significant leverage (including off-balance-sheet activity) or (2) the parent holding company has a significant amount of outstanding debt that is held by the general public.

By year-end 1992 and thereafter, banking organizations are expected to meet the minimum risk-based capital ratio. The minimum ratio of capital to risk-weighted assets should be 8 percent or more with at least 4 percent taking the form of tier 1 capital. An assessment of the banking organization's capital adequacy should reflect the level and severity of the classified assets summarized in the examination and inspection.

Banking organizations that do not meet the minimum risk-based capital ratios, or that are considered to lack sufficient capital to support their activities, are expected to develop and implement capital plans acceptable to the Federal Reserve for achieving adequate levels of capital that will satisfy the provisions of the guidelines or that will satisfy agreed-upon arrangements established with the Federal Reserve for designated banking organizations. In addition, such banking organizations should avoid any actions, including increased risk-taking or unwarranted expansion, that would lower or further erode their capital positions. In these cases, examiners are to review and comment on banking organizations' capital plans and their progress in meeting minimum risk-based capital requirements.

It would be appropriate to include comments on risk-based capital in the open section of the examination or inspection report when assessing the organization's capital adequacy. Banking organizations should be encouraged to establish as soon as possible capital levels and ratios that are consistent with their overall financial profiles. Examiner comments should address the adequacy of the banking organization's plans and progress toward meeting and maintaining the minimum capital ratios, according to the guidelines.

4060.3.4 DOCUMENTATION

Banking organizations are expected to have adequate systems in place to compute their risk-based capital ratios. Such systems should be sufficient to document the composition of the ratios for regulatory reporting and other supervisory purposes. Generally, supporting documentation will be expected to establish how banking organizations track and report their capital components and on- and off-balance-sheet items that are given preferential treatment. It may be necessary for examiners to reassign on- or off-balance-sheet items that are given a preferential risk weight to a weight of 100 percent, when supporting documentation is inadequate. Examiners are expected to verify that bank holding companies are correctly reporting the information requested on the holding companies' consolidated financial statements (FR Y-9C), which are used to compute the organization's risk-based capital ratios.

4060.3.5 SUPERVISORY CONSIDERATIONS FOR CALCULATING AND EVALUATING RISK-BASED CAPITAL

Examiners must consider certain requirements and factors when assessing the risk-based capital ratios and the overall capital adequacy of banking organizations. Analysis of these requirements and factors may have a material impact on the amount of capital banking organizations must hold to appropriately support certain activities for on- and off-balance-sheet items. The treatment of the following such activities must be used when assessing compliance with the guidelines and overall capital adequacy of banking organizations.

- *Certain capital-adjustment considerations:*
  - — investments and advances to unconsolidated banking and finance subsidiaries
  - — review and monitoring of goodwill and certain other intangible assets
  - — certain credit-enhancing interest-only strips (I/Os)
  - — reciprocal holdings of banking organizations' capital instruments
  - — deferred tax assets
  - — nonfinancial equity investments
- *Certain balance-sheet activity considerations:*
  - — investment in shares of a mutual fund
  - — mortgage-backed securities
  - — loans secured by first liens on one- to four-family residential properties
- *Certain off-balance-sheet activity considerations:*
  - — small-business loans and leases on personal property
  - — assets sold with recourse (FAS 140 sales)
  - — securities lent
  - — unused commitments
  - — financial and performance standby letters of credit
  - — avoidance of double-counting of interest-rate and exchange-rate contracts
  - — treatment of commodity and equity swaps
  - — netting of swaps and similar contracts
  - — assets sold with recourse
- *Considerations in the overall assessment of capital adequacy:*
  - — unrealized asset values
  - — terms of subordinated debt and intermediate-term preferred stock
  - — ineligible collateral and guarantees
  - — overall asset quality
  - — interest-only and principal-only strips
  - — interest-rate risk
  - — claims on, and claims guaranteed by, OECD central governments

If the terms and conditions of a particular instrument cause uncertainty as to how the instrument should be treated for capital purposes, it may be necessary to consult with Federal Reserve staff for a final determination. The Federal Reserve will, on a case-by-case basis, determine whether a capital instrument has characteristics that warrant its inclusion in tier 1 or tier 2 capital, as well as any quantitative limit on the amount of an instrument that will be counted as an element of tier 1 or tier 2 capital. In making this determination, the Federal Reserve will consider the similarity of the instrument to instruments explicitly treated in the guidelines, the ability of the instrument to absorb losses while the bank holding company operates as a going concern, the maturity and redemption features of the instrument, and other relevant terms and factors.

Redemptions of permanent equity or other capital instruments before their stated maturity could have a significant impact on a bank's overall capital structure. Consequently, a bank holding company considering such a step should consult with the Federal Reserve before redeeming any equity or debt capital instrument (before maturity) if its redemption could have a material effect on the level or composition of the organization's capital base.[11]

4060.3.5.1 Investments in and Advances to Unconsolidated Banking and Finance Subsidiaries and Other Subsidiaries

Generally, debt and equity capital investments and any other instruments deemed to be capital in unconsolidated banking and finance subsidiaries[12] are to be deducted from the consolidated capital of the banking organizations, regardless of whether the investment is made by a parent bank holding company or its direct or indirect subsidiaries.[13] Fifty percent of the investment is to be deducted from tier 1 capital and 50 percent from tier 2 capital. In cases where tier 2 capital is not sufficient to absorb the portion

11. Consultation would not ordinarily be necessary if an instrument were redeemed with the proceeds of, or replaced by, a like amount of a similar or higher-quality capital instrument and the organization's capital position is considered fully adequate by the Federal Reserve.

12. A banking and finance subsidiary generally is defined as any company engaged in banking or finance in which the parent institution directly or indirectly holds more than 50 percent of the outstanding voting stock, or which is otherwise controlled or capable of being controlled by the parent organization.

13. An exception to this deduction is to be made in the case of shares acquired in the regular course of securing or collecting a debt previously contracted in good faith.

(50 percent) of the investment allocated to it, the remainder (up to 100 percent) is to be deducted from tier 1 capital. In addition, capital investments in certain other subsidiaries that, while consolidated for accounting purposes, are not consolidated for certain supervisory or regulatory purposes, such as to facilitate functional regulation, are to be deducted from tier 1 and tier 2 capital of the banking organization in the same proportion as for unconsolidated banking and finance subsidiaries.

Advances to banking and finance subsidiaries (that is, loans, extensions of credit, guarantees, commitments, or any other credit exposures) not considered as capital are included in risk assets at the 100 percent risk weight (unless recognized collateral or guarantees dictate weighting at a lower percentage). However, such advances may be deducted from the parent banking organization's consolidated capital if the Federal Reserve finds that the risks associated with the advances are similar to the risks associated with capital investments, or if such advances possess risk factors that warrant an adjustment to capital for supervisory purposes. These risk factors could include the absence of collateral support or the clear intention of banking organizations to allow the advances, regardless of form, to serve as capital to subsidiaries.

The Board does not automatically deduct investments in other unconsolidated subsidiaries or investments in joint ventures and associated companies. Nonetheless, resources invested in these entities support assets that are not consolidated with the rest of the bank holding company and, therefore, may not be generally available to support additional leverage or absorb losses of affiliated institutions. Moreover, experience has shown that banking organizations often stand behind the losses of affiliated institutions in order to protect the reputation of the organization as a whole. In some cases, this support has led to losses that have exceeded the investments in these entities.

Accordingly, the level and nature of such investments should be closely monitored. For risk-based capital purposes, on a case-by-case basis, a bank holding company may be required to deduct such investments from total capital, to apply an appropriate risk-weighted capital charge against its pro rata share of the assets of the affiliated entity, to perform a required line-by-line consolidation of the entity, or to operate with a risk-based capital ratio above the minimum. In determining the appropriate capital treatment for such actions, the Board will generally take into account whether (1) the banking organization has significant influence over the financial or managerial policies or operations of the affiliated entity, (2) the banking organization is the largest investor in the entity, or (3) other circumstances prevail (such as the existence of significant guarantees from the bank holding company) that appear to closely tie the activities of the affiliated company to the banking organization.

4060.3.5.1.1 Review and Monitoring of Intangible Assets

For bank holding companies, tier 1 capital is generally defined as the sum of core capital elements less goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of the risk-based measure of the capital adequacy guidelines for BHCs. Certain intangible assets *are not required to be deducted* from capital.

4060.3.5.1.1.1 Certain Assets That May Be Included in Capital

All servicing assets, including servicing assets on assets other than mortgages (that is, nonmortgage-servicing assets), are deemed identifiable intangible assets. The only types of identifiable intangible assets that may be included in, that is, not deducted from, an organization's capital are readily marketable mortgage-servicing assets, nonmortgage-servicing assets, purchased credit-card relationships (PCCRs), and credit-enhancing I/Os. The total amount of these assets that are included in capital, in the aggregate, cannot exceed 100 percent of tier 1 capital. Nonmortgage-servicing assets and purchased credit-card relationships are subject to a separate sublimit of 25 percent of tier 1 capital. The total amount of credit-enhancing I/Os (both purchased and retained) that may be included in capital cannot exceed 25 percent of tier 1 capital.[14] The total amount of credit-enhancing I/Os (both purchased and retained) that may be

14. Amounts of mortgage-servicing rights and purchased credit-card relationships in excess of these limitations, as well as all other identifiable intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from an organization's core capital elements in determining tier 1 capital. Identifiable intangible assets, however, exclusive of mortgage-servicing assets and purchased credit-card relationships, acquired on or before February 19, 1992, generally *will not* be deducted from capital for supervisory purposes. They will, however, continue to be deducted for applications purposes.

included in capital cannot exceed 25 percent of tier 1 capital.

Purchased mortgage-servicing assets are identifiable intangible assets associated with the right to service mortgage loans. They usually arise when the rights are purchased from the entity that originated the mortgage loans. An organization that acquires purchased mortgage-servicing assets (PMSAs) has the obligation to collect principal and interest payments and escrow accounts from the mortgagor and to ensure that all amounts collected from the mortgagor are passed on to the appropriate parties. For performing these services, the servicer receives a fee, which is generally based on the remaining principal amount due on the mortgages being serviced.

Originated mortgage-servicing assets (OMSAs) generally represent the servicing rights acquired when an organization originates mortgage loans and subsequently sells the loans but retains the servicing rights. OMSAs are capitalized as balance-sheet assets in the same manner as PMSAs as a result of a Financial Accounting Standards Board decision, FAS 140, "Accounting for the Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." FAS 140 requires the right to service mortgage loans for others to be separately recognized as a servicing asset or liability, however the rights were acquired. Servicing becomes a distinct asset or liability only when it is contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or by separate purchase or assumption of the servicing. See section 3070.0.6 for information on, and accounting for, mortgage-servicing assets.

Purchased credit-card relationships are identifiable intangible assets associated with the right to provide future advances and other services to credit card holders and to provide correspondent-merchant processing under credit card arrangements that have been originated by, and purchased from, another entity. PCCRs usually arise when a credit card portfolio is bought, and the purchaser acquires the current advances outstanding under the credit card arrangements, which are tangible assets, as well as the right to provide future services to the cardholders, which is an intangible asset. The value of PCCRs is derived from the anticipated profit the purchaser will earn from interest on future advances and from fees charged for other future credit card–related services, after covering expenses and other operating costs such as credit losses.

When calculating the limitations on mortgage-servicing assets, nonmortgage-servicing assets, purchased credit-card relationships, and credit-enhancing I/Os, the definition of tier 1 capital will be the sum of core capital elements, net of goodwill and net of all identifiable intangible assets and similar assets other than mortgage-servicing assets, nonmortgage-servicing assets, and purchased credit-card relationships, regardless of when they were acquired. (This calculation of tier 1 is before the deduction of any disallowed mortgage-servicing assets, any disallowed nonmortgage-servicing assets, any disallowed purchased credit-card relationships, any disallowed credit-enhancing I/Os (purchased or retained), and any disallowed deferred tax assets.)

4060.3.5.1.1.2 Valuation Review

Bank holding companies must review the book value of all intangible assets at least quarterly and make adjustments to these values as necessary. The fair market values of all intangible assets, nonmortgage-servicing assets, purchased credit-card relationships, and credit-enhancing I/Os also must be determined at least quarterly. This determination is to include adjustments for any significant changes made to the original valuation assumptions, including changes in prepayment estimates or account-attrition rates.

Examiners will review both the book value and the fair market value assigned to these assets, together with supporting documentation, during the inspection process. In addition, the Federal Reserve may require, on a case-by-case basis, an independent valuation of a BHC's intangible assets and credit-enhancing I/Os.

4060.3.5.1.1.3 Fair-Value and Book-Value Limits

The amount of mortgage-servicing rights, nonmortgage-servicing assets, and purchased credit-card relationships that a bank holding company may include in capital is limited to the lesser of 90 percent of their fair value (as determined according to the guidance herein), or 100 percent of their book value, as adjusted for capital purposes in accordance with the instructions to the Consolidated Financial Statements for Bank Holding Companies (FR Y-9C Report). If both the application of the limits on mortgage-servicing assets, nonmortgage-servicing assets, and purchased credit-card relationships and the adjustment of the balance-sheet amount for these assets would result in an amount being deducted from capital, the BHC would deduct only the greater of the two amounts from its core capital elements in determining tier 1 capital.

The amount of credit-enhancing interest-only strips (I/Os) that a bank holding company may include in capital is their fair value. Such I/Os are on-balance-sheet assets that, in form or substance, represent the contractual right to receive some or all of the interest due on transferred assets. I/Os expose the bank holding company to credit risk directly or indirectly associated with transferred assets that exceeds a pro rata share of the bank holding company's claim on the assets, whether through subordination provisions or other credit-enhancement techniques. Such I/Os, whether purchased or retained, and including other similar "spread" assets, may be included in, that is, not deducted from, a bank holding company's capital subject to the fair value and tier 1 limitations. Both purchased and retained credit-enhancing I/Os, on a non-tax-adjusted basis, are included in the total amount that is used for purposes of determining whether a bank holding company exceeds the tier 1 limitation. In determining whether an I/O or other types of spread assets serve as a credit enhancement, the Federal Reserve will look to the economic substance of the transaction.

Bank holding companies may elect to deduct disallowed mortgage-servicing assets, any disallowed nonmortgage-servicing assets, and any disallowed credit-enhancing I/Os (purchased and retained) on a basis that is net of any associated deferred tax liability. Deferred tax liabilities netted in this manner cannot also be netted against deferred tax assets when determining the amount of deferred tax assets that are dependent upon future taxable income.

4060.3.5.1.1.4 Growing Organizations

Banking organizations experiencing substantial growth, whether internally or by acquisition, are expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets or credit-enhancing I/Os.

4060.3.5.1.1.5 Examiners' Review of Intangibles

During on-site examinations and inspections, examiners are to review the evidence of title to and the accounting for intangible assets, including their respective amortization schedules and supporting documentation. Carrying values of intangible assets and fair market values assigned to these assets that are overstated or not adequately supported with documentation on how the carrying values were originated, amortized, or adjusted should be excluded from banking organizations' risk-based capital calculations. Intangible assets in excess of 25 percent of tier 1 capital should be closely scrutinized along with any unusual items and, if supervisory concerns warrant, deducted from tier 1 capital. An arrangement whereby a bank holding company enters into a licensing or leasing agreement or similar transaction to avoid booking an intangible asset should be subject to particularly close scrutiny. Normally, such arrangements will be dealt with by adjusting the bank holding company's capital calculation in an appropriate manner. In making their evaluation of intangible assets, examiners are to consider a number of factors, including—

1. the reliability and predictability of any cash flows associated with the asset and the degree of certainty that can be achieved in periodically determining the asset's useful life and value,
2. the existence of an active and liquid market for the asset, and
3. the feasibility of selling the asset apart from the banking organization or from the bulk of its assets.

Intangible rights that have been allowed to lapse or that are no longer used should be recommended for authorized write-off. Examiners should review intangible assets, such as mortgage-servicing rights, nonmortgage-servicing rights (for example, core deposit intangibles and leaseholds), and purchased credit-card relationships, and determine that the organization properly monitors their level and quality.

4060.3.5.1.2 Reciprocal Holdings of Banking Organizations' Capital Instruments

Reciprocal holdings (intentional cross-holdings) of banking organizations' capital instruments are to be deducted from the total capital of an organization for the purpose of determining the total risk-based capital ratio. Reciprocal holdings are cross-holdings resulting from formal or informal arrangements between banking organizations to swap or exchange each other's capital instruments. Deductions of holdings of capital securities also would not be made in the case of interstate ''stake-out'' investments that comply with the Board's policy statement on nonvoting equity investments (12 C.F.R. 225.143). In addition, holdings of capital instruments issued by other banking organizations but taken in satisfaction of debts previously contracted would be exempt from any deduction from capital.

4060.3.5.1.3 Limit on Deferred Tax Assets

The amount of deferred tax assets that are dependent on future taxable income, net of the valuation allowance for deferred tax assets, that may be included in, that is, not deducted from, a bank holding company's capital may not exceed the lesser of—

1. the amount of these deferred tax assets that the bank holding company is expected to realize within one year of the calendar quarter–end, based on the projections of future taxable income for that year,[15] or
2. 10 percent of tier 1 capital.

The reported amount of deferred tax assets, net of any valuation allowance for deferred tax assets, in excess of the lesser of these two amounts is to be deducted from a banking organization's core capital elements in determining tier 1 capital. For purposes of calculating the 10 percent limitation, tier 1 capital is defined as the sum of the core capital elements, net of goodwill and net of all identifiable intangible assets other than mortgage-servicing assets, nonmortgage-servicing assets, and purchased credit-card relationships, before the deduction of any disallowed mortgage-servicing assets, any disallowed nonmortgage-servicing assets, any disallowed purchased credit-card relationships, any disallowed credit-enhancing I/Os, any disallowed deferred tax assets, and any nonfinancial equity investments. There generally is no limit in tier 1 capital on the amount of deferred tax assets that can be realized from taxes paid in prior carry-back years and from future reversals of existing taxable temporary differences.

4060.3.5.1.4 Nonfinancial Equity Investments

A bank holding company must deduct from its core capital elements the sum of the appropriate percentages (as determined below) of the adjusted carrying value of all nonfinancial equity investments held by the parent bank holding company or by its direct or indirect subsidiaries. Investments held by a bank holding company include all investments held directly or indirectly by the bank holding company or any of its subsidiaries. The adjusted carrying value of investments is the aggregate value at which the investments are carried on the balance sheet of the consolidated bank holding company reduced by any unrealized gains on those investments that are reflected in such carrying value but excluded from the bank holding company's tier 1 capital and associated deferred tax liabilities. For example, for investments held as available-for-sale (AFS), the adjusted carrying value of the investments would be the aggregate carrying value of the investments (as reflected on the consolidated balance sheet of the bank holding company) *less* any unrealized gains on those investments that are included in other comprehensive income and not reflected in tier 1 capital, and associated deferred tax liabilities.[16]

A nonfinancial equity investment, subject to the risk-based capital rule (the rule), is any equity investment held by the bank holding company (1) under the merchant banking authority of section 4(k)(4)(H) of the Bank Holding Company Act (the BHC Act) and subpart J of the Board's Regulation Y (12 C.F.R. 225.175 et seq.); (2) under section 4(c)(6) or 4(c)(7) of the BHC Act in a nonfinancial company or in a company that makes investments in nonfinancial companies; (3) in a nonfinancial company through a small business investment company (SBIC) under section 302(b) of the Small Busi-

15. To determine the amount of expected deferred tax assets realizable in the next 12 months, a banking organization should assume that all existing temporary differences fully reverse as of the report date. Projected future taxable income should not include net operating loss carry-forwards to be used during that year or the amount of existing temporary differences a bank holding company expects to reverse within the year. Such projections should include the estimated effect of tax-planning strategies that the organization expects to implement to realize net operating losses or tax-credit carry-forwards that would otherwise expire during the year. A new 12-month projection does not have to be prepared each quarter. Rather, on interim report dates, banking organizations may use the future-taxable-income projections for their current fiscal year, adjusted for any significant changes that have occurred or are expected to occur.

16. Unrealized gains on AFS investments may be included in supplementary capital to the extent permitted by the risk-based capital guidelines. In addition, the unrealized losses on AFS equity investments are deducted from tier 1 capital.

ness Investment Act of 1958;[17] (4) in a nonfinancial company under the portfolio investment provisions of the Board's Regulation K (12 C.F.R. 211.8(c)(3)); or (5) in a nonfinancial company under section 24 of the Federal Deposit Insurance Act (other than section 24(f)).[18]

17. An equity investment made under section 302(b) of the Small Business Investment Act of 1958 in an SBIC that is not consolidated with the parent banking organization is treated as a nonfinancial equity investment.

18. See 12 U.S.C. 1843(c)(6), (c)(7), and (k)(4)(H); 15 U.S.C. 682(b); 12 C.F.R. 211.5(b)(1)(iii); and 12 U.S.C. 1831a. In a case in which the board of directors of the FDIC, acting directly in exceptional cases and after a review of the proposed activity, has permitted a lesser capital deduction for an investment approved by the board of directors under section 24 of the Federal Deposit Insurance Act, such deduction shall also apply to the consolidated bank holding company capital calculation so long as the bank's investments under section 24 and SBIC investments represent, in the aggregate, less than 15 percent of the tier 1 capital of the bank.

A nonfinancial company is an entity that engages in any activity that has not been determined to be financial in nature or incidental to financial activities under section 4(k) of the Bank Holding Company Act (12 U.S.C. 1843(k)).

The bank holding company must deduct from its core capital elements the sum of the appropriate percentages, as stated in table 1, of the adjusted carrying value of all nonfinancial equity investments held by the bank holding company. The amount of the percentage deduction increases as the aggregate amount of nonfinancial equity investments held by the bank holding company increases as a percentage of the bank holding company's tier 1 capital.

Table 1—Deduction for Nonfinancial Equity Investments

Aggregate adjusted carrying value of all nonfinancial equity investments held directly or indirectly by the bank holding company (as a percentage of the tier 1 capital of the parent banking organization)[1]	*Deduction from core capital elements (as a percentage of the adjusted carrying value of the investment)*
Less than 15 percent	8 percent
15 percent to 24.99 percent	12 percent
25 percent and above	25 percent

1. For purposes of calculating the adjusted carrying value of nonfinancial equity investments as a percentage of tier 1 capital, tier 1 capital is defined as the sum of core capital elements net of goodwill and net of all identifiable intangible assets other than MSAs, NMSAs, and PCCRs, but before the deduction for any disallowed MSAs, any disallowed NMSAs, any disallowed PCCRs, any disallowed credit-enhancing I/Os (both purchased and retained), any disallowed deferred tax assets, and any nonfinancial equity investments.

These deductions are applied on a marginal basis to the portions of the adjusted carrying value of nonfinancial equity investments that fall within the specified ranges of the parent holding company's tier 1 capital. For example, if the adjusted carrying value of all nonfinancial equity investments held by a bank holding company equals 20 percent of the tier 1 capital of the bank holding company, then the amount of the deduction would be 8 percent of the adjusted carrying value of all investments up to 15 percent of the company's tier 1 capital, and 12 percent of the adjusted carrying value of all investments in excess of 15 percent of the company's tier 1 capital. The total adjusted carrying value of any nonfinancial equity investment that is subject to deduction is excluded from the bank holding company's risk-weighted assets for purposes of computing the denominator of the company's risk-based capital ratio.[19]

The rule establishes minimum risk-based capital ratios, and banking organizations are at all times expected to maintain capital commensurate with the level and nature of the risks to which they are exposed. The risk to a banking organization from nonfinancial equity investments increases with its concentration in such investments, and strong capital levels above the minimum requirements are particularly important when a banking organization has a high degree of concentration in nonfinancial equity

19. For example, if 8 percent of the adjusted carrying value of a nonfinancial equity investment is deducted from tier 1 capital, the entire adjusted carrying value of the investment will be excluded from risk-weighted assets in calculating the denominator for the risk-based capital ratio.

investments (for example, in excess of 50 percent of tier 1 capital).

The Federal Reserve intends to monitor banking organizations and apply heightened supervision to equity investment activities as appropriate, including where the banking organization has a high degree of concentration in nonfinancial equity investments, to ensure that each organization maintains capital levels that are appropriate in light of its equity investment activities. The Federal Reserve also reserves authority to impose a higher capital charge in any case where the circumstances, such as the level of risk of the particular investment or portfolio of investments, the risk-management systems of the banking organization, or other information, indicate that a higher minimum capital requirement is appropriate.

4060.3.5.1.4.1 SBIC Investments

No deduction is required for nonfinancial equity investments that are held by a bank holding company through one or more SBICs that are consolidated with the bank holding company or in one or more SBICs that are not consolidated with the bank holding company to the extent that all such investments, in the aggregate, do not exceed 15 percent of the aggregate of the bank holding company's pro rata interests in the tier 1 capital of its subsidiary banks. Any nonfinancial equity investment that is held through or in an SBIC and not required to be deducted from tier 1 capital will be assigned a 100 percent risk weight and included in the parent holding company's consolidated risk-weighted assets.[20]

To the extent the adjusted carrying value of all nonfinancial equity investments that a bank holding company holds through one or more SBICs that are consolidated with the bank holding company or in one or more SBICs that are not consolidated with the bank holding company exceeds, in the aggregate, 15 percent of the aggregate tier 1 capital of the company's subsidiary banks, the appropriate percentage of such amounts (as set forth in table 1) must be deducted from the bank holding company's core capital elements. In addition, the aggregate adjusted carrying value of *all* nonfinancial equity investments held through a consolidated SBIC and in a nonconsolidated SBIC (including any investments for which no deduction is required) must be included in determining, for purposes of table 1, the total amount of nonfinancial equity investments held by the bank holding company in relation to its tier 1 capital.

No deduction is required to be made with respect to the adjusted carrying value of any nonfinancial equity investment (or portion of such an investment) that was made by the bank holding company before March 13, 2000, or that was made after such date pursuant to a binding written commitment[21] entered into by the bank holding company before March 13, 2000, provided that in either case the bank holding company has continuously held the investment since the relevant investment date.[22] A nonfinancial equity investment made before March 13, 2000, includes any shares or other interests received by the bank holding company

20. If a bank holding company has an investment in an SBIC that is consolidated for accounting purposes but that is not wholly owned by the bank holding company, the adjusted carrying value of the bank holding company's nonfinancial equity investments through the SBIC is equal to the holding company's proportionate share of the adjusted carrying value of the SBIC's equity investments in nonfinancial companies. The remainder of the SBIC's adjusted carrying value (that is, the minority interest holders' proportionate share) is excluded from the risk-weighted assets of the bank holding company. If a bank holding company has an investment in an SBIC that is not consolidated for accounting purposes and has current information that identifies the percentage of the SBIC's assets that are equity investments in nonfinancial companies, the bank holding company may reduce the adjusted carrying value of its investment in the SBIC proportionately to reflect the percentage of the adjusted carrying value of the SBIC's assets that are not equity investments in nonfinancial companies. If a bank holding company reduces the adjusted carrying value of its investment in a nonconsolidated SBIC to reflect financial investments of the SBIC, the amount of the adjustment will be risk weighted at 100 percent and included in the bank's risk-weighted assets.

21. A "binding written commitment" means a legally binding written agreement that requires the banking organization to acquire shares or other equity of the company, or make a capital contribution to the company, under terms and conditions set forth in the agreement. Options, warrants, and other agreements that give a banking organization the right to acquire equity or make an investment, but do not require the banking organization to take such actions, are not considered a binding written commitment.

22. For example, if a bank holding company made an equity investment in 100 shares of a nonfinancial company before March 13, 2000, that investment would not be subject to a deduction. However, if the bank holding company made any additional equity investment in the company after March 13, 2000, such as by purchasing additional shares of the company (including through the exercise of options or warrants acquired before or after March 13, 2000) or by making a capital contribution to the company, and such investment was not made pursuant to a binding written commitment entered into before March 13, 2000, the adjusted carrying value of the additional investment would be subject to a deduction. In addition, if the bank holding company sold and repurchased shares of the company after March 13, 2000, the adjusted carrying value of the reacquired shares would be subject to a deduction.

through a stock split or stock dividend on an investment made before March 13, 2000, provided the bank holding company provides no consideration for the shares or interests received and the transaction does not materially increase the bank holding company's proportional interest in the company. The exercise on or after March 13, 2000, of options or warrants acquired before March 13, 2000, is *not* considered to be an investment made before March 13, 2000, if the bank holding company provides any consideration for the shares or interests received upon exercise of the options or warrants. Any nonfinancial equity investment (or portion thereof) that is not required to be deducted from tier 1 capital must be included in determining the total amount of nonfinancial equity investments held by the bank holding company in relation to its tier 1 capital for purposes of table 1. In addition, any nonfinancial equity investment (or portion thereof) that is not required to be deducted from tier 1 capital will be assigned a 100 percent risk weight and included in the bank holding company's consolidated risk-weighted assets.

As discussed above for consolidated SBICs, some equity investments may be in companies that are consolidated for accounting purposes. For investments in a nonfinancial company that is consolidated for accounting purposes under generally accepted accounting principles, the parent banking organization's adjusted carrying value of the investment is determined under the equity method of accounting (net of any intangibles associated with the investment that are deducted from the consolidated bank holding company's core captial). Even though the assets of the nonfinancial company are consolidated for accounting purposes, these assets (as well as the credit-equivalent amounts of the company's off-balance-sheet items) should be excluded from the banking organization's risk-weighted assets for regulatory capital purposes.

4060.3.5.1.4.2 Equity Investments

The term "equity investment" means any equity instrument (including common stock, preferred stock, partnership interests, interests in limited-liability companies, trust certificates, and warrants and call options that give the holder the right to purchase an equity instrument), any equity feature of a debt instrument (such as a warrant or call option), and any debt instrument that is convertible into equity. An investment in any other instrument (including subordinated debt) may be treated as an equity investment if, in the judgment of the Federal Reserve, the instrument is the functional equivalent of equity or exposes the banking organization to essentially the same risks as an equity instrument.

4060.3.5.1.5 Revaluation Reserves

Revaluation reserves reflect the formal balance-sheet restatement or revaluation for capital purposes of asset carrying values to reflect the current market values. The Federal Reserve generally has not included unrealized asset appreciation in capital-ratio calculations, although it has long taken such values into account as a separate factor in assessing the overall financial strength of a banking organization.

Consistent with long-standing supervisory practice, the excess of market values over book values for assets held by bank holding companies will generally not be recognized in supplementary capital or in the calculation of the risk-based capital ratio. However, all bank holding companies are encouraged to disclose their equivalent of premises (building) and security-revaluation reserves. The Federal Reserve will consider any appreciation, as well as any depreciation, in specific asset values as additional considerations in assessing overall capital strength and financial condition.

4060.3.5.2 Certain Balance-Sheet-Activity Considerations

4060.3.5.2.1 Investment in Shares of a Mutual Fund

An exception to the general rule exists for an investment in shares of a fund that invests in various securities or money market instruments that are eligible to be assigned to different risk categories. In this case, the total investment would generally be assigned to the risk category appropriate to the highest risk-weighted asset the fund may hold, in accordance with the stated limits set forth in the prospectus. Bank holding companies have the option of assigning the investment on a pro rata basis to different risk categories according to the investment limits in the fund's prospectus. Regardless of the risk-weighting method used, the total risk weight of a mutual fund must not be less than 20 percent. If the bank holding company chooses to assign a fund investment on a pro rata basis, and the sum of the investment limits for all asset categories, as described in the fund's prospectus, exceeds 100 percent, it must assign risk weights in descending order *based on the assumption that the fund invests the largest possible percentage of its assets in the highest risk-weighted categories.*[23] If, in order to maintain a necessary degree of short-term liquidity, a fund is permitted to hold an insignificant amount of its assets in short-term, highly liquid securities of superior credit quality that do not qualify for a preferential risk weight, then those securities may be disregarded in determining the fund's risk weight.

The prudent use of hedging instruments by a fund to reduce the risk of its assets will not increase the risk weighting of the fund investment. For example, the use of hedging instruments by a fund to reduce the interest-rate risk of its government bond portfolio will not increase the risk weight of that fund above the 20 percent category. Nonetheless, if a fund engages in any activities that appear speculative in nature or the fund has any other characteristics that are inconsistent with the preferential risk weighting assigned to the fund's assets, holdings in the fund will be assigned to the 100 percent risk-weight category.

4060.3.5.2.2 Loans Secured by First Liens on One- to Four-Family Residential Properties or Multifamily Residential Properties

Qualifying one- to four-family residential properties, either owner-occupied or rented, or multifamily residential properties (as listed in the instructions to the bank holding company FR Y-9C Report), are accorded preferential risk-weighting treatment under the guidelines. These loans include loans to builders with substantial project equity for the construction of one- to four-family residential properties that have been presold under firm contracts to purchasers who have obtained firm commitments for permanent qualifying mortgage loans and have made substantial earnest-money deposits.[24] Effective with an April 1, 1999, amendment, such loans to builders will be considered prudently underwritten only if the bank holding company has obtained sufficient documentation that the buyer of the home intends to purchase the home (that is, has a legally binding written sales contract). The buyer must have the ability to obtain a mortgage sufficient to purchase the home (that is, has a firm written commitment for permanent financing of the home upon completion).

To ensure that only qualifying residential mortgage loans are assigned to the 50 percent risk-weight category, examiners are to review the real estate loans that are included in that category. Such loans are not eligible for preferential treatment unless the loans are made subject to prudent credit-underwriting standards; the loan-to-value ratios are conservative;[25] the loan-to-value ratios[26] are based on the most current appraisal or evaluation[27] of the properties, with such appraisal or evaluation conforming to both the Board's real estate appraisal regulations and guidelines and the banking organization's internal appraisal guidelines; and the loans are performing in accordance with their original terms and are not 90 days or more past due or carried in nonaccrual status. Where examiners find that some residential mortgage loans do not meet all the specified criteria or are made for the purpose of speculative real estate development, such loans should be assigned to

23. For example, assume that a fund's prospectus permits up to 30 percent of the fund's assets to be invested in 100 percent risk-weighted assets, up to 40 percent of the fund's assets to be invested in 50 percent risk-weighted assets, and up to 60 percent of the fund's assets to be invested in 20 percent risk-weighted assets. In such a case, the bank holding company must assign 30 percent of the total investment to the 100 percent risk category, 40 percent to the 50 percent risk category, and 30 percent to the 20 percent risk category. It may not minimize its capital requirement by assigning 60 percent of the total investment to the 20 percent risk category and 40 percent to the 50 percent risk category.

24. An amendment, effective December 29, 1992, lowered from 100 percent to 50 percent the risk weight on loans to finance the construction of one- to four-family residences that have been presold.

25. Prudent underwriting standards dictate that a loan-to-value ratio used in the case of originating a loan to acquire a property would not be deemed conservative unless the value is based on the lower of the acquisition cost of the property or the appraised (or, if appropriate, evaluated) value. Otherwise, the loan-to-value ratio generally would be based on the value of the property as determined by the most current appraisal or, if appropriate, the most current evaluation. All appraisals and evaluations must be made in a manner consistent with the federal banking agencies' real estate appraisal regulations and guidelines and with the banking organization's own appraisal guidelines.

26. If a banking organization holds the first and junior lien(s) on a residential property and no other party holds an intervening lien, the transaction is treated as a single loan secured by a first lien for the purposes of determining the loan-to-value ratio and assigning a risk weight.

27. Appraisals made at the inception of one- to four-family residential property loans are to be used in calculating loan-to-value ratios. Subsequent appraisals showing increased property values may be used to support higher loan-to-value ratios. However, to avoid penalizing banking organizations doing business in markets with declining real estate values, appraisals of residential properties as conducted at inception are to be used in calculating loan-to-value ratios, even though more current appraisals showing decreases in values are available.

the 100 percent risk-weight category in accordance with the guidelines.

Examiners should keep in mind that loans secured by multifamily residential property must meet additional criteria to be included in the 50 percent risk-weight category. These include the requirement that all principal and interest payments on the loan must have been made on time for at least the year preceding the placement of the loan in this risk-weight category. If the existing property owner is refinancing a loan on that property, all principal and interest payments on the loan being refinanced must have been made on time for at least the year preceding placement in this risk-weight category. In addition, amortization of the principal and interest must occur over a period of not more than 30 years, and the minimum original maturity for repayment of principal must not be less than seven years. Also, the annual net operating income (before debt service) generated by the property during its most recent fiscal year must not be less than 120 percent of the loan's current annual debt service (115 percent if the loan is based on a floating interest rate), or, in the case of a cooperative or other not-for-profit housing project, the property must generate sufficient cash flow to provide comparable protection to the institution.

If examiners find material evidence of residential mortgage loans having questionable eligibility for preferential risk-weighting, but cannot readily identify the amounts that were inappropriately weighted, the overall evaluation of the banking organization's capital adequacy should reflect a higher capital requirement than otherwise would be the case.

4060.3.5.3 Certain Off-Balance-Sheet Activity Considerations

Off-balance-sheet transactions include recourse obligations and direct-credit substitutes. The treatment for direct-credit substitutes, assets transferred with recourse, and securities issued in connection with asset securitizations and structured financings is described below. The terms "asset securitizations" or "securitizations," as used in this subsection, include structured financings as well as asset-securitization transactions.

4060.3.5.3.1 Assets Sold with Recourse

For risk-based capital adequacy purposes, recourse means the retention, by a bank holding company, in form or in substance, of any credit risk directly or indirectly associated with an asset it has transferred and sold that exceeds a pro rata share of the banking organization's claim on the asset. If a banking organization has no claim on a transferred asset, then the retention of any risk of credit loss is recourse. A recourse obligation typically arises when a bank holding company transfers assets and retains an explicit obligation to repurchase the assets or absorb losses due to a default on the payment of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may also exist implicitly if a bank holding company provides credit enhancement beyond any contractual obligation to support assets it has sold. The following are examples of recourse arrangements:

1. credit-enhancing representations and warranties made on the transferred assets
2. loan-servicing assets retained pursuant to an agreement under which the bank holding company will be responsible for credit losses associated with the loans being serviced (Mortgage-servicer cash advances that meet the conditions of section III.B.3.a.viii. of the guidelines (12 C.F.R. 225, appendix A) are not recourse arrangements.)
3. retained subordinated interests that absorb more than their pro rata share of losses from the underlying assets
4. assets sold under an agreement to repurchase, if the assets are not already included on the balance sheet
5. loan strips sold without contractual recourse, when the maturity of the transferred loan is shorter than the maturity of the commitment under which the loan is drawn
6. credit derivatives issued that absorb more than the bank holding company's pro rata share of losses from the transferred assets
7. clean-up calls that are greater than 10 percent of the balance of the original pool of transferred loans or of the outstanding principal amount of securities (Clean-up calls that are 10 percent or less of the original pool balance or of the outstanding principal amount of securities are not recourse arrangements.)

To qualify as an asset sale with recourse, a transfer of assets must first qualify as a sale according to the GAAP criteria set forth in paragraph 14 of the Financial Accounting Standards Board's Statement No. 140 (FAS 140), ''Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.'' If a transfer of assets does not meet these criteria, the assets must remain on the bank holding company's balance sheet and thus they are subject to the appropriate risk-based capital charge.

If a transfer of assets qualifies as a sale under GAAP, but the bank holding company retains any risk of loss or obligation for payment of principal or interest, then the transfer is considered to be a sale with recourse. A more detailed definition of an asset sale with recourse may be found in the ''Summary Description of the Risk-Based Capital Treatment of Recourse Arrangements'' in the glossary to the Consolidated Financial Statements for Bank Holding Companies, the FR Y-9C Report instructions. Although the assets are removed from a bank holding company's balance sheet in an asset sale with recourse, the credit-equivalent amount is assigned to the risk category appropriate to the obligor in the underlying transaction, after considering any associated guaranties or nature of the collateral. This assignment also applies when the contractual terms of the recourse agreement limit the seller's risk to a percentage of the value of the assets sold or to a specific dollar amount.

If, however, the risk retained by the seller is limited to some fixed percentage of any losses that might be incurred and there are no other provisions resulting in the direct or indirect retention of risk by the seller, the maximum amount of possible loss for which the selling bank holding company is at risk (the stated percentage times the amount of assets to which the percentage applies) is subject to risk-based capital requirements. The remaining amount of assets transferred would be treated as a sale that is not subject to the risk-based capital requirements. For example, a seller would treat a sale of $1 million in assets with a recourse provision that the seller and buyer proportionately share in losses incurred on a 10 percent and 90 percent basis, respectively, and with no other retention of risk by the seller, as a $100,000 asset sale with recourse and a $900,000 sale not subject to risk-based capital requirements.

There are exceptions to this general reporting rule for recourse transactions. The first exception applies to recourse transactions for which the amount of recourse the bank holding company is contractually liable for is less than the capital requirement for the assets transferred under the recourse agreement. For such transactions, a bank holding company must hold capital equal to its maximum contractual recourse obligation. For example, assume that a bank holding company transfers a $100 pool of commercial loans and retains a recourse obligation of 2 percent. Ordinarily, it would be subject to an 8 percent capital charge, or $8. Because the recourse obligation is only 2 percent, however, the bank holding company would be required to hold capital of $2 against the recourse exposure. This capital charge may be reduced further by the balance of any associated noncapital GAAP recourse liability account.

A second exception to the general rule applies to the transfer of small-business loans and the transfer of leases on personal property with recourse. A bank holding company should include in risk-weighted assets only the amount of retained recourse—instead of the entire amount of assets transferred—in connection with a transfer of small-business loans or a transfer of leases on personal property with recourse, provided two conditions are met. First, the transaction must be treated as a sale under GAAP; second, the bank holding company must establish a non-capital reserve that is sufficient to cover its estimated liability under the recourse arrangement. The total outstanding amount of recourse retained under such transactions may not exceed 15 percent of a BHC's total risk-based capital without Board approval.

4060.3.5.3.2 Definitions

The capital adequacy guidelines provide special treatment for recourse obligations, direct-credit substitutes, residual interests, and asset- and mortgage-backed securities involved in asset-securitization activities. A brief discussion of some of the other primary definitions follows.

4060.3.5.3.2.1 Direct-Credit Substitutes

The term ''direct-credit substitute'' refers to an arrangement in which a bank holding company assumes, in form or in substance, credit risk associated with an on- or off-balance-sheet asset or exposure that was not previously owned by the bank holding company (third-party asset), and the risk assumed by the bank holding company exceeds the pro rata share of its interest in the third-party asset. If the bank holding company has no claim on the third-party asset, then the bank holding company's assumption of any credit risk on the third-party asset is a direct-credit substitute.

The term direct-credit substitute explicitly includes items such as purchased subordinated interests, agreements to cover credit losses that arise from purchased loan-servicing rights, credit derivatives, and lines of credit that provide credit enhancement. Some purchased subordinated interests, such as credit-enhancing I/O strips, are also residual interests for regulatory capital purposes.

Direct-credit substitutes include, but are not limited to—

1. financial standby letters of credit that support financial claims on a third party that exceed a bank holding company's pro rata share of losses in the financial claim;
2. guarantees, surety arrangements, credit derivatives, and similar instruments backing financial claims that exceed a bank holding company's pro rata share in the financial claim;
3. purchased subordinated interests or securities that absorb more than their pro rata share of losses from the underlying assets;
4. credit-derivative contracts under which the bank holding company assumes more than its pro rata share of credit risk on a third-party exposure;
5. loans or lines of credit that provide credit enhancement for the financial obligations of an account party;
6. purchased loan-servicing assets if the servicer is responsible for credit losses or if the servicer makes or assumes credit-enhancing representations and warranties with respect to the loans serviced (mortgage-servicer cash advances that meet the conditions of section III.B.3.a.viii. of the guidelines (12 C.F.R. 225, appendix A) are not direct-credit substitutes); and
7. clean-up calls on third-party assets (clean-up calls that are 10 percent or less of the original pool balance or outstanding principal amount of securities and that are exercisable at the option of the bank holding company are not direct-credit substitutes).

4060.3.5.3.2.2 Residual Interests

Residual interests are defined as any on-balance-sheet asset (1) that represents an interest (including a beneficial interest) created by a transfer that qualifies as a sale (in accordance with GAAP) of financial assets, whether through a securitization or otherwise, and (2) that exposes the bank holding company to any credit risk directly or indirectly associated with the transferred assets that exceeds a pro rata share of the bank holding company's claim on the asset, whether through subordination provisions or other credit-enhancement techniques. Examples of residual interests (assets) include credit-enhancing I/O strips receivables; 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; other forms of overcollateralization; and similar on-balance-sheet assets that function as a credit enhancement. The functional-based definition reflects the fact that securitization structures vary in the way they use certain assets as credit enhancements. Residual interests therefore include any retained on-balance-sheet asset that functions as a credit enhancement in a securitization, regardless of how a bank holding company refers to the asset in financial or regulatory reports. In addition, due to their similar risk profile, purchased credit-enhancing I/O strips are residual interests for regulatory capital purposes. Residual interests generally do not include interests purchased from a third party, except for credit-enhancing I/O strips.

In general, the definition of residual interests includes only an on-balance-sheet asset that represents an interest created by a transfer of financial assets treated as a sale under GAAP, in accordance with FAS 140. Interests retained in a securitization or transfer of assets accounted for as a financing under GAAP are generally excluded from the definition of residual interest. In the case of GAAP financings, the transferred assets remain on the transferring bank holding company's balance sheet and are, therefore, directly included in both the leverage and risk-based capital calculations. Further, when a transaction is treated as a financing, no gain is recognized from an accounting standpoint.

Sellers' interests generally do not function as a credit enhancement. Thus, if a seller's interest shares losses on a pro rata basis with investors, such an interest would not be considered a residual interest. However, bank holding companies should recognize that sellers' interests that are structured to absorb a disproportionate share of losses will be considered residual interests.

The definition of residual interest also includes overcollateralization and spread accounts because these accounts are susceptible to the potential future credit losses within the loan pools that they support, and thus are subject to valuation inaccuracies. Spread accounts and overcollateralizations that do not meet the definition of credit-enhancing I/O strips generally do not expose a bank holding company to the same level of risk as credit-enhancing I/O strips, and thus are excluded from the concentration limit.

The capital treatment for a residual interest applies when a bank holding company effectively retains the risk associated with that residual interest, even if the residual is sold. The economic substance of the transaction will be used to determine whether the bank holding company has transferred the risk associated with the residual-interest exposure. Bank holding companies that transfer the risk on residual interests, either directly through a sale or indirectly through guarantees or other credit-risk-mitigation techniques, and then reassume this risk in any form will be required to hold risk-based capital as though the residual interest remained on its books. For example, if a bank holding company sells an asset that is an on-balance-sheet credit enhancement to a third party and then writes a credit derivative to cover the credit risk associated with that asset, the selling bank holding company must continue to risk-weight, and hold capital against, that asset as a residual interest as if the asset had not been sold.

4060.3.5.3.2.3 Spread Accounts That Function as Credit-Enhancing Interest-Only Strips

A spread account is an on-balance-sheet asset that functions as a credit enhancement and that can represent an interest in expected interest and fee cash flows derived from assets an organization has sold into a securitization. In those cases, the spread account is considered to be a "credit-enhancing interest-only strip" and is subject to the concentration limit. (See SR-02-16.) However, any portion of a spread account that represents an interest in cash that has already been collected and is held by the trustee is a "residual interest" subject to dollar-for-dollar capital, but it is not a credit-enhancing interest-only strip subject to the concentration limit. For example, assume that a bank holding company books a single spread-account asset that is derived from two separate cash-flow streams:

1. *A receivable from the securitization trust that represents cash that has already accumulated in the spread account.* In accordance with the securitization documents, the cash will be returned to the bank holding company at some date in the future after having been reduced by amounts used to reimburse investors for credit losses. Based on the date when the cash is expected to be paid out to the bank holding company, the present value of this asset is currently estimated to be $3.
2. *A projection of future cash flows that are expected to accumulate in the spread account.* In accordance with the securitization documents, the cash, to the extent collected, will also be returned to the bank holding company at some date in the future after having been reduced by amounts used to reimburse investors for credit losses. Based on the date when the cash is expected to be paid out to the bank holding company, the present value of this asset is currently estimated to be $2.

Both components of the spread account are considered to be residual interests under the current capital standards because both represent on-balance-sheet assets subject to more than their pro rata share of losses on the underlying portfolio of sold assets. However, the $2 asset that represents the banking holding company's retained interest in future cash flows exposes the organization to a greater degree of risk because the $2 asset presents additional uncertainty as to whether it will ever be collected. This additional uncertainty associated with the recognition of future subordinated excess cash flows results in the $2 asset being treated as a credit-enhancing interest-only strip, a subset of residual interests.

The face amount of all of the banking holding company's credit-enhancing interest-only strips is first subject to a 25 percent of tier 1 capital concentration limit. Any portion of this face amount that exceeds 25 percent of tier 1 capital is deducted from tier 1 capital. This limit will affect both a bank holding company's risk-based and leverage capital ratios. The remaining face amount of the bank holding company's credit-enhancing interest-only strips, as well as the face amount of the spread-account receivable for cash already held in the trust, is subject to the dollar-for-dollar capital requirement established for residual interests, which affects only the risk-based capital ratios.

4060.3.5.3.2.4 Credit-Enhancing Interest-Only Strips

A credit-enhancing interest-only (I/O) strip is an on-balance-sheet asset that, in form or substance, (1) represents the contractual right to receive some or all of the interest due on transferred assets and (2) exposes the bank holding company to credit risk that exceeds its pro rata claim on the underlying assets, whether through subordination provisions or other credit-enhancing techniques. Thus, credit-enhancing I/O strips include any balance-sheet asset that represents the contractual right to receive some or all of the remaining interest cash flow generated from assets that have been transferred into a trust (or other special-purpose entity), after taking into account trustee and other administrative expenses, interest payments to investors, servicing fees, and reimbursements to investors for losses attributable to the beneficial interests they hold, as well as reinvestment income and ancillary revenues[28] on the transferred assets.

Credit-enhancing I/O strips are generally carried on the balance sheet at the present value of the expected net cash flow that the banking organization reasonably expects to receive in future periods on the assets it has securitized, adjusted for some level of prepayments if relevant to that asset class, and discounted at an appropriate market interest rate. Typically, when assets are transferred in a securitization transaction that is accounted for as a sale under GAAP, the accounting recognition given to the credit-enhancing I/O strip on the seller's balance sheet results in the recording of a gain on the portion of the transferred assets that has been sold. This gain is recognized as income, thus increasing the bank holding company's capital position. The economic substance of a transaction will be used to determine whether a particular interest cash flow functions as a credit-enhancing I/O strip, and the Federal Reserve reserves the right to identify other cash flows or spread-related assets as credit-enhancing I/O strips on a case-by-case basis. For example, including some principal payments with interest and fee cash flows will not otherwise negate the regulatory capital treatment of that asset as a credit-enhancing I/O strip. Credit-enhancing I/O strips include both purchased and retained interest-only strips that serve in a credit-enhancing capacity, even though purchased I/O strips generally do not result in the creation of capital on the purchaser's balance sheet.

4060.3.5.3.2.5 Credit Derivatives

Credit derivative means a contract that allows one party (the protection purchaser) to transfer the credit risk of an asset or off-balance-sheet credit exposure to another party (the protection provider). The value of a credit derivative depends, at least in part, on the credit performance of a "reference asset."

4060.3.5.3.2.6 Credit-Enhancing Representations and Warranties

When a bank holding company transfers assets, including servicing rights, it customarily makes representations and warranties concerning those assets. When a bank holding company purchases loan-servicing rights, it may also assume representations and warranties made by the seller or a prior servicer. These representations and warranties give certain rights to other parties and impose obligations on the seller or servicer of the assets. To the extent a bank holding company's representations and warranties function as credit enhancements to protect asset purchasers or investors from credit risk, they are considered as recourse or direct-credit substitutes.

Banks and bank holding companies typically make a number of factual warranties that are unrelated to the ongoing performance or credit quality of transferred assets. These warranties entail operational risk, as opposed to the open-ended credit risk inherent in a financial guaranty, and are not considered recourse or a direct-credit substitute. Warranties that create operational risk include warranties that assets have been underwritten or collateral appraised in conformity with identified standards, as well as warranties that provide for the return of assets in instances of incomplete documentation, fraud, or misrepresentation.

Warranties can impose varying degrees of operational risk. For example, a warranty that asset collateral has not suffered damage from potential hazards entails a risk that is offset to some extent by prudent underwriting practices requiring the borrower to provide hazard insurance to the bank holding company. A warranty that asset collateral is free of environmental hazards may present acceptable operational risk for certain types of properties that have been subject to environmental assessment, depending on the circumstances. The appropriate limits for these operational risks are monitored through supervision of a bank holding company's loan-underwriting, -sale, and -servicing practices. Also, a bank holding company that provides warranties to loan purchasers and investors must

28. According to FAS 140, ancillary revenues include such revenues as late charges on the transferred assets.

include associated operational risks in its risk management of exposures arising from loan-sale or securitization-related activities. Bank holding companies should be prepared to demonstrate to examiners that operational risks are effectively managed.

Recourse or direct-credit-substitute treatment is required for warranties providing assurances about the actual value of asset collateral, including that the market value corresponds to its appraised value or that the appraised value will be realized in the event of foreclosure and sale. Warranties such as these, which make representations about the future value of a loan or related collateral, constitute an enhancement of the loan transferred, and thus are recourse arrangements or direct-credit substitutes. When a seller represents that it ''has no knowledge'' of circumstances that could cause a loan to be other than investment quality, the representation is not recourse. Bank holding companies may limit recourse exposure with warranties that directly address the condition of the asset at the time of transfer (that is, creation of an operational warranty) and by monitoring compliance with stated underwriting standards. Alternatively, bank holding companies might create warranties with exposure caps that would permit them to take advantage of the low-level-recourse rule.

The definition of credit-enhancing representations and warranties excludes warranties, such as early-default clauses and similar warranties, as discussed below. Early-default clauses typically give the purchaser of a loan the right to return the loan to the seller if the loan becomes 30 or more days delinquent within a stated period after the transfer, for example, four months after transfer. Early-default clauses can allow for a reasonable, but limited, period of time to review file documentation. Once the stated period has expired, the early-default clause will no longer trigger recourse treatment, provided there are no other provisions that constitute recourse.

Such early-default clauses and warranties are excluded from the definition of representations and warranties if they permit the return of qualifying one- to four-family residential first mortgage loans for a maximum period of 120 days from the date of transfer. To be eligible for exclusion, these warranties must cover only one- to four-family residential mortgage loans that are eligible for the 50 percent risk weight and that were originated within one year of the date of transfer. All other early-default clauses, including those for periods of greater than 120 days on qualifying one- to four-family residential first mortgages, are recourse or direct-credit substitutes until expiration.

A premium-refund clause is a warranty that obligates a seller who has sold a loan at a price in excess of par, that is, at a premium, to refund the premium, either in whole or in part, if the loan defaults or is prepaid within a certain period of time. Although premium-refund clauses can be triggered as a result of prepayments, they can also be triggered by defaults. Accordingly, premium-refund clauses are generally considered to be credit-enhancing representations and warranties. An exception exists, however, for premium-refund clauses on U.S. government–guaranteed loans and qualifying one- to four-family first mortgage loans that impose a refund obligation on a seller for a period not to exceed 120 days from the date of transfer. These types of loans hold significantly reduced credit risk.

4060.3.5.3.2.7 Clean-Up Calls

A clean-up call is an option that permits a servicer or its affiliate (which may be the originator) to take investors out of their positions in a securitization before all of the transferred loans have been repaid. The servicer accomplishes this by repurchasing the remaining loans in the pool once the pool balance has fallen below some specified level. This option in a securitization raises long-standing agency concerns that a bank holding company may implicitly assume a credit-enhancing position by exercising the option when the credit quality of the securitized loans is deteriorating. An excessively large clean-up call facilitates a securitization servicer's ability to take investors out of a pool to protect them from absorbing credit losses, and thus may indicate that the servicer has retained or assumed the credit risk on the underlying pool of loans.

Generally, clean-up calls (whether or not they are exercised) are treated as recourse and direct-credit substitutes. The purpose of treating large clean-up calls as recourse or direct-credit substitutes is to ensure that bank holding companies are not able to provide credit to the trust investors by repaying their investment when the credit quality of the pool is deteriorating without holding capital against the exposure. The focus should be on the arrangement itself and not the exercise of the call. Thus, the existence, not the exercise, of a clean-up call that does not meet the requirements of the risk-based capital rule will trigger treatment as a recourse obligation or a direct-credit substitute. A clean-up call can function as a credit enhancement because its existence provides the opportunity for a bank holding company (as servicer or an affiliate of a servicer) to provide credit support to investors by taking an action that is within the contractual terms of the securitization documents. Because clean-up calls can also serve an administrative function in the operation of a securitization, a limited exemption therefore exists for these options.

When an agreement permits a bank holding company that is a servicer or an affiliate of the servicer to elect to purchase loans in a pool, the agreement is not considered a recourse obligation or a direct-credit substitute if the agreement permits the banking organization to purchase the remaining loans in a pool when the balance of those loans is equal to or less than 10 percent of the original pool balance. This treatment will also apply to clean-up calls written with reference to less than 10 percent of the outstanding principal amount of securities. If, however, an agreement permits the remaining loans to be repurchased when their balance is greater than 10 percent of the original pool balance, the agreement is considered to be a direct-credit substitute. The exemption from direct-credit-substitute treatment for a clean-up call of 10 percent or less recognizes the real market need to be able to call a transaction when the costs of keeping it outstanding are burdensome. However, to minimize the potential for using such a feature as a means of providing support for a troubled portfolio, a bank holding company that exercises a clean-up call should not repurchase any loans in the pool that are 30 days or more past due. Alternatively, the bank holding company should repurchase the loans at the lower of their estimated fair value or their par value plus accrued interest.

Bank holding companies that repurchase assets pursuant to a clean-up call may do so based on an aggregate fair value for all repurchased assets. Bank holding companies do not have to evaluate each individual loan remaining in the pool at the time a clean-up call is exercised to determine fair value. Rather, the overall repurchase price should reflect the aggregate fair value of the assets being repurchased so that the bank holding company is not overpaying for the assets and, in so doing, providing credit support to the trust investors.

Examiners will review the terms and conditions relating to the repurchase arrangements in clean-up calls to ensure that transactions are done at the lower of fair value or par value plus accrued interest. Bank holding companies should be able to support their fair-value estimates. If the Federal Reserve concludes that a bank holding company has repurchased assets at a price that exceeds the lower of these two amounts, the clean-up call provisions in its future securitizations may be treated as recourse obligations or direct-credit substitutes. Regardless of the size of the clean-up call, the Federal Reserve will closely scrutinize and take appropriate supervisory action for any transaction in which the bank holding company repurchases deteriorating assets for an amount greater than a reasonable estimate of their fair value.

4060.3.5.3.2.8 Financial Standby Letters of Credit

A financial standby letter of credit means a letter of credit or similar arrangement that represents an irrevocable obligation to a third-party beneficiary—

1. to repay money borrowed by, advanced to, or for the account of a second party (the account party), or
2. to make payment on behalf of the account party, in the event that the account party fails to fulfill its obligation to the beneficiary.

4060.3.5.3.2.9 Loan-Servicing Arrangements

The definitions of recourse and direct-credit substitute cover loan-servicing arrangements if the bank holding company, as servicer, is responsible for credit losses associated with the serviced loans. However, cash advances made by residential mortgage servicers to ensure an uninterrupted flow of payments to investors or the timely collection of the mortgage loans are specifically excluded from the definitions of recourse and direct-credit substitute, provided the residential mortgage servicer is entitled to reimbursement for any significant advances and this reimbursement is not subordinate to other claims. To be excluded from recourse and direct-credit-substitute treatment, the bank holding company, as servicer, should make an independent credit assessment of the likelihood of repayment of the servicer advance before advancing funds, and should only make such an advance if prudent lending standards are met. Risk-based capital is assessed only against the amount of the cash advance, and the advance is assigned to the risk-weight category appropriate to the party obligated to reimburse the servicer.

If a residential mortgage servicer is not entitled to full reimbursement, then the maximum possible amount of any nonreimbursed advances on any one loan must be contractually limited to an insignificant amount of the outstanding principal on that loan. Otherwise, the servicer's obligation to make cash advances will not be excluded from the definitions of recourse and direct-credit substitute. Bank holding companies that act as servicers should establish policies on servicer advances and use discretion in determining what constitutes an ''insignificant'' servicer advance. The Federal Reserve will exercise its supervisory authority to apply recourse or direct-credit-substitute treatment to servicer cash advances that expose a bank holding company, acting as servicer, to excessive levels of credit risk.

4060.3.5.3.3 Recourse Obligations, Direct-Credit Substitutes, Residual Interests, and Asset- and Mortgage-Backed Securities

The risk-based capital treatment for recourse obligations, direct-credit substitutes, residual interests, and asset- and mortgage-backed securities in connection with asset securitizations and structured financings is described below. The capital treatment described in this subsection applies to the bank holding company's own positions.[29] For bank holding companies that comply with the market-risk rules, positions in the trading book that arise from asset securitizations, including recourse obligations, residual interests, and direct-credit substitutes, should be treated according to the market-risk rules. However, these bank holding companies remain subject to the 25 percent concentration limit for credit-enhancing I/O strips.

4060.3.5.3.3.1 Credit-Equivalent Amount

The credit-equivalent amount for a recourse obligation or direct-credit substitute is the full amount of the credit-enhanced assets for which the bank holding company directly or indirectly retains or assumes credit risk, multiplied by a 100 percent conversion factor. This treatment, however, does not apply to externally rated positions, senior positions not externally rated, residual interests, certain internally rated positions, and certain small-business loans and leases on personal property transferred with recourse.

4060.3.5.3.3.2 Risk-Weight Factor for Off-Balance-Sheet Recourse Obligations and Direct-Credit Substitutes

To determine the bank holding company's risk-weight factor for off-balance-sheet recourse obligations and direct-credit substitutes, the credit-equivalent amount is assigned to the risk category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral. For a direct-credit substitute that is an on-balance-sheet asset (for example, a purchased subordinated security), a bank holding company must calculate risk-weighted assets using the amount of the direct-credit substitute and the full amount of the assets it supports, that is, all the more senior positions in the structure. Direct-credit substitutes that have been syndicated or in which risk participations have been conveyed or acquired are considered off-balance-sheet items that are converted at a 100 percent conversion factor. (See section III.D.1. of the guidelines (12 C.F.R. 225, appendix A).)

4060.3.5.3.4 Ratings-Based Approach—Externally Rated Positions

Each loss position in an asset-securitization structure functions as a credit enhancement for the more senior loss positions in the structure. A multilevel, ratings-based approach is used to assess capital requirements on recourse obligations, residual interests (except credit-enhancing I/O strips), direct-credit substitutes, and senior and subordinated securities in asset securitizations. The approach uses credit ratings from the rating agencies to measure relative exposure to credit risk and determine the associated risk-based capital requirement. Using these credit ratings provides a way to use determinations of credit quality that are relied on by investors and other market participants to differentiate the regulatory capital treatment for loss positions representing different gradations of risk.

Under the ratings-based approach, the capital requirement for a position is computed by multiplying the face amount of the position by the appropriate risk weight, determined in accor-

29. This treatment also applies to BHCs that hold positions in their trading book, but are not otherwise subject to the market-risk rules.

dance with the following tables.[30] Table 2 maps long-term ratings to the appropriate risk weights. Table 3 maps short-term ratings for asset-backed commercial paper to the appropriate risk weights. The Federal Reserve has the authority, however, to override the use of certain ratings or the ratings on certain instruments, either on a case-by-case basis or through broader supervisory policy, if necessary or appropriate to address the risk that an instrument poses to a bank holding company.

The ratings-based approach can be used for certain designated asset-backed securities (including asset-backed commercial paper), recourse obligations, direct-credit substitutes, and residual interests (other than credit-enhancing I/O strips). Credit-enhancing I/O strips have been excluded from the ratings-based approach based on their high risk profile. While the ratings-based approach is available for both traded and untraded positions, the approach applies different requirements to each type of position.

Ratings-based qualification for corporate bonds or other securities. Corporate bonds or other securities not related in any way to a securitization or structured-finance program do not qualify for the ratings-based approach. Only mortgage- and asset-backed securities, recourse obligations, direct-credit substitutes, and residual interests (except credit-enhancing I/O strips) retained, assumed, or issued in connection with a securitization or structured-finance program qualify for the ratings-based approach. Securitization is defined as the pooling and repackaging by a special-purpose entity of assets or other credit exposures that can be sold to investors. A structured-finance program is defined as a program in which receivable interests and asset-backed securities issued by multiple participants are purchased by a special-purpose entity that repackages those exposures into securities that can be sold to investors. Corporate debt instruments, municipal bonds, and other securities that are not related to a securitization or structured-finance program do not meet these definitions and thus do not qualify for the ratings-based approach.

30. The rating designations (for example, AAA, BBB, A-1, and P-1) used in the tables are illustrative only and do note indicate any preference for, or endorsement of, any particular rating-agency designation system.

4060.3.5.3.4.1 Traded Positions

A traded position is only required to be rated by one rating agency. A position is defined as "traded" if, at the time it is rated by an external rating agency, there is a reasonable expectation that in the near future (1) the position may be sold to unafffiliated investors relying on the rating, or (2) an unaffiliated third party may enter into a transaction (for example, a loan or repurchase agreement) involving the position, whereby the third party relies on the rating of the position.

For a traded position that has received an external rating on a long-term position that is one grade below investment grade or better, or that has received a short-term rating that is investment grade, the bank holding company multiplies the face amount of the position by the appropriate risk weight, determined in accordance with tables 2 and 3. Stripped mortgage-backed securities and other similar instruments, such as interest-only or principal-only strips that are not credit enhancements, must be assigned to the 100 percent risk category. If a traded position has received more than one external rating, the lowest single rating will apply. Moreover, if a rating changes, the bank holding company must use the new rating.

Table 2—Risk-Weight Assignments for Externally Rated Long-Term Positions

Long-term rating category	*Rating-designation examples*	*Risk weight*
Highest or second-highest investment grade	AAA, AA	20 percent
Third-highest investment grade	A	50 percent
Lowest investment grade	BBB	100 percent
One category below investment grade	BB	200 percent

Table 3—Risk-Weight Assignments for Externally Rated Short-Term Positions

Short-term rating category	*Rating-designation examples*	*Risk weight*
Highest investment grade	A-1, P-1	20 percent
Second-highest investment grade	A-2, P-2	50 percent
Lowest investment grade	A-3, P-3	100 percent

Table 3, for short-term ratings, is not identical to table 2, for long-term ratings, because the rating agencies do not assign short-term ratings using the same methodology as long-term ratings. Each short-term rating category covers a range of longer-term rating categories.[31] For example, a P-1 rating could map to a long-term rating that is as high as Aaa or as low as A3.

4060.3.5.3.4.2 Externally Rated, Nontraded Positions

For a rated, but untraded, position to be eligible for the ratings-based approach, it must meet certain conditions. To qualify, the position (1) must be rated by more than one rating agency; (2) must have received an external rating on a long-term position that is one grade below investment grade or better or, for a short-term position, a rating that is investment grade or better by all rating agencies providing a rating; (3) must have ratings that are publicly available; and (4) must have ratings that are based on the same criteria used to rate traded securities. If the ratings are different, the lowest single rating will determine the risk-weight category to which the position will be assigned.

Split or partially rated instruments. For instruments that have been assigned separate ratings for principal and interest (split or partially rated instruments), the Federal Reserve will apply to the entire instrument the risk weight that corresponds to the lowest component rating. For example, a purchased subordinated security whose principal component is rated BBB, but whose interest component is rated B, is subject to the gross-up treatment accorded to direct-credit substitutes rated B or lower. Similarly, if a portion of an instrument is unrated, the entire position will be treated as if it were unrated. In addition to this regulatory capital treatment, the Federal Reserve may also, as appropriate, adversely classify and require write-downs for an other-than-temporary impairment on unrated and below-investment-grade securities, including split or partially rated securities. (See SR-02-16.)

4060.3.5.3.4.3 Senior Positions Not Externally Rated

A position that is not externally rated (an unrated position), but that is senior or preferred in all respects (including collateralization and maturity) to a rated position that is traded, is treated as if it had the rating assigned to the rated position. The bank holding company must satisfy the Federal Reserve that such treatment is appropriate. Senior unrated positions qualify for the risk weighting of the subordinated rated positions in the same securitization transaction as long as the subordinated rated position (1) is traded and (2) remains outstanding for the entire life of the unrated position, thus providing full credit support until the unrated position matures.

Recourse obligations and direct-credit substitutes (other than residual interests) that do not qualify for the ratings-based approach (or for the internal-ratings, program-ratings, or computer-program-ratings approaches outlined below) receive "gross-up" treatment, that is, the bank holding company holding the position must hold capital against the amount of the position, plus all more senior positions, subject to the low-level-exposure requirement.[32] This

31. See, for example, *Moody's Global Ratings Guide*, June 2001, p. 3.

32. Gross-up treatment means that a position is combined with all more senior positions in the transaction. The result is then risk-weighted based on the obligor or, if relevant, the guarantor or the nature of the collateral. For example, if a BHC retains a first-loss position (other than a residual interest) in a pool of mortgage loans that qualify for a 50 percent risk weight, the BHC would include the full amount of the assets in the pool, risk-weighted at 50 percent, in its risk-weighted assets for purposes of determining its risk-based capital ratio. The low-level-exposure rule provides that the dollar amount of risk-based capital required for assets transferred with recourse should not exceed the maximum dollar amount for which a BHC is contractually liable.

grossed-up amount is placed into a risk-weight category according to the obligor or, if relevant, according to the guarantor or nature of the collateral. The grossed-up amount multiplied by both the risk weight and 8 percent is never greater than the full capital charge that would otherwise be imposed on the assets if they were on the banking organization's balance sheet.[33]

4060.3.5.3.5 Residual Interests

4060.3.5.3.5.1 Credit-Enhancing I/O Strips

After applying the concentration limit to credit-enhancing I/O strips (both purchased and retained), a bank holding company must maintain risk-based capital for a credit-enhancing I/O strip (both purchased and retained), regardless of the external rating on that position, equal to the remaining amount of the credit-enhancing I/O strip (net of any existing associated deferred tax liability), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. Transactions that, in substance, result in the retention of credit risk associated with a transferred credit-enhancing I/O strip will be treated as if the credit-enhancing I/O strip were retained by the bank holding company and not transferred.

4060.3.5.3.5.2 Other Residual Interests

Residual interests that are not eligible for the ratings-based approach receive dollar-for-dollar treatment. Dollar-for-dollar treatment means, effectively, that one dollar in total risk-based capital must be held against every dollar of a residual interest retained on the balance sheet (net of any existing associated deferred tax liability), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. This capital treatment applies to all residual interests, except for credit-enhancing I/O strips that have already been deducted from tier 1 capital under the concentration limit.[34] Transactions that, in substance, result in the retention of credit risk associated with a transferred residual interest will be treated as if the residual interest were retained by the bank holding company and not transferred. When the aggregate capital requirement for residual interests and other recourse obligations in connection with the same transfer of assets exceeds the full risk-based capital requirement for those assets, a bank holding company must maintain risk-based capital equal to the greater of the risk-based capital requirement for the residual interest or the full risk-based capital requirement for the assets transferred.

Accrued interest receivables held on credit card securitizations. The accrued interest receivable (AIR) asset constitutes a subordinated residual (retained) interest in the transferred securitized assets, and it meets the definition of recourse exposure for risk-based capital purposes. Recourse exposures (such as the AIR asset) require risk-based capital against the full, risk-weighted amount of the assets transferred with recourse, subject to the low-level-recourse rule.[35] The AIR asset serves as a credit enhancement to protect third-party investors in the securitization from credit losses, and it meets the definition of a residual interest under the risk-based capital adequacy rules for the treatment of recourse arrangements. Under those rules, an institution must hold dollar-for-dollar capital against residual interests, even if that amount exceeds the full equivalent risk-based capital charge on the transferred assets.[36] The institution is expected to hold risk-based capital in an amount consistent with the subordinated nature of the AIR asset.

In a typical credit card securitization, an institution transfers a pool of credit card receivables to a trust, as well as the rights to receive future payments of principal, interest, and fee income

33. For assets that are assigned to the 100 percent risk-weight category, the minimum capital charge is 8 percent of the amount of assets transferred, and banking organizations are required to hold 8 cents of capital for every dollar of assets transferred with recourse. For assets that are assigned to the 50 percent risk-weight category, the minimum capital charge is 4 cents of capital for every dollar of assets transferred with recourse.

34. Residual interests that are retained or purchased credit-enhancing I/O strips are first subject to a capital concentration limit of 25 percent of tier 1 capital. For risk-based capital purposes (but not for leverage capital purposes), once this concentration limit is applied, a bank holding company must then hold dollar-for-dollar capital against the face amount of credit-enhancing I/O strips remaining.

35. The low-level-recourse rule limits the maximum risk-based capital requirement to the lesser of a banking organization's maximum contractual exposure or the full capital charge against the outstanding amount of assets transferred with recourse.

36. For a complete description of the appropriate capital treatment for recourse, residual interests, and credit-enhancing interest-only strips, see "Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations," 66 *Fed. Reg.* 59614 (November 29, 2001).

from those receivables. If a securitization transaction qualifies as a sale under FAS 140, 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; the right to these future cash flows should be reported as an AIR asset.[37,38] Any accrued amounts (cash flows) the institution collects (for example, accrued fees and finance charges) generally must be transferred to the trust and will be used first by the trustee for the benefit of third-party investors to satisfy more senior obligations and for the payment of trust expenses (such as servicing fees, investor-certificate interest, and investor-principal charge-offs). Any remaining excess fee and finance charges will flow back to the seller.

In accounting for the sale, the AIR asset is treated as a subordinated retained interest of credit card receivables when computing the gain or loss on sale. Consistent with GAAP, this means that the value of the AIR, at the date of transfer, must be adjusted based on its relative fair (market) value. This adjustment will typically result in the carrying amount of the AIR being lower than its book (face) value prior to securitization. The AIR should be reported in regulatory reports as "Other Assets" and not as a loan receivable. (See SR-02-12 and SR-02-22.)

37. The AIR represents fees and finance charges that have been accrued on receivables that the institution has securitized and sold to other investors. For example, in credit card securitizations, this AIR asset may include both finance charges billed but not yet collected and finance charges accrued but not yet billed on the securitized receivables.

38. Some institutions may categorize part or all of this receivable as a loan, a "due from trust" account, a retained interest in the trust, or as part of an interest-only strip receivable.

4060.3.5.3.6 Other Unrated Positions

A position (but not a residual interest) maintained in connection with a securitization and that is not rated by a rating agency may be risk-weighted based on the bank holding company's internal determination of the credit rating of the position, as specified in table 4 below, multiplied by the face amount of the position. The bank holding company may use three approaches to determine the capital requirements for certain unrated direct-credit substitutes and recourse obligations. Under each of these approaches, the bank holding company must satisfy the Federal Reserve that the use of the approach is appropriate for the particular bank holding company and for the exposure being evaluated. The risk weight that may be applied to an exposure under these alternative approaches is limited to a minimum of 100 percent.

Table 4—Risk-Weight Assignments for Unrated Positions Using the Alternative Approaches[1]

Rating category	*Rating-designation examples*	*Risk weight*
Highest or second-highest investment grade	AAA, AA	100 percent
Third-highest investment grade	A	100 percent
Lowest investment grade	BBB	100 percent
One category below investment grade	BB	200 percent

1. such as the internal-ratings approach

4060.3.5.3.6.1 Internal Risk-Rating Systems for Asset-Backed Commercial Paper Programs

A bank holding company that has a qualifying internal risk-rating system can use that system to apply the ratings-based approach to its unrated direct-credit substitutes in asset-backed commercial paper programs. Internal risk ratings could be used to qualify such a credit enhancement for a risk weight of 100 percent or 200 percent under the ratings-based approach, but not for a risk weight of less than 100 percent.

Most sophisticated banking organizations that participate extensively in the asset-securitization business assign internal risk ratings to their credit exposures, regardless of the form of the exposure. Usually, internal risk ratings more finely differentiate the credit quality of a banking organization's exposures than the categories used to evaluate credit risk during bank holding company inspections (pass, substandard, doubtful, or loss). An individual bank holding company's internal risk ratings may be associated with a certain probability of default, loss in the event of default, and loss volatility.

The credit enhancements that sponsors obtain for their commercial paper conduits are rarely rated or traded. If an internal risk-ratings approach were not available for these unrated credit enhancements, the provider of the enhancement would have to obtain two ratings solely to avoid the gross-up treatment that would otherwise apply to nontraded positions in asset securitizations for risk-based capital purposes. However, before a provider of an enhancement decides whether to provide a credit enhancement for a particular transaction (and at what price), the provider will generally perform its own analysis of the transaction to evaluate the amount of risk associated with the enhancement. An internal risk-ratings approach, therefore, is potentially less costly than a ratings-based approach that relies exclusively on ratings by the rating agencies for the risk weighting of these positions.

Internal risk ratings that correspond to the rating categories of the rating agencies can be mapped to risk weights under the Federal Reserve's capital standards. This mapping can be done in a way that would make it possible to differentiate the riskiness of various unrated direct-credit substitutes in asset-backed commercial paper programs based on credit risk. The use of internal risk ratings, however, may raise concerns about the accuracy and consistency of the ratings, especially because the mapping of ratings to risk-weight categories will give bank holding companies an incentive to rate their risk exposures in a way that minimizes the effective capital requirement. A bank holding company engaged in asset-backed commercial paper securitization activities that wishes to use the internal risk-ratings approach must therefore be able to demonstrate to the satisfaction of the Federal Reserve, before relying on its internal ratings, that the bank holding company's internal credit-risk rating system is adequate. Adequate internal risk-rating systems usually have the following characteristics:

1. The internal risk ratings are an integral part of a bank holding company's effective risk-management system that explicitly incorporates the full range of risks arising from the bank holding company's participation in securitization activities. The system must also fully take into account the effect of such activities on the bank holding company's risk profile and capital adequacy.
2. The internal credit ratings must link to measurable outcomes, such as the probability that a position will experience any losses, the expected losses on that position in the event of default, and the degree of variance in losses given default on that position.
3. The ratings separately consider the risk associated with the underlying loans or borrowers, as well as the risk associated with the specific positions in a securitization transaction.
4. The ratings identify gradations of risk among "pass" assets and other risk positions, and not just among assets that have deteriorated to the point that they fall into "watch" grades. Although it is not necessary for a bank holding company to use the same categories as the rating agencies, its internal ratings must correspond to the ratings of the rating agencies so that the Federal Reserve can determine which internal risk rating corresponds to each rating category of the rating agencies. A bank holding company would be responsible for demonstrating, to the satisfaction of the Federal Reserve, how these ratings correspond with the rating-agency standards that are used as the framework for the asset-securitization portion of the risk-based capital rule. This correlation is necessary so that the mapping of credit ratings to risk-weight categories in the ratings-based approach can be applied to internal ratings.
5. The ratings classify assets into each risk grade using clear, explicit criteria, including subjective factors.
6. Independent credit-risk-management or loan-review personnel assign or review the credit-risk ratings. These personnel should have adequate training and experience to ensure that they are fully qualified to perform this function.
7. An internal-audit procedure periodically verifies that internal risk ratings are assigned in accordance with the bank holding company's established criteria.[39]

39. The audit may be performed by any group within the organization that is qualified to audit the system and is independent of both the group that makes the decision to extend credit to the asset-baked commercial paper program and the groups that develop and maintain the internal credit-risk rating system. (See SR-02-16.)

8. The performance of internal ratings is tracked over time to evaluate how well risk grades are being assigned, and adjustments are being made to the rating system when the performance of the rated positions diverges from assigned ratings, and the individual ratings are adjusted accordingly.
9. Credit-risk rating assumptions are consistent with, or more conservative than, the credit-risk rating assumptions and methodologies of the rating agencies.

If it determines that a bank holding company's rating system is not adequate, the Federal Reserve may preclude the bank holding company from applying the internal risk-ratings approach to new transactions for risk-based capital purposes until the deficiencies have been remedied. Additionally, depending on the severity of the problems identified, the Federal Reserve may decline to rely on the internal risk ratings that the bank holding company had applied to previous transactions for purposes of determining its regulatory capital requirements.

4060.3.5.3.6.2 Ratings of Specific Unrated Positions in Structured-Financing Programs

A bank holding company may also use a rating obtained from a rating agency for an unrated direct-credit substitute or recourse obligation (other than a residual interest) that is assumed or retained in connection with a structured-finance program, if a rating agency has reviewed the terms of the program (according to the specifications set by the rating agency) and stated a rating for positions associated with the program. If the program has options for different combinations of assets, standards, internal credit enhancements, and other relevant factors, and if the rating agency specifies ranges of rating categories to them, the bank holding company may apply the rating category that corresponds to the bank holding company's position. To rely on a program rating, the bank holding company must demonstrate to the Federal Reserve's satisfaction that the credit-risk rating assigned to the program meets the same standards generally used by rating agencies for rating traded positions.

The bank holding company must also demonstrate to the Federal Reserve's satisfaction that the criteria underlying the rating agency's assignment of ratings for the structured-financing program are satisfied for the particular position. If a bank holding company participates in a securitization sponsored by another party, the Federal Reserve may authorize the bank holding company to use this approach based on a programmatic rating obtained by the sponsor of the program.

Bank holding companies with limited involvement in securitization activities may find the above alternative to be useful. In addition, some bank holding companies extensively involved in securitization activities already rely on ratings of the credit-risk positions under their securitization programs as part of their risk-management practices. Such bank holding companies can rely on these ratings for regulatory capital purposes if the ratings are part of a sound overall risk-management process and the ratings reflect the risk of nontraded positions to the bank holding companies.

This approach in a structured-financing program can be used to qualify a direct-credit substitute or recourse obligation (but not a residual interest) for a risk weight of 100 percent or 200 percent of the face value of the position under the ratings-based approach, but not for a risk weight of less than 100 percent.

4060.3.5.3.6.3 Credit-Assessment Computer Programs

A bank holding company (particularly a bank holding company with limited involvement in securitization activities) may use an internal ratings-based approach if it is using an acceptable credit-assessment computer program, developed by a rating agency, to determine the rating of a direct-credit substitute or a recourse obligation (but not a residual interest) issued in connection with a structured-finance program. To be used by a bank holding company for risk-based capital purposes, a computer program must have been developed by a rating agency. Further, the bank holding company must demonstrate to the satisfaction of the Federal Reserve that the computer program's credit assessments correspond credibly and reliably to the rating standards of the rating agencies for traded positions in securitizations and with the rating of traded positions in the financial markets. The latter would generally be shown if investors and other market participants significantly used the computer program for risk-assessment purposes. In addition, the bank holding company must demonstrate to the Federal Reserve's satisfaction that the program was designed to apply to its particular direct-credit substitute or recourse exposure and that it has properly implemented the computer program. In general, sophisticated bank holding companies with extensive securitization activities should use this approach only if the computer program is an integral part of their risk-management systems and if the bank holding company's systems fully capture the risks from its securitization activities. This computer-program approach can be used to qualify a direct-credit substitute or recourse obligation (but not a residual interest) for a risk weight of 100 percent or 200 percent of the face value of the position under the ratings-based approach, but not for a risk weight of less than 100 percent.

4060.3.5.3.7 Limitations on Risk-Based Capital Requirements

4060.3.5.3.7.1 Low-Level Exposure

If a bank holding company's maximum contractual exposure to loss retained or assumed in connection with a recourse obligation or a direct-credit substitute, except for a residual interest, is less than the effective risk-based capital requirement for the enhanced assets, the risk-based capital requirement is limited to the maximum contractual exposure, less any recourse liability account established in accordance with GAAP. This limitation does not apply when a bank holding company provides credit enhancement beyond any contractual obligation to support assets it has sold.

4060.3.5.3.7.2 Mortgage-Related Securities or Participation Certificates Retained in a Mortgage Loan Swap

If a bank holding company holds a mortgage-related security or a participation certificate as a result of a mortgage loan swap with recourse, capital is required to support the recourse obligation plus the percentage of the mortgage-related security or participation certificate that is not covered by the recourse obligation. The total amount of capital required for the on-balance-sheet asset and the recourse obligation, however, is limited to the capital requirement for the underlying loans, calculated as if the bank holding company continued to hold the loans as on-balance-sheet assets.

4060.3.5.3.7.3 Related On-Balance-Sheet Assets

If a recourse obligation or direct-credit substitute also appears as a balance-sheet asset, the balance-sheet asset is not included in a bank holding company's risk-weighted assets to the extent the value of the balance-sheet asset is already included in the off-balance-sheet credit-equivalent amount for the recourse obligation or direct-credit substitute. In the case of loan-servicing assets and similar arrangements with embedded recourse obligations or direct-credit substitutes, both the on-balance-sheet assets and the related recourse obligations and direct-credit substitutes must be separately risk-weighted and incorporated into the risk-based capital calculation.

4060.3.5.3.8 Other Types of Off-Balance-Sheet Transactions

4060.3.5.3.8.1 Distinction Between Financial and Performance Standby Letters of Credit

For risk-based capital purposes, the vast majority of standby letters of credit a bank holding company issues are considered financial in nature. On the one hand, in issuing a financial standby letter of credit, a bank holding company guarantees that the account party will fulfill a contractual financial obligation that involves payment of money. On the other hand, in issuing a performance standby letter of credit, a bank holding company guarantees that the account party will fulfill a contractual nonfinancial obligation, that is, an obligation that does not entail the payment of money. For example, a standby letter of credit that guarantees that an insurance company will pay as required under the terms of a policy is deemed to be financial and is converted at 100 percent, while a letter of credit that guarantees a contractor will pave a street according to certain specifications is deemed to be performance-related and is converted at 50 percent. Financial standby letters of credit have a higher conversion factor in large part because, unlike performance standby letters of credit, they tend to be drawn down only when the account party's financial condition has deteriorated.

4060.3.5.3.8.2 Sale and Repurchase Agreements and Forward Agreements

Forward agreements are legally binding contractual obligations to purchase assets with certain drawdown at a specified future date. Such obligations include forward purchases, forward forward deposits placed,[40] and partly paid shares and securities; they do not include commitments to make residential mortgage loans or forward foreign-exchange contracts.

4060.3.5.3.8.3 Participations of Off-Balance-Sheet Transactions

If a standby letter of credit or commitment has been participated to other institutions in the form of a syndication, as defined in the instructions to the call report, that is, if each bank holding company is responsible only for its pro rata share of loss and there is no recourse to the originating bank holding company, each bank holding company includes only its pro rata share of the standby or commitment in its risk-based capital calculation.

The treatment differs, however, if the participation takes the form of a conveyance of a risk participation. In such a participation, the originating bank holding company remains liable to the beneficiary for the full amount of the standby or commitment if the institution that has acquired the participation fails to pay when the instrument is drawn. Under this arrangement, the originating bank holding company is exposed to the credit risk of the institution that has acquired the conveyance rather than that of the account party. Accordingly, for risk-based capital purposes, the originating bank holding company should convert the full amount of the standby or commitment to an on-balance-sheet credit-equivalent amount. The credit-equivalent amount of the portion of the credit that has not been conveyed is assigned to the risk category appropriate to the obligor, after giving effect to any collateral or guarantees. The portion that has been conveyed is assigned either to the same risk category as the obligor or to the risk category appropriate to the institution acquiring the participation, whichever category carries the lower risk weight. Any remainder is assigned to the risk category appropriate to the obligor, guarantor, or collateral. For example, the pro rata share of the full amount of the assets supported, in whole or in part, by a direct-credit substitute conveyed as a risk participation to a U.S. domestic depository institution or foreign bank holding company is assigned to the 20 percent risk category. Risk participations with a remaining maturity of over one year that are conveyed to non-OECD banks are to be assigned to the 100 percent risk category, unless a lower risk category is appropriate to the obligor, guarantor, or collateral.

40. Forward forward deposits accepted are treated as interest-rate contracts.

4060.3.5.3.9 Small-Business Loans and Leases on Personal Property Transferred with Recourse (FAS 140 Sales)

A qualifying banking organization (that is, a bank holding company) that has transferred small-business loans and leases on personal property (small-business obligations) with recourse can include in weighted-risk assets only the amount of retained recourse, provided two conditions are met. First, the transaction must be treated as a FAS 140 sale under GAAP and, second, the banking organization must establish pursuant to GAAP a noncapital reserve sufficient to meet the organization's reasonably estimated liability under the recourse arrangement. Only loans and leases to businesses that meet the criteria for a small-business concern established by the Small Business Administration under section 3(a) of the Small Business Act are eligible for this capital treatment.

A banking organization qualifies if it meets the criteria for well capitalized or, by order of the Board, adequately capitalized, as those criteria are set forth in the Board's prompt-corrective-action regulation for state member banks (12 C.F.R. 208.40). For purposes of determining whether an organization meets these criteria, its capital ratios must be calculated without regard to the capital treatment for transfers of small-business obligations with recourse. The total outstanding amount of recourse retained by a qualifying banking organization on transfers of small-business obligations receiving the preferential capital treatment cannot exceed 15 percent of the organization's total risk-based capital. By order, the Board may approve a higher limit.

If a bank holding company ceases to be qualifying or exceeds the 15 percent capital limitation, the preferential capital treatment will continue to apply to any transfers of small-business obligations with recourse that were consummated during the time that the organization was qualifying and did not exceed the capital limit.

4060.3.5.3.10 Securities Lent

Examiners are to review securities-lent transactions of banking organizations and verify that, when banking organizations have risk of loss as either principal or agent, the transaction is converted at 100 percent and assigned to the appropriate risk-weight category. The guidelines treat securities lent in two ways, depending on the nature of the transactions and the risk of loss. If, however, banking organizations are acting as their customers' agent and do not indemnify their customers against loss, the amount of securities lent is excluded from risk-based capital calculations. If banking organizations lend their own securities or, acting as an agent for a customer, lend the customers' securities and indemnify their customers against loss, the amount of securities lent is converted at 100 percent and assigned the risk weight appropriate to the obligor or, if applicable, to any collateral delivered to the lending organization or the independent custodian acting on the lending organization's behalf. Where a banking organization is acting as agent for a customer in a transaction involving the lending or sale of securities that is collateralized by cash delivered to the banking organization, the transaction is deemed to be collateralized by cash on deposit in a subsidiary depository institution for purposes of determining the appropriate risk-weight category—provided that (1) any indemnification is limited to no more than the difference between the market value of the securities and the cash collateral received and (2) any reinvestment risk associated with that cash collateral is borne by the customer.

If securities lent are secured by cash on deposit in subsidiary depository institutions, the appropriate risk weight is either zero or 20 percent, depending on qualification criteria. Claims collateralized by cash on deposit in subsidiary depository institutions for which a margin of collateral is maintained on a daily basis—fully taking into account any change in the bank's exposure to the obligor or counterparty under a claim in relation to the market value of the collateral held in support of that claim—are assigned the zero risk weight. When securities lent are collateralized by cash on deposit in subsidiary lending institutions for which a daily margin is *not* maintained, the cash collateral is assigned a 20 percent risk weight.

4060.3.5.3.11 Commitments to Make Off-Balance-Sheet Transactions

A commitment to make a standby letter of credit is considered to be a standby letter of credit. Accordingly, such a commitment should be converted to an on-balance-sheet credit-equivalent amount at 100 percent if it is a commitment to make a financial standby letter of credit or at 50 percent if it is a commitment to make a performance standby letter of credit.

A commitment to make a commitment is treated as a single commitment whose maturity is the combined maturity of the two commitments. For example, a six-month commitment to make a one-year commitment is considered to be a single 18-month commitment. Since the maturity is over one year, such a commitment would be accorded the 50 percent conversion factor appropriate to long-term commitments, rather than the zero percent conversion factor that would be accorded to separate unrelated short-term commitments of six months and one year.

A commitment to make a commercial letter of credit may be treated as either a commitment or a commercial letter of credit, whichever results in the lower conversion factor. Normally, this would mean that a commitment under one year to make a commercial letter of credit would be treated as a commitment and converted at zero percent, while a similar commitment of over one year would be treated as a commercial letter of credit and converted at 20 percent.

If a commitment facility is structured so that it can be drawn down in several forms, such as a standby letter of credit, a loan, or a commercial letter of credit, the entire facility should be treated as a commitment to extend credit in the form that incurs the highest capital charge. Thus, if a facility could be drawn down in any of the three forms just cited, the entire facility would be treated as a commitment to issue a standby letter of credit and would be converted at 100 percent rather than being treated as a commitment to make a loan or commercial letter of credit, which would have a lower conversion factor.

4060.3.5.3.12 Unused Commitments

Unused commitments (including underwriting commitments and commercial and consumer credit commitments) that have an original maturity of one year or less are converted at zero percent. Facilities that are unconditionally cancelable at any time by the banking organization are not deemed to be commitments, provided that a separate credit decision is made before each drawing under the facility.

Unused commitments with an original maturity of over one year are converted at 50 percent. For this purpose, ''original maturity'' is defined as the length of time between the date the commitment is issued and the earliest date on which (1) the banking organization can, at its option, unconditionally cancel[41] the commitment *and* (2) the banking organization is scheduled to (and as a normal practice actually does) review the facility to determine whether or not the unused commitment should be extended. (See SR-90-23 regarding loan commitments and put options.)

Banking organizations must continue to review unused commitments at least annually to determine that they qualify for short-term commitment treatment. Examiners are to review unused commitments to determine that they meet the conditions for being treated as short-term or long-term and are appropriately weighted for risk-based capital calculations.

A commitment may be issued that expires within one year with the understanding that the commitment will be renewed upon expiration subject to a thorough credit review of the obligor. Such a commitment may be converted at zero percent only if (1) the renegotiation process is carried out in good faith, involves a full credit assessment of the obligor, and allows the bank holding company the flexibility to alter the terms and conditions of the new commitment; (2) the bank holding company has absolute discretion to decline renewal or extension of the commitment; and (3) the renegotiated commitment expires within 12 months from the time it is made. Some commitments contain unusual renegotiation arrangements that would give the borrower a considerable amount of advance notice that a commitment would not be renewed. Provisions of this kind can have the effect of creating a rolling-commitment arrangement that should be treated for risk-based capital purposes as a long-term commitment and, thus, be converted to a credit-equivalent amount at 50 percent. Normally, the renegotiation process should take no more than six to eight weeks, and in many cases it should take less time. The renegotiation period should immediately precede the expiration date of the commitment. The reasons for provisions in a commitment arrangement that would appear to provide for a protracted renegotiation period should be thoroughly documented by the bank holding company and reviewed by the examiner.

A commitment may be structured to be drawn down in a number of tranches, some exercisable in one year or less and others exercisable in over one year. The full amount of such a commitment is deemed to be over one year and converted at 50 percent. Some long-term commitments may permit the customer to draw down varying amounts at different times to accommodate, for example, seasonal borrowing needs. The 50 percent conversion factor should be applied to the maximum amount that could be drawn down under such commitments.

41. This does not refer to material-adverse-change clauses.

4060.3.5.3.13 Derivative Contracts (Interest-Rate, Exchange-Rate, and Commodity- (Including Precious Metals) and Equity-Linked Contracts)

Credit-equivalent amounts are computed for each of the following off-balance-sheet-derivative contracts:

1. interest-rate contracts
   a. single-currency interest-rate swaps
   b. basis swaps
   c. forward rate agreements
   d. interest-rate options purchased (including caps, collars, and floors purchased)
   e. any other instrument linked to interest rates that gives rise to similar credit risks (including when-issued securities and forward forward deposits accepted)
2. exchange-rate contracts
   a. cross-currency interest-rate swaps
   b. forward foreign-exchange-rate contracts
   c. currency options purchased
   d. any other instrument linked to exchange rates that gives rise to similar credit risks
3. equity derivative contracts
   a. equity-linked swaps
   b. equity-linked options purchased
   c. forward equity-linked contracts
   d. any other instrument linked to equities that gives rise to similar credit risks
4. commodity (including precious metal) derivative contracts
   a. commodity-linked swaps
   b. commodity-linked options purchased
   c. forward commodity-linked contracts

d. any other instrument linked to commodities that gives rise to similar credit risks

Derivative contract exceptions. Exchange-rate contracts with an original maturity of 14 or fewer calendar days and derivative contracts traded on exchanges that require daily receipt and payment of cash-variation margin may be excluded from the risk-based ratio calculation. Gold contracts are accorded the same treatment as exchange-rate contracts except that gold contracts with an original maturity of 14 or fewer calendar days are included in the risk-based ratio calculation. Over-the-counter options purchased are included and treated in the same way as other derivative contracts.

4060.3.5.3.13.1 Calculation of Credit-Equivalent Amounts and the Application of Risk Weights

The credit-equivalent amount of a derivative contract that is not subject to a qualifying bilateral netting contract in accordance with subsection 4060.3.5.3.4 above is equal to the sum of—

1. the current exposure (sometimes referred to as the replacement cost) of the contract and
2. an estimate of the potential future credit exposure of the contract.

The current exposure is determined by the mark-to-market value of the contract. If the mark-to-market value is positive, then the current exposure is equal to that mark-to-market value. If the mark-to-market value is zero or negative, then the current exposure is zero. Mark-to-market values are measured in dollars, regardless of the currency or currencies specified in the contract, and should reflect changes in the relevant rates, prices, and indices, as well as in counterparty credit quality.

The potential future credit exposure of a contract, including a contract with a negative mark-to-market value, is estimated by multiplying the notional principal amount of the contract by a credit-conversion factor. Banking organizations should use, subject to examiner review, the effective rather than the apparent or stated notional amount in this calculation. The conversion factors (in percent) are listed on the next page.

For a contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the contract is zero, the remaining maturity is equal to the time until the next reset date. For an interest-rate contract with a remaining maturity of more than one year that meets these criteria, the minimum conversion factor is 0.5 percent.

For a contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the contract. A derivative contract not included in the definitions of interest-rate, exchange-rate, equity, or commodity contracts as set forth in subsection 4060.3.5.3.4 is subject to the same conversion factors as a commodity, excluding precious metals.

No potential future credit exposure is calculated for a single-currency interest-rate swap in which payments are made based on two floating-rate indices, so-called floating/floating or basis swaps; the credit exposure on these contracts is evaluated solely on the basis of their mark-to-market values.

The Board has noted that these conversion factors, which are based on observed volatilities of the particular types of instruments, are subject to review and modification in light of changing volatilities or market conditions.

100 Percent Credit-Conversion Factor for Off-Balance-Sheet Items for BHCs

1. direct-credit substitutes (These include general guarantees of indebtedness and all guarantee-type instruments, including standby letters of credit backing the financial obligations of other parties.)
2. risk participations in banker's acceptances and direct-credit substitutes, such as standby letters of credit
3. sale and repurchase agreements and assets sold with recourse that are not included on the balance sheet
4. forward agreements to purchase assets, including financing facilities, on which drawdown is certain
5. securities lent for which the banking organization is at risk

50 Percent Conversion Factor

1. transaction-related contingencies (These include bid bonds, performance bonds, warranties, and standby letters of credit related to particular transactions and performance standby letters of credit. Performance standby letters of credit represent obligations backing the performance of nonfinancial or commercial contracts or undertakings.)

CONVERSION FACTORS
[in percent]

Remaining maturity	*Interest-rate*	*Exchange-rate and gold*	*Equity*	*Commodity, excluding precious metals*	*Precious metals, except gold*
One year or less	0.0	1.0	6.0	10.0	7.0
Over one to five years	0.5	5.0	8.0	12.0	7.0
Over five years	1.5	7.5	10.0	15.0	8.0

2. unused portions of commitments with an original maturity exceeding one year, including underwriting commitments and commercial and consumer credit commitments
3. revolving underwriting facilities (RUFs), note-issuance facilities (NIFs), and other similar arrangements

20 Percent Conversion Factor

Short-term, self-liquidating, trade-related contingencies that arise from the movement of goods, including commercial letters of credit and other documentary letters of credit collateralized by the underlying shipments.

Zero Percent Conversion Factor

Unused portions of commitments with an original maturity of one year or less, or which are unconditionally cancelable at any time, provided a separate credit decision is made before each drawing under the facility.

Examples of the calculation of credit-equivalent amounts for these instruments are shown on the following page.

CALCULATING CREDIT-EQUIVALENT AMOUNTS FOR DERIVATIVE CONTRACTS

Type of contract	*Notional principal amount*	*Conversion factor*	*Potential exposure (dollars)*	*Mark-to-market*	*Current exposure (dollars)*		*Credit-equivalent amount*
(1) 120-day forward foreign exchange	5,000,000	.01	50,000	100,000	100,000		150,000
(2) 4-year forward foreign exchange	6,000,000	.05	300,000	–120,000	0		300,000
(3) 3-year single-currency fixed and floating interest-rate swap	10,000,000	.005	50,000	200,000	200,000		250,000
(4) 6-month oil swap	10,000,000	.10	1,000,000	–250,000	0		1,000,000
(5) 7-year cross-currency floating and floating interest-rate swap	20,000,000	.075	1,500,000	–1,500,000	0		1,500,000
TOTAL			2,900,000	+	300,000	=	3,200,000

If contracts (1) through (5) above are subject to a qualifying bilateral netting contract, then the following applies:

Contract	*Potential future exposure*		*Net current exposure*		*Credit-equivalent amount*
(1)	50,000				
(2)	300,000				
(3)	50,000				
(4)	1,000,000				
(5)	1,500,000				
TOTAL	2,900,000	+	0	=	2,900,000

Note: The total of the mark-to-market values from the first table is –$1,570,000. Since this is a negative amount, the net current exposure is zero.

To recognize the effects of bilateral netting on potential future exposure, the following formula applies:

$$A_{net} = (0.4 \times A_{gross}) + 0.6(NGR \times A_{gross})$$

In the above example, where the net current exposure is zero, the credit-equivalent amount would be calculated as follows:

$$NGR = 0 = (0/300{,}000)$$

$$A_{net} = (0.4 \times \$2{,}900{,}000) + .6(0 \times \$2{,}900{,}000)$$

$$A_{net} = \$1{,}160{,}000$$

The credit-equivalent amount is

$$\$1{,}160{,}000 + 0 = \$1{,}160{,}000.$$

If the net current exposure was a positive number, for example $200,000, the credit equivalent would be calculated as follows:

$$NGR = .67 = (\$200{,}000/\$300{,}000)$$

$$A_{net} = (0.4 \times \$2{,}900{,}000) + 0.6(.67 \times \$2{,}900{,}000)$$

$$A_{net} = \$2{,}325{,}800$$

The credit-equivalent amount would be $2,325,800 + $200,000 = $2,525,800.

Applying risk weights. Once the credit-equivalent amount for a derivative contract, or a group of derivative contracts subject to a qualifying bilateral netting contract, has been determined, that amount is assigned to the risk-weight category appropriate to the counterparty, or, if relevant, the guarantor or the nature of any collateral.[42] However, the maximum weight that will be applied to the credit-equivalent amount of such contracts is 50 percent.

4060.3.5.3.13.2 Avoidance of Double-Counting of Derivative Contracts

In certain cases, credit exposures arising from derivative contracts may be reflected, in part, on the balance sheet. To avoid double-counting such exposures in the assessment of capital adequacy and, perhaps, assigning inappropriate risk weights, counterparty credit exposures arising from the derivative instruments covered by the guidelines may need to be excluded by examiners from balance-sheet assets in calculating a banking organization's risk-based capital ratios. This exclusion will eliminate the possibility that an organization could be required to hold capital against both an off-balance-sheet and on-balance-sheet amount for the same item. This treatment is not accorded to margin accounts and accrued receivables related to interest-rate and exchange-rate contracts.

The aggregate on-balance-sheet amount excluded from the risk-based capital calculation is equal to the lower of—

1. each contract's positive on-balance-sheet amount or
2. its positive market value included in the off-balance-sheet risk-based capital calculation.

For example, a forward contract that is marked to market will have the same market value on the balance sheet as is used in calculating the credit-equivalent amount for off-balance-sheet exposures under the guidelines. Therefore, the on-balance-sheet amount is not included in the risk-based capital calculation. Where either the contract's on-balance-sheet amount or its market value is negative or zero, no deduction from on-balance-sheet items is necessary for that contract.

If the positive on-balance-sheet asset amount exceeds the contract's market value, the excess (up to the amount of the on-balance-sheet asset) should be included in the appropriate risk-weight category. For example, a purchased option will often have an on-balance-sheet amount equal to the fee paid until the option expires. If that amount exceeds market value, the excess of carrying value over market value would be included in the appropriate risk-weight category for purposes of the on-balance-sheet portion of the calculation.

4060.3.5.3.14 Treatment of Commodity and Equity Contracts

Credit-equivalent amounts of swap agreements and futures, forwards, and option contracts on commodities, equities, and equity indexes are calculated in the same way as credit-equivalent amounts of foreign-exchange-rate contracts. Contracts on commodities, equities, and equity

42. For derivative contracts, sufficiency of collateral or guarantees is determined by the market value of the collateral or the amount of the guarantee in relation to the credit-equivalent amount. Collateral and guarantees are subject to the same provisions noted under section III.B. of appendix A of Regulation Y.

indexes traded on exchanges that require daily payment of variation margin are excluded from the risk-based capital calculation. Such a margining arrangement requires the marking to market of contracts and the settling of the resulting gains and losses in cash on a daily basis.

4060.3.5.3.15 Netting of Swaps and Similar Contracts

Netting refers to the offsetting of positive and negative mark-to-market values in the determination of a current exposure to be used in the calculation of a credit-equivalent amount. Any legally enforceable form of bilateral netting (that is, netting with a single counterparty) of derivative contracts is recognized for purposes of calculating the credit-equivalent amount provided that—

1. the netting is accomplished under a written netting contract that creates a single legal obligation, covering all included individual contracts, with the effect that the organization would have a claim to receive, or an obligation to receive or pay, only the net amount of the sum of the positive and negative mark-to-market values on included individual contracts in the event that a counterparty, or a counterparty to whom the contract has been validly assigned, fails to perform due to default, insolvency, liquidation, or similar circumstances;
2. the banking organization obtains written and reasoned legal opinions that in the event of a legal challenge—including one resulting from default, insolvency, liquidation, or similar circumstances—the relevant court and administrative authorities would find the banking organization's exposure to be such a net amount under—
   a. the law of the jurisdiction in which the counterparty is chartered or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;
   b. the law that governs the individual contracts covered by the netting contract; and
   c. the law that governs the netting contract;
3. the banking organization establishes and maintains procedures to ensure that the legal characteristics of netting contracts are kept under review in light of possible changes in relevant law; and
4. the banking organization maintains in its files documentation adequate to support the netting of rate contracts, including a copy of the bilateral netting contract and necessary legal opinions.

A contract containing a walkaway clause is not eligible for netting for purposes of calculating the credit-equivalent amount.[43]

By netting individual contracts for the purpose of calculating credit-equivalent amounts of derivative contracts, a banking organization represents that it has met the requirements of the risk-based measure of the capital adequacy guidelines for BHCs and that all the appropriate documents are in the organization's files and available for inspection by the Federal Reserve. The Federal Reserve may determine that a banking organization's files are inadequate or that a netting contract, or any of its underlying individual contracts, may not be legally enforceable. If such a determination is made, the netting contract may be disqualified from recognition for risk-based capital purposes, or underlying individual contracts may be treated as though they are not subject to the netting contract.

The credit-equivalent amount of contracts that are subject to a qualifying bilateral netting contract is calculated by adding—

1. the current exposure of the netting contract (net current exposure) and
2. the sum of the estimates of the potential future credit exposures on all individual contracts subject to the netting contract (gross potential future exposure) adjusted to reflect the effects of the netting contract.[44]

The net current exposure of the netting contract is determined by summing all positive and negative mark-to-market values of the individual contracts included in the netting contract. If the net sum of the mark-to-market values is positive, then the current exposure of the netting

43. A walkaway clause is a provision in a netting contract that permits a nondefaulting counterparty to make lower payments than it would make otherwise under the contract, or no payment at all, to a defaulter or to the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the contract.

44. For purposes of calculating potential future credit exposure to a netting counterparty for foreign-exchange contracts and other similar contracts in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts falling due on each value date in each currency.

contract is equal to that sum. If the net sum of the mark-to-market values is zero or negative, then the current exposure of the netting contract is zero. The Federal Reserve may determine that a netting contract qualifies for risk-based capital netting treatment even though certain individual contracts may not qualify. In such instances, the nonqualifying contracts should be treated as individual contracts that are not subject to the netting contract.

Gross potential future exposure or A_{gross} is calculated by summing the estimates of potential future exposure (determined in accordance with subsection 4060.3.5.3.4.1) for each individual contract subject to the qualifying bilateral netting contract.

The effects of the bilateral netting contract on the gross potential future exposure are recognized through the application of a formula that results in an adjusted add-on amount (A_{net}). The formula, which employs the ratio of net current exposure to gross current exposure (NGR), is expressed as:

$$A_{net} = (0.4 \times A_{gross}) + 0.6(NGR \times A_{gross})$$

The NGR may be calculated in accordance with either the counterparty-by-counterparty approach or the aggregate approach.

Under the counterparty-by-counterparty approach, the NGR is the ratio of the net current exposure for a netting contract to the gross current exposure of the netting contract. The gross current exposure is the sum of the current exposures of all individual contracts subject to the netting contract calculated in accordance with subsection 4060.3.5.3.4.1. Net negative mark-to-market values for individual netting contracts with the same counterparty may not be used to offset net positive mark-to-market values for other netting contracts with the same counterparty.

Under the aggregate approach, the NGR is the ratio of the sum of all the net current exposures for qualifying bilateral netting contracts to the sum of all the gross current exposures for those netting contracts (each gross current exposure is calculated in the same manner as in subsection 4060.3.5.3.6 (counterparty-by-counterparty approach)). Net negative mark-to-market values for individual counterparties may not be used to offset net positive current exposures for other counterparties.

A banking organization must consistently use either the counterparty-by-counterparty approach or the aggregate approach to calculate the NGR. Regardless of the approach used, the NGR should be applied individually to each qualifying bilateral netting contract to determine the adjusted add-on for that netting contract.

In the event a netting contract covers contracts that are normally excluded from the risk-based ratio calculation—for example, exchange-rate contracts with an original maturity of 14 or fewer calendar days or instruments traded on exchanges that require daily payment of cash-variation margin—an institution may elect to either include or exclude all mark-to-market values of such contracts when determining net current exposure, provided the method chosen is applied consistently.

Examiners are to review the netting of off-balance-sheet derivative contractual arrangements used by banking organizations when calculating or verifying risk-based capital ratios to ensure that the positions of such contracts are reported gross unless the net positions of those contracts reflect netting arrangements that comply with the netting requirements listed previously.

4060.3.5.3.16 Financial Standby Letters of Credit and Performance Standby Letters of Credit

The determining characteristic of whether a standby letter of credit is financial or performance is the contractual obligation that triggers payment. If the event that triggers payment is financial, such as a failure to pay money, the standby letter of credit should be classified as financial. If the event that triggers payment is performance-related, such as a failure to ship a product or provide a service, the standby letter of credit should be classified as performance. The vast majority of standby letters of credit a bank issues are considered, for risk-based capital purposes, to be financial standby letters of credit. (See SR-95-20 (SUP).)

4060.3.5.3.16.1 Financial Standby Letters of Credit

The risk-based capital guidelines describe a financial standby letter of credit as an irrevocable undertaking by a banking organization to guarantee repayment of a financial obligation. Such a guarantee is considered a direct-credit substitute and is converted to an on-balance-sheet credit-equivalent amount at 100 percent.

The resulting credit-equivalent amount is then risk-weighted according to the type of counterparty or, if relevant, to any guarantee or collateral.

Financial standby letters of credit have a higher conversion factor than performance standby letters of credit. This is primarily because, unlike performance standby letters of credit, financial standby letters of credit tend to be drawn down only when the account party's financial condition has deteriorated.

A standby letter of credit guaranteeing the performance of a contractual obligation to pay money is viewed as a financial letter of credit. For example, a standby letter of credit backing a purchaser's contractual obligation to pay for delivered goods is a financial guarantee backing the purchaser's credit standing for the sale. It would not be viewed as a performance letter of credit guaranteeing the purchaser's performance to make payment under the contract.

A failure to perform a contractual obligation involving the payment of money can arise in a variety of situations, for example, failure to pay insurance premiums or deductibles, failure to pay insurance claims, failure to pay workers' compensation obligations, or failure to pay for (or arrange) cleanup in the event the account party's operations cause environmental damage. In each instance, the triggering event is the failure to pay money under a contractual obligation. A standby letter of credit guaranteeing payment in the event the account party fails to perform any of these contractual financial obligations or other circumstances should be treated as a financial standby letter of credit and converted to an on-balance-sheet credit-equivalent amount at 100 percent.

4060.3.5.3.16.2 Performance Standby Letters of Credit

A performance standby letter of credit is an irrevocable undertaking by the organization to make payment in the event the customer fails to perform a nonfinancial contractual obligation. This type of letter of credit is considered a transaction-related contingency and is converted to an on-balance-sheet credit-equivalent amount at 50 percent. The resulting credit-equivalent amount is then risk-weighted according to the type of counterparty or, if relevant, to any guarantee or collateral.

4060.3.5.3.17 Credit Derivatives

For purposes of risk-based capital, credit derivatives generally are to be treated as off-balance-sheet direct-credit substitutes. They are arrangements that allow one party (the beneficiary) to transfer the credit risk of a "reference asset," which it often actually owns, to another party (the guarantor).[45] The notional amount of the contract should be converted at 100 percent to determine the credit-equivalent amount to be included in risk-weighted assets of the guarantor.[46] A banking organization providing a guarantee through a credit-derivative transaction should assign its credit exposure to the risk category appropriate to the obligor of the reference asset or any collateral. On the other hand, a banking organization that owns the underlying asset upon which effective credit protection has been acquired through a credit derivative may under certain circumstances assign the unamortized portion of the underlying asset to the risk category appropriate to the guarantor (for example, to the 20 percent risk category if the guarantor is a bank or, if a bank holding company, to the 100 percent risk-weight category).

Whether the credit derivative is considered an eligible guarantee for purposes of risk-based capital depends on the *degree of credit protection* actually provided, which may be limited depending on the terms of the arrangement. For example, a relatively restrictive definition of a default event or a materiality threshold that requires a comparably high percentage of loss to occur before the guarantor is obliged to pay could effectively limit the amount of credit risk actually transferred in the transaction. If the terms of the credit-derivative arrangement significantly limit the degree of risk transference, then the beneficiary bank cannot reduce the risk weight of the "protected" asset to that of the guarantor. On the other hand, even if the transfer of credit risk is limited, a banking organization providing limited credit protection through a credit derivative should hold appropriate capital against the underlying exposure while the organization is exposed to the credit risk of the reference asset.

45. Credit derivatives that are held in a banking organization's (a bank's or bank holding company's) trading account are subject to the market-risk rules.

46. Guarantor banks or bank holding companies that have made cash payments representing depreciation on reference assets may deduct such payments from the notional amount when computing credit-equivalent amounts for capital purposes. For example, if a guarantor bank or bank holding company makes a depreciation payment of $10 on a $100 notional total-rate-of-return swap, the credit-equivalent amount would be $90.

Banking organizations providing a guarantee through a credit derivative may mitigate the credit risk associated with the transaction by entering into an offsetting credit derivative with another counterparty, a so-called ''back-to-back'' position. Organizations that have entered into such a position may treat the first credit derivative as guaranteed by the offsetting transaction for risk-based capital purposes. Accordingly, the notional amount of the first credit derivative may be assigned to the risk category appropriate to the counterparty providing credit protection through the offsetting credit-derivative arrangement (for example, to the 20 percent risk category if the counterparty is an OECD bank).

In some instances, the reference asset in the credit-derivative transaction may not be identical to the underlying asset for which the beneficiary has acquired credit protection. For example, a credit derivative used to offset the credit exposure of a loan to a corporate customer may use a publicly traded corporate bond of the customer as the reference asset, whose credit quality serves as a proxy for the on-balance-sheet loan. In such a case, the underlying asset will still generally be considered guaranteed for capital purposes as long as both the underlying asset and the reference asset are obligations of the same legal entity and have the same level of seniority in bankruptcy. In addition, banking organizations offsetting credit exposure in this manner would be obligated to demonstrate to examiners that there is a high degree of correlation between the two instruments; the reference instrument is a reasonable and sufficiently liquid proxy for the underlying asset so that the instruments can be reasonably expected to behave similarly in the event of default; and, at a minimum, the reference asset and underlying asset are subject to mutual cross-default provisions. A banking organization that uses a credit derivative, which is based on a reference asset that differs from the protected underlying asset, must document the credit derivative being used to offset credit risk and must link it directly to the asset or assets whose credit risk the transaction is designed to offset. The documentation and the effectiveness of the credit-derivative transaction are subject to examiner review. Banking organizations providing credit protection through such arrangements must hold capital against the risk exposures that are assumed.

4060.3.5.3.18 Credit Derivatives Used to Synthetically Replicate Collateralized Loan Obligations

Credit derivatives can be used to synthetically replicate collateralized loan obligations (CLOs). Banking organizations (BOs) can use CLOs and their synthetic variants to manage their balance sheets and, in some instances, transfer credit risk to the capital markets. Such transactions allow economic capital to be more efficiently allocated, resulting in, among other things, improved shareholders' returns. Supervisors and examiners need to fully understand these complex structures, and identify the relative degree of transference and retention of the securitized portfolio's credit risk. They must also determine whether the BO's regulatory risk-based and leverage capital is adequate given the retained credit exposures.[47]

A CLO is an asset-backed security that is usually supported by a variety of assets, including whole commercial loans, revolving credit facilities, letters of credit, banker's acceptances, or other asset-backed securities. In a typical CLO transaction, the sponsoring banking organization (SBO) transfers the loans and other assets to a bankruptcy-remote special-purpose vehicle (SPV), which then issues asset-backed securities consisting of one or more classes of debt. This type of transaction represents a so-called cash-flow CLO that enables the SBO to reduce its leverage and risk-based capital requirements, improve its liquidity, and manage credit concentrations.

The first synthetic CLO (issued in 1997) used credit-linked notes (CLNs).[48] Rather than transferring assets to the SPV, the sponsoring bank issued CLNs to the SPV, individually referencing the payment obligation of a particular company or ''reference obligor.'' The notional amount of the CLNs issued equaled the dollar amount of the reference assets the sponsor was hedging on its balance sheet. Other structures have evolved that use credit-default swaps to transfer credit risk and create different levels of risk exposure, but that hedge only a portion of the notional amount of the overall reference portfolio.[49]

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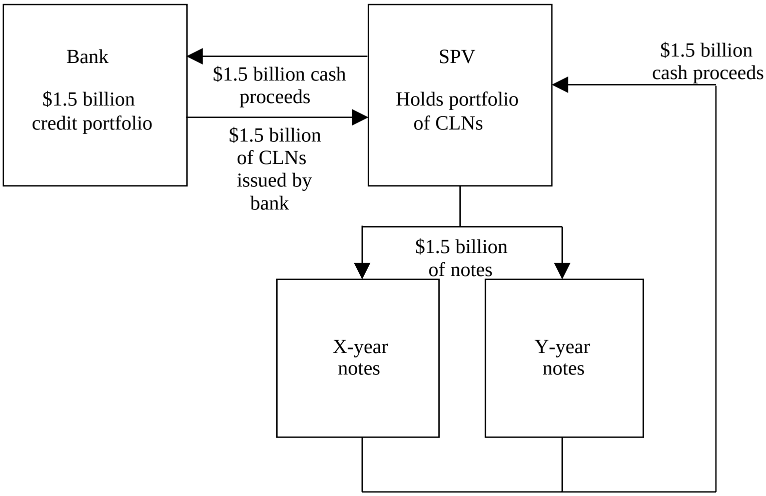
47. See SR-99-32 and its attached November 15, 1999, FRB-OCC capital interpretation on synthetic collateralized loan obligations.

48. CLNs are obligations whose principal repayment is conditioned upon the performance of a referenced asset or portfolio. The assets' performance may be based on a variety of measures, such as movements in price or credit spread, or the occurrence of default.

49. A credit-default swap is similar to a financial standby letter of credit in that the BO writing the swap provides, for a fee, credit protection against credit losses associated with a

Figure 1—Transaction 1



Traditional CLO structures usually transfer assets into the SPV. In synthetic securitizations, the underlying exposures that make up the reference portfolio remain in the BO's banking book.[50] The credit risk is transferred into the SPV through credit-default swaps or CLNs. The BO is thus able to maintain client confidentiality and avoid sensitive client-relationship issues that arise from loan-transfer-notification requirements, loan-assignment provisions, and loan-participation restrictions

Corporate credits are assigned to the 100 percent risk-weighted asset category for risk-based capital calculation purposes. In the case of high-quality, investment-grade corporate exposures, the associated 8 percent capital requirement may exceed the economic capital that the SBO sets aside to cover the credit risk of the transaction. Therefore, one of the apparent motivations behind CLOs and other securitizations is to more closely align the SBO's regulatory capital requirements with the economic capital required by the market.

Synthetic CLOs can raise questions about their capital treatment when calculating the risk-based and leverage capital ratios. Capital treatments for three synthetic transactions follow. They are discussed from the perspective of the investors and the SBOs.

default on a specified reference asset or pool of assets.

50. "Banking book" refers to nontrading accounts. See the "trading account" definition in the Glossary for the instructions to the Consolidated Financial Statements for Bank Holding Companies, FR Y-9C.

4060.3.5.3.18.1 Transaction 1—Entire Notional Amount of the Reference Portfolio Is Hedged

In the first type of synthetic securitization, the SBO, through a synthetic CLO, hedges the entire notional amount of a reference asset portfolio. An SPV acquires the credit risk on a reference portfolio by purchasing CLNs issued by the SBO. The SPV funds the purchase of the CLNs by issuing a series of notes in several tranches to third-party investors. The investor notes are in effect collateralized by the CLNs. Each CLN represents one obligor and the BO's credit-risk exposure to that obligor, which could take the form of bonds, commitments, loans, and counterparty exposures. Since the noteholders are exposed to the full amount of credit risk associated with the individual reference obligors, all of the credit risk of the reference portfolio is shifted from the SBO to the capital markets. The dollar amount of notes issued to investors equals the notional amount of the reference portfolio. In the example shown in figure 1, this amount is $1.5 billion.

If the obligor linked to a CLN in the SPV defaults, the SBO will call the individual CLN and redeem it based on the repayment terms specified in the note agreement. The term of each CLN is set so that the credit exposure (to which it is linked) matures before the maturity of the CLN, which ensures that the CLN will be in place for the full term of the exposure to which it is linked.

An investor in the notes issued by the SPV is exposed to the risk of default of the underlying reference assets, as well as to the risk that the SBO will not repay principal at the maturity of the notes. Because of the linkage between the credit quality of the SBO and the issued notes, a downgrade of the sponsor's credit rating most likely will result in the notes also being downgraded. Thus, a BO investing in this type of synthetic CLO should assign the notes to the higher of the risk categories appropriate to the underlying reference assets or the issuing entity.

For purposes of risk-based capital, the SBOs may treat the cash proceeds from the sale of CLNs that provide protection against underlying reference assets as cash collateralizing these assets.[51] This treatment would permit the reference assets, if carried on the SBO's books, to be assigned to the zero percent risk category to the extent that their notional amount is fully collateralized by cash. This treatment may be applied even if the cash collateral is transferred directly into the general operating funds of the BO and is not deposited in a segregated account. The synthetic CLO would not confer any benefits to the SBO for purposes of calculating its tier 1 leverage ratio, however, because the reference assets remain on the organization's balance sheet.

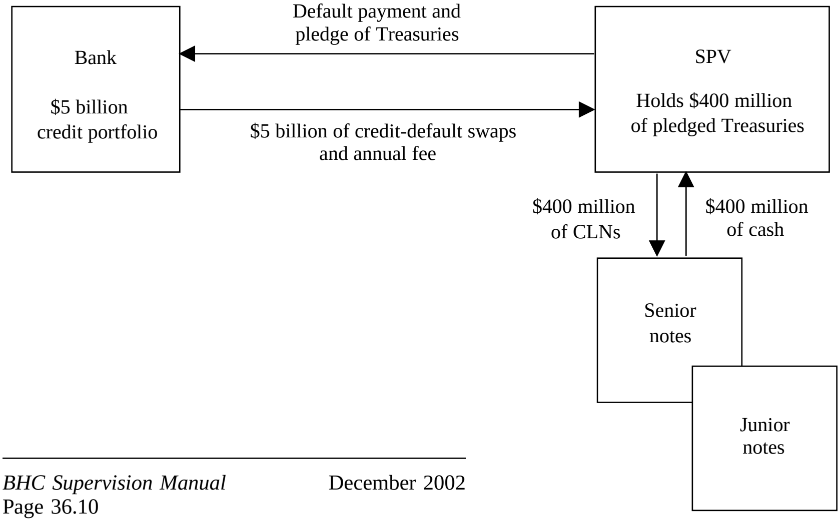
51. The CLNs should not contain terms that would significantly limit the credit protection provided against the underlying reference assets, for example, a materiality threshold that requires a relatively high percentage of loss to occur before CLN payments are adversely affected, or a structuring of CLN post-default payments that does not adequately pass through credit-related losses on the reference assets to investors in the CLNs.

4060.3.5.3.18.2 Transaction 2—High-Quality, Senior Risk Position in the Reference Portfolio Is Retained

In the second type of synthetic CLO transaction, the SBO hedges a portion of the reference portfolio and retains a high-quality, senior risk position that absorbs only those credit losses in excess of the junior-loss positions. For some noted synthetic CLOs, the SBO used a combination of credit-default swaps and CLNs to transfer to the capital markets the credit risk of a designated portfolio of the organization's credit exposures. Such a transaction allows the SBO to allocate economic capital more efficiently and to significantly reduce its regulatory capital requirements.

In the structure illustrated in figure 2, the SBO purchases default protection from an SPV for a specifically identified portfolio of banking-book credit exposures, which may include letters of credit and loan commitments. The credit risk on the identified reference portfolio (which continues to remain in the sponsor's banking book) is transferred to the SPV through the use of credit-default swaps. In exchange for the credit protection, the SBO pays the SPV an annual fee. The default swaps on each of the

Figure 2—Transaction 2



obligors in the reference portfolio are structured to pay the average default losses on all senior unsecured obligations of defaulted borrowers. To support its guarantee, the SPV sells CLNs to investors and uses the cash proceeds to purchase U.S. government Treasury notes. The SPV then pledges the Treasuries to the SBO to cover any default losses.[52] The CLNs are often issued in multiple tranches of differing seniority and in an aggregate amount that is significantly less than the notional amount of the reference portfolio. The amount of notes issued typically is set at a level sufficient to cover some multiple of expected losses, but well below the notional amount of the reference portfolio being hedged.

There may be several levels of loss in this type of synthetic securitization. The first-loss position may consist of a small cash reserve, sufficient to cover expected losses. The cash reserve accumulates over a period of years and is funded from the excess of the SPV's income (that is, the yield on the Treasury securities plus the credit-default-swap fee) over the interest paid to investors on the notes. The investors in the SPV assume a second-loss position through their investment in the SPV's senior and junior notes, which tend to be rated AAA and BB, respectively. Finally, the SBO retains a high-quality, senior risk position that would absorb any credit losses in the reference portfolio that exceed the first- and second-loss positions.

Typically, no default payments are made until the maturity of the overall transaction, regardless of when a reference obligor defaults. While operationally important to the SBO, this feature has the effect of ignoring the time value of money. Thus, the Federal Reserve expects that when the reference obligor defaults under the terms of the credit derivative and when the reference asset falls significantly in value, the SBO should, in accordance with generally accepted accounting principles, make appropriate adjustments in its regulatory reports to reflect the estimated loss that takes into account the time value of money.

For risk-based capital purposes, the BOs investing in the notes must assign them to the risk weight appropriate to the underlying reference assets.[53] The SBO must include in its risk-weighted assets its retained senior exposure in the reference portfolio, to the extent these underlying assets are held in its banking book. The portion of the reference portfolio that is collateralized by the pledged Treasury securities may be assigned a zero percent risk weight. Unless the SBO meets the stringent minimum conditions for transaction 2 outlined in the subsection ''Minimum Conditions,'' the remainder of the portfolio should be risk-weighted according to the obligor of the exposures.

When the SBO has virtually eliminated its credit-risk exposure to the reference portfolio through the issuance of CLNs, and when the other minimum requirements are met, the SBO may assign the uncollateralized portion of its retained senior position in the reference portfolio to the 20 percent risk weight. However, to the extent that the reference portfolio includes loans and other on-balance-sheet assets, the SBO would not realize any benefits in the determination of its leverage ratio.

In addition to the three stringent minimum conditions, the Federal Reserve may impose other requirements, as it deems necessary to ensure that an SBO has virtually eliminated all of its credit exposure. Furthermore, the Federal Reserve retains the discretion to increase the risk-based capital requirement assessed against the retained senior exposure in these structures, if the underlying asset pool deteriorates significantly.

Federal Reserve staff will make a case-by-case determination, based on a qualitative review, as to whether the senior retained portion of an SBO's synthetic securitization qualifies for the 20 percent risk weight. The SBO must be able to demonstrate that virtually all the credit risk of the reference portfolio has been transferred from the banking book to the capital markets. As they do when BOs are engaging in more traditional securitization activities, examiners must carefully evaluate whether the SBO is fully capable of assessing the credit risk it retains in its banking book and whether it is adequately capitalized given its residual risk exposure. The Federal Reserve will require the SBO to maintain higher levels of capital if it is not deemed to be adequately capitalized given the retained residual risks. In addition, an SBO involved in synthetic securitizations must adequately disclose to the marketplace the effect of its transactions on its risk profile and capital adequacy.

The Federal Reserve may consider an SBO's failure to require the investors in the CLNs to absorb the credit losses that they contractually agreed to assume an unsafe and unsound bank-

52. The names of corporate obligors included in the reference portfolio may be disclosed to investors in the CLNs.

53. Under this type of transaction, if a structure exposes investing BOs to the creditworthiness of a substantive issuer, for example, the SBO, then the investing BOs should assign the notes to the higher of the risk categories appropriate to the underlying reference assets or the SBO.

ing practice. In addition, such a failure generally would constitute ''implicit recourse'' or support to the transaction, which result in the SBO's losing preferential capital treatment on its retained senior position.

If an SBO of a synthetic securitization does not meet the stringent minimum conditions, it may still reduce the risk-based capital requirement on the senior risk position retained in the banking book by transferring the remaining credit risk to a third-party OECD bank through the use of a credit derivative. Provided the credit-derivative transaction qualifies as a guarantee under the risk-based capital guidelines, the risk weight on the senior position may be reduced from 100 percent to 20 percent. SBOs may not enter into nonsubstantive transactions that transfer banking-book items into the trading account to obtain lower regulatory capital requirements.[54]

4060.3.5.3.18.3 Minimum Conditions

The following stringent minimum conditions are those that the SBOs must meet to use the synthetic securitization capital treatment for transaction 2. The Federal Reserve may impose additional requirements or conditions as deemed necessary to ascertain that an SBO has sufficiently isolated itself from the credit-risk exposure of the hedged reference portfolio.

Condition 1—Demonstration of transfer of virtually all the risk to third parties. Not all transactions structured as synthetic securitizations transfer the level of credit risk needed to receive the 20 percent risk weight on the retained senior position. To demonstrate that a transfer of virtually all of the risk has been achieved, SBOs must—

1. produce credible analyses indicating a transfer of virtually all the credit risk to substantive third parties;
2. ensure the absence of any early-amortization or other credit performance–contingent clauses;[55]
3. subject the transaction to market discipline through the issuance of a substantive amount of notes or securities to the capital markets;
4. have notes or securities rated by a nationally recognized credit rating agency;
5. structure a senior class of notes that receives the highest possible investment-grade rating, for example, AAA, from a nationally recognized credit rating agency;
6. ensure that any first-loss position retained by the SBO in the form of fees, reserves, or other credit enhancement—which effectively must be deducted from capital—is no greater than a reasonable estimate of expected losses on the reference portfolio; and
7. ensure that the SBO does not reassume any credit risk beyond the first-loss position through another credit derivative or any other means.

Condition 2—Demonstration of ability to evaluate remaining banking-book risk exposures and provide adequate capital support. To ensure that the SBO has adequate capital for the credit risk of its unhedged exposures, it is expected to have adequate systems that fully account for the effect of these transactions on its risk profiles and capital adequacy. In particular, the SBO's systems should be capable of fully differentiating the nature and quality of the risk exposures it transfers from the nature and quality of the risk exposures it retains. Specifically, to gain capital relief SBOs are expected to—

1. have a credible internal process for grading credit-risk exposures, including the following:
   a. adequate differentiation of risk among risk grades
   b. adequate controls to ensure the objectivity and consistency of the rating process
   c. analysis or evidence supporting the accuracy or appropriateness of the risk-grading system;
2. have a credible internal economic capital-assessment process that defines the SBO to be adequately capitalized at an appropriate insolvency probability and that readjusts, as necessary, its internal economic capital requirements to take into account the effect of the synthetic securitization transaction. In

54. For instance, a lower risk weight would not be applied to a nonsubstantive transaction in which the SBO (1) enters into a credit-derivative transaction to pass the credit risk of the senior retained portion held in its banking book to an OECD bank, and then (2) enters into a second credit-derivative transaction with the same OECD bank, in which it reassumes into its trading account the credit risk initially transferred.

55. Early-amortization clauses may generally be defined as features that are designed to force a wind-down of a securitization program and rapid repayment of principal to asset-backed securities investors if the credit quality of the underlying asset pool deteriorates significantly.

addition, the process should employ a sufficiently long time horizon to allow necessary adjustments in the event of significant losses. The results of an exercise demonstrating that the organization is adequately capitalized after the securitization transaction must be presented for examiner review;

3. evaluate the effect of the transaction on the nature and distribution of the nontransferred banking-book exposures. This analysis should include a comparison of the banking book's risk profile and economic capital requirements before and after the transaction, including the mix of exposures by risk grade and by business or economic sector. The analysis should also identify any concentrations of credit risk and maturity mismatches. Additionally, the SBO must adequately manage and control the forward credit exposure that arises from any maturity mismatch. The Federal Reserve retains the flexibility to require additional regulatory capital if the maturity mismatches are substantive enough to raise a supervisory concern. Moreover, as stated above, the SBO must demonstrate that it meets its internal economic capital requirement subsequent to the completion of the synthetic securitization; and
4. perform rigorous and robust forward-looking stress testing on nontransferred exposures (remaining banking-book loans and commitments), transferred exposures, and exposures retained to facilitate transfers (credit enhancements). The stress tests must demonstrate that the level of credit enhancement is sufficient to protect the SBO from losses under scenarios appropriate to the specific transaction.

Condition 3—Provide adequate public disclosures of synthetic CLO transactions regarding their risk profile and capital adequacy. In their 10-K and annual reports, SBOs must adequately disclose to the marketplace the accounting, economic, and regulatory consequences of synthetic CLO transactions. In particular, SBOs are expected to disclose—

1. the notional amount of loans and commitments involved in the transaction;
2. the amount of economic capital shed through the transaction;
3. the amount of reduction in risk-weighted assets and regulatory capital resulting from the transaction, both in dollar terms and in terms of the effect in basis points on the risk-based capital ratios; and
4. the effect of the transaction on the distribution and concentration of risk in the retained portfolio by risk grade and sector.

4060.3.5.3.18.4 Transaction 3—First-Loss Position Is Retained

In the third type of synthetic transaction, the SBO may retain a subordinated position that absorbs the credit risk associated with a first loss in a reference portfolio. Furthermore, through the use of credit-default swaps, the SBO may pass the second- and senior-loss positions to a third-party entity, most often an OECD bank. The third-party entity, acting as an intermediary, enters into offsetting credit-default swaps with an SPV, thus transferring its credit risk associated with the second-loss position to the SPV.[56] The SPV then issues CLNs to the capital markets for a portion of the reference portfolio and purchases Treasury collateral to cover some multiple of expected losses on the underlying exposures.

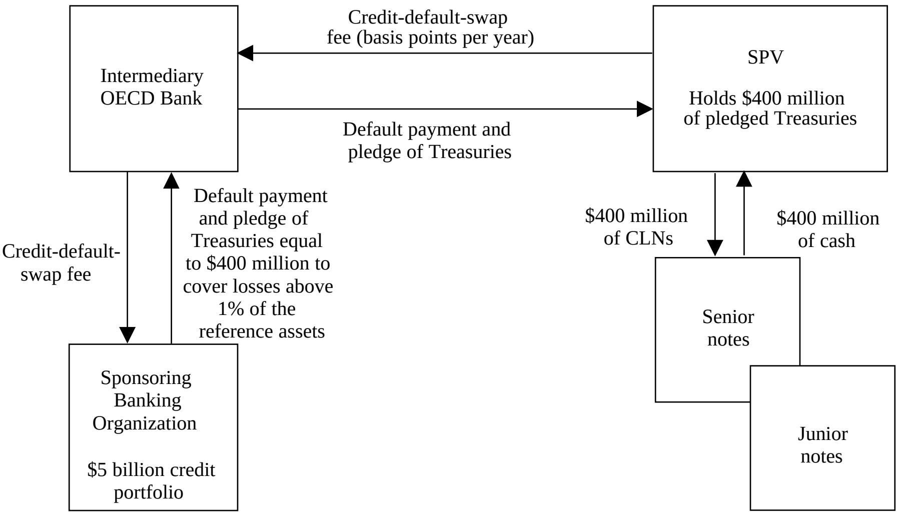
Two alternative approaches could be used to determine how the SBO should treat the overall transaction for risk-based capital purposes. The first approach employs an analogy to the low-level capital rule for assets sold with recourse. Under this rule, a transfer of assets with recourse that contractually is limited to an amount less than the effective risk-based capital requirements for the transferred assets is assessed a total capital charge equal to the maximum amount of loss possible under the recourse obligation. If this rule applied to an SBO retaining a 1 percent first-loss position on a synthetically securitized portfolio that would otherwise be assessed 8 percent capital, the SBO would be required to hold dollar-for-dollar capital against the 1 percent first-loss risk position. The SBO would not be assessed a capital charge against the second- and senior-risk positions.[57]

The second approach employs a literal reading of the capital guidelines to determine the SBO's risk-based capital charge. In this instance, the 1 percent first-loss position retained by the SBO would be treated as a guarantee, that is, a direct-credit substitute, which would be assessed

56. Because the credit risk of the senior position is not transferred to the capital markets but remains with the intermediary bank, the SBO should ensure that its counterparty is of high credit quality, for example, at least investment grade.

57. The SBO would not realize any benefits in the determination of its leverage ratio since the reference assets remain on the SBO's balance sheet.

Figure 3—Transaction 3



an 8 percent capital charge against its face value of 1 percent. The second-loss position, which is collateralized by Treasury securities, would be viewed as fully collateralized and subject to a zero percent capital charge. The senior-loss position guaranteed by the intermediary bank would be assigned to the 20 percent risk category appropriate to claims guaranteed by OECD banks.[58]

The second approach may result in a higher risk-based capital requirement than the dollar-for-dollar capital charge imposed by the first approach, depending on whether the reference portfolio consists primarily of loans to private obligors or undrawn long-term commitments. The latter generally have an effective risk-based capital requirement one-half of the requirement for loans because these commitments are converted to an on-balance-sheet credit-equivalent amount using the 50 percent conversion factor. If the reference pool consists primarily of drawn loans to private obligors, then the capital requirement on the senior-loss position would be significantly higher than if the reference portfolio contained only undrawn long-term commitments. As a result, the capital charge for the overall transaction could be greater than the dollar-for-dollar capital requirement set forth in the first approach.

SBOs will be required to hold capital against a retained first-loss position in a synthetic securitization equal to the higher of the two capital charges resulting from application of the first and second approaches, as discussed above. Further, although the SBO retains only the credit risk associated with the first-loss position, it still should continue to monitor all the underlying credit exposures of the reference portfolio to detect any changes in the credit-risk profile of the counterparties. This is important to ensure that the SBO has adequate capital to protect against unexpected losses. Examiners should determine whether the SBO has the capability to assess and manage the retained risk in its credit portfolio after the synthetic securitization is completed. For risk-based capital purposes, BOs investing in the notes must assign them to the risk weight appropriate to the underlying reference assets.[59]

58. If the intermediary is a BO, then it could place both sets of credit-default swaps in its trading account and, if subject to the Federal Reserve's market-risk capital rules, use its general market-risk model and, if approved, specific-risk model to calculate the appropriate risk-based capital requirement. If the specific-risk model has not been approved, then the SBO would be subject to the standardized specific-risk capital charge.

59. Under this type of transaction, if a structure exposes investing BOs to the creditworthiness of a substantive issuer, for example, the SBO, then the investing BOs should assign the notes to the higher of the risk categories appropriate to the underlying reference assets or the SBO.

4060.3.5.3.19 Reservation of Authority

The Federal Reserve reserves its authority to determine, on a case-by-case basis, the appropriate risk weight for assets and credit-equivalent amounts and the appropriate credit-conversion factor for off-balance-sheet items. The Federal Reserve's exercise of this authority may result in a higher or lower risk weight for an asset or credit-equivalent amount, or in a higher or lower credit-conversion factor for an off-balance-sheet item. This reservation of authority explicitly recognizes that the Federal Reserve retains sufficient discretion to ensure that bank holding companies, as they develop novel financial assets, will be treated appropriately under the regulatory capital standards. Under this authority, the Federal Reserve reserves its right to assign risk positions in securitizations to appropriate risk categories on a case-by-case basis, if the credit rating of the risk position is determined to be inappropriate.

4060.3.5.4 Considerations in the Overall Assessment of Capital Adequacy

Examiners are to take into account the following factors when assessing the overall capital adequacy of banking organizations.

4060.3.5.4.1 Unrealized Asset Values

Banking organizations often have assets on their books that are carried at significant discounts below current market values. This difference between book value (historical cost or acquisition value) and market value of any asset, particularly for banking premises, may represent potential capital to the banking organization. These "unrealized asset values" *are not included* in the risk-based capital calculation. Examiners should take into consideration such unrecognized capital when assessing capital adequacy. Particular attention should be given to the nature of the asset, the reasonableness of its valuation, its marketability, and the likelihood of its sale.

4060.3.5.4.2 Subordinated Debt

To be included in tier 2 capital, subordinated debt must be subordinated in right of payment to the claims of the issuer's general creditors. For bank holding companies, such debt must be subordinated to senior indebtedness. To meet this requirement, bank holding company debt must, at a minimum, be subordinated to (1) all borrowed and purchased money, (2) similar obligations arising from off-balance-sheet guarantees and direct-credit substitutes, and (3) obligations associated with derivative products such as interest-rate and foreign-exchange-rate contracts, commodity contracts, and similar arrangements. (See SR-92-37.)

Subordinated debt (and intermediate-term preferred stock) must have an original weighted average maturity of at least five years to qualify as supplementary capital. The average maturity of an obligation whose principal is repayable in scheduled periodic payments (for example, a so-called serial redemption issue) is the weighted average of the maturities of all such scheduled repayments. If the holder has the option to require the issuer to redeem, repay, or repurchase the instrument before the original stated maturity, maturity is defined as the earliest possible date on which the holder can put the instrument back to the issuing banking organization. This date may be much earlier than the instrument's stated maturity date. The outstanding amount includable in tier 2 capital must be discounted by 20 percent a year (20 percent of the original amount less any redemptions) during the instrument's last five years before maturity. The aggregate amount of subordinated debt and intermediate-term preferred stock that may be included in tier 2 capital is limited to 50 percent of tier 1 capital (net of goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of the risk-based capital measure). Amounts issued or outstanding in excess of this limit are not included in the risk-based capital calculation. However, examiners are to take any excess amount not included in the risk-based capital calculation into consideration when assessing the banking organization's funding and financial condition.

A state member bank may not repay, redeem, or repurchase a subordinated debt issue without the Federal Reserve's prior written approval. Prior written approval is not required for BHCs. They should consult with the Federal Reserve before redeeming subordinated debt. (See 12 C.F.R. 250.166(f)(2).)

Close scrutiny should be given to terms that permit the holder to accelerate payment of principal upon the occurrence of certain events. The only acceleration clauses acceptable in a subordinated debt issue included in tier 2 capital are those that are triggered by bankruptcy (in the case of a bank holding company) or receivership (in the case of a bank.)[60] (See SR-92-37.) Terms that permit the holder to accelerate payment of principal upon the occurrence of other events jeopardize the subordination of the debt because such terms could permit debtholders in a troubled institution to be paid out before the depositors. In addition, debt whose terms permit holders to accelerate payment of principal upon the occurrence of events other than insolvency does not meet the minimum five-year maturity requirement for debt capital instruments. Holders of such debt have the right to put the debt back to the issuer upon the occurrence of the named events, which could happen on a date well in advance of the debt's stated maturity.

Close scrutiny should also be given to the terms of those debt issues if an event of default is defined more broadly than insolvency or a failure to pay interest or principal when due. There is a strong possibility that such terms are inconsistent with safe and sound banking practice and that, accordingly, the debt issue should not be included in capital. Concern is heightened when an event of default gives the holder the right to accelerate payment of principal or when other borrowings contain cross-default clauses. Some events of default, such as making additional borrowings in excess of a certain amount, may unduly restrict the day-to-day operations. Other events of default, such as change of control or disposal of a banking organization subsidiary, may limit the flexibility of management or supervisors to work out the problems of a troubled organization. Still other events of default, such as failure to maintain certain capital ratios or rates of return or to limit the amount of nonperforming assets or charge-offs to a certain level, may be intended to allow the debtholder to be made whole before a deteriorating banking organization becomes truly troubled. Debt issues that include any of these types of events of default are not truly subordinated and should not be included in capital. Likewise, bank holding companies should not include in capital debt issues that otherwise contain terms or covenants that could adversely affect the issuer's liquidity; unduly restrict management's flexibility to run the organization, particularly in times of financial difficulty; or limit the regulator's ability to resolve problem situations.

Certain terms found in subordinated debt, however, may provide protection to investors without adversely affecting the overall benefits of the instrument to the organization, and thus would be acceptable for subordinated debt to be included in capital. Among such acceptable terms would be a provision that prohibits a bank holding company from merging, consolidating, or selling substantially all of its assets unless the new entity assumes the subordinated debt. Another acceptable provision would be the inclusion as an event of default of the failure to pay principal and interest on a timely basis or to make mandatory sinking-fund deposits, so long as such event of default does not allow the debtholders to accelerate the repayment of principal. (See SR-92-37.)

Debt issues, including mandatory convertible securities, that tie interest payments to the financial condition of the borrower generally should not be included in capital. Such payments may be linked to the financial condition of an institution through various ways, such as (1) an auction-rate mechanism, which is a preset schedule-mandating interest-rate increase either over the passage of time or as the credit rating of the bank holding company declines,[61] or (2) a term that raises the interest rate if payment is not made in a timely fashion. As the financial condition of a bank holding company declines, it is faced with higher and higher payments on its credit-sensitive subordinated debt at a time when it most needs to conserve its resources. Thus, credit-sensitive debt does not provide the support expected of a capital instrument to an institution whose financial condition is deteriorating; rather, the credit-sensitive feature can accelerate depletion of the organization's resources and increase the likelihood of default on the debt. While such terms may be acceptable in perpetual preferred stock qualifying for tier 2 capi-

60. A provision in bank holding company subordinated debt that permits acceleration in the event a major bank subsidiary enters into receivership would not jeopardize the issue's tier 2 capital status. A provision permitting acceleration in the event that any other type of affiliate of the issuer entered into bankruptcy or receivership would not be acceptable in a subordinated debt issue included in capital.

61. Although payment on debt whose interest rate increases over time may not on the surface appear to be directly linked to the financial condition of the issuing banking organization, such debt (sometimes referred to as expanding- or exploding-rate debt) has a strong potential to be credit sensitive in substance. Banking organizations whose financial condition has strengthened are more likely to be able to refinance the debt at a lower rate than that mandated by the preset increase, whereas those banking organizations whose condition has deteriorated are less likely to be able to do so. Moreover, just when these latter institutions would be in the most need of conserving capital, they would be under strong pressure to redeem the debt as an alternative to paying higher rates and therefore would accelerate depletion of their resources.

tal, they are not acceptable in a capital debt issue because a banking organization in a deteriorating financial condition may not have the option available in equity issues of eliminating the higher payments without going into default. If a bank holding company has included in its capital subordinated debt issued by an operating or nonoperating subsidiary, it is possible that the debt is in effect secured and, thus, not includable in capital.

4060.3.5.4.3 Ineligible Collateral and Guarantees

The risk-based capital guidelines recognize collateral and guarantees in only a limited number of cases. Other types of collateral and guarantees support the asset mix of banking organizations, particularly within their loan portfolios. Such collateral or guarantees may serve to substantially improve the overall quality of loan portfolios and other credit exposures, and should be considered by examiners when they are arriving at their overall assessment of capital adequacy.

4060.3.5.4.4 Overall Asset Quality

The conclusions drawn by banking organizations from calculating their risk-based capital ratios may be significantly different from conclusions drawn by examiners. The main reason for these differences is the assessment of asset quality. Examiners must assess the capital adequacy of banking organizations, taking into account examination or inspection findings, particularly those findings regarding the severity of problem and classified assets and investment or loan-portfolio concentrations, as well as the adequacy of the banking organization's allowance for loan and lease losses.

4060.3.5.4.5 Interest-Only Strips and Principal-Only Strips

Interest-only strips (IOs) and principal-only strips (POs) have highly volatile price characteristics as interest rates change, and they are generally not considered appropriate investments for most banking organizations. However, some sophisticated banking organizations may use IOs and POs as hedging vehicles. The Board does not want to discourage the legitimate use of IOs and POs as hedging vehicles. Examiners' assessments of capital adequacy should reflect banking organizations' appropriate use of hedging instruments, including IOs and POs. Banking organizations that have appropriately hedged their interest-rate exposure may be permitted to operate with lower levels of capital than those banking organizations that are vulnerable to interest-rate changes.

4060.3.5.4.6 Interest-Rate Risk

Examiners are to continue to scrutinize banking organizations' interest-rate risk exposure carefully and to require that organizations with undue levels of interest-rate risk strengthen their capital positions even though they may meet the minimum risk-based capital standards.

4060.3.5.4.7 Claims on, and Claims Guaranteed by, OECD Central Governments

The risk-based capital guidelines assign a zero percent risk weight to all direct claims (including securities, loans, and leases) on the central governments of the OECD-based group of countries and U.S. government agencies. Generally, the only direct claims banking organizations have on the U.S. government and its agencies are in the form of Treasury securities. Zero-coupon, that is, single-payment, Treasury securities trading under the U.S. Treasury's Separately Traded Registered Interest and Principal (STRIP) Program are assigned to the zero percent risk category. A security that has been stripped by a private-sector entity, such as a brokerage firm, is considered an obligation of that entity and, accordingly, is assigned to the 100 percent risk category.

Claims that are directly and unconditionally guaranteed by an OECD-based central government or a U.S. government agency are also assigned to the zero percent risk category. Such claims that are not unconditionally guaranteed are assigned to the 20 percent risk category. A claim is not considered to be unconditionally guaranteed by a central government if the validity of the guarantee depends on some affirmative action by the holder or a third party. Generally, securities guaranteed by the U.S. government or its agencies that are actively traded in financial markets are considered to be unconditionally guaranteed. These include Government National Mortgage Association (GNMA) and

Small Business Administration (SBA) securities.

As of December 30, 1992, banking organizations are permitted to assign to the zero percent risk category claims collateralized by cash on deposit in the banking organization or by OECD central governments or U.S. government agency securities for which a positive collateral margin is maintained on a daily basis, fully taking into account any change in the banking organization's exposure to the obligor or counterparty under a claim in relation to the market value of the collateral held in support of that claim. The Board is not requiring that a specific minimum margin of collateral be maintained on collateralized transactions assigned to the zero percent risk category. The Board expects that banking organizations will establish, as a part of prudent operating procedures, a minimum level of margin for these transactions based on such factors as the volatility of the securities involved, so as to avoid unduly frequent margin calls.

A limited number of U.S. government agency–guaranteed loans are deemed to be unconditionally guaranteed and, hence, can be assigned to the zero percent risk category. These include most loans guaranteed by the Export-Import Bank (Exim Bank),[62] loans guaranteed by the U.S. Agency for International Development (AID) under its Housing Guaranty Loan Program, SBA loans subject to a secondary participation guaranty (in accordance with SBA Form 1086), and Farmers Home Administration (FmHA) loans subject to an assignment guaranty agreement in accordance with FmHA Form 449–36.

Apart from the exceptions noted in the preceding paragraph, loans guaranteed by the U.S. government or its agencies are considered conditionally guaranteed. The guaranteed portion of the loans is assigned to the 20 percent category. These loans include, but are not limited to, loans guaranteed by the Commodity Credit Corporation (CCC), the Federal Housing Administration (FHA), the Foreign Credit Insurance Association (FCIA), the Overseas Private Investment Corporation (OPIC), and the Veterans Administration (VA), and, except as indicated above, portions of loans guaranteed by the FmHA and the SBA. Loan guarantees offered by FCIA and OPIC often guarantee against political risk. However, only that portion of a loan guaranteed by FCIA or OPIC against commercial or credit risk may receive a preferential 20 percent risk weight. The portion of government trust certificates issued to provide funds for the refinancing of foreign military sales loans made by the Federal Financing Bank or the Defense Security Assistance Agency that are indirectly guaranteed by the U.S. government also qualify for the 20 percent risk weight.

62. Loans guaranteed under Exim Bank's Working Capital Guarantee Program, however, receive a 20 percent risk weight.

4060.3.6 DIFFERENCE IN APPLICATION OF THE RISK-BASED CAPITAL GUIDELINES TO BANKING ORGANIZATIONS

The capital guidelines are generally the same for state member banks and bank holding companies. Since year-end 1992, however, there has been one significant difference: the manner in which capital is defined for use in computing the risk-based capital ratio. Specifically, perpetual preferred stock is handled differently for state member banks than it is for bank holding companies.

4060.3.6.1 Difference in Treatment of Perpetual Preferred Stock

Bank holding companies may include unlimited amounts of *noncumulative* perpetual preferred stock in tier 1 capital and limited amounts of cumulative perpetual preferred stock. The aggregate amount of *cumulative* stock that may be included in a bank holding company's tier 1 capital is limited to one-third of the sum of core capital elements, excluding cumulative perpetual preferred stock. Any amount of *cumulative* perpetual preferred stock in excess of this limit may be included as tier 2 capital. In contrast, state member banks may include only noncumulative perpetual preferred stock in tier 1 capital.

4060.3.6.2 Perpetual Preferred Stock (Terms Relating to Tier 1 Treatment)

Given the importance of core capital, the Federal Reserve's guidelines exclude from tier 1 capital preferred stock (including auction-rate preferred) in which the dividend rate is reset periodically, based in whole or in part upon the banking organization's financial condition or credit standing. Under such instruments, the obligation to pay out higher dividends in response to a deterioration in an organization's financial condition is inconsistent with the essential precept that capital should provide both strength and loss-absorption capacity to an organization during periods of adversity. Rather than paying out higher dividends, banking organizations are expected to conserve capital during such periods.

Ordinarily, fixed-rate preferred stock and traditional floating- or adjustable-rate preferred stock—where the dividend rate is based on an independent market index that is in no way tied to the issuer's financial condition—do not raise significant supervisory concerns, especially if the adjustable-rate instrument is accompanied by reasonable spreads and cap rates. However, certain other features that have been incorporated in, or mentioned for possible inclusion in, some preferred stock issues do raise serious questions about whether these issues will truly serve as a permanent, or even long-term, source of capital. Such features include exploding-rate or similar mechanisms, whereby, after a specified period, the dividend rate automatically increases to a level that appears unreasonable or that could create substantial incentives for the issuer to redeem the instrument. Perpetual preferred stock with this type of feature could cause the banking organization to be faced with higher dividend requirements at a future date when it is experiencing financial difficulties. Such preferred stock is not generally includable in tier 1 capital.

4060.3.7 CASH REDEMPTION OF PERPETUAL PREFERRED STOCK

Under the Federal Reserve's risk-based capital guidelines, two essential characteristics of core (tier 1) capital—which comprises common stock and perpetual preferred stock—are loss-absorption capacity and stability. In addition to existing laws and regulations that pertain to the redemption or repurchase of capital securities, the Federal Reserve's risk-based capital guidelines generally provide that any bank holding company contemplating the redemption of material amounts of permanent equity instruments, including perpetual preferred stock, should receive Federal Reserve approval before taking such action.[63] Any perpetual preferred stock with a feature permitting redemption at the option of the issuer may qualify as capital *only* *if* the redemption is subject to prior approval of the Federal Reserve.

The guidelines indicate that consultation with the Federal Reserve could be unnecessary if the instrument is redeemed with the proceeds of another acceptable tier 1 instrument and the organization's capital is considered fully adequate. However, because of the need to make supervisory judgments on these conditions, as well as the objective of fostering sound capital positions, banking organizations contemplating material redemptions of core capital are generally expected to discuss these plans with their appropriate supervisory authorities, regardless of the circumstances. This has long been the expectation and practice of the Federal Reserve. Prior consultation puts the supervisory authority in a position to take appropriate action if any planned capital redemption could have an adverse impact on an organization's financial condition.

The Federal Reserve's interest in the level and composition of capital derives both from the System's general supervisory responsibilities to monitor and address any actions that could erode an organization's capital base and from the need to implement the letter and spirit of supervisory guidelines on capital adequacy. Under the Federal Reserve's guidelines, to qualify as capital an instrument may not contain or be covered by covenants, terms, or restrictions that are inconsistent with safe and sound banking practice. Moreover, perpetual preferred stock cannot contain provisions that would require future redemption of the issue, and the issuer must have the ability and legal right to defer or eliminate preferred dividends.

4060.3.7.1 Federal Reserve's Supervisory Position on Cash Redemption of Tier 1 Preferred Stock

To qualify for tier 1 treatment, redemption for cash, regardless of source, is permissible only at the issuer's option. Moreover, in view of the importance of ensuring the stability of tier 1 capital, tier 1 preferred stock instruments should also provide that cash redemption would be permitted only with the prior consent of the Federal Reserve. The Federal Reserve expects that it would usually grant such approval, when consistent with the organization's overall financial condition, if the preferred shares are redeemed with the proceeds of an acceptable

63. This general principle also applies to the redemption of limited-life capital instruments before their stated maturities.

tier 1 capital instrument that would maintain or strengthen the issuer's capital base. Approval could also be granted if the Federal Reserve determines that the issuer's capital position after the redemption would clearly be adequate and that the issuer's condition and circumstances warrant the reduction of a source of permanent capital.

4060.3.8 COMMON STOCK REPURCHASES AND DIVIDEND INCREASES ON COMMON STOCK

The Federal Reserve has long emphasized the importance of prudent levels of capital to the overall safety and soundness of banking organizations. In pursuit of its supervisory objective to achieve an adequate level of capitalization in banking organizations, the Federal Reserve has over time promulgated various rules, guidelines, and standards concerning capital levels and the acceptable characteristics of various capital instruments and transactions. With respect to cash redemptions of common stock, section 225.4(b)(1) of Regulation Y requires bank holding companies to give the Federal Reserve prior notice of any repurchase of common stock that would reduce total equity capital by 10 percent or more aggregated over any 12-month period. The risk-based capital guidelines further request that bank holding companies consult with the Federal Reserve before any material redemption of permanent equity instruments.

Because of the need for banking organizations to strengthen their capital positions generally, the Board strongly recommends that bank holding companies deemed to be experiencing financial weaknesses (or those at significant risk of developing financial weaknesses) consult with the appropriate Federal Reserve Bank before any cash redemption of common stock. Similarly, any bank holding company considering expansion, either through acquisitions or through new activities, is also requested to consult with the appropriate Federal Reserve Bank before any cash redemption of common stock. Although there may be legitimate uses of repurchased shares (for example, in ESOP transactions), this request is intended to prevent an imprudent or untimely repurchase that would have an immediate or potentially adverse impact on the financial condition of the banking organization. In general, Reserve Banks should discourage bank holding companies from repurchasing their shares if there would be an adverse effect on the capital of the organization. A similar procedure was adopted for redemptions of perpetual preferred stock. (See section 4060.3.7 or SR-89-20.)

Further, because the banking organizations' ability to gain access to capital markets can be further diminished by rating-agency downgrades, the Federal Reserve considers internal capital generation an important element in a banking organization's capital planning. Therefore, bank holding companies in general, but particularly those experiencing any degree of financial weakness, are requested to consult with the appropriate Federal Reserve Bank before increasing the rate of cash dividends paid on common stock, an action that reduces capital-generation rates for companies experiencing financial weakness. It is the intention of the Federal Reserve to ensure that the financial condition, future earnings prospects, and capital level of the banking organization are consistent with any proposed increase in dividends. (See Regulation Y, section 225.4(b)(1) and appendix A, section II.)

4060.3.9 MANDATORY CONVERTIBLE DEBT SECURITIES AND PERPETUAL DEBT

Mandatory convertible debt securities are essentially subordinated debt instruments that may be converted into common or perpetual preferred stock within a specified period of time, not to exceed 12 years. To be counted as tier 2 capital, mandatory convertible securities must meet the criteria set forth below. These criteria cover the two basic types of mandatory convertible securities: equity contract notes (securities that obligate the holder to take common or perpetual preferred stock of the issuer in lieu of cash for repayment of principal) and equity commitment notes (securities that are redeemable only with the proceeds from the sale of common or perpetual preferred stock). Bank holding companies may include mandatory convertible debt securities (net of the stock dedicated to retire the issue(s)), in the form of equity contract notes or equity commitment notes as unlimited elements of tier 2 capital, provided that the applicable criteria set forth below are met. (See also Regulation Y, appendix B.) They are also permitted to include perpetual debt as an element of tier 2 capital. To be included as unlimited elements of tier 2 capital for bank holding companies, these instruments must meet the respective criteria set forth below (also found in Regulation Y, appendix B). The amount of mandatory convertible securities that have the proceeds of the issuance of common stock dedicated to redeem or retire them are treated as term subordinated debt subject to the specified limitation. A banking organization must receive Federal Reserve approval before redeeming (or repurchasing) mandatory convertible debt before maturity. The terms of the securities should note that such approval is required.

4060.3.9.1 Treatment of Debt with Dedicated Proceeds

If a bank holding company has issued common or perpetual preferred stock and dedicated the proceeds to the retirement or redemption of mandatory convertibles, the portion of mandatory convertibles covered by the dedication no longer carries a commitment to issue equity and, thus, has in effect been rendered into ordinary subordinated debt. Accordingly, the amount of the stock dedicated is netted from the amount of mandatory convertibles includable as unlimited tier 2 capital. The portion of such securities covered by dedications should be included in capital as subordinated debt, subject to amortization in the last five years of its life, and should be limited, together with other subordinated debt and intermediate-term preferred stock, to 50 percent of tier 1 capital. For example, a bank holding company has an outstanding equity contract note for $1 million and issues $300,000 of common stock, dedicating the proceeds to the retirement of the note. It would include the $300,000 of common stock in its tier 1 capital. The $700,000 of the equity contract note not covered by the dedication would be treated as an unlimited element of tier 2 capital. The $300,000 of the note covered by the dedication would be treated as subordinated debt.

4060.3.9.2 Treatment of Debt with Segregated Funds

In some cases, the indenture of a mandatory convertible debt issue may require the bank holding company to set up segregated trust funds to hold the proceeds from the sale of equity securities dedicated to pay off the principal of the mandatory convertibles at maturity. The portion of mandatory convertible securities covered by the amount of such segregated trust funds is considered secured and, thus, may not be included in capital. The maintenance of such a separate segregated fund for the redemption of mandatory convertibles exceeds the requirements of appendix B of Regulation Y. Accordingly, if a banking organization, with the agreement of the debtholders, wishes to eliminate the fund, regulatory approval normally should be given unless supervisory concerns warrant otherwise.

4060.3.9.3 Criteria Applicable to Both Types of Mandatory Convertible Securities

1. The securities must mature in 12 years or less.
2. The issuer may redeem securities before maturity only with the proceeds from the sale of common or perpetual preferred stock of the bank holding company. Any exception to this rule must be approved by the Federal Reserve. The securities may not be redeemed with the proceeds of another issue of mandatory convertible securities, nor may the issuer repurchase or acquire its own mandatory convertible securities for resale or reissuance.
3. Holders of the securities may not accelerate the payment of principal except in the event of bankruptcy, insolvency, or reorganization.
4. The securities must be subordinate in right of payment to all senior indebtedness of the issuer. If the proceeds of the securities are reloaned to an affiliate, the loan must be subordinated to the same degree as the original issue.
5. If an issuer intends to dedicate the proceeds of an issue of common or perpetual preferred stock to satisfy the funding requirements of an issue of mandatory convertible securities (that is, the requirement to retire or redeem the notes with the proceeds from the issuance of common or perpetual preferred stock), the issuer generally must make the dedication during the quarter in which the new common or preferred stock is issued.[64] As a general rule, if the dedication is not made within the

64. Common or perpetual preferred stock issued under dividend reinvestment plans or issued to finance acquisitions, including acquisitions of business entities, may be dedicated to the retirement or redemption of the mandatory convertible securities. Documentation certified by an authorized agent of the issuer showing the amount of common stock or perpetual preferred stock issued, the dates of issue, and amounts of such issues dedicated to the retirement or redemption of mandatory convertible securities will satisfy the dedication requirement.

prescribed period, then the securities issued may not at a later date be dedicated to the retirement or redemption of the mandatory convertible securities.[65]

4060.3.9.3.1 Additional Criteria Applicable to Equity Contract Notes

1. The note must contain a contractual provision (or be issued with a mandatory stock purchase contract) that requires the holder of the instrument to take the common or perpetual stock of the issuer in lieu of cash in satisfaction of the claim for principal repayment. The holder's obligation to take the common or perpetual preferred stock of the issuer may be waived if, and to the extent that, before the maturity date of the obligation, the issuer sells new common or perpetual preferred stock and dedicates the proceeds to the retirement or redemption of the notes. The dedication generally must be made during the quarter in which the new common or preferred stock is issued.
2. A stock purchase contract may be separated from a security only if (1) the holder of the contract provides sufficient collateral[66] to the issuer, or to an independent trustee for the benefit of the issuer, to ensure performance under the contract, and (2) the stock purchase contract requires the purchase of common or perpetual preferred stock.

65. For each dollar of common or perpetual preferred proceeds dedicated to the retirement or redemption of the notes, there is a corresponding reduction in the amount of outstanding mandatory securities that may qualify as tier 2 capital (the amount of proceeds dedicated would be included in tier 2 capital as subordinated debt subject, together with other subordinated debt, to a limit of 50 percent of tier 1 capital and to discounting of 20 percent per year during the last five years to maturity). De minimis amounts of common or perpetual stock issued under arrangements in which the amount of stock issued is not predictable, such as dividend reinvestment plans and employee stock option plans (but excluding public stock offerings and stock issued in connection with acquisitions), should be dedicated by no later than the company's fiscal year-end.

66. Collateral is defined as (1) cash or certificates of deposit; (2) U.S. government securities that will mature prior to or simultaneous with the maturity of the equity contract and that have a par or maturity value at least equal to the amount of the holder's obligation under the stock purchase contract; (3) standby letters of credit issued by an insured U.S. bank that is not an affiliate of the issuer; and (4) other collateral as may be designated from time to time by the Federal Reserve.

4060.3.9.3.2 Additional Criteria Applicable to Equity Commitment Notes

1. The indenture or note agreement must contain the following two provisions:
   a. The proceeds of the sale of common or perpetual preferred stock will be the sole source of repayment for the notes, and the issuer must dedicate the proceeds for the purpose of repaying the notes. (Documentation, certified by an authorized agent of the issuer, showing the amount of common or perpetual preferred stock issued, the dates of issue, and amounts of such issues dedicated to the retirement or redemption of mandatory convertible securities will satisfy the dedication requirement.)
   b. By the time that one-third of the life of the securities has run, the issuer must have raised and dedicated an amount equal to one-third of the original principal of the securities. By the time that two-thirds of the life of the securities has run, the issuer must have raised and dedicated an amount equal to two-thirds of the original principal of the securities. At least 60 days before the maturity of the securities, the issuer must have raised and dedicated an amount equal to the entire original principal of the securities. Proceeds dedicated to redemption or retirement of the notes must come only from the sale of common or perpetual preferred stock.[67]
2. If the issuer fails to meet any of these periodic funding requirements, the Federal Reserve will immediately cease to treat the unfunded securities as tier 2 capital and will take appropriate supervisory action. In addition, failure to meet the funding requirements will be viewed as a breach of a regulatory commitment, which the Board will take into consideration when it acts on statutory applications.
3. If a security is issued by a subsidiary of a bank or bank holding company, any guarantee of the principal by that subsidiary's parent bank or bank holding company must be subordinate to the same degree as the security issued by the subsidiary and limited to repayment of the principal amount of the security at its final maturity.

67. The funded portions of the securities will be deducted from the amount of mandatory convertible securities outstanding, but included in the amount of subordinated debt.

4060.3.9.4 Criteria for Determining the Tier 2 Capital Status of Perpetual Debt Instruments of Bank Holding Companies

1. The instrument must be unsecured.
2. The instrument may not give the noteholder the right to demand repayment of principal except in the event of bankruptcy, insolvency, or reorganization. The instrument must provide that nonpayment of interest shall not trigger repayment of the principal of the perpetual debt note or any other obligation of the issuer, nor shall it constitute prima facie evidence of insolvency or bankruptcy.
3. The issuer shall not voluntarily redeem the debt issue without prior Federal Reserve approval, except when the debt is converted to, exchanged for, or simultaneously replaced in like amount by an issue of common or perpetual preferred stock of the issuer or the issuer's parent company.
4. If issued by a bank holding company, a bank subsidiary, or a subsidiary with substantial operations, the instrument must contain a provision that allows the issuer to defer interest payments on the perpetual debt in the event of, and at the same time as, the elimination of dividends on all outstanding common or preferred stock of the issuer (or, in the case of a guarantee by a parent company, at the same time as the elimination of the dividends of the parent company's common and preferred stock). In the case of a nonoperating subsidiary (a funding subsidiary or one formed to issue securities), the deferral of interest payments must be triggered by elimination of dividends by the parent company.
5. If issued by a bank holding company or a subsidiary with substantial operations, the instrument must convert automatically to common or perpetual preferred stock of the issuer when the issuer's retained earnings and surplus accounts become negative. If an operating subsidiary's perpetual debt is guaranteed

by its parent, the debt may convert to the shares of the issuer or parent when the issuer's or parent's retained earnings and surplus accounts become negative. If issued by a nonoperating subsidiary of a bank holding company or bank, the instrument must convert automatically to common or preferred stock of the issuer's parent when the retained earnings and surplus accounts of the issuer's parent become negative.

4060.3.10 INSPECTION OBJECTIVES

1. To determine the adequacy of capital in relation to the risks inherent in the transactions and activities of the banking organization.
2. To determine compliance with the risk-based and tier 1 leverage measures of the capital adequacy guidelines as they apply to bank holding companies (see section 4060.4 of this manual).
3. To determine if the capital management and operating policies, practices, and procedures are adequate, and whether they reflect the requirements of the capital adequacy guidelines, if applicable.
4. To evaluate the performance of the bank holding company's officers and employees in administering and controlling the capital position of the organization, including its banking and nonbanking subsidiaries.
5. To evaluate the propriety and consistency of the banking organization's present and planned level of capitalization in light of the risk-based and leverage capital measures, as required, as well as existing conditions and future plans.
6. To initiate corrective action, in conjunction with the inspection process, when policies, procedures, or capital are deficient.

4060.3.11 INSPECTION PROCEDURES

Section 4060.3.5 lists items that examiners should consider during their analysis of capital adequacy with regard to the risk-based measure. The instructions in that section are to be followed in addition to the inspection procedures listed below.

Verification of the Risk-Based Capital Ratio

NOTE: Examiners should verify that the bank holding company has adequate systems in place to compute and document its risk-based capital ratios.

1. Determine if the bank holding company is correctly reporting risk-based capital information requested on the Federal Reserve's FR Y-9C Reports of Condition and Income and supplementary schedules.
   a. If the bank holding company has consolidated assets of less than $150 million, determine whether the bank holding company risk-based capital guidelines still apply because—
      (1) the bank holding company is engaged in nonbank activity involving significant leverage (includes off-balance-sheet activities) or
      (2) the parent company has a significant amount of outstanding debt that is held by the general public.

For the qualifying components of capital

2. Determine if management is adhering to the underlying terms of any currently outstanding stock issues.
3. Review common stock to ensure that the bank holding company is in compliance with the terms of any underlying agreement(s) and to determine if more than one class exists. If more than one class exists, review the terms for any preference or nonvoting features. If the terms include such features, determine whether the class of common stock qualifies for inclusion in tier 1 capital.
4. Review any perpetual and long-term preferred stock for the following:
   a. compliance with terms of the underlying agreement(s), carefully noting—
      (1) adherence to the cumulative or noncumulative nature of the stock and
      (2) adherence to any conversion rights
   b. proper categorization as tier 1 or tier 2 for capital adequacy purposes, noting the following requirements:
      (1) Tier 1 perpetual preferred stock must have the following characteristics:
         — no maturity date
         — not redeemable at the option of the holder
         — unsecured
         — ability to absorb losses

— ability and legal right for issuer to defer or eliminate dividends
— any issuer redemption feature subject to Federal Reserve prior approval
— fixed-rate or traditional floating- or adjustable-rate
— no features that would require or create an incentive for the issuer to redeem or repurchase the instrument, such as an ''exploding rate,'' an auction-rate pricing mechanism, or a feature that allows the stock to be converted into increasing numbers of common shares

(2) Perpetual preferred stock, includable within tier 2 capital without a sublimit, must have the characteristics listed within inspection procedure 4.b.(1) above for tier 1 perpetual preferred stock, but does not otherwise qualify for inclusion in tier 1 capital. For example, cumulative or auction-rate perpetual preferred stock, which does not qualify for tier 1 capital, may be includable in tier 2 capital.

5. Verify that minority interest in equity accounts of consolidated subsidiaries included in tier 1 capital consists of tier 1 capital elements. Determine whether any perpetual preferred stock of a subsidiary that is included in minority interest is secured by the subsidiary's assets; if so, that stock may not be included in capital.
6. Review the intermediate-term preferred stock and subordinated debt instruments included in capital for the following:
   a. compliance with terms of the underlying agreement(s), noting that subordinated debt containing one or both of the following terms may not be included in capital:
      (1) interest payments tied to the banking organization's financial condition
      (2) acceleration clauses or broad conditions of events of default that are inconsistent with safe and sound banking practices
   b. compliance with restrictions on the inclusion of such instruments in capital by verifying that the aggregate amount of both types of instruments does not exceed 50 percent of tier 1 capital (net of all goodwill) and that the portions includable in tier 2 capital possess the following characteristics:
      (1) unsecured
      (2) minimum five-year original weighted-average maturity
      (3) in the case of subordinated debt, contains terms stating that the debt (1) is not a deposit, (2) is not insured by a federal agency, (3) cannot be redeemed without prior approval from the Federal Reserve, and (4) is subordinated to depositors and general creditors
   c. appropriate amortization, if the instruments have a remaining maturity of less than five years
7. Determine, through review of minutes of the board of directors meetings, if a stock offering or subordinated debt issue is being considered. If so, determine that management is aware of the risk-based capital requirements for inclusion in capital.
8. Review any mandatory convertible debt securities for the following:
   a. compliance of the terms with the criteria set forth in Regulation Y (12 C.F.R. 225), appendix B
   b. notification in the terms of agreement that the redemption or repurchase of such securities prior to maturity is subject to prior approval from the Federal Reserve
   c. the treatment of the portions of such securities covered by the issuance of common or perpetual preferred stock dedicated to the repayment of the securities, bearing in mind the following:
      (1) The amount of the security covered by dedicated stock should be treated as subordinated debt and is subject, together with other subordinated debt and intermediate-term preferred stock, to a sublimit within tier 2 capital of 50 percent of tier 1 capital, as well as to amortization in the last five years of life.
      (2) The portion of a mandatory convertible security that is not covered by dedication qualifies for inclusion in tier 2 capital without any sublimit and without being subject to amortization in the last five years of life.
9. Verify that the transactions within the allowance for loan and lease losses have been properly accounted for during the inspection period and verify that the amount included in tier 2 capital has been limited to 1.25 percent of weighted-risk assets.

For the calculation of risk-weighted assets

10. Verify that each on- and off-balance-sheet item has been assigned to the appropriate risk category in accordance with the risk-based capital guidelines. Close attention should be paid to the underlying obligor, collateral, and guarantees, and to assignment to a risk category based upon the terms of a claim. The claim should be assigned to the risk category appropriate to the highest risk option available under the terms of the transaction. Verify that the bank holding company's documentation supports the assignment of preferential risk weights. If necessary, recalculate the value of risk-weighted assets.
11. Verify that all off-balance-sheet items have been converted properly to credit-equivalent amounts based on the risk-based capital guidelines. Close attention should be paid to the proper reporting of assets sold with recourse, financial and performance standby letters of credit, participations of off-balance-sheet transactions, and commitments.

Verification of the Tier 1 Leverage Ratio

1. Verify that the bank holding company has correctly calculated tier 1 capital in accordance with the definition of tier 1 capital for year-end 1992 as set forth in the risk-based capital guidelines.
2. Verify that the bank holding company has properly calculated average total consolidated assets.

Overall Assessment of Capital Adequacy

1. For bank holding companies that do not meet the minimum risk-based tier 1 leverage capital standard, as required, or that are otherwise considered to lack sufficient capital to support their activities, examine the capitalization plans for achieving adequate levels of capital and determine whether they are acceptable to the Federal Reserve District's management. Review and comment on these plans and any progress achieved in meeting the requirements.
2. The analysis of capital adequacy requires an evaluation of the propriety and consistency of the bank holding company's present and planned level of capitalization in light of existing conditions and future plans. In this regard, the examiner assigned to assessing capital adequacy should do the following:
   a. Using the latest Bank Holding Company Performance Report (BHCPR), analyze applicable ratios involving capital funds, comparing these ratios with those of its peer group and investigating trends or significant variations from peer-group averages.
   b. Determine that capital is sufficient to compensate for any instabilities or deficiencies in asset and liability mix and quality.
   c. Determine if the bank holding company's consolidated earnings performance enables it to fund its expansion adequately, to remain competitive in the market, and to replenish or increase its capital funds as needed.
   d. Analyze trends in the levels of debt versus equity funding, including double leverage, to determine the level of borrowing to fund equity, if any.
   e. If the reserve for loan losses is determined to be inadequate, analyze the impact of current and potential losses on the bank holding company's capital structure.
   f. Consider the impact of any management deficiencies on present and projected capital.
   g. Determine if there are any assets or contingent accounts whose quality represents an actual or potential serious weakening of capital.
   h. Consider the potential impact, should approval be given, of any proposed changes in controlling ownership on the projected capital position.
   i. Analyze assets that are considered undervalued on the balance sheet and carried at below-market values. The excess of market value over cost may represent an additional cushion to the bank holding company.
   j. Consider the cushion for absorbing losses that may be provided by any subordinated debt or intermediate-term preferred stock not included in tier 2 capital because of the 50 percent of tier 2 capital limitation or not included in capital for tier 1 leverage ratio purposes.
   k. Analyze any collateral and guarantees supporting assets that may not be taken into account for risk-based or tier 1 leverage capital purposes, and consider these in the

overall assessment of capital adequacy. This includes guarantees provided through credit-derivative transactions (see section 4060.3.5.3.9) in which the credit exposure is assigned to the risk category of the obligor of the reference asset or any collateral. For the latter, determine whether adequate capital and reserves are held against the exposures to reference assets.

l. Evaluate the consolidated asset quality of the bank holding company and determine whether it needs to strengthen its capital position based on the following:
   (1) the severity of problem and classified assets
   (2) investment or loan portfolio concentrations
   (3) the adequacy of loan-loss reserves

m. Analyze the bank holding company's management of interest-rate risk and use of hedging instruments. Determine if the bank holding company should strengthen its capital position based on undue levels of risk at any structural level within the organization. Review hedging instruments for any use of IOs and POs that may raise concerns, and management's expertise in using hedging instruments.

3. Review capital adjustments for goodwill, and other intangible assets (such as core deposit intangibles, favorable leasehold rights, organization costs, purchased trust-servicing rights, purchased investment-management relationships, purchased home-equity rights, merchant-servicing rights), that are required to be deducted from capital. An analysis of intangible assets that may be included in capital also must be performed. The analysis of these intangible assets should be performed using the following procedures:
   a. Verify the existence, the evidence of title to, and the accounting for intangible assets. Review and assess both the book values and the fair market values assigned to intangible assets, as well as the adequacy of the documentation evidencing the values, the amortization methods, and assigned amortization periods. When assessing the quality of a banking organization's intangible assets for purposes of evaluating its overall capital position, consider—
      (1) the reliability and predictability of any cash flows associated with the assets and the degree of certainty that can be achieved in periodically determining the asset's useful life and value,
      (2) the existence of an active and liquid market for the assets, and
      (3) the feasibility of selling the asset apart from the banking organization or from the bulk of its assets.
   b. Verify that intangibles are being reduced in accordance with the amortization method and that, if the carrying amount exceeds its value, the carrying value of the intangible asset is reduced accordingly, or is written off.
   c. Determine if a quarterly review of the level and quality of all intangibles is performed.
   d. Verify that goodwill and nonqualifying identifiable intangibles are deducted from tier 1 capital.
   e. Determine if the amount of mortgage-servicing rights or purchased credit-card relationships was within the established limitations on the amount that may be included in tier 1 capital.
   f. Ascertain whether the asset values of the intangible assets were reassessed during the annual audit.
4. In light of the overall capital adequacy analysis, and in accordance with the Federal Reserve's capital adequacy guidelines, determine if any appropriate supervisory action is warranted because of deficient levels of capital in relation to inherent risks of the bank holding company organization.
5. Review the following in preparation for discussion with appropriate management:
   a. all noted deficiencies regarding the capital accounts and
   b. the adequacy of present and projected capital
6. Ascertain through minutes, reports, etc., or through discussions with management how the bank holding company's future business and operational plans will affect its asset quality, capital position, and other areas of its balance sheet.
7. Prepare comments for the inspection report based on the bank holding company's capital position, including any comments on deficiencies that were observed.
8. Update the appropriate workpapers with any information that will facilitate future inspections.

4060.3.12 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Capital adequacy guidelines—BHCs:				
Measures:				
Risk-based		225, Appendix A	4–797	
Tier 1 leverage		225, Appendix D	4–798	
Bank holding company should be a source of financial and managerial strength to its subsidiaries		225.4(a)		1981 FRB 344
Policy statement on the responsibility of BHCs to act as a source of strength to their subsidiary banks			4–878	1987 FRB 441

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

On August 2, 1990, the Board issued capital leverage guidelines, effective September 10, 1990. The Board established the capital leverage ratio to be applied in conjunction with the risk-based capital guidelines. The leverage ratio is designed to complement the risk-based capital ratios when the overall capital adequacy of banking organizations is being determined. This section includes the subsequent revisions to the capital leverage guidelines.

4060.4.1 CAPITAL ADEQUACY GUIDELINES FOR BANK HOLDING COMPANIES: TIER 1 LEVERAGE MEASURE

The tier 1 leverage measure is found in appendix D of Regulation Y (12 C.F.R. 225).

4060.4.1.1 Overview of the Tier 1 Leverage Measure for Bank Holding Companies

The Board of Governors of the Federal Reserve System has adopted a minimum ratio of tier 1 capital to total assets to assist in the assessment of the capital adequacy of bank holding companies (banking organizations).[1] The principal objective of this measure is to place a constraint on the maximum degree to which a banking organization can leverage its equity capital base. It is intended to be used as a supplement to the risk-based capital measure.

The guidelines apply on a consolidated basis to bank holding companies with consolidated assets of $150 million or more. For bank holding companies with less than $150 million in consolidated assets, the guidelines will be applied on a bank-only basis unless (1) the parent bank holding company is engaged in a nonbank activity involving significant leverage[2] or (2) the parent company has a significant amount of outstanding debt that is held by the general public.

The tier 1 leverage guidelines are to be used in the inspection and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. The Board will review the guidelines from time to time and will consider the need for possible adjustments in light of any significant changes in the economy, financial markets, and banking practices.

4060.4.1.2 Tier 1 Leverage Ratio for Bank Holding Companies

The Board has established a minimum level of tier 1 capital to total assets of 4.0 percent for bank holding companies. For strong bank holding companies (rated composite 1 under the BOPEC rating system of bank holding companies) and for bank holding companies that have implemented the Board's risk-based capital measure for market risk as set forth in appendixes A and E of part 225 of Regulation Y, however, the minimum ratio of tier 1 capital to total assets is 3.0 percent. Banking organizations with supervisory, financial, operational, or managerial weaknesses, as well as organizations that are anticipating or experiencing significant growth, are expected to maintain capital ratios well above the minimum levels. Moreover, higher capital ratios may be required for any bank holding company if warranted by its particular circumstances or risk profile. In all cases, bank holding companies should hold capital commensurate with the level and nature of the risks, including the volume and severity of problem loans, to which they are exposed.

A banking organization's tier 1 leverage ratio is calculated by dividing its tier 1 capital (the numerator of the ratio) by its average total consolidated assets (the denominator of the ratio). The ratio will also be calculated on the basis of period-end assets, whenever necessary, on a case-by-case basis. For the purpose of this leverage ratio, the definition of tier 1 capital, as set forth in the risk-based capital guidelines in appendix A of Regulation Y, will be used.[3] As a

1. Supervisory ratios that related capital to total assets for state member banks are outlined in appendix B of Regulation Y.

2. A parent company that is engaged in significant off-balance-sheet activities would generally be deemed to be engaged in activities that involve significant leverage.

3. Tier 1 capital for bank holding companies includes common equity, minority interest in the equity accounts of consolidated subsidiaries, qualifying noncumulative perpetual preferred stock, and qualifying cumulative perpetual preferred stock. (Cumulative perpetual preferred stock is limited to 25 percent of tier 1 capital.) In addition, as a general matter, tier 1 capital excludes goodwill; amounts of mortgage-servicing assets, nonmortgage-servicing assets, and purchased credit-card relationships that, in the aggregate, exceed 100 percent of tier 1 capital; amounts of nonmortgage-servicing assets and purchased credit-card relationships that, in the aggregate, exceed 25 percent of tier 1 capital; amounts

general matter, average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the banking organization's Consolidated Financial Statements (FR Y-9C Report), less goodwill; amounts of mortgage-servicing assets, nonmortgage-servicing assets, and purchased credit-card relationships that, in the aggregate, are in excess of 100 percent of tier 1 capital; amounts of nonmortgage-servicing assets and purchased credit-card relationships that, in the aggregate, are in excess of 25 percent of tier 1 capital; amounts of credit-enhancing interest-only strips that are in excess of 25 percent of tier 1 capital; all other identifiable intangible assets; any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from tier 1 capital; deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of the limitation set forth in section II.B.4 of appendix A of Regulation Y;[4] and the amount of the total adjusted carrying value of nonfinancial equity investments that is subject to a deduction from tier 1 capital.

of credit-enhancing interest-only strips that are in excess of 25 percent of tier 1 capital; all other identifiable intangible assets; deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations; and a percentage of the organization's nonfinancial equity investments. The Federal Reserve may exclude certain investments in subsidiaries and associated companies as appropriate.

Whenever appropriate, including when an organization is undertaking expansion, seeking to engage in new activities, or otherwise facing unusual or abnormal risks, the Board will continue to consider the level of an individual organization's tangible tier 1 leverage ratio (after deducting all intangibles) in making an overall assessment of capital adequacy. This is consistent with the Federal Reserve's risk-based capital guidelines and long-standing Board policy and practice with regard to leverage guidelines. Organizations experiencing growth, whether internally or by acquisition, are expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets.

4. Deductions from tier 1 capital and other adjustments are discussed more fully in section II.B. of appendix A of Regulation Y.

Banking organizations and supervisors[1] must consider a broader range of exposures and deal with an increasingly complex array of financial instruments and activities that reflect important, but often subtle, differences in the levels of risk. Many banking organizations, especially large banking organizations and others with complex risk profiles, or those that are engaged in complex transfers of risk,[2] require formal analytical processes to identify and measure their risks and to maintain an adequate overall level of capital that is appropriate to those risks.

4060.7.1 FACTORS USED IN EVALUATING OVERALL CAPITAL ADEQUACY

Most banking organizations are currently considering several factors in evaluating their overall capital adequacy:

1. a comparison of their own capital ratios with regulatory standards and with those of industry peers
2. consideration of their—
   a. identified risk concentrations in credit and other activities;
   b. current and desired credit-agency ratings, if applicable; and
   c. the organization's historical experiences, including severe adverse events in its past.

4060.7.2 SOPHISTICATED TECHNIQUES USED IN ASSESSING CAPITAL ADEQUACY

Some more sophisticated banking organizations use risk-modeling techniques and scenario analyses to evaluate risk, but they generally have not formally incorporated these analyses into their overall assessment of capital adequacy. Those banking organizations that are using risk modeling and scenario analysis as tools to illuminate potential economic losses arising from certain types of risk are working to integrate these tools, as they apply to different risk types, into their capital adequacy assessments. The approaches and methods used vary among banking organizations, as does the degree of precision and integration. Sound practices are clearly moving toward a more quantitative, systematic, and comprehensive process for risk evaluation. Sophisticated banking organizations are also increasingly using analytical techniques developed either for pricing and performance measurement across business and product lines or for making portfolio risk-management decisions. Such techniques incorporate one or more volatility-based measures that allow for analysis of unexpected losses as well as more subjective considerations.

Regardless of the techniques used, nearly all U.S. banking organizations have found it advantageous to operate with capital levels above regulatory minimums—and above levels defined as ''well capitalized'' by regulation. High capital ratios are often not indicative of overall capital adequacy, especially for securitizations of high-quality assets and other capital arbitrage techniques. Supervisors often cannot rely solely on risk-based capital ratios as indicators of capital strength at banking organizations engaging in these types of activities.

4060.7.3 STRENGTHENING CAPITAL ADEQUACY

Banking organizations and their supervisors are increasingly emphasizing internal processes for assessing risks and for ensuring that capital, liquidity, and other financial resources are adequate in relation to an organization's overall risk profile. This increased emphasis stems from the greater scope and complexity of the banking business, particularly those activities related to ongoing financial innovation. Banking organizations therefore need to ensure that their capital is not only adequate to meet formal regulatory standards, but is also fully sufficient to support their underlying risk positions. Internal capital-management processes at large, complex banking organizations need to be significantly improved for better integration with internal risk measurement and analysis. See SR-99-18.

1. The term ''supervisors'' refers to, as an example, federal banking organization supervisors.

2. Such complex transfers of risk would include collateralized loan obligations (CLOs), credit derivatives, and credit-linked notes. For information on CLOs, see section 4353.1 in the *Trading and Capital-Markets Activities Manual*. For information on credit derivatives, see SR-96-17 or section 2129.0, and for secondary-market credit activities, SR-97-21 or section 2129.05.

4060.7.4 SUPERVISORY APPROACH TO EVALUATING CAPITAL ADEQUACY MANAGEMENT

Supervisors and examiners need to determine whether internal capital-management processes meaningfully tie the identification, monitoring, and evaluation of the risks that arise from the banking organization's business activities to the determination of its capital needs. The larger and more complex banking organizations are working to broaden their consideration of risks in assessing capital adequacy, and examiners should not immediately expect these organizations to have in place a comprehensive internal process for assessing capital adequacy. Examiners should expect, however, that such banking organizations will initiate improved capital-management efforts to do so promptly, and thereafter will make steady and meaningful progress toward that end. As these processes develop and become fully implemented, supervisors and examiners should also place increasing reliance on internal assessments of capital adequacy as an integral part of a banking organization's *capital adequacy* rating. Examiners should evaluate an organization's progress in developing these internal processes for capital adequacy assessment since the previous inspection, considering the organization's former practices and current status relative to its peers. The results of the examiner's evaluation should be recorded in the inspection report.

4060.7.5 FUNDAMENTAL ELEMENTS OF AN INTERNAL ANALYSIS OF CAPITAL ADEQUACY

A sound and effective internal analysis of capital adequacy should include the following elements:

1. *Identifying and measuring all material risks.* A disciplined risk-measurement program promotes consistency and thoroughness in assessing current and prospective risk profiles, recognizing that risks often cannot be precisely measured. The detail and sophistication of risk measurement should be appropriate for the nature of the risks posed by each of the banking organization's activities and its asset size. At a minimum, risk-measurement systems should be sufficiently comprehensive and rigorous to capture the nature and magnitude of the risks faced by the organization, while differentiating risk exposures consistently among risk categories and levels of riskiness. Controls should be in place to ensure objectivity and consistency and that all material risks—both on- and off-balance-sheet—are adequately addressed.

   Banking organizations should conduct detailed analyses to support the accuracy or appropriateness of the risk-measurement techniques used. Similarly, inputs used in risk measurement should be of good quality. Those risks not easily quantified should be evaluated through more subjective, qualitative techniques or through stress testing. Risk-profile changes should be promptly incorporated into risk measures, whether the changes are due to new products, increased volumes or changes in concentrations, the quality of the portfolio, or the overall economic environment. Such measurement *should not* be oriented to the current treatment of these transactions under risk-based capital regulations.

   When measuring such risks, banking organizations should perform comprehensive and rigorous stress tests to identify possible events or changes in markets that could have serious adverse effects in the future. Adequate consideration should be given to contingent exposures arising from loan commitments, securitization programs, and other transactions or activities that may create such exposure.
2. *Relating capital to the level of risk.* The amount of capital held should reflect not only the measured amount of risk but also an additional amount to account for potential uncertainties in risk measurement. A banking organization's capital should reflect the perceived level of precision in the risk measures used, the potential volatility of exposures, and the relative importance of the activities producing the risk. Capital levels should also reflect the fact that historical correlation among exposures can change rapidly.

   Banking organizations should be able to demonstrate that their approach to relating capital to risk is conceptually sound and that outputs and results are reasonable.[3] Sensi-

3. One credible method for assessing capital adequacy would be for a banking organization to consider itself adequately capitalized if it meets a reasonable and objectively determined standard of financial health, tempered by sound judgment—such as a target public-agency debt rating or even a statistically measured maximum probability of becoming insolvent over a given time horizon. In effect, this latter method is the foundation of the Basle Accord's treatment of capital requirements for market and foreign-exchange risk.

tivity analysis of key inputs and peer analysis can be used in assessing an organization's approach to relating its capital to risk.

3. *Stating explicit capital adequacy goals with respect to risk.* Explicit goals need to be established for capitalization as a standard for evaluating the banking organization's capital adequacy with respect to risk. Its target capital levels might reflect the desired level of risk coverage or, alternatively, a desired credit rating that reflects a desired degree of creditworthiness and thus access to funding sources. These goals should be reviewed and approved by the board of directors. Because risk profiles and goals may differ across banking organizations, the chosen target levels of capital may differ significantly from one organization to another. Moreover, banking organizations should evaluate whether long-run capital targets might differ from short-run goals, based on current and planned changes in risk profiles and the recognition that accommodating new capital needs can require significant lead time.

   In addition, capital goals and the monitoring of performance against those goals should be integrated with the methodology used to identify the adequacy of the allowance for credit losses (the allowance). Both the allowance and capital represent the ability to absorb losses; however, an insufficiently clear distinction between their respective roles can distort the analysis of their adequacy. For example, a banking organization's internal standard of *capital* adequacy for credit risk could reflect the desire that capital absorb ''unexpected losses''—that is, some level of potential losses above that level already estimated as being inherent in the current portfolio and reflected in the allowance.[4] If the allowance is not maintained at the high end of the range of estimated credit losses, the banking organization would require more capital than would otherwise be necessary to maintain its overall desired capacity to absorb potential losses. Failure to recognize this relationship could lead to overestimating the strength of its capital position.

4. *Assessing conformity to the banking organization's stated objectives.* A banking organization's target level and composition of capital, along with the process for setting and monitoring such targets, should be periodically reviewed and approved by its board of directors.

4. In March 1999, the banking agencies and the Securities and Exchange Commission issued a joint interagency letter to financial institutions stressing that depository institutions should have prudent and conservative allowances that fall within an acceptable range of estimated losses. The Federal Reserve has issued additional guidance on credit-loss allowances to supervisors and bankers. See SR-99-13 and SR-99-22.

4060.7.6 RISKS ADDRESSED IN A SOUND INTERNAL ANALYSIS OF CAPITAL ADEQUACY

Sound internal risk-measurement and capital-assessment processes should address the full range of risks faced by the banking organization. The capital regulations of the Federal Reserve (and the other U.S. banking agencies) refer to many specific factors and other risks that banking organizations should consider in assessing capital adequacy.[5]

Credit risk. Internal credit-risk-rating systems are vital to measuring and managing credit risk at large banking organizations. A large banking organization's internal ratings system should be adequate to support the identification and measurement of risk for its lending activities and be adequately integrated into its overall analysis of capital adequacy (see SR-98-25). Well-structured credit-risk-rating systems should reflect implicit, if not explicit, judgments of loss probabilities or expected loss, and should be supported where possible by quantitative analysis. Definitions of risk ratings should be sufficiently detailed and descriptive, consistently applied, and reviewed throughout the organization.[6]

Banking organizations should also take full account of credit risk arising from securitization and other secondary-market credit activities, including credit derivatives (see SR-97-21).[7] Maintaining detailed and comprehensive credit-risk measures is most necessary at banking orga-

5. See 12 CFR 208, appendix A (overview), for state member institutions and 12 CFR 225, appendix A (overview), for bank holding companies.

6. SR-98-25 and section 2122.0 discuss the need for banking organizations to have sufficiently detailed, consistent, and accurate risk ratings for all loans, not only for criticized or problem credits. This guidance also describes an emerging sound practice of incorporating such ratings information into internal capital- allocation frameworks, recognizing that riskier assets require higher capital levels.

7. Secondary-market credit activities generally include loan syndications, loan sales and participations, credit derivatives, and asset securitizations, as well as the provision of credit enhancements and liquidity facilities to support such transactions. See SR-97-21 and section 2129.05.

nizations that conduct asset securitization programs, as these activities have the potential to greatly change—and reduce the transparency of—the risk profile of credit portfolios.[8] Because the current capital standard treats most loans alike, banking organizations have incentives to reduce their regulatory capital requirements by securitizing or otherwise selling lower-risk assets, while increasing the average level of remaining credit risk through devices like first-loss positions and contingent exposure. Thus, it is important that banking organizations are able to assess their remaining risks and hold appropriate levels of capital and allowances. Banking organizations are at the frontier of financial innovation, and they should also be at the frontier of risk measurement and internal capital allocation.

Market risk. The regulatory capital standard for market risk is based largely on a banking organization's own measure of value-at-risk (VaR). The market-risk standard emphasizes the importance of stress testing as a critical complement to a VaR-based calculation in evaluating the adequacy of capital to support the trading function.

Interest-rate risk. The interest-rate risk inherent in a banking organization's activities should also be closely monitored. The banking agencies have emphasized that banking organizations should carefully assess the risk to the economic value of their capital from adverse changes in interest rates. The Joint Agency Policy Statement on Interest-Rate Risk (see SR-96-13) stresses the importance of (1) assessing interest-rate risk in relation to the economic value of a banking organization's capital and (2) sound practices in selecting appropriate interest-rate scenarios to be applied for capital adequacy purposes.

Operational and other risks. Many banking organizations view operational risk—often viewed as any risk not categorized as credit or market risk—as being second in significance only to credit risk. Although operational risk does not easily lend itself to quantitative measurement, it can result in substantial costs through error, fraud, or other performance problems. The growing dependence of banking organizations on information technology emphasizes one aspect of the need to identify and control this risk.

4060.7.7 CAPITAL COMPOSITION

The analysis of capital adequacy should couple (1) a rigorous assessment of the particular measured and unmeasured risks the banking organization faces with (2) consideration of the capacity of its paid-in equity and other capital instruments to absorb economic losses. The Board's long-standing view is that common equity (that is, common stock and surplus and retained earnings) should be the dominant component of a banking organization's capital structure and that organizations should avoid undue reliance on capital elements that do not form common equity.[9] Common equity allows an organization to absorb losses on an ongoing basis and is permanently available for this purpose. Further, this element of capital best allows organizations to conserve resources when they are under stress because it provides full discretion as to the amount and timing of dividends and other distributions. Consequently, common equity is the basis on which most market judgments of capital adequacy are made.

Consideration of the capacity of a banking organization's capital structure to absorb losses should also take into account how that structure could be affected by changes in performance. For example, a banking organization experiencing a net operating loss—perhaps due to realization of unexpected losses—will not only face a reduction in its retained earnings, but also possible constraints on its access to capital markets. These constraints could be exacerbated if detrimental conversion options are exercised. A decrease in common equity, the key element of tier 1 capital, may have further unfavorable implications for a banking organization's regulatory capital position. The eligible amounts of most types of tier 1 preferred stock and tier 2 or tier 3[10] capital elements may be reduced because

8. SR-97-21 and section 2129.05 state that such changes have the effect of distorting portfolios that were previously ''balanced'' in terms of credit risk. The term ''balanced'' refers to the overall weighted mix of risks assumed in a loan portfolio by the current regulatory risk-based capital standard. This standard, for example, effectively treats the commercial loan portfolios of all banks as having ''typical'' levels of risk.

9. The Basle Committee on Banking Supervision affirmed this view in an October 1998 release, which stated that common shareholders' funds are the key element of capital. It also suggested that, to protect the integrity of an organization's tier 1 capital and its common equity base, innovative instruments included in tier 1 capital generally should be limited to 15 percent of total tier 1.

10. For the definition of tier 3 capital, see market-risk measure, Regulation Y (12 C.F.R. 225), appendix E, section 2(d).

current capital requirements limit the amount of these elements to a maximum percentage of tier 1 capital. Such adverse magnification effects could be further accentuated if adverse events take place at critical junctures for raising or maintaining capital (for example, as limited-life capital instruments are approaching maturity or new capital instruments are being issued).

4060.7.8 EXAMINER REVIEW OF INTERNAL ANALYSIS OF CAPITAL ADEQUACY

During inspections and supervisory contacts at large, complex banking organizations (LCBOs), examiners should review internal capital-assessment processes, as well as the adequacy of the organizations' capital and their compliance with regulatory capital standards. Such reviews should assess the degree to which an organization has in place, or is making progress toward implementing, a sound internal process to assess capital adequacy. Examiners should briefly describe in the inspection report the approach and internal processes that are used by the banking organization to assess capital adequacy with respect to its risks. Examiners should then document their evaluation of the adequacy and appropriateness of these processes for the size and complexity of the organization and its risk profile. Examiners should also report their assessment of the quality and timing of the organization's plans to develop and enhance its processes for evaluating capital adequacy with respect to risk. Significant deficiencies and inadequate progress in developing and maintaining capital-assessment procedures should also be noted. Examiners should discuss plans for correcting any deficiency with the organization's directors and management and, as appropriate, initiate supervisory action.

In all cases, the examiner's evaluation of the internal processes for an organization's capital adequacy review should be considered in determining its supervisory rating for management. Examiners should expect those organizations that are already active in complex activities involving the transfer of risk, such as securitization and related activities, to have sound internal processes for assessing capital adequacy in place immediately as a fundamental element of safe and sound operation.

Beyond its consideration in evaluating management, the examiner's review should also become, over time, an integral element of assessing and assigning a supervisory rating for capital adequacy. The banking organization should be developing appropriate processes for establishing capital targets and analyzing its capital adequacy. If these internal assessments suggest that capital levels appear to be insufficient to support the risks taken by the banking organization, examiners should note this finding in the inspection report; discuss plans for correcting this insufficiency with the banking organization's directors and management; and, as appropriate, initiate follow-up supervisory actions.

4060.7.8.1 Adequacy of Risk Measurement and Risk Coverage

Examiners should assess the degree to which internal targets and processes incorporate the full range of material risks faced by the banking organization. They should also assess the adequacy of risk measures used in assessing internal capital adequacy, and the extent to which these risk measures are also used operationally in setting limits, evaluating business-line performance, and evaluating and controlling risk. Measurement systems that are in place but are not integral to the banking organization's risk management should be viewed with some skepticism. Examiners should review whether an organization's approach treats similar risks across products and/or business lines consistently, and whether changes in its risk profile are timely. Finally, examiners should consider the results of sensitivity analyses and stress tests conducted by the banking organization and how these results relate to its capital plans.

4060.7.8.2 Relating Capital to the Level of Risk

In addition to complying with regulatory capital ratios, banking organizations should be able to demonstrate through internal analysis that their capital levels and composition are adequate to support the risks they face, and that these levels are properly monitored and reviewed by directors. Examiners should review this analysis, including the target levels of capital chosen, to determine whether it is sufficiently comprehensive and relevant to the current operating environment. Examiners should also consider the extent to which the banking organization has provided for unexpected events in setting its capital levels. The analysis should cover a sufficiently wide range of external conditions and scenarios, and the sophistication of techniques and stress tests used should be commensurate with the banking organization's activities. Consideration of such conditions and scenarios should take appropriate account of the possibility that adverse events may have disproportionate effects on overall capital levels, such as the effect of tier 1 limitations, adverse capital-market responses, and other magnification effects. Finally, supervisors should consider the quality of the banking organization's management information reporting and systems, the manner in which business risks and activities are aggregated, and management's record in responding to emerging or changing risks.

Finally, when performing their review, supervisors and examiners should be careful to distinguish between a comprehensive process that seeks to identify a banking organization's capital requirements on the basis of measured economic risk, and one that focuses only narrowly on the calculation and use of allocated capital or "economic value added" (EVA) for individual products or business lines for internal profitability analysis. This latter approach, which measures the amount by which operations or projects return more or less than their cost of capital, can be important to an organization in targeting activities for future growth or cutbacks. It requires, however, that the organization first determine—by some method—the amount of capital necessary for each activity or business line. The process for determining the necessary capital should not be confused with management's related efforts to measure relative returns of the firm or of individual business lines, given an amount of capital already invested or allocated. Such EVA approaches often do not meaningfully aggregate the allocated capital across business lines and risk types as a tool for evaluating the banking organization's overall capital adequacy.

4060.7.9 INSPECTION OBJECTIVES

1. To integrate an assessment of capital adequacy with a comprehensive analysis of existing risk.
2. To determine whether internal capital-management processes meaningfully tie the identification, monitoring, and evaluation of the banking organization's risks, arising from its business activities, to the determination of its capital needs.
3. To evaluate a banking organization's progress in developing a comprehensive internal process for assessing capital adequacy, and to document that progress in the inspection report.
4. To place greater reliance on internal assessments of the banking organization's processes that are used to evaluate capital adequacy, and to incorporate those assessments into a supervisory rating for management and capital adequacy.
5. For banking organizations involved in complex activities such as securitization, other secondary-market activities (including credit derivatives), or other complex transfers of risk, to determine and report whether a sound, fundamental internal process for the analysis of capital adequacy currently exists.
6. To discuss with the board of directors and management any insufficiency in capital adequacy management, recognizing the risks taken, and to reach agreements for corrective action.

4060.7.10 INSPECTION PROCEDURES

Internal Capital Assessment

1. Review the banking organization's internal capital-assessment processes as well as its capital adequacy and compliance with regulatory capital standards.
2. Briefly describe in the inspection report the approach and internal processes that are used to assess capital adequacy with respect to the banking organization's risks.
   a. Evaluate and document an assessment of the adequacy and appropriateness of these internal processes (including the extent of their contribution to the assignment of a management supervisory rating). Consider the size and complexity of the banking organization with respect to the quality and timing of its plans to develop and enhance its processes for evaluating capital adequacy with respect to risk.
   b. If the banking organization is already involved in complex activities involving the transfer of risk, such as securitization and related activities, ascertain whether sound internal processes currently exist for evaluating capital adequacy.
   c. If the internal assessments described above suggest that capital levels appear to be insufficient to support the risks taken, dis-

cuss plans for correcting this insufficiency with the directors and management, and note these finding(s) in the inspection report and initiate follow-up supervisory action(s).

Measurement and Risk Coverage

1. Determine the degree to which internal targets and processes incorporate the full range of material risks faced by the banking organization.
   a. Evaluate the adequacy of risk measures used in assessing internal capital adequacy.
   b. Assess the extent to which these risk measures are used operationally in setting limits, evaluating business-line performance, and evaluating and controlling risk.
2. Ascertain whether the banking organization's approach treats similar risks across products and/or business lines consistently, and whether changes in the risk profile are fully reflected in a timely manner.
3. Evaluate the results of sensitivity analyses and stress tests conducted by the banking organization, and determine how these results relate to its capital plans.

Relating Capital to the Level of Risk

1. Determine whether the banking organization can demonstrate through internal analysis that its target capital levels and composition are adequate to support present risks, and whether these levels are properly monitored and reviewed by the directors. Decide if the internal analysis is sufficiently comprehensive and relevant to the current operating environment.
2. Ascertain if the banking organization has provided for unexpected events in setting its capital levels.
   a. Evaluate whether the analysis covers a sufficiently wide range of external conditions and scenarios.
   b. Determine if the sophistication of techniques and stress tests used are commensurate with the banking organization's activities.
3. Evaluate the quality of the banking organization's management information reporting and systems, the manner in which business risks and activities are aggregated, and management's record in responding to emerging or changing risks.
4. Establish whether the internal capital-analysis plan is—
   a. a comprehensive process that seeks to identify the banking organization's capital requirements on the basis of measured economic risk; or
   b. a narrow process that focuses only on the calculation and use of allocated capital or ''economic value added'' (EVA) for individual products or business lines for internal profitability analysis.

The bank holding company rating system is a management information and supervisory tool which defines the condition of bank holding companies in a systematic way. The system adopts the ‘‘component’’ approach by: (1) evaluating the financial condition and risk characteristics of each major component of the bank holding company; (2) assessing the important interrelationships among the components; and (3) analyzing the strength and significance of key consolidated financial and operating performance characteristics. This approach is particularly appropriate since holding companies are to be a source of financial and managerial strength to their bank subsidiaries.

In order to arrive at an overall assessment of financial condition, the following elements of the bank holding company are evaluated and rated on a scale of one through five in descending order of performance quality:

1. Bank Subsidiaries
2. Other (Nonbank) Subsidiaries
3. Parent Company
4. Earnings—Consolidated
5. Capital Adequacy—Consolidated

The first three elements of the rating, i.e., the bank, other subsidiaries, and parent company, reflect the contribution of each to the fundamental financial soundness of the holding company. The rating of consolidated earnings and capital recognizes the importance that regulators place on these factors and their crucial role in maintaining the financial strength and supporting the risk characteristics of the entire organization.

The ability and competence of holding company management bear importantly on every aspect of holding company operations and, consequently, are included as a major factor in the evaluation of each of the five principal elements of the bank holding company rating, as well as in the assignment of an overall holding company rating.

In addition to the individual elements described above, each company is accorded an overall or composite rating, comprising both a financial and managerial component. The financial composite rating is predicated upon an overall evaluation of the ratings of each of the five principal elements of the holding company’s operations as defined above. The financial composite rating is also based upon a scale of one through five in descending order of performance quality. Thus, one represents the lowest and five the highest degree of supervisory concern. The managerial composite is predicated upon a comprehensive evaluation of holding company management as reflected in the conduct of the affairs of the bank and nonbank subsidiaries and the parent company. The managerial composite is indicated by the assignment of ‘‘S’’, ‘‘F’’, or ‘‘U’’ for, respectively, management that is found to be satisfactory, fair or unsatisfactory.

The complete rating represents a summary evaluation of the bank holding company in the form of a rating ‘‘fraction.’’ The ‘‘numerator’’ reflects the condition of the principal components of the holding company and assessments of certain key consolidated financial and operating factors. The ‘‘denominator’’ represents the composite rating, as defined in greater detail below, including both its financial and managerial components. While the elements in the ‘‘numerator’’ represent the essential foundation upon which the composite rating is based, the composite need not reflect a simple arithmetic mean or rigid formula weighting of the individual performance dimensions. Any kind of formula could be misleading and inappropriate. Rather, the composite should reflect the rater’s judgment of the overall condition of the bank holding company based upon his knowledge and experience with the company. Thus, the complete rating is displayed as follows:

$$\frac{\text{B–O–P–E–C}}{\text{F–M}}$$

The bank holding company rating system parallels the uniform interagency bank rating system to some degree by utilizing similar rating scales and performance definitions to evaluate both the individual elements and the summary or overall condition of the holding company. This framework will provide for consistency and facilitate the adoption and use of the holding company rating system. The rating system is also sufficiently flexible to allow for appropriate differences in appraising shell bank holding companies.

Since shell bank holding companies comprise the majority of supervised companies, and involve a substantial volume of banking assets, they must also be addressed by the rating system. The procedure would be similar to that so far described; however, the other (nonbank) subsidiaries, consolidated earnings, and consolidated capital ratings would be assigned a ‘‘0’’ rating since these components have little relevance for the shell company. This leaves the parent (with emphasis on cash flow and debt servicing ability), bank and composite (both financial and managerial) as remaining elements of the shell bank holding company rating.

For purposes of the rating, shell companies shall be defined as bank holding companies that have total consolidated assets less than $150 million *and* that have no significant nonbank subsidiaries. Companies with consolidated assets of $150 million or more are obliged to file consolidated FR Y–9 C and FR Y–9 LP reports and, therefore, are to be accorded a complete rating regardless of the existence of nonbank subsidiaries. (Companies of $150 million or more in assets with no significant nonbank subsidiaries would be assigned a ''0'' for the ''other subsidiary'' component of the rating.) Nonshell companies under $150 million in consolidated assets with significant nonbank assets should be assigned a rating that includes a component for the nonbank subsidiaries. Thus, such companies' ratings will include the bank, other nonbank, and parent components, but may exclude consolidated earnings and capital ratings since the needed figures may not be available. In order to avoid confusion as to which components have been rated, and to provide for computer processing, whenever a component is not rated, a ''0'' should be assigned (i.e., 2–0–3–0–0).

As this scheme suggests, elements are to be rated whenever they are relevant for a particular company. In practice, this means that: (1) all companies with $150 million or more in consolidated assets should be given a complete rating; (2) shell companies as defined above should be accorded a rating for the bank and parent components and both composites; and (3) nonshell companies under $150 million in assets *with* significant nonbank operating subsidiaries should receive a rating that includes a nonbank component. Ratings of consolidated earnings and capital may also be included for such companies at the discretion of the examiner if the figures are available or if deemed necessary to accurately reflect overall condition. Of course, a managerial composite rating should be provided for all companies.

4070.0.1 FINANCIAL COMPOSITE RATING

The five composite ratings are defined and distinguished as follows:

1. Composite 1

Bank holding companies in this group are sound in almost every respect; any negative findings are basically of a minor nature and can be handled in a routine manner. Such holding companies and their subsidiaries are resistant to external economic and financial disturbances and readily generate cash flow which is more than adequate to service their debt and other fixed obligations with no harm to subsidiaries.

2. Composite 2

Bank holding companies in this group are also fundamentally sound but may reflect modest weaknesses correctable in the normal course of business. Such holding companies and their subsidiaries generate cash flow which is adequate to service their obligations; however, areas of weakness could develop into conditions of greater concern. To the extent that the minor adjustments are handled in the normal course of business, the supervisory response is limited.

3. Composite 3

Bank holding companies in this group exhibit a combination of weaknesses ranging from fair to moderately severe. Such holding companies and their subsidiaries are less resistant to the onset of adverse business conditions and could likely deteriorate if concerted action is not effective in correcting the areas of weakness. The company's cash flow is sufficient to meet immediate obligations but, unless action is taken to correct weaknesses, parent cash flow needs could adversely affect the financial condition of the subsidiaries. Consequently, such bank holding companies are vulnerable and require more than normal supervision. Overall strength and financial capacity, however, are still such as to pose only a remote threat to the viability of the company.

4. Composite 4

Bank holding companies and their subsidiaries in this group have an immoderate volume of asset weaknesses, or a combination of other conditions that are less than satisfactory. An additional weakness may be that the holding company's cash flow needs are met only by upstreaming imprudent dividends and/or fees from its subsidiaries. Unless prompt action is taken to correct these conditions, they could impair future viability. Bank holding companies in this category require close supervisory attention and increased financial surveillance.

5. Composite 5

The volume and character of the weaknesses of bank holding companies in this category are so critical as to require urgent aid from shareholders or other sources to prevent insolvency. The imminent inability of such companies to service their fixed obligations and/or prevent capital depletion from severe operating losses places their viability seriously in doubt. Such companies require immediate corrective action and constant supervisory attention.

4070.0.2 MANAGEMENT COMPOSITE RATING

The management rating is intended to reflect an overall evaluation of the capabilities and competence of the management of the parent company and senior management of the bank(s) and nonbank subsidiaries. The assessment of management must take place within the context of the situation and circumstances surrounding the individual holding company under evaluation. Since business complexities and operating problems vary with the size and type of holding company activity, management that is competent to effectively discharge responsibilities under one set of conditions may be less competent as these conditions change. Management performance must be evaluated against virtually all factors necessary to operate the holding company's activities soundly and prudently. In addition to objective operating results, important subjective considerations in assessing management performance include the following:

1. technical competence, leadership, administrative ability, and management depth and succession
2. knowledge of and compliance with the Bank Holding Company Act and related regulations, and all other relevant laws and regulations
3. history of serving the banking needs of the community
4. ability to plan and respond to changing circumstances
5. ability of parent management to monitor and direct subsidiary operations to ensure prudent operation and compliance with established holding company policies
6. adequacy and scope of internal audit systems and controls, and evaluation of them as contained in audit reports
7. attitude toward risk as indicated by any undue reliance on resources of subsidiary bank(s) to support nonbank activities

A rating of satisfactory (S) is indicative of management that is fully effective with respect to almost all factors and that exhibits a responsiveness and ability to cope successfully with existing and foreseeable problems that may arise in the conduct of the parent's or subsidiaries' affairs. Management rated satisfactory is knowledgeable concerning relevant laws and regulations, and has demonstrated an understanding of the need to insulate the subsidiary bank(s) from any undue risk associated with nonbank activities. A rating of fair (F) reflects performance that is lacking in some measure of ability that would be desirable to meet responsibilities necessitated by various situations which management must address. Performance is characterized by modest talent when above-average abilities are called for or by distinctly below-average talent for the type and size of organization. Thus, management's responsiveness or ability to correct less than satisfactory conditions may be lacking. Moreover, such management may reflect a less than satisfactory understanding of relevant holding company laws and regulations. A rating of unsatisfactory (U) is indicative of management that is demonstrably inferior or incompetent in relation to the responsibilities or problems it faces. This rating may also be indicative of management that has demonstrated an inclination to subject the subsidiary bank(s) to excessive or unwarranted risk as a result of the activities of the nonbank subsidiaries. In these cases, problems resulting from management weakness are of such severity that management must be strengthened or replaced before sound conditions can be brought about.

4070.0.3 PERFORMANCE EVALUATION

The five components of holding company operations (bank subsidiaries, nonbank subsidiaries, parent only, consolidated earnings, and capital) are to be evaluated on a scale of one to five. The following is a description of the gradations to be utilized in assigning performance ratings:

1. Rating No. 1 indicates strong performance. It is the highest rating and is indicative of performance that is significantly higher than average and that obviates the need for supervisory concern.
2. Rating No. 2 reflects satisfactory performance. It reflects performance that is average or above; it includes performance that adequately provides for the safe and sound operation of the bank holding company and its subsidiaries.
3. Rating No. 3 represents performance that is flawed to some degree; as such, it is considered fair. It is neither satisfactory nor marginal but is characterized by performance of below-average quality. Such performance requires man-

agement attention due to the distinct possibility of further deterioration.

4. Rating No. 4 represents marginal performance which is significantly below average; if left unchecked, such performance might evolve into weaknesses or conditions that could threaten the viability of the institution.

5. Rating No. 5 is considered unsatisfactory. It is the lowest rating and is indicative of performance that is critically deficient and in need of immediate remedial attention. Such performance by itself, or in combination with other weaknesses, could threaten the viability of the institution.

4070.0.4 BANK CONDITION

The bank condition component is intended to reflect the overall condition of the banking subsidiary or subsidiaries. For this purpose, use is made of the subsidiary bank CAMELS composite rating(s). In the case of multibank companies, each bank's composite rating should be weighted according to its asset size to arrive at an average bank composite rating. Weighting implies that, in most cases, the bank condition component in the holding company rating system will usually reflect the lead bank's composite according to the Uniform Financial Institutions Rating System (CAMELS).

To highlight the presence of one or more problem bank(s) in a multibank holding company whose bank condition component, based on weighted averages, might not otherwise reveal their presence (that is, bank condition ratings of 1, 2, or 3), a problem identifier (P) would be attached to the bank condition rating (for example, 1P, 2P, 3P). Thus, 2P would indicate that, while on balance the banking subsidiaries are rated satisfactory, there exists a problem bank (composite 4 or 5) among the banking subsidiaries. The problem identifier is unnecessary when the bank condition component is rated 4 or 5. Although the bank condition component is a weighted average, it can be adjusted for subjective, judgmental reasons at the discretion of the rater.

4070.0.5 OTHER (NONBANK) SUBSIDIARIES

The other subsidiaries rating is designed to assess the condition of the nonbank subsidiaries in the context of their overall impact on the financial condition of the holding company and the subsidiary bank(s). In so doing, emphasis must be placed on the asset quality of credit-extending subsidiaries and the profitability and operating soundness of non-credit-extending subsidiaries. The evaluation of other subsidiaries should concentrate on the quality and condition of nonbank assets defined as—

1. the underlying assets of credit-extending nonbank subsidiaries; and
2. the parent's investment in and advances to non-credit-extending subsidiaries.

The inclusion of No. 2 in the definition acknowledges the fact that poorly run servicing or other non-credit-extending subsidiaries can pose significant risk exposure to the holding company, which should be explicitly reflected in the rating. Such exposure might result, for example, from operating losses or off-balance-sheet items such as guarantees. In many cases, since non-credit-extending subsidiaries are not heavy borrowers from external sources, the parent's investments in and advances to such companies will serve as a proxy for the magnitude of their operations. The degree of risk associated with the non-credit-extending subsidiaries may be quantified for the purpose of analyzing nonbank asset quality by classifying the parent's investments in and advances to such subsidiaries if the financial condition of the subsidiaries or the characteristics of their assets permits a meaningful conventional asset classification. This might be the case, for instance, if the subsidiaries' historical earnings record has not, in the examiner's judgment, adequately accounted for the development of clearly identifiable loss potential associated with the entity's operations. If a conventional classification of the investments in or advances to the non-credit-extending subsidiaries is not considered suitable, the examiner should identify and fully analyze the risk exposure posed by the non-credit-extending subsidiaries in the inspection report, specifically in the open section narrative analysis of financial condition. Any classifications or analysis of the parent's investments in and advances to non-credit-extending subsidiaries should be presented in the open section of the report and considered in arriving at the nonbank subsidiary component of the rating system. In assessing the investment in or advance to a non-credit-extending subsidiary, the analysis should parallel that for any asset appraisal, with particular attention given to the subsidiary's purpose and operating efficiency, management reporting procedures, and profitability. Also, foreign subsidiaries should be assessed in a manner similar to that for the company's domestic nonbank investments.

The degree of risk associated with credit-extending subsidiaries is determined by the classification of the underlying assets of the subsidiaries. The severity of both problem investments and classified assets should be reflected by using the following weights: 100 percent of "loss," 50 percent of "doubtful," and 20 percent of "substandard."

A major step in rating nonbank activities is first to appraise their significance to the company's overall financial performance. The appraisal should focus on the potential loss exposure these activities pose to the bank holding company. One way of estimating this exposure is to compare total nonbank assets as defined above, plus any additional exposure not reflected in total assets, to total consolidated capital. As a general rule, other subsidiaries should be rated whenever nonbank assets exceed 5 percent of consolidated capital or $10 million, whichever is lower. If this condition is not met, a "0" should be entered for the rating of other subsidiaries. Other subsidiary assets that do not meet the significance conditions may be rated if, in the opinion of the rater, not to do so would significantly misrepresent the condition of the holding company.

When a rating is assigned to nonbank assets, considerations should include—

1. the relationship of problem investments in and advances to non-credit-extending subsidiaries plus classified assets in the credit-extending nonbank subsidiaries to total nonbank assets as defined above;
2. the relationship of problem investments and advances plus classified assets to the sum of parent company and nonbank valuation reserves and ex-bank consolidated equity capital, or to any more appropriate or refined capital index or measure, if warranted;
3. the ability of nonbank management to supervise and exercise overall control over nonbank subsidiary operations in order to ensure prudent operation, sound asset administration, and compliance with established holding company policies and relevant laws and regulations; and
4. management attitudes toward risk as indicated by any undue reliance on resources of affiliated bank(s) to support nonbank subsidiaries.

The specific delineation of the above considerations is not meant to preclude taking into account other relevant factors such as profitability, operating efficiency, management controls, reporting procedures, and any other relevant factors that, in the judgment of the rater, are necessary to assess accurately the condition of the nonbank subsidiaries.

An asset quality rating of 1 obviates the need for supervisory concern due to the existence of sound, well-managed nonbank operations, investments, and loan portfolios. A 2 rating may indicate the existence of some asset problems or other minor operational weaknesses, but still represents fundamentally sound, well-managed asset conditions warranting minimal supervisory concern. A 2 may also reflect asset problems that are clearly of little supervisory concern, given their unlikely impact on the bank(s) and the size and overall strength of the holding company. Problems associated with a 2 rating can readily be resolved in the normal course of business. A 3 rating represents the existence of deficiencies such as a significant upward trend in classifications, management control weaknesses, or other problems that, if left unchecked, could cause substantial deterioration and have an adverse impact on the banking subsidiaries. A 4 rating represents an increased need for supervisory surveillance and concern due to any combination of poor operations, weak management, or severe asset problems that are currently having a serious impact on the holding company or the banking subsidiaries. A 5 rating applies to a critical level of nonbank problems.

4070.0.6 PARENT COMPANY

The parent company rating reflects the financial condition of the parent company by focusing on (1) its ability to readily service its debt and other fixed obligations and (2) the quality of direct parent credit extensions to entities that are not subsidiaries of the holding company. (Investments in and advances to holding company subsidiaries are treated above in connection with the evaluation of the nonbank subsidiaries.)

In analyzing the parent company, consideration should be given to its ability to generate adequate cash flow from its ongoing operations and the liquidity of its assets. Potential sources of cash flow to the parent include, for example, bank and nonbank dividends, loan repayments, management and service fees, tax benefits, interest income, and liquidation of assets; cash needs would include interest and operating expenses, debt retirement, and preferred and common stock dividends. The analysis should also take into account the capacity of the parent company to safely obtain liquidity from its subsidiaries by, for example, the prudent upstreaming of additional subsidiary dividends.

Factors which should be incorporated in the analysis of the parent company include—

1. volume and composition of parent-company debt, and cash-flow needs deriving therefrom;
2. comparison of the maturities of parent-company borrowings with the maturities of the investments which they fund;
3. quality of credits to nonaffiliated companies;
4. ability to readily convert assets to cash without incurring serious loss or adversely affecting the banking subsidiaries;
5. ability of management to plan for liquidity and cash-flow needs and respond to changing conditions in the markets for short-term funds;
6. ability of the company to obtain long- and short-term funds on reasonable terms, and the existence of firm backup lines of credit;
7. reasonableness of any bank management or service fees paid to the parent;
8. demonstrated performance in meeting past and current servicing requirements; and
9. ability of parent management to supervise and exercise overall control over subsidiary and parent operations to ensure prudent operation, sound asset administration, and compliance with established holding company policies and relevant laws and regulations.

Also of importance, but treated elsewhere, are the use of parent debt to fund equity investments in subsidiaries, the adequacy of the company's capital and capital plans, and the strength of corporate earnings.

The shell company would be appraised in a manner similar to that outlined above. Cash flow to service parent-company debt would be the major aspect of the analysis, with attention focused on its effects on the subsidiary bank's capital position. In addition, the amount of parent-company debt should be compared to the parent's proportionate interest in the subsidiary bank's equity capital. This serves as a good estimate of the company's ability to carry existing debt or to borrow additional funds should an unexpected need arise.

A parent company rating of 1 indicates that the holding company can readily generate cash flow which is more than adequate to service its debt obligations and other cash-flow needs and provide for the smooth rollover of debt without adverse effect on its subsidiaries. The rating also reflects good management and the absence of significant asset problems. A 2 rating, while reflecting a fundamentally sound situation, indicates a possible trend toward tighter liquidity due to lower earnings, asset quality, or other relevant operating indices. A rating of 3 represents a decidedly tight, but still manageable, cash-flow situation. The company will likely have little or no liquidity in its asset portfolio and/or be overly dependent on potentially harmful dividends and fees from its subsidiaries. Weak earnings might also be expected to complicate such a situation. The 3 rating would reflect increasing difficulty for the parent company in obtaining short-term funds on favorable terms. A rating of 4 indicates serious cash-flow problems caused or exacerbated by severe asset deterioration or poor or no corporate earnings. Companies so rated may be seriously draining funds from bank subsidiaries to service cash-flow needs and may be completely unable to serve as a source of funds or financial strength to their subsidiaries. A rating of 5 may represent an inability to enter money markets. Moreover, the problems represented by a rating of 5 would reflect an imminent danger of default or insolvency of the parent company.

4070.0.7 EARNINGS—CONSOLIDATED

The rating of earnings is based on the assessment of fully consolidated profitability. This approach is appropriate since consolidated earnings serve as a source of financial strength and capital growth for the entire organization.

Profitability has two dimensions, quantity and quality, both of which must be incorporated in the evaluation of earnings. Quantity refers to the absolute level of net income and its adequacy in relation to the considerations listed below. The appraisal of quality is an attempt to determine the strength of operating earnings (i.e., the ability to generate ongoing revenues and hold down expenses), and the degree to which earnings reflect the impact of unusually large securities gains or losses, unusual tax items (i.e., credits, carryforwards, etc.), or other large, nonrecurring, extraordinary gains or losses. Quality of earnings also refers to the effect on net income of adequately providing additions to the loan-loss reserve to properly recognize the impact of poor, overstated, or loss assets carried on the balance sheet. Other things being equal, consolidated net income that relies unduly on unusually large, nonrecurring gains or that fails to reflect adequate loan-loss provisions is of lower quality than net income of equal magnitude that reflects strong operations and adequate loss provisions. On the other hand, the concept of quality "works both ways." While care must be taken to avoid attempting to predict the future, net income that otherwise appears somewhat low may be of high quality and, consequently, suggests stronger future net income. This would especially be the case if current earnings reflected a level of charge-offs that was not expected to recur, given the relatively high quality of the company's assets.

Generally, consolidated earnings since the prior inspection will be rated with emphasis given to the most recent year's performance. In light of the above discussion, earnings will be rated with respect to the following considerations:

1. the return on consolidated assets, historical earnings trends, and peer-group comparisons
2. the quality of earnings as reflected by (a) extent of reliance on nonrecurring gains or losses or unusual tax effects, and (b) the sufficiency of loss provisions in view of the condition of the asset portfolio and the adequacy of the loan-loss reserves
3. the ability to adequately cover charge-offs, maintain public confidence, and provide for the safe, ongoing operation of the company
4. the ability of management to plan and devise realistic earnings projections in light of the risk structure and quality of assets
5. the outlook for earnings as implied by the current risk structure and quality of assets
6. the ability of earnings to provide for the growth of capital in light of recent and planned asset growth

Inclusion of no. 6 above is not meant to suggest that the level or adequacy of current capital determines the rating for earnings; capital per se is treated elsewhere. It simply recognizes that retained earnings is a primary source of capital. If a company opts for rapid growth, its earnings must enable it to raise the necessary capital either through retention or by permitting ease of entry into the capital markets. While this notion must be kept in mind in evaluating a company's profitability, it is quite possible for a company to simultaneously have low capital and good earnings or vice versa.

Earnings rated 1 are sufficient to make full provision for the absorption of losses and accretion of capital when due consideration is given to asset quality and bank holding company growth. Generally, holding companies so rated will have earnings well above peer-group averages. A company whose earnings are relatively static or even moving downward may receive a 2 rating, provided its level of earnings is adequate in view of the considerations discussed above. Normally, companies so rated will have earnings that are in line with or slightly above peer-group norms. A 3 rating should be accorded earnings that are not fully adequate to make sufficient provisions for the absorption of losses and the accretion of capital in relation to company growth. The earnings pictures of such companies may be further clouded by static or inconsistent earnings trends, chronically insufficient earnings, or less than satisfactory asset quality. Earnings of such companies are generally below peer-group averages. Earnings rated 4, while generally positive, are clearly not adequate to make full provision for losses and the necessary accretion of capital. Companies with earnings rated 4 may be characterized by erratic fluctuations in net income, poor earnings (and the likelihood of the development of a further downward trend), intermittent losses, chronically depressed earnings, or a substantial drop from the previous year. Earnings of such companies are ordinarily substantially below peer-group averages. Bank holding companies with earnings accorded a 5 rating should be experiencing losses or reflecting a level of earnings that is worse than that defined in rating 4 above. Such losses, if not reversed, could represent a distinct threat to the holding company's solvency through the erosion of capital.

4070.0.8 CAPITAL ADEQUACY—CONSOLIDATED

Capital is to be evaluated with regard to the volume and risk of the operations of the consolidated corporation. Emphasis on capital from the standpoint of the consolidated entity is appropriate since holding company management exercises some discretion with respect to the allocation of capital resources within the corporation. Thus, it is the holding company's capital on a consolidated basis that must serve as the ultimate source of support and strength to the entire corporation.

To be considered adequate, holding company capital must (1) support the volume and risk characteristics of all parent and subsidiary activities; (2) provide a sufficient cushion to absorb unanticipated losses arising from holding company and subsidiary activities; (3) support the level and composition of corporate and subsidiary borrowing; and (4) serve as a source of strength by providing an adequate base for the growth of risk assets and permitting entry into the capital markets as the need arises. An essential step in the analysis of capital is the assessment of the risk characteristics and capital requirements deriving from the lending activities and operations of the parent and each of the operating subsidiaries.

The analysis of capital should incorporate the following considerations:

1. the relationship of consolidated capital to risk-weighted assets as reflected in (a) the ratio of tier 1 capital to total risk-weighted assets, and (b) the ratio of total capital to risk-weighted assets
2. the capital requirements that derive from the asset quality and risk associated with each holding company activity
3. the relationship of consolidated debt to tier 1 capital
4. the extent of reliance on long-term debt in the capital structure
5. the extent of the use of debt at the parent level to fund capital investments in subsidiaries
6. the trends of indices of capital adequacy and peer-group ratio comparisons
7. the management's ability to devise adequate capital plans and retention policies in light of any capital deficiency and/or planned expansion of risk assets
8. the capacity to enter capital markets or tap other sources of long-term debt and equity
9. the extent of any balance-sheet concentration in any category or related categories of intangible assets, particularly those in excess of the 25 percent threshold, including the reasonableness of the amortization periods of those assets
10. the relationship of high or inordinate off-balance-sheet risk exposure to tier 1 capital
11. the nature and amount of nonbanking activities in relationship to tier 1 and total capital levels

4070.0.8.1 Rating Consolidated Capital

The capital adequacy guidelines discussed in sections 4060.3 and 4060.4 are to be used in the inspection of bank holding companies. Holding company inspections should contain information on the principal subsidiary banks' capital positions. Inspection reports should contain critical comments on the capital positions of individual subsidiary banks supervised by other agencies only if the criticisms are consistent with the other agencies' positions as described in examination reports, or if they have first been discussed with the primary supervisor of the bank. Inspection reports should address any instances of noncompliance with capital commitments made in connection with the Federal Reserve's approval of bank holding company applications.

While the ratio guidelines are to be applied to both the bank and its holding company, it is the consolidated entity whose financial condition and strength will ultimately determine the condition of the banking organization. It is recognized that, to some extent, strong consolidated holding company capital positions may offset minor deficiencies in the bank subsidiaries. However, bank capital positions, particularly those that reflect double leveraging, generally do not alleviate consolidated holding company capital deficiencies.

4070.0.9 DISCLOSURE OF NUMERIC BOPEC COMPOSITE AND COMPONENT INSPECTION RATINGS

It is a long-standing policy of the Federal Reserve to discuss fully and clearly in examination and inspection reports, and in meetings with senior management and boards of directors, supervisory issues, problems, or concerns relating to the banking organizations under the System's supervision. Beginning on December 16, 1988, the Board authorized examiners to disclose to the senior officials and boards of directors of inspected bank holding companies the composite numeric rating assigned in an inspection as part of the inspection report process (see SR-88-37). Generally, the Federal Reserve has also provided senior management and directors with the word descriptions that consist of a single word corresponding to the numeric component ratings assigned.

In an effort to further strengthen communication with supervised banking organizations, beginning on January 1, 1997, the Federal Reserve will also provide the numeric and the assigned alphabetic component ratings under various supervisory rating systems[1] to senior manage-

1. The disclosure of the composite and supporting component rating applies to the following rating systems:
- CAMELS (state member banks)
- BOPEC (bank holding companies)

continued

ment and directors (see SR-96-26 and section 5010.4). Such disclosure includes the alphabetic component ratings assigned to management under the BOPEC rating system. Building on existing practice, this step is intended to better focus management's attention on possible areas of weakness and the need for timely corrective actions.

The disclosure of the rating and its components should be made in the Examiner's Comments and Matters Requiring Special Board Attention, core page 1 of inspection reports; in the summary reports prepared for boards of directors of inspected institutions; and in meetings with senior management and directors. In conjunction with disclosing the ratings and their components, examiners and/or supervisory officials should clearly explain their meaning.

In the context of the exit meeting, the examiner should discuss key overall inspection findings, including preliminary composite and component numeric ratings. Examiner-assigned ratings are subject to a review by Reserve Bank supervisory officials, and final ratings are to be included in the inspection report. *In disclosing composite and component ratings, the examiner-in-charge should remind management that the ratings assigned are a part of the findings of the inspection and are privileged and confidential under applicable law.* If composite and component ratings are changed between inspections as a result of off-site analysis, the board of directors and management should be informed of the change. Ratings should not be disclosed to the bank holding company's directors and management until preliminary approval has been received from the appropriate senior Reserve Bank supervisory officials.

- CAMEO (Edge and agreement corporations and overseas subsidiaries of U.S. banks)
- ROCA (U.S. branches and agencies of foreign banking organizations)
- the Uniform Interagency Trust Rating System
- the Uniform Interagency Rating System for Data Processing Operations

The Federal Reserve places significant supervisory emphasis on the importance of sound risk-management processes and strong internal controls when evaluating the activities of banking organizations it supervises. Properly managing risks is always critical to the conduct of safe and sound banking activities, and it is even more important as new technologies, product innovation, and the size and speed of financial transactions change the nature of banking markets.

A bank holding company's failure to establish a management structure that adequately identifies, measures, monitors, and controls the risks involved in its various products and lines of business has long been considered unsafe and unsound conduct. Accordingly, while a bank holding company's financial performance is an important indicator of the adequacy of management, it is essential that examiners give significant weight to the quality of risk-management practices and internal controls when they evaluate the management and overall financial condition of banking organizations.

Consistent with the greater supervisory emphasis given to risk management in Federal Reserve examination and supervisory policy statements, System examiners are to assign a formal supervisory rating to the adequacy of a bank holding company's risk-management processes, including its internal controls. This step is a natural extension of current procedures that incorporate an assessment of risk management and internal controls during each on-site, full-scope inspection. The specific rating of risk management and internal controls should be given significant weight when evaluating management under the bank holding company (BOPEC) rating system. Like the components of this system, the risk-management rating should be based on a five-point numerical scale.

This rating of the risk-management process is designed to bring together and summarize much of the analysis of and many of the findings about a bank holding company's process for managing and controlling risks, which are an important part of the examiner's review of these individual areas. The formal rating is intended to highlight and incorporate both the quantitative and qualitative aspects of an examiner's review of an organization's overall process for identifying, measuring, monitoring, and controlling risk and to facilitate appropriate follow-up action.

The overall profitability, asset quality, and capital adequacy of a bank or bank holding company should continue to influence the examiner's assessment of management, but these indicators can to some extent be affected, either favorably or adversely, by factors outside management's control. For this reason, the specific evaluation of the risk-management process should be a primary factor when rating management, especially in the case of larger banking organizations whose activities and structures require more formal and extensive procedures.

Examiners should apply this guidance flexibly to appropriately reflect the banking organization's circumstances and the nature, scope, and complexity of its operations. Risk-management ratings should be assigned to all bank holding companies, regardless of their size.

Examiners should discuss in a clear and straightforward manner in the appropriate open sections of the inspection report the nature and severity of any problems or deficiencies found and the steps required to correct them, particularly if the risk-management rating is less than satisfactory. Serious lapses or deficiencies in internal controls, including inadequate separation of duties, can constitute an unsafe and unsound practice and possibly lead to significant losses or otherwise compromise the financial integrity of the organization. If appropriate, the bank holding company's directors and officers should be advised that the Federal Reserve will initiate supervisory actions if its failure to separate critical operational duties creates the potential for serious losses or if material deficiencies or situations that threaten the safe and sound conduct of its activities are not adequately addressed in a timely manner. Such supervisory actions may include formal enforcement actions against the bank holding company, its responsible officers and directors, or both and would require the immediate implementation of all necessary corrective measures.

4070.1.1 ELEMENTS OF RISK MANAGEMENT

When rating the quality of risk management at bank holding companies as part of the evaluation of the overall quality of management, examiners should place primary consideration on findings relating to the following elements of a sound risk-management system:

- active board and senior management oversight
- adequate policies, procedures, and limits
- adequate risk measurement, monitoring, and management information systems
- comprehensive internal controls

Examiners should recognize that the considerations specified in SR-95-51 are intended only to assist in the evaluation of risk-management practices. *They are not a checklist of requirements for an individual organization*. Moreover, while all bank holding companies should be able to assess the major risks of the consolidated organization, examiners should expect parent companies that centrally manage the operations and functions of their subsidiary banks to have more comprehensive, detailed, and developed risk-management systems than companies that delegate the management of risks to relatively autonomous banking subsidiaries.

4070.1.1.1 Active Board and Senior Management Oversight

In assessing the quality of the oversight by boards of directors and senior management, examiners should consider whether the bank holding company follows policies and practices such as those described below:

- The board and senior management have identified and have a clear understanding and working knowledge of the types of risks inherent in the bank holding company's activities, and they make appropriate efforts to remain informed about these risks as financial markets, risk-management practices, and the bank holding company's activities evolve.
- The board has reviewed and approved appropriate policies to limit risks inherent in the bank holding company's lending, investing, trading, trust, fiduciary, and other significant activities or products.
- The board and management are sufficiently familiar with and are using adequate record-keeping and reporting systems to measure and monitor the major sources of risk to the organization.
- The board periodically (1) reviews and approves risk exposure limits to conform with any changes in the bank holding company's strategies, (2) addresses new products, and (3) reacts to changes in market conditions.
- Management ensures that its lines of business are managed and staffed by personnel with knowledge, experience, and expertise consistent with the nature and scope of the bank holding company's activities.
- Management ensures that the depth of staff resources is sufficient to operate and soundly manage the bank holding company's activities and that its employees have the integrity, ethical values, and competence that are consistent with a prudent management philosophy and operating style.
- All levels of management adequately supervise the day-to-day activities of officers and employees, including management supervision of senior officers or heads of business lines.
- Management is able to respond to risks that may arise from changes in the competitive environment or from innovations in markets in which the organization is active.
- Before embarking on new activities or introducing new products, management identifies and reviews all risks associated with the activity or product and ensures that the infrastructure and internal controls necessary to manage the related risks are in place.

4070.1.1.2 Adequate Policies, Procedures, and Limits

A bank holding company's board of directors and senior management should tailor their risk-management policies and procedures to the types of risks that arise from the organization's activities. The following guidelines should assist examiners in evaluating the adequacy of a bank holding company's policies, procedures, and limits:

- The bank holding company's policies, procedures, and limits provide for adequate identification, measurement, monitoring, and control of the risks posed by its lending, investing, trading, trust, fiduciary, and other significant activities.
- The policies, procedures, and limits are consistent with management's experience level, the organization's stated goals and objectives, and its overall financial strength.
- Policies clearly delineate accountability and lines of authority across the organization's activities.
- Policies provide for the review of new activities of the organization to ensure that the infrastructures necessary to identify, monitor,

and control risks associated with an activity are in place before the activity is initiated.

4070.1.1.3 Adequate Risk Monitoring and Management Information Systems

Effective risk monitoring requires banking organizations to identify and measure all material risk exposures. Consequently, risk-monitoring activities must be supported by information systems that provide senior managers and directors with timely reports on the financial condition, operating performance, and the risk exposure of the consolidated organization, as well as with regular and sufficiently detailed reports for line managers engaged in the day-to-day management of the organization's activities.

In assessing the adequacy of a bank holding company's measurement and monitoring of risk and its management reports and information systems, examiners should consider whether the following conditions exist:

- The bank holding company's risk-monitoring practices and reports address all of its material risks.
- Key assumptions, data sources, and procedures used in measuring and monitoring risk are appropriate and adequately documented and tested for reliability on an ongoing basis.
- Reports and other forms of communication are consistent with the bank holding company's activities; are structured to monitor exposures and compliance with established limits, goals, or objectives; and, as appropriate, compare actual versus expected performance.
- Reports to management or the directors are accurate and timely and contain sufficient information for decision makers to identify any adverse trends and to evaluate adequately the level of risk the bank holding company faces.

4070.1.1.4 Adequate Internal Controls

A bank holding company's internal control structure is critical to its safe and sound functioning generally and to its risk-management system, in particular. Establishing and maintaining an effective system of controls, including the enforcement of official lines of authority and the appropriate separation of duties—such as trading, custodial, and back-office—is one of management's more important responsibilities.

Appropriate segregation of duties is a fundamental and essential element of a sound risk-management and internal control system. Failure to implement and maintain an adequate separation of duties can constitute an unsafe and unsound practice and possibly lead to serious losses or otherwise compromise the financial integrity of the bank holding company. Serious lapses or deficiencies in internal controls, including inadequate segregation of duties, may warrant supervisory action, including formal enforcement action.

When properly structured, a system of internal controls promotes effective operations and reliable financial and regulatory reporting; safeguards assets; and helps to ensure compliance with relevant laws, regulations, and bank holding company policies. Ideally, internal controls are tested by an independent internal auditor who reports directly to either the bank holding company's board of directors or its designated committee, which is typically the audit committee. Personnel who perform these reviews should generally be independent of the function they are assigned to review. Given the importance of appropriate internal controls to banking organizations of all sizes and risk profiles, the results of audits or reviews, whether conducted by an internal auditor or other personnel, should be adequately documented, as should management's responses to them. In addition, communication channels should exist that allow negative or sensitive findings to be reported directly to the board of directors or the relevant board committee.

In evaluating the adequacy of a bank holding company's internal controls and audit procedures, examiners should consider whether the following conditions are met:

- The system of internal controls is appropriate to the type and level of risks posed by the nature and scope of the organization's activities.
- The bank holding company's organizational structure establishes clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits.
- Reporting lines provide sufficient independence of the control areas from the business lines, and they provide adequate separation of duties throughout the organization, such as those relating to trading, custodial, and back-office activities.
- Official organizational structures reflect actual operating practices.
- Financial, operational, and regulatory reports are reliable, accurate, and timely. When appli-

cable, exceptions are noted and promptly investigated.
- Adequate procedures exist for ensuring compliance with applicable laws and regulations.
- Internal audit or other control review practices provide for independence and objectivity.
- Internal controls and information systems are adequately tested and reviewed; the coverage, procedures, findings, and responses to audits and review tests are adequately documented; identified material weaknesses are given appropriate and timely high-level attention; and management's actions to address material weaknesses are objectively verified and reviewed.
- The audit committee or board of directors reviews the effectiveness of internal audits and other control review activities regularly.

4070.1.2 RATING DEFINITIONS

The rating for risk management is based on a scale of one through five in ascending order of supervisory concern. Examiners should assign this rating to reflect their findings in all four of the elements of sound risk management described above. The risk-management rating should be reflected in the overall ''Management'' rating of the bank holding company and should be consistent with the following criteria:

Rating 1 (Strong). A rating of 1 indicates that management effectively identifies and controls all major types of risk posed by the bank holding company's activities, including those from new products and changing market conditions. The board and management are active participants in managing risk and ensure that appropriate policies and limits exist, and the board understands, reviews, and approves them. Policies and limits are supported by risk-monitoring procedures, reports, and management information systems that provide management and the board with the necessary information and analysis to make timely and appropriate responses to changing conditions.

Internal controls and audit procedures are sufficiently comprehensive and appropriate to the size and activities of the bank holding company. There are few noted exceptions to the organization's established policies and procedures, and none is material. Management effectively and accurately monitors the condition of the organization consistent with standards of safety and soundness and in accordance with internal and supervisory policies and practices. Risk management is considered fully effective to identify, monitor, and control risks to the bank holding company.

Rating 2 (Satisfactory). A rating of 2 indicates that the bank holding company's management of risk is largely effective but lacking to some modest degree. It reflects a responsiveness and ability to cope successfully with existing and foreseeable exposures that may arise in carrying out the organization's business plan. While the bank holding company may have some minor risk-management weaknesses, these problems have been recognized and are being addressed. Overall, board and senior management oversight, policies and limits, risk-monitoring procedures, reports, and management information systems are considered satisfactory and effective in maintaining a safe and sound bank holding company. Generally, risks are being controlled in a manner that does not require additional or more than normal supervisory attention.

Internal controls may display modest weaknesses or deficiencies, but they are correctable in the normal course of business. The examiner may have recommendations for improvement, but the weaknesses noted should not have a significant effect on the safety and soundness of the organization.

Rating 3 (Fair). A rating of 3 signifies that risk-management practices are lacking in some important ways and, therefore, are a cause for more than normal supervisory attention. One or more of the four elements of sound risk management is considered fair and has precluded the organization from fully addressing a significant risk to its operations. Certain risk-management practices are in need of improvement to ensure that management and the board are able to identify, monitor, and adequately control all significant risks to the organization. Weaknesses may include continued control exceptions or failures to adhere to written policies and procedures, which could have adverse effects on the organization.

The internal control system may be lacking in some important respects, particularly as indicated by continued control exceptions or by the failure to adhere to written policies and procedures. The risks associated with the internal control system could have adverse effects on the safety and soundness of the bank holding company if corrective actions are not taken by management.

Rating 4 (Marginal). A rating of 4 represents marginal risk-management practices that generally fail to identify, monitor, and control significant risk exposures in many material respects. Generally, such a situation reflects a lack of adequate guidance and supervision by management and the board. One or more of the four elements of sound risk management is considered marginal and requires immediate and concerted corrective action by the board and management. A number of significant risks to the organization have not been adequately addressed, and the risk-management deficiencies warrant a high degree of supervisory attention.

The bank holding company may have serious identified weaknesses, such as an inadequate separation of duties, that require substantial improvement in its internal control or accounting procedures or in its ability to adhere to supervisory standards or requirements. Unless properly addressed, these conditions may result in unreliable financial records or reports or operating losses that could seriously affect the safety and soundness of the bank holding company.

Rating 5 (Unsatisfactory). A rating of 5 indicates a critical absence of effective risk-management practices to identify, monitor, or control significant risk exposures. One or more of the four elements of sound risk management is considered wholly deficient, and management and the board have not demonstrated the capability to address deficiencies.

Internal controls may be sufficiently weak as to seriously jeopardize the continued viability of the bank holding company. If such weaknesses are not already evident, there is an immediate concern as to the reliability of accounting records and regulatory reports and about potential losses that could result if corrective measures are not taken immediately. Deficiencies in the bank holding company's risk-management procedures and internal controls require immediate and close supervisory attention.

4070.1.3 REPORTING CONCLUSIONS

For bank holding companies, the separate numerical rating for risk management and the rationale for the rating assigned should be included as "Risk-Management Rating: (numerical rating)" and discussed on confidential page B, Condition of Bank Holding Company, of the bank holding company inspection report, and should also be reflected in the examiner's overall rating of management. Comments, conclusions, and criticisms relating to a bank holding company's risk-management process should be brought to the attention of management and included on the Policies and Supervision page[1] of the bank holding company inspection report, as well as on Core Page 1, Examiner's Comments and Matters Requiring Special Board Attention, if considered appropriate and particularly if the rating is less than satisfactory.

In inspection reports and transmittal letters to boards of directors of bank holding companies, reference should be made specifically to the types and nature of corrective actions that bank holding companies need to take to address noted risk-management and internal control deficiencies. When appropriate, bank holding companies should also be advised that the Federal Reserve will initiate supervisory actions if the failure to separate critical operational duties creates the potential for serious losses or if material deficiencies or situations that threaten the safe and sound conduct of their activities are not adequately addressed in a timely manner. Such supervisory actions may include formal enforcement actions against the bank holding company (or a state member bank), its responsible officers and directors, or both and would require the immediate implementation of all necessary corrective measures.

1. If a problem area is cited within the Core Section, the respective supporting report pages (the Policies and Supervision page) are to be included in the report to support the critical comments. See section 5010.1.3.

Supervisory ratings should be revised whenever there is strong evidence that the financial condition or risk profile of an institution has significantly changed.[1] In a risk-focused and continuous-supervision environment, supervisory ratings should be viewed as a continuum, rather than as a point-in-time assessment of an institution's financial condition.[2] It is important that supervisory ratings reflect a current assessment of an institution's financial condition and risk profile. The ratings can affect risk-based deposit insurance premiums; statutory and regulatory requirements, including applications and the prompt-corrective-action provisions of the Federal Deposit Insurance Act; and supervisory reporting and inspection/examination requirements, as well as other factors. While supervisory ratings are most frequently revised as a result of on-site supervisory activities, other sources of information reviewed off-site may also indicate the need for a rating change.[3] See SR-99-17.

In addition, when a component of one of the supervisory rating systems is changed, the Reserve Bank must also reaffirm or revise the other component ratings and the composite rating, based upon available information at that time. The factors contributing to a change in the rating of a selected component can affect one or more of the other components in the rating system, as well as the composite rating. Accordingly, if there is a compelling reason to change a selected component rating, all of the other components in the supervisory rating system must be either reaffirmed or revised. As applicable for bank holding companies and state member banks, the risk-management rating must also be reaffirmed or revised when a CAMELS or BOPEC rating is changed.[4]

Any change to a component or composite rating and the rationale for that change must be communicated in writing via a letter or report to the board of directors of the affected institution (or to the senior U.S. management official in the case of a U.S. branch, agency, office, or nonbank subsidiary of a foreign bank) and to the appropriate state and federal supervisory agencies.

1. SR-99-17 supersedes SR-92-31, which suspended the practice of revising CAMELS ratings for state member banks between examinations.

2. The procedures in SR-99-17 pertain to supervisory rating systems for bank holding companies (BOPEC); state member banks (CAMELS); U.S. branches and agencies of foreign banking organizations (ROCA); and Edge and agreement corporations, overseas subsidiaries of U.S. banks, and U.S. nonbank subsidiaries of foreign banking organizations (CAMEO).

3. For example, a significant change in financial condition may be evident from some combination of reports of examination conducted by other agencies, meetings or other communication with management of the institution, published financial reports or press releases, status reports submitted by the institution as required by an enforcement action, and information generated by ongoing surveillance activities.

4. Pursuant to the guidelines set forth in SR-97-27, the assignment of a separate risk-management rating is not required for small shell bank holding companies.

The Federal Reserve System BHC surveillance program (the program) defined in SR-95-43, "Revised Bank Holding Company Surveillance Procedures," covers companies with consolidated assets of $1 billion or more. Under the program, bank holding company financial data are monitored by computer-generated screens on an ongoing basis. Information generated through the surveillance process is to be used to monitor the financial condition of BHCs between inspections, assist in setting inspection schedules, and allocate supervisory or inspection resources toward institutions with declining financial conditions. The surveillance program for BHCs with total consolidated assets of less than $1 billion is discussed in section 4080.1 and in SR-02-01.

The program consists of three components: The first phase consists of computer screening of BHC financial data, which involves generating and reviewing an exception list of organizations meeting the exception criteria. (These BHCs are referred to as having "failed the screen.") During the second phase, an analysis is prepared that discusses the factors or reasons why the BHCs appeared on the exception list. The analysis is based on data summarized in the BHC Performance Report (BHCPR), the off-site weighted SEER (System to Estimate Examination Ratings) rating and the on-site CAMELS rating for subsidiary banks, and supplemental investment and other screens, as well as on other relevant financial data. The third phase focuses on developing a suitable supervisory response, corrective action, and follow-up by System staff to address problems first identified through the surveillance process.

The *computer screen*, generated at the Board, identifies BHCs that have $1 billion or more in consolidated assets and that may have financial weaknesses or deficiencies. The *analytical* effort of Reserve Bank analysts and examiners is designed to spot trends and changes in financial condition and to determine if companies identified by the screening effort require further in-depth review. The System *corrective action and follow-up* ensures that identified problems are monitored until they can be corrected or resolved.

The BHC surveillance program is designed to meet the following objectives:

1. To monitor BHC performance using the BHCPR.
2. To incorporate SEER and CAMELS ratings for subsidiary banks into an off-site monitoring program. The SEER rating model identifies, based on the most recent call report data, banks that exhibit financial characteristics of banks in lower-rated categories.[1] Because the condition of a consolidated holding company is typically highly correlated with the condition of its bank subsidiaries, the BHC surveillance program uses the off-site SEER ratings and on-site CAMELS ratings of bank subsidiaries in identifying deteriorating holding companies.
3. To achieve a BHC program that is sensitive to changes in the condition of the banking industry. The financial criteria, as discussed below, identify outliers based on either a poor relative percentile ranking or absolute levels of key financial ratios that meet minimum benchmarks.
4. To incorporate supplemental screens into the BHC surveillance process. A supplemental investment-activities screen identifies holding companies with high levels of unrealized securities depreciation relative to tier 1 capital. Additional supplemental criteria may include BHCs identified through growth and parent company screens.
5. To enhance and maintain quarterly communication with Reserve Bank surveillance staff. The Board's Surveillance Section sends a quarterly memorandum to all Reserve Banks to inform them of the most recent quarter's surveillance results. A corresponding Reserve Bank quarterly letter to the Board provides Reserve Bank staff with an opportunity to report on BHCs not identified in the Board screening process, but whose condition has deteriorated significantly since the last inspection.

4080.0.1 EXCEPTION LIST

BHC surveillance is conducted quarterly for banking organizations for the reporting periods ending on the last days of March, June, Septem-

1. The SEER methodology is described in detail in "FIMS: A New Monitoring System for Banking Institutions," January 1995 *Federal Reserve Bulletin* 1–15. The acronym FIMS was substituted in the article for the acronym SEER. However, both acronyms describe the same system.

ber, and December. Board staff initiate the surveillance process by subjecting all BHCs to the screens. BHCs that fail the screens and are top-tier holding companies that (1) have consolidated assets of $1 billion or more; (2) have a composite BOPEC rating of 1, 2, or 3; (3) have not been designated as an ''atypical'' BHC by the responsible Reserve Bank; and (4) are not part of the top 50 population are placed on the exception list.

The Board sends quarterly BHC exception lists to the surveillance staff at each Reserve Bank following the finalization of FR Y-9 data. Reserve Banks review the condition of the BHC, prepare a written analysis addressing factors that caused the BHC to be placed on the exception list, and submit written analyses of the BHCs on the list to the Board. The deadline for submission of written analyses is extended if the Reserve Bank determines that an on-site presence is warranted to satisfy the requirements of the written analysis.

Three surveillance screens are used to identify BHC exceptions as outlined below:

1. *Rating screen*. The rating screen provides a comparison between the bank (B) component in a BHC's BOPEC rating and the asset-weighted CAMELS and SEER ratings for the company's bank subsidiaries. It includes companies meeting the criteria below:

Bank (B) component BOPEC rating	*Weighted CAMELS rating*	*or Weighted SEER rating*
1	3 +	3 +
2	3 +	3 +
3	4 +	4 +

2. *Financial screen*. The financial screen uses three consolidated ratios from the BHCPR and identifies exceptions as bank holding companies meet the cut-off criteria for at least *two* of these ratios. A company can qualify as an exception if it (1) meets the minimum *relative* criteria for two of the ratios, which indicates a BHC with a poor percentile ranking relative to its BHCPR peer group, or (2) meets the *absolute* criteria for two of the ratios. The latter indicates a BHC with a low level of earnings or capital or with a high level of nonperforming assets. Specific ratios are presented in the table on the following page.
3. *Investment-activities screen*. The investment-activities screen identifies BHCs whose ratio of total unrealized securities depreciation (after tax) to tier 1 capital is −15 percent or worse *and* whose leverage ratio, adjusted for total securities depreciation, is less than 5 percent.

A written analysis is prepared for investment-activities exceptions when one or both of the following conditions apply: (1) the organization manages the investment process on a consolidated or global basis (that is, the parent company or lead bank formulates and possibly implements the investment strategy for the parent company and bank subsidiaries) or (2) the majority of the organization's bank subsidiary assets consist of state member bank assets.

If the written-analysis conditions do not apply, Reserve Banks are requested to provide a brief summary of the primary regulator's findings and actions concerning the bank subsidiaries' investment activities. This summary is to ensure that the primary regulator is aware of potential concerns with subsidiary banks' investment activities, and it also ensures that the BHC is acting as a source of strength to these particular bank subsidiaries. In addition, a BHC investment-activities analysis does not have to be prepared if the Reserve Bank is in the process of preparing or has provided (in one of the previous two quarters) an investment-activities analysis for one of the bank holding company's state member bank subsidiaries.

4080.0.2 REVIEW OF BHC EXCEPTION LIST AND RESERVE BANK ANALYSIS

The exception list provides a record of BHCs that failed the screens and helps track Reserve Bank conclusions on the reasons why they failed the screens. In their review, Reserve Banks are specifically requested to prepare a written analysis for all BHCs on the exception list. This Reserve Bank analysis is to include the following sections:

CUT-OFF CRITERIA—BHCPR FINANCIAL-SCREEN RATIOS

	Last fourth-quarter return on average assets	*Tier 1 leverage ratio*	*Nonperforming and 90+ days past-due ratio*
Peer-ranking criteria	percentile of 5 or less	percentile of 5 or less	percentile of 95 or more
Ratio-level criteria	0.5% or less	5.0% or less	5.0% or more

1. *Heading*, including the BHC's name, location, total assets, BOPEC rating, and date of last inspection; lead bank's name, location, charter, total assets, CAMELS rating, and date of last examination; reason for appearance on the exception list; and Reserve Bank analyst's name. For investment-activities exceptions, also include the ratio of total securities depreciation to tier 1 capital and the leverage ratio adjusted for total securities depreciation.
2. *Background*, including a summary of prior surveillance results. For investment-activities exceptions, a brief summary of the investment process is included (that is, who formulates and approves the investment strategy and how it is implemented for the organization).
3. *Analysis* of the current period's surveillance results, highlighting key changes in the BHC's condition during the most recent quarter and since the most recent inspection. In particular, this analysis explicitly discusses whether the factors identified as being responsible for the company's appearance on the exception list present any cause for supervisory concern. Any areas where the current period's surveillance results are believed to be misleading or inaccurate are detailed in this section. Additional guidance regarding the analysis section is provided below:
   a. The analysis should note any acquisitions, mergers, or de novo activities responsible for the BHC's meeting the exception criteria.
   b. For BHCs that meet the criteria for the CAMELS rating exception, the analysis should explicitly discuss the factors underlying the CAMELS rating as presented in the examination findings.
   c. For BHCs that meet the criteria for the SEER rating exception, the analysis should explicitly discuss the factors responsible for the SEER results, as presented in SEER Schedule 1A for bank subsidiaries.
   d. For BHCs that meet the financial exception criteria, the analysis should explicitly discuss the ratios identified by the financial screen.
   e. For BHCs that require a written analysis of investment activities, the discussion should include—
      - the securities portfolio composition and maturity;
      - the investment strategy;
      - management's ability to understand and manage the risks inherent in the investment portfolio, including a discussion of risk limits (For example, are the limits appropriate and is the BHC in compliance with these limits?);
      - the ability and intent to hold securities with unrealized losses and any contingency plans if the ability to hold these securities is tested;
      - the susceptibility of the portfolio to further depreciation (quantify if possible);
      - hedging strategies, if any;
      - the liquidity position of the BHC, including a discussion of the structure of the funding base and concentration of funding sources; and
      - the overall impact of securities depreciation on the financial condition of the BHC.
   f. For BHCs that fail the investment-activities screen but do not meet the conditions requiring a written analysis of investment activities, a brief summary of the primary regulator's findings and actions concerning the bank subsidiaries' investment activities should be provided.

4. *Conclusion*, summarizing the BHC's condition and the key factors supporting the analysis.
5. *Corrective action*, detailing corrective action taken by the BHC or Reserve Bank staff, including supervisory follow-up actions resulting from the current period's surveillance results. If no further actions are to be taken or recommended, the reason for this decision is stated, as well as the date and scope of the next scheduled inspection.
6. *Sign-off* by an officer in charge of bank holding company supervision, an officer in charge of bank holding company surveillance, and, if there are any investment-activities exceptions, a capital-markets coordinator. The signatures need only appear once on the cover letter accompanying the individual BHC analyses.

4080.0.3 CORRECTIVE ACTION AND FOLLOW-UP

Corrective action associated with newly identified problems must be initiated by the Reserve Bank as soon as possible. Follow-up action may include correspondence or meetings with the banking organization's management or an on-site inspection or examination. Problem situations are closely monitored by System surveillance and supervision staff until they have been resolved.

4080.0.4 ATYPICAL BHCs

No written analysis is required for BHCs that are designated "atypical." Reserve Banks identify atypical BHCs annually. Atypical BHCs could include those whose parent equity in nonbank subsidiaries is one-third or more than their equity in bank subsidiaries, those that choose not to consolidate material nonbank subsidiaries, and those BHCs that are directly owned by banks. BHCs may also be considered atypical due to other characteristics determined at the Reserve Bank's discretion.

The atypical BHC list should (1) provide the name, location, and RSSD-ID of the company; (2) explain the reason why the BHC is considered atypical; and (3) indicate whether the company was included on the list during the prior year. BHCs coming off the prior year's atypical listing are similarly identified and discussed. Reserve Banks should monitor atypical BHCs quarterly and provide a written analysis for an atypical company when deemed appropriate.

4080.0.5 ROLE IN INSPECTION PROCESS

In setting inspection schedules, companies identified as having weak or declining financial conditions would generally not qualify for an extension of the inspection cycle as discussed in section 5000.0 of this manual. These companies, therefore, would be inspected more frequently than companies without deficiencies.

A pre-inspection analysis, using the latest BHCPR and other relevant data, should be performed to help the examiner focus the inspection on areas that may require supervisory attention. This analysis may uncover declining financial trends or may indicate financial positions recently taken by the BHC that could eventually lead to a problem situation.

The performance report covers consolidated and parent-only, current and historical financial information; ratios; and peer-group percentiles. This information can be used to analyze and spot trends with respect to parent or consolidated asset growth, earnings, capital, liquidity, cash flow and leverage, and reliance on subsidiary dividends. By reviewing performance reports, analysts and examiners can gain insights to weaknesses, as well as to their nature and severity. For example, parent leverage, cash-flow, and coverage ratios may indicate problems at the parent level, which could have implications for the bank's financial condition. Information on the parent's income from subsidiaries could indicate that nonbank subsidiaries of the holding company are experiencing financial difficulties. Financial information on the parent's dependence on bank and nonbank subsidiaries through dividends and management fees, for example, can give the examiner valuable insights on the effect the holding company may be having on the financial condition of the subsidiaries, particularly on the depository institutions. Analysis of profitability ratios, income and expense data, and loan-loss information can also be used to pinpoint areas for further review when the examiners arrive on-site.

Much of this analysis can be conducted before the on-site inspection, thus enabling the examiner to better allocate his or her time on-premises to those areas requiring on-site review. For example, initial evaluations of capital, earnings, liquidity, leverage, and cash flow can be accomplished using information from the performance reports before the examiner's arrival on-site. This early evaluation will allow the examiner to isolate areas requiring further on-site review and also to focus attention on other areas that require on-site inspection, such as asset quality, nonbank activities, management, supervisory report accuracy, and legal compliance.

Screening results should also be reviewed to determine which screens, or combination of screens, the BHC failed and by what margin. If a particular company has been identified as an exception, analyses conducted by Reserve Bank analysts should be reviewed, as well as information available from Board staff. Finally, follow-up material available from Reserve Bank and Board staff should be reviewed and, in some cases, consultation with surveillance staff may be appropriate. The goal of all these activities is to help the examiner identify areas to focus on during the inspection.

The surveillance program for bank holding companies having total consolidated assets of less than $1 billion is described below. (See SR-02-1.) The surveillance program is a primary tool for identifying potentially significant changes in the condition of these organizations between reviews and for targeting the work of any on-site reviews. Quarterly surveillance screens identify potential parent-company and nonbank issues that may adversely affect affiliated insured depository institutions. In particular, the screens address parent-company cash flow; intercompany transactions; parent-company leverage; and consolidated capital ratios, where applicable. The surveillance screens are periodically updated to reflect industry trends and issues as well as changes in regulatory reporting requirements.

Upon receipt and finalization of quarterly Y-9 data, Board surveillance staff provide each Reserve Bank with the results of the small bank holding company surveillance screens, which identify companies that fail key screening criteria. Reserve Bank staff are requested to evaluate this information and take action, as appropriate, within 45 days of receipt. In doing so, Reserve Bank staff determine whether the screen results reveal that the holding company or its affiliates could pose or exacerbate a material risk to an insured depository institution subsidiary. If the screen results reveal no basis for a significant concern, a short note documenting this conclusion is prepared and filed, and no further action may be needed. If it is determined that the screen results reveal the potential for material risk to an insured depository institution, Reserve Bank staff are requested to take appropriate follow-up action within 90 days, such as contacting the institution to obtain more information, requesting a corrective action plan from the institution, implementing heightened monitoring procedures, or scheduling an on-site review. In most cases, follow-up action can be completed off-site; documentation supporting the action taken in these cases should be commensurate with the level of concerns. Typically, a short memorandum posted in the National Examination Data (NED) system will suffice. If an on-site review is recommended, the review is to commence within 90 days of the Reserve Bank's being notified of the surveillance results, and the findings of the review are to be communicated to the company, Board staff, and appropriate state and federal regulatory authorities within 120 days of that notification.

In addition to the surveillance monitoring screens, Board staff will provide Reserve Banks with program support screens that provide additional information to assist in the supervision of small bank holding companies. One set of support screens identifies companies that are classified as noncomplex, but which exhibit characteristics of complex organizations. Reserve Banks are to evaluate any company meeting those screens to determine whether its designation as noncomplex should be changed and its supervision program modified accordingly. A second set of support screens monitors compliance of financial holding companies with the capital, managerial, and Community Reinvestment Act standards set forth in the Gramm-Leach-Bliley Act. Follow-up requirements for companies failing those screens are outlined in previous guidance. (See SR-00-11.)

Surveillance information is crucial to identifying potential issues between reviews and for ensuring that on-site work is risk-focused. Accordingly, Reserve Bank staff are to continue taking steps to ensure the accuracy of the regulatory reports that are the basis for the surveillance program. In particular, System staff are to follow up promptly on identified inaccuracies.

Apart from the consideration of the creditworthiness of individual borrowers, holding companies engaged in international activities are subject to elements of country risk. Country risk encompasses the entire spectrum of risks arising from the economic, social, and political environments of a foreign country, as well as the governmental policies structured to respond to these conditions. These factors may have potentially favorable or adverse consequences for foreigners' debt and equity investments in a particular country. The Federal Reserve, along with the Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation, has issued enhanced supervisory guidance concerning the elements of an effective country-risk management process for banking organizations. (See SR-02-05.) Country risk is the risk that economic, social, or political conditions in a foreign country might adversely affect an organization's financial condition, primarily through impaired credit quality or transfer risk.[1]

Country risk can occur in many different forms, and the nature of specific risks can change over time. It is essential that a U.S. banking organization with significant direct or indirect international exposure have in place an effective country-risk management process that is commensurate with the volume and complexity of its international activities. More specifically, country risk focuses on a borrower's capacity to obtain the foreign exchange required to service his cross-currency debt. A borrower's debt-service capacity may also be affected by the risks of political and social upheaval, nationalization and expropriation, governmental repudiation of external indebtedness, exchange controls, and devaluation. Events such as these may materially affect the condition of investments and the profitability of lending activities overseas; examiners must alert management to those risks that may be difficult for the holding company and its subsidiaries to absorb.

Using uniform examination procedures and techniques for evaluating country-risk exposures for domestic banks, examiners segregate country-risk factors from the evaluation of other lending risks. The procedures emphasize diversification of exposure to individual countries as the primary method of moderating country risk in international portfolios. The approach generally consists of three parts:

1. measuring exposure in each country where a business relationship exists
2. analyzing exposure in relation to the bank's capital resources and the economic and financial conditions of each country in which the bank has outstanding credits
3. evaluating the risk-management system used by the bank in relation to the size and nature of its foreign lending activities

Examiners should evaluate the adequacy of the country-risk management process at internationally active bank holding companies. This risk-assessment process should include, at a minimum, effective oversight by the board of directors, adequate risk-management policies and procedures, an accurate country-exposure reporting system, an effective country-risk analysis process, a country-risk rating system, country-exposure limits, ongoing monitoring of country conditions, periodic stress testing of foreign exposures, and adequate internal controls and an audit function. A bank holding company's country-risk management process should give particular attention to any concentrations of country risk, first at the consolidated level and then within the parent company and nonbank subsidiaries, as well as to any concentrations reported by supervisors at the bank subsidiaries.

4090.0.1 COUNTRY RISKS AND FACTORS

Country or sovereign risk encompasses the entire spectrum of risks and factors that arise from the economic, social, and political environments of a foreign country that may have potential consequences for foreigners' debt and equity investments in that country. A detailed description of these factors is described below.

4090.0.1.1 Macroeconomic Factors

The first factor affecting country risk is the size and structure of a country's external debt in relation to its economy, more specifically—

1. Transfer risk is the possibility that an asset cannot be serviced in the country of payment because the obligor's country lacks the necessary foreign exchange or has put restraints on its availability. For more information, see the Guide to the Interagency Country Exposure Review Committee Process (SR-99-35).

1. the current level of short-term debt and the potential effect that a liquidity crisis would have on the ability of otherwise creditworthy borrowers in the country to continue servicing their obligations, and
2. to the extent the external debt is owed by the public sector, the ability of the government to generate sufficient revenues, from taxes and other sources, to service its obligations.

The condition and vulnerability of the country's current account is also an important consideration, including—

1. the level of international reserves, including forward market positions of the country's monetary authority (especially when the exchange rate is fixed);
2. the level of import coverage provided by the country's international reserves;
3. the importance of commodity exports as a source of revenue, the existence of any price-stabilization mechanisms, and the country's vulnerability to a downturn in either its export markets or the price of an exported commodity; and
4. the potential for sharp movements in exchange rates and the effect on the relative price of the country's imports and exports.

The role of foreign sources of capital in meeting the country's financing needs is another important consideration in the analysis of country risk, including—

1. the country's access to international financial markets and the potential effects of a loss of market liquidity;
2. the country's relationships with private-sector creditors, including the existence of loan commitments and the attitude among bankers toward further lending to borrowers in the country;
3. the country's current standing with multilateral and official creditors, including the ability of the country to qualify for and sustain an International Monetary Fund or other suitable economic adjustment program;
4. the trend in foreign investments and the country's ability to attract foreign investment in the future; and
5. the opportunities for privatization of government-owned entities.

Past experience has highlighted the importance of a number of other important macroeconomic considerations, including—

1. the degree to which the country's economy may be adversely affected through the contagion of problems in other countries;
2. the size and condition of the country's banking system, including the adequacy of the country's system for bank supervision and any potential burden of contingent liabilities that a weak banking system might place on the government;
3. the extent to which state-directed lending or other government intervention may have adversely affected the soundness of the country's banking system, or the structure and competitiveness of the favored industries or companies; and
4. for both in-country and cross-border exposures, the degree to which macroeconomic conditions and trends may have adversely affected the credit risk associated with counterparties in the country.

4090.0.1.2 Social, Political, and Legal Climate

The analysis of country risk should also consider the country's social, political, and legal climate, including—

1. the country's natural- and human-resource potential;
2. the willingness and ability of the government to recognize economic or budgetary problems and implement appropriate remedial action;
3. the degree to which political or regional factionalism or armed conflicts are adversely affecting the government of the country;
4. any trends toward government-imposed price, interest-rate, or exchange controls;
5. the degree to which the country's legal system can be relied on to fairly protect the interests of foreign creditors and investors;
6. the accounting standards in the country and the reliability and transparency of financial information;
7. the extent to which the country's laws and government policies protect parties in electronic transactions and promote the development of technology in a safe and sound manner;
8. the extent to which government policies promote the effective management of the bank holding company's exposures; and

9. the level of adherence to international legal and business-practice standards.

4090.0.1.3 Factors Specific to Banking Organizations

Finally, a bank holding company's analysis of country risk should consider factors relating to the nature of its actual (or approved) exposures in the country, including, for example—

1. the bank holding company's business strategy and its exposure-management plans for the country;
2. the mix of exposures and commitments, including the types of investments and borrowers, the distribution of maturities, the types and quality of collateral, the existence of guarantees, whether exposures are held for trading or investment, and any other distinguishing characteristics of the portfolio;
3. the economic outlook for any specifically targeted industries within the country;
4. the degree to which political or economic developments in a country are likely to affect the bank holding company's chosen lines of business in the country (for instance, the unemployment rate or changes in local bankruptcy laws may affect certain activities more than others);
5. for a bank holding company involved in capital markets, its susceptibility to changes in value based on market movements (As the market value of claims against a foreign counterparty rise, the counterparty may become less financially sound, thus increasing the risk of nonpayment (this is especially true for over-the-counter derivative instruments.));
6. the degree to which political or economic developments are likely to affect the credit risk of individual counterparties in the country (for example, foreign counterparties with healthy export markets or whose business is tied closely to supplying manufacturing entities in developed countries may have significantly less exposure to the local country's economic disruptions than do other counterparties in the country); and
7. the bank holding company's ability to effectively manage its exposures in a country through in-country or regional representation, or by some other arrangement that ensures the timely reporting of, and response to, any problems.

4090.0.2 RISK-MANAGEMENT PROCESS FOR COUNTRY RISK

Country risk has an overarching effect on a bank holding company'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. Country risk can occur in many different forms, and the nature of specific risks can change over time. A U.S. banking organization with significant direct or indirect international exposure should have in place an effective country-risk management process that is commensurate with the volume and complexity of its international activities. Examiners should be continually evaluating the adequacy of the country-risk management process at internationally active bank holding companies, and they should regularly update their assessments. A bank holding company's country-risk management process should give particular attention to any concentrations of country risk at the parent level or within its bank and nonbank subsdiaries.

Country risk is not necessarily limited to banking organizations with direct international exposures. Domestic counterparties with significant economic dependence on a foreign country or region (for example, through export dependence) can pose an indirect country risk to banking organizations that do not have direct international activity. While banking organizations are not required to incorporate indirect country risk into a formal country-risk management process, they should nevertheless take these country-risk factors into account, where appropriate, when assessing the creditworthiness of domestic counterparties. Examiners should ensure that the overall credit-risk management process takes into account indirect country risk where applicable in all Federal Reserve–supervised banking organizations.

To effectively control the risk associated with international activities, bank holding companies must have a risk-management process that focuses on the broadly defined concept of country risk. The elements of a sound country-risk management process are discussed in further detail below.

4090.0.2.1 Oversight by the Board of Directors

If country risk is to be managed properly, the board of directors must oversee the process effectively. The board is responsible for periodically reviewing and approving policies governing its international activities to ensure that they are consistent with the bank holding company's strategic plans and goals. The board is also responsible for reviewing and approving limits on country exposure and ensuring that management is effectively controlling the risk. When evaluating the adequacy of the bank holding company's capital and allowance for loan and lease losses (ALLL), the board should take into account the volume of foreign exposures and the ratings of the countries to which it is exposed.

4090.0.2.2 Policies and Procedures for Managing Country Risk

Bank management is responsible for implementing sound, well-defined policies and procedures for managing country risk that—

1. establish risk-tolerance limits;
2. delineate clear lines of responsibility and accountability for country-risk management decisions;
3. specify authorized activities, investments, and instruments; and
4. identify both desirable and undesirable types of business.

Management should also ensure that country-risk management policies, standards, and practices are clearly communicated to the affected offices and staff.

4090.0.2.3 Country-Exposure Reporting System

To effectively manage country risk, the bank holding company must have a reliable system for capturing and categorizing the volume and nature of foreign exposures. The reporting system should cover all aspects of the bank holding company's operations, whether conducted through paper transactions or electronically. An accurate country-exposure reporting system is also necessary to support the regulatory reporting of foreign exposures on the quarterly Country Exposure Report, FFIEC 009, and the supplemental Country Exposure Information Report, FFIEC 009a.

The board of directors should regularly receive reports on the level of foreign exposures. If the level of foreign exposures in a bank holding company is significant,[2] or if a country to which the bank holding company is exposed is considered to be high risk, exposures should be reported to the board at least quarterly. More frequent reporting is appropriate when a deterioration in foreign exposures would threaten the soundness of the bank holding company.

4090.0.2.4 Country-Risk Analysis Process

Although the nature of the country-risk analysis process and the level of resources devoted to it will vary, depending on the size and sophistication of the banking organization's international operations, a number of considerations are relevant to evaluating the process in all banking organizations:

1. Is there a quantitative and qualitative assessment of the risk associated with each country in which the banking organization is conducting or planning to conduct business?
2. Is a formal analysis of country risk conducted at least annually, and does the banking organization have an effective system for monitoring developments in the interim?
3. Does the analysis take into account all aspects of the broadly defined concept of country risk, as well as any unique risks associated with specific groups of counterparties the banking organization may have targeted in its business strategy?
4. Is the analysis adequately documented, and are conclusions concerning the level of risk communicated in a way that provides decision makers with a reasonable basis for determining the nature and level of the banking organization's exposures in a country?
5. Given the size and sophistication of the banking organization's international activities, are the resources devoted to the analysis of country risk adequate?

2. For purposes of this guidance, concentrations of exposures to individual countries that exceed 25 percent of the bank holding company's or bank'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.

6. As a final check of the process, are the banking organization's conclusions concerning a country reasonable in light of information available from other sources, including external research and rating services and the Interagency Country Exposure Review Committee (ICERC)?

4090.0.2.5 Country-Risk Ratings

Country-risk ratings summarize the conclusions of the country-risk analysis process. The ratings are an important component of country-risk management because they provide a framework for establishing country-exposure limits that reflect the bank holding company's tolerance for risk.

Because some counterparties may be more exposed to local country conditions than others, it is a common and acceptable practice for banking organizations to distinguish between different types of exposures when assigning their country-risk ratings. For example, trade-related and banking-sector exposures typically receive better risk ratings than other categories of exposure because the importance of these types of transactions to a country's economy has usually moved governments to give them preferential treatment for repayment.

The risk-rating systems of some banking organizations differentiate between public-sector and private-sector exposures. In some banking organizations, a country's private-sector credits cannot be rated less severely than its public-sector credits (that is, the banking organization imposes a "sovereign ceiling" on the rating for all exposures in a country). Both are acceptable practices.

A banking organization's country-risk ratings may differ from the ICERC-assigned transfer-risk ratings because the two ratings differ in purpose and scope. A banking organization's internally assigned ratings help it to decide whether to extend additional credit, as well as how it should manage existing exposures. Such ratings should, therefore, have a forward-looking and broad country-risk focus. The ICERC's more narrowly focused transfer-risk ratings are primarily a supervisory tool to identify countries where concentrations of transfer risk might warrant greater scrutiny and to determine whether some minimum level of reserves against transfer risk should be established. For more information on ICERC ratings, see section 7040.3 of the *Commercial Bank Examination Manual* and SR-99-35.

4090.0.2.6 Country-Exposure Limits

As part of their country-risk management process, internationally active bank holding companies should adopt a system of country-exposure limits. Because the limit-setting process often involves divergent interests within the banking organization (such as the country managers, the bank holding company's overall country-risk manager, and the country-risk committee), country-risk limits will usually reflect a balancing of several considerations, including—

1. the overall strategy guiding the bank holding company's international activities,
2. the country's risk rating and the bank holding company's appetite for risk,
3. perceived business opportunities in the country, and
4. the desire to support the international business needs of domestic customers.

Country-exposure limits should be approved by the board of directors, or a committee thereof, and communicated to all affected departments and staff. Exposure limits should be reviewed and approved at least annually—and more frequently when concerns about a particular country arise.

A bank holding company's board of directors and senior management should consider whether its international operations are such that it should supplement its aggregate exposure limits with more discrete controls. Such controls might take the form of limits on the different lines of business in the country, limits by type of counterparty, or limits by type or tenor of exposure. A bank holding company might also limit its exposure to local currencies. Bank holding companies that have both substantial capital-market exposures and credit-related exposures typically set separate aggregate exposure limits for each because exposures to the two lines of business are usually measured differently.

Although country-by-country exposure limits are customary, bank holding companiess should also consider limiting (or at least monitoring) exposures on a broader (for example, regional) basis. A troubled country's problems often affect its neighbors, and the adverse effects may also extend to geographically distant countries with close ties through trade or investment. By monitoring and controlling exposures on a regional basis, bank holding companies are in a better position to respond if the adverse effects of a country's problems begin to spread.

For bank holding companies that are engaged primarily in direct lending activities, monthly monitoring of compliance with country exposure limits is adequate. However, bank holding companies with more volatile portfolios, including those with significant trading accounts, should monitor compliance with approved limits more frequently. Exceptions to approved country-exposure limits should be reported to an appropriate level of management or the board of directors so that it can consider corrective measures.

4090.0.2.7 Monitoring Country Conditions

The bank holding company should have a system in place to monitor current conditions in each of the countries where it is significantly exposed. The level of resources devoted to monitoring conditions within a country should be proportionate to the bank holding company's level of exposure and the perceived level of risk. If the bank holding company maintains an in-country office, reports from the local staff are an obviously valuable resource for monitoring country conditions. In addition, periodic country visits by the regional or country manager are important to properly monitor individual exposures and conditions in a country. The bank holding company may also draw on information from rating agencies and other external sources.

Communication between senior management and the responsible country managers should be regular and ongoing. The bank holding company should not rely solely on informal lines of communication and ad hoc decision making in times of crisis. Established procedures should be in place for dealing with exposures in troubled countries, including contingency plans for reducing risk and, if necessary, exiting the country.

4090.0.2.8 Stress Testing

Bank holding companies should periodically stress-test their foreign exposures and report the results to the board of directors and senior management. As used here, stress testing does not necessarily refer to the use of sophisticated financial modeling tools, but rather to the need for all bank holding companies to evaluate in some way the potential impact different scenarios may have on their country-risk profiles. The level of resources devoted to this effort should be commensurate with the significance of foreign exposures in the bank holding company's overall operations.

4090.0.2.9 Internal Controls and Audit

Bank holding companies should ensure that their country-risk management process includes adequate internal controls and that an audit mechanism ensures the integrity of the information used by senior management and the board to monitor compliance with country-risk policies and exposure limits. The system of internal controls should, for example, ensure that the responsibilities of marketing and lending personnel are properly segregated from the responsibilities of personnel who analyze country risk, rate country risk, and set country limits.

4090.0.3 REPORTING REQUIREMENTS

4090.0.3.1 Country Exposure Report (FFIEC 009)

Banks and bank holding companies that own banks are required to file the Country Exposure Report (Form FFIEC 009, formerly Form FR 2036) when the bank or banks have a foreign branch, a foreign subsidiary, or an Edge corporation, and when they have, on a consolidated basis, total outstanding claims on residents of foreign countries of $30 million or more. The report is to be filed quarterly within 45 days of the end of March, June, September, and December.

The report measures lending to residents of foreign countries by U.S. banking organizations. It is used to provide information on the distribution, by country, of foreign claims held by such banking organizations to (1) determine the degree of risk in bank portfolios and how adverse developments in particular countries affect the U.S. banking system; (2) assess country risk for supervisory purposes, and (3) assist the Bank for International Settlements in compiling worldwide data on cross-border claims. The report also includes information on revaluation gains for off-balance-sheet items and for securities held in trading accounts.

4090.0.3.2 Country Exposure Information Report (FFIEC 009a)

The County Exposure Information Report (Form FFIEC 009a) supplements the Country Exposure Report. The purpose of FFIEC 009a is to provide public disclosure of significant country exposures of U.S. banking institutions. Every institution that submits the FFIEC 009 and that has exposures to a country that exceed 1 percent of total assets or 20 percent of capital of the reporting institution submits the FFIEC 009a. FFIEC 009a respondents also furnish a list of countries in which exposures were between ¾ of 1 percent and 1 percent of total assets or between 15 and 20 percent of capital. Filing of the report is required.

4090.0.3.3 Country Exposure Report for U.S. Branches and Agencies of Foreign Banks (FFIEC 019)

The Country Exposure Report for U.S. Branches and Agencies of Foreign Banks (Form FFIEC 019) is similar to the FFIEC 009 report that is filed by U.S. banks. The FFIEC 019 report collects information, by country, on the direct claims, indirect claims, and total adjusted claims on foreign residents; information on direct claims on related non–U.S. offices domiciled in countries other than the home country of the parent bank that are ultimately guaranteed in the home country that are included in total adjusted claims on the home country; and a breakdown of adjusted claims on unrelated foreign residents. The data are used by the supervisory agencies to monitor significant foreign-country exposures of U.S. branches and agencies of foreign banks. The reports are also used to evaluate the financial condition of these branches and agencies.

The FFIEC 019 is collected quarterly from those branches and agencies of foreign banks that have, as of the quarterly report date, more than $30 million in total direct claims on residents of foreign countries. The FFIEC 019 provides data on the foreign-risk exposure of each reporting branch and agency.

Respondents to the FFIEC 019 must prepare the data as of the close of each calendar quarter and submit the forms to the appropriate Reserve Bank no later than 45 days following the report date. Data are due at the Board 60 days following the report date. Bank holding companies should obtain, from the management of their respective foreign bank subsidiaries, written confirmation that the FFIEC 019 and all other Federal Reseserve and FFIEC reports have been filed, as required.

4090.0.4 INSPECTION OBJECTIVES

1. If the bank holding company is internationally active, to determine the nature and extent of its direct and indirect country-risk exposures.
2. If the bank holding company has significant direct or indirect international exposure, to evaluate and determine whether it has in place an effective country-risk management process that is commensurate with the volume and complexity of its international activities.
3. To review and determine if the bank holding company's system of policies, procedures, internal controls, rating system, and stress testing for county-risk management are adequate and reliable.
4. To determine if the bank holding company's board of directors oversees and regularly reviews its country-risk management process, approves limits on country exposure, provides for adequate capital that is commensurate with its direct and indirect country-risk exposures, and ensures that management is effectively controlling the risk.
5. To determine if management clearly communicates the bank holding company's country-risk management policies, standards, and practices to the affected offices and staff.
6. To (1) determine if the scope of the bank holding company's audit function is adequate and if the function is sufficiently comprehensive to ensure the integrity of the information senior management and the board use to monitor the bank holding company's country-risk management process, and (2) ensure that the board of directors or its audit committee has provided for adequate audit coverage of country-risk management functions.
7. To recommend corrective action if a bank holding company's country-risk management process and controls are deficient in relation to the level of country-risk exposure.
8. To determine if the bank holding company is properly preparing the Country Exposure Report, FFIEC 009, and the supplemental

Country Exposure Information Report, FFIEC 009a, both of which are required to be filed quarterly with the respective Reserve Banks, as applicable.
9. To identify and report individual exposures considered significant in relation to the bank holding company's capital and the economic performance of the country.
10. To prepare a report on the bank holding company's country-exposure management system and on any noted deficiencies.

4090.0.5 INSPECTION PROCEDURES

When performing and updating the bank holding company's risk assessment, the central point of contact for the bank holding company should include an analysis of its direct and indirect country-risk exposures (including any significant country-risk concentrations) and of the adequacy and reliability of its country-risk management. The analysis of the bank holding company's country-risk management systems should consist of three important components.

One component is the provision for evaluation of economic trends, political developments, and the social fabric within countries where the bank holding company's funds are at risk. These so-called country studies are derived from economic data supplied by the borrower or published by institutional lenders; sociopolitical commentaries; on-site reports from bank branches, subsidiaries, or affiliates; or bank-officer visits to the country.

In the second component, the board of directors and senior management define the level of country exposure the bank is willing to assume. This undertaking normally includes the establishment of limits on aggregate outstandings, maturities, and categories of risk exposures by country, which serve as a guide to operating management in the development and servicing of the bank holding company's international credit portfolio.

The third component is the bank holding company's internal reporting system, which should be designed to monitor and control country exposure. A comprehensive reporting system is required to accurately assign risk exposures to the country of risk, ensure adherence to the directives of the board of directors, provide for at least an annual review of portfolio composition in individual countries, and establish a clear-cut methodology for reporting exceptions to established limits.

A summary of the country-risk management system should be prepared. Set forth below are guidelines and procedures for examiners to use in evaluating the systems banks use to monitor and control country-risk elements in their international loan portfolios. In assessing the quality of the country-risk management system, examiners should, as a matter of course, spot-check the accuray of the data submitted on the Country Exposure Report, FFIEC 009, and the supplemental Country Exposure Information Report, FFIEC 009a, as applicable. The review should include a review of the exposures for at least several countries. The report page, Examiners' Comments and Matters Requiring Special Board Attention, should be used to comment on material exceptions.

1. Obtain any written policies, procedures, or summaries of the bank holding company's country-risk management system. Determine whether the bank holding company's country-risk management system includes—
   a. effective oversight by the board of directors,
   b. adequate risk-management policies and procedures,
   c. an accurate country-exposure reporting system,
   d. an effective country-risk analysis process,
   e. a country-risk rating system,
   f. country-exposure limits,
   g. ongoing monitoring of country conditions,
   h. periodic stress testing of foreign exposures, and
   i. adequate internal controls and an audit function. (See SR-02-05.)
2. Review international-lending policies and determine—
   a. if the board of directors regularly reviews and gives final approval to the limits on country exposure at least annually (or quarterly, if the foreign exposures are high risk or the concentrations are significant);
   b. who initiates the country ratings and country limits;
   c. how frequently and by whom country ratings and limits are reviewed and changed;
   d. how the bank holding company defines the ratings assigned to the various countries;
   e. how country limits are determined;
   f. who is responsible for monitoring compliance with country limits;
   g. if country-risk limits consider—
      (1) the overall strategy guiding the insti-

tution's international activities,
(2) the country's risk rating and the institution's appetite for risk,
(3) perceived business opportunities in the country, and
(4) the desire to support the international business needs of domestic customers;

h. to what extent country limits are viewed as guidelines that may be exceeded;
i. if the bank holding company has different sublimits for private- and public-sector credits;
j. if separate limits are established for private- and public-sector credits;
k. if the board of directors or a committee thereof periodically reviews country ratings and limits, and evaluates the bank holding company's performance against those standards;
l. to what extent comments or classifications of bank supervisors are considered in establishing, increasing, or decreasing country limits;
m. how the system has been changed since the last examination;
n. if the bank holding company has a reliable system for capturing and categorizing the volume and nature of foreign exposures;
o. whether the bank holding company has a system to monitor current conditions in each of the countries where it is significantly exposed;
p. if there is regular, ongoing communication between senior management and the responsible country managers;
q. if established procedures are in place for dealing with exposures in troubled countries, including contingency plans for reducing risk and, if necessary, exiting the country; and
r. whether the bank holding company periodically conducts stress tests (financial modeling or measuring the impact of various scenarios on its country-risk profiles) of its foreign exposures, and if the results are reported to senior management and the board of directors.

3. Review reports furnished to the board or the appropriate committee to ensure that comprehensive and accurate information is being submitted on a timely basis.
4. Obtain the bank holding company's report on the general distribution and characteristics of the international loan portfolio and compare loan-category distributions for adherence to guidelines.
5. During a discussion with senior management, direct inquiries to—
   a. gain insight into general management's international-lending philosophy, and
   b. elicit management responses for correction of deficiencies.
6. When reporting on the bank holding company's country-risk management system, consider factors such as—
   a. the quality of internal policies, practices, procedures, and controls over the international-lending functions;
   b. the scope and adequacy of the internal loan- review system as it pertains to country risk;
   c. causes of existing problems;
   d. commitments from management for correction of deficiencies;
   e. expectations for continued sound international lending or correction of existing deficiencies;
   f. the ability of management to monitor and control transfer risk;
   g. the general level of adherence to internal policies, practices, procedures, and controls; and
   h. the scope and adequacy of the bank holding company's analysis of country conditions.

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5000.0.1 INSPECTION REPORTING PROGRAM

The BHC inspection report is intended to effectively communicate the result of inspections without compromising the integrity of inspection and reporting procedures. The inspection report serves the needs of several distinct audiences: the BHC (its directors, executive management, and line management), the Federal Reserve Board, the Federal Reserve Bank, and other banking organization regulators (state banking agencies, the OCC, and the FDIC). The inspection report should serve as an effective and efficient vehicle for communicating conclusions, concerns, and recommendations to the principal audience—the BHC's board of directors—without sacrificing to any great extent the needs of the other users. The inspection reporting program operates on the condition that inspection workpapers can be obtained for immediate review by Federal Reserve Bank or Federal Reserve Board staff, when requested.

The presentation within the inspection report is intended to be concise and direct, with the information needed by all audiences found in the core section. The core section contains the report pages, which consist of the "Examiner's Comments and Other Matters Requiring Special Board Attention," "Scope," "Structure and Abbreviations," and "Analysis of Financial Factors," as well as an analysis of asset quality and off-balance-sheet risk and certain other required financial statements and schedules. Supporting schedules are required and added to the core section when an area of concern or a problem is addressed in the report.

One standardized BHC inspection report format, FR 1225, has been designed to meet the desired objectives of the full-scope report for all organizations, regardless of the structure and complexity of the BHC under inspection. A few report pages, designated FR 1241, are to be used for BHCs that have less than $150 million in assets. These pages are "Parent Company and Nonbank Assets Subject to Classification," "Bank Subsidiary," "Capital Structure," and "Other Supervisory Issues." The latter two report pages are for the lead bank or other comparable bank subsidiary.

This part of the manual presents policy and procedures for the inspection process, the collection and presentation of data, and the preparation of the resulting analyses in the inspection report. Section 5010.0 corresponds directly to each page for the report (FR 1225). Sections 5020.0 and 5030.0 provide instructions for limited and targeted inspections.

In each report page, instructions are generally organized to state what information is to be presented on a page, the objectives for the information to be presented, the potential source of the information, and how the information is to be presented in the report. Also, the instructions mention other report areas that are affected by material reported on the page.

The examiner is reminded that the instructions in sections 5010, 5020, and 5030 are only a starting point. As such, the instructions focus principally on the collection of information and the presentation in the report of inspection findings. When working on specific functional aspects of the inspection, the examiner should also refer to the appropriate subject heading in this manual.

5000.0.2 POLICY FOR FREQUENCY AND SCOPE OF INSPECTIONS FOR BHCs

On October 7, 1985, the Board announced its policy, effective January 1, 1986, to increase the frequency of inspections of BHCs.[1] The policy objectives are to (1) help prevent the development of problems at banking institutions and (2) make more effective the Federal Reserve's ability to identify and resolve problems that develop nonetheless.

In general, the policy provides that—

1. the largest and most complex BHCs will be inspected at least annually;
2. the largest BHCs, and those with significant problems, will be inspected semiannually; and
3. as an exception to the general rule, small holding companies with no known problems will be reviewed on a more limited basis.

(See section 5000.0.3 for the parameters of the policy statement.)

Federal Reserve Banks are to intensify their involvement in the inspection of large organizations and those with significant problems. Greater

1. All financial holding companies are BHCs; hence, the supervisory guidance in this section applies to financial holding companies as well as BHCs.

reliance is to be placed on state examinations or inspections, in the case of smaller organizations. If a state lacks the resources to conduct inspections in accordance with the specifications of the policy or is unwilling to do so, or, in the case of holding companies, lacks authority, the Federal Reserve will conduct the examinations or inspections to the extent needed to meet the specifications. In addition, if a BHC or its state member bank subsidiary indicates its wish to be examined or inspected by its Federal Reserve Bank, that wish should be honored.

5000.0.3 FREQUENCY AND SCOPE OF INSPECTIONS OF THE LARGEST BHCs

Rating	*Asset Size*		
	$10 billion and over	*$5 billion to $10 billion*	
		Complex[4]	*Noncomplex*[5]
1 or 2	Full-scope required annually.[1] Additional limited-scope or targeted presumed annually.	Full-scope required annually. Limited-scope[2] or targeted[3] when needed.	Limited-scope required every two years. Additional limited-scope or targeted when needed.
3	Full-scope required annually. One limited-scope or targeted also required annually.		
4 or 5	Full-scope required annually. One limited-scope or targeted also required annually.		

Source: Board policy statement, October 7, 1985.

Special Characteristics:

1. BHCs formed to acquire going concerns: inspection to be conducted between the 6th and 18th months of operation, or within 36 months under specific condition, or waived if under $50 mm with specific conditions.
2. Change in control or de novo BHCs: inspection required within 12 months.
3. BHCs that fail surveillance screen or for which other significant adverse information is received: triggers in-depth off-site review to evaluate need for limited-scope or targeted inspection.

Notes:

1. A *full-scope inspection* covers all areas of interest to the Federal Reserve in depth.
2. A *limited-scope* inspection will review all areas of activity covered by a full-scope inspection, but less intensively.
3. *Targeted inspections* will focus intensively on one or two activities.
4. A complex BHC is defined as one with material credit-extending nonbank subsidiaries or debt outstanding to the general public.
5. A noncomplex BHC is without credit-extending subsidiaries and without public debt.

5000.0.4 INSPECTION-FREQUENCY REQUIREMENTS

5000.0.4.1 BHCs with No Identified Problems or Special Characteristics

Multinational bank holding companies and all others with consolidated assets over $10 billion are to receive a full-scope inspection annually, to be coordinated with the examination of the lead bank to the extent possible. Although the inspection of the holding company and the examination of the lead bank need not be commenced simultaneously, they should overlap and rely on financial statements as of the same date, if possible, to facilitate the analysis and presentation of findings to management and directors. A limited-scope or targeted inspection of these companies is also to be conducted between the annual full-scope inspections; the precise timing will be determined by off-site surveillance reports and opportunities to coordinate with the examination of the lead bank. The requirement for a limited-scope or targeted inspection may be waived by the Reserve Bank if, on the basis of the findings of the last full-scope inspection and of the surveillance system, the institution is judged to be in satisfactory condition.

Complex BHCs (defined as companies with nonbank subsidiaries that extend a material amount of credit or companies whose parent has a material amount of debt outstanding to the general public[2]) with consolidated assets of $15 billion or more receive a full-scope inspection annually. These inspections should be conducted, to the extent possible, in coordination with the examination of the lead bank. All BHCs in this size group should be subject to additional limited-scope or targeted inspections when the Reserve Bank has information that suggests the institution may be developing significant problems.

5000.0.4.2 BHCs Requiring Special Supervisory Attention

The inspection frequency of BHCs requiring special supervisory attention is to be determined by both the size and complexity of the organization. The most intensive frequency requirements are directed at BHCs rated BOPEC composite 3, 4, or 5, or whose lead bank subsidiary has been rated CAMELS composite 3, 4, or 5. All BHCs so rated and with consolidated assets of $5 billion or more are to receive an annual full-scope inspection and a limited-scope or targeted inspection during the interval between full-scope inspections.

5000.0.4.3 Supervision Procedures for BHCs with Total Consolidated Assets of Less Than $5 Billion

5000.0.4.3.1 Holding Companies with Total Consolidated Assets Between $1 Billion and $5 Billion

In accordance with SR-02-1, a full-scope inspection for holding companies with total consolidated assets between $1 billion and $5 billion may be satisfied, when appropriate, with a targeted or limited-scope on-site review supplemented by other information sources. A full-scope inspection (which may include a targeted review for the on-site portion) is to be conducted for the *complex holding companies* at least once annually, after which a complete rating is assigned.[3] For the *noncomplex holding companies,* an inspection (which may be targeted or limited in scope) is required at least once every two years, after which a complete rating is assigned. For both complex and noncomplex companies in this size group that are rated composite 3, 4, or 5, one full-scope inspection—which under this program may include a targeted review for the on-site portion—plus one limited-scope inspection must be conducted at least annually. The inspection's scope and documentation requirements are governed by the guidance in this manual. The scope and documentation requirements are to be tailored to the risks—in particular, the risks posed to an insured depository institution subsidiary by the holding company's operations or activities—and to the company's compliance with applicable laws and regulations.

5000.0.4.3.2 Holding Companies with Total Consolidated Assets of Less Than $1 Billion

For *complex holding companies,* Reserve Banks can conduct an off-site review of the organization using surveillance results and relevant supervisory, financial, and other information, including correspondence or other communications with bank management and the primary bank supervisor or functional or other regulator. The supervisory cycle will be determined by the examination frequency of the lead depository institution.[4] Surveillance results or other relevant financial and supervisory information may prompt more frequent reviews and reassignment or confirmation of ratings. If the information obtained off-site from these sources is not sufficient for the Reserve Bank to determine the overall condition of the company and to assign a complete holding company rating, an on-site review should be conducted. The on-site review should be targeted, as appropriate, to those areas where additional information or analysis is needed to develop the complete holding company rating.

2. SR-02-1 extended the definition of a complex BHC to take into account a number of considerations: the size and structure of the holding company; the extent of intercompany transactions between insured depository institution subsidiaries and the holding company or uninsured subsidiaries of the holding company; the nature and scale of any nonbank activities, including whether the activities are subject to review by another regulator and the extent to which the holding company is conducting Gramm-Leach-Bliley authorized activities (for example, insurance, securities, merchant banking); and whether risk-management processes for the holding company are consolidated. Such a determination is made at least annually on a case-by-case basis.

3. The complete holding company rating would include a composite rating as well as all of the component ratings.

4. The lead depository institution is generally the largest depository institution subsidiary. However, a Reserve Bank may, based on the facts and circumstances of a particular holding company, designate another depository institution as the lead.

For the *noncomplex holding companies,* where all subsidiary depository institutions have satisfactory composite and management ratings, and where no material outstanding holding company or consolidated issues are otherwise indicated, the Reserve Bank assigns only a composite rating and a management rating to the company based on the ratings of the lead depository institution. Also, for those noncomplex holding companies that have a subsidiary depository institution in less than satisfactory condition, or with a less than satisfactory management rating, or where a material supervisory issue is otherwise indicated, the Reserve Bank is to conduct an off-site review of the organization using surveillance results and relevant financial, supervisory, and other information, including correspondence or other communications with bank management and the primary bank supervisor. If the information obtained off-site from these sources is not sufficient to determine the overall financial condition of the holding company and to assign the composite and management ratings, an on-site review should be conducted. Any on-site review should be targeted, as appropriate, to those areas where additional information is needed to develop the management and composite ratings.

5000.0.4.4 BHCs with Special Characteristics

BHCs formed to acquire an existing bank are to be inspected to determine their compliance with Federal Reserve regulations and the extent to which they have fulfilled commitments the Board of Governors required of the organization in approving its application. Such inspections should be conducted between the 6th and 18th month after the acquisition; their scope is to be determined by the Reserve Bank. If information available to the Reserve Bank (the most recent examination of the bank, the most recent FR Y-6 and FR Y-9 reports from the holding company, and other pertinent information) indicates that (1) the condition of the bank and BHC is satisfactory, (2) the BHC is fulfilling its commitments to the Board of Governors, and (3) the ratio of the parent's debt to its proportionate interest in the book value of the subsidiary bank (or banks) is less than 75 percent, then, at the Reserve Bank's discretion, the inspection may be delayed as long as 36 months after the formation. Moreover, the requirement for an inspection may be waived in the case of a BHC whose bank subsidiary has less than $50 million in total assets if, in the Reserve Bank's judgment, (1) the holding company's financial condition is satisfactory and its commitments to the Board of Governors are being fulfilled and (2) the ratio of the holding company's debt to its proportionate interest in the book value of the subsidiary bank (or banks) is less than 75 percent.

BHCs that have undergone a change in control and de novo BHCs organized to acquire de novo banks are to receive a full-scope inspection within 12 months following the change in control or formation. A limited-scope or targeted inspection may be conducted in lieu of the full-scope inspection if, in the Reserve Bank's judgment, the financial condition of the holding company appears satisfactory.

When BHCs fail the surveillance screen or when other information suggests the company has experienced an adverse development, an in-depth, off-site review will be made to determine the need for a limited-scope or targeted inspection.

5000.0.4.5 Inspection of Nonbank Subsidiaries of BHCs

The instructions in this subsection are intended to supplement the guidance in the Board's policy statement regarding the frequency and scope of inspections for BHCs, as set forth above and included with SR-85-28 (October 7, 1985). (See sections 4030.0.2, 5010.6.3, and 5010.31; SR-93-19 (April 13, 1993); and the *Federal Reserve Regulatory Service* at 3–1531.)

5000.0.4.5.1 On-Site Reviews of Nonbank Subsidiaries

Notwithstanding the risk assessment that is to be performed for each nonbank subsidiary (see section 4030.2), an on-site review is required for the following nonbank subsidiaries:[5]

1. *Any individual subsidiary that meets either of the following two significance criteria or that is otherwise deemed by the Reserve Bank to have a significant impact on the BHC's condition or performance:*[6]
   - The subsidiary has total assets equal to

5. The on-site review for these nonbank subsidiaries should be performed with the same frequency as required for a full-scope inspection but may be performed as a targeted review that is not concurrent with the full-scope inspection.

6. Generally, examiners would not be required to conduct

10 percent or more of the bank holding company's consolidated tier 1 capital.
- The subsidiary's total operating revenue equals 10 percent or more of the BHC's consolidated total operating revenue.[7]

2. *Nonbank subsidiaries that are issuing debt to unaffiliated parties or relying to a significant degree on affiliated banks for funding.* ''Significant'' is defined as debt that exceeds the lesser of $10 million or 5 percent of the BHC's consolidated tier 1 capital.
3. *Those mortgage banking subsidiaries and other nonbank subsidiaries involved in asset securitization and all nonbank subsidiaries that generate assets and sell them to affiliated parties.* Examiners involved in the on-site review of these subsidiaries should consider the appropriate examination guidelines for asset securitization, for example, those set forth in SR-90-16 (May 25, 1990) and in SR-91-2 (January 31, 1991), dealing with collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs). (See section 2128.02.)
4. *All nonbank subsidiaries that broker or deal in derivative instruments, as a principal or agent, to unaffiliated parties.*

Furthermore, for each credit-extending nonbank subsidiary that meets the above on-site review criteria, examiners are to review sufficient credit files through either judgmental or attribute sampling to assess the adequacy and accuracy of internal risk-identification systems.

5000.0.4.5.2 Off-Site Review of Nonbank Activities

Reserve Banks should review reports submitted to the Federal Reserve to monitor the condition and performance of significant nonbank subsidiaries between inspections. FR Y-series reports on individual and combined nonbank subsidiaries should be used for this purpose and, when available, financial statements on nonbank activities that are included with the FR Y-6 annual reports of BHCs should also be reviewed.[8] When warranted by (1) a deterioration in the condition and performance of nonbank subsidiaries, (2) the significance of the nonbank subsidiaries (including those selected for on-site review as discussed above), or (3) other reasons, Reserve Banks should require BHCs to submit additional information (for example, balance sheets, income statements, and schedules on nonperforming assets and off-balance-sheet activities) obtained from a company's internal systems. Furthermore, on an exception basis, Reserve Banks will be expected to obtain from a BHC's internal systems information on the off-balance-sheet exposures of nonbank subsidiaries and, when considered significant, monitor the risks posed by these exposures. If the Reserve Bank determines that a situation warrants material departure from these procedures, it should be discussed with Board staff.

5000.0.4.6 Rating Assignments for Complex and Noncomplex Holding Companies with Total Consolidated Assets of Less Than $1 Billion

The documentation for the ratings and the off-site or on-site review for both complex and noncomplex companies with total consolidated assets of less than $1 billion should be commensurate with the risk of the company and the nature and scope of issues. At a minimum, this documentation will generally consist of the examination reports for the insured depository institution subsidiaries, a copy of the transmittal letter communicating the ratings to the company, information related to relevant surveil-

an on-site review of those nonbank subsidiaries that hold premises that are necessary for the operation of the banks or other affiliates. Furthermore, these criteria are not intended to include nonbank subsidiaries that have been subject to recent on-site review by another federal or state banking agency in accordance with interagency agreements or Reserve Bank agreements with state banking supervisors (for example, the Interagency EDP Examination, Scheduling, and Distribution Policy). These criteria also should not limit Reserve Bank flexibility in coordinating supervisory efforts with functional regulators at the federal or state level.

7. For BHCs, ''total operating revenue'' is the sum of total interest income and total noninterest income (before extraordinary items).

8. For example, combined financial statements of nonbank subsidiaries are submitted to the Board quarterly on Form FR Y-11Q when the nonbank subsidiary is owned or controlled by a BHC with total consolidated assets equal to or greater than $150 million *and*—
1. the total assets of the nonbank subsidiary are equal to or greater than 5 percent of the top-tier BHC's consolidated tier 1 capital or
2. the total operating revenue of the nonbank subsidiary is equal to or greater than 5 percent of the top-tier BHC's consolidated total operating revenue.

Operating revenue is defined for this pupose as the sum of total interest income and total noninterest income (before deduction of expenses and extraordinary items).

Annual reports of selected financial data for individual nonbank subsidiaries are also submitted to the Board on Form FR Y-11I. Section 20 subsidiaries submit quarterly financial statements to the Board on the FR Y-20 report.

lance results, and memoranda supporting any on-site review conducted. All ratings assigned should be communicated to the company, Board staff, and appropriate state and federal regulatory authorities as soon as possible, but generally no later than 90 days after receipt of the lead depository institution examination report. If an on-site review is required to assign the ratings, the findings of that review and the assigned ratings should be communicated no later than 120 days after receipt of the lead depository institution examination report. The ratings should be entered into the National Examination Data (NED) system.

5000.0.4.6.1 Rating Assignments for Complex Holding Companies with Total Consolidated Assets of Less Than $1 Billion

The Reserve Bank will assign a complete holding company rating, using surveillance results and relevant supervisory, financial, and other information, including correspondence or other communication with bank management and the primary bank supervisor or functional or other regulator.[9] If the information obtained off-site from these sources is not sufficient for the Reserve Bank to determine the overall condition of the company and assign a complete holding company rating, the information must be derived from an on-site review.

5000.0.4.6.2 Rating Assignments for Noncomplex Holding Companies with Total Consolidated Assets of Less Than $1 Billion

For noncomplex holding companies with total consolidated assets of less than $1 billion, where all subsidiary depository institutions have satisfactory composite and management ratings and no material outstanding holding company or consolidated issues are otherwise indicated, the Reserve Bank should assign only a composite rating and a management rating to the company on the basis of the ratings of the lead depository institution. For those holding companies in this asset group that have a subsidiary depository institution in less than satisfactory condition, or with a less than satisfactory management rating, or where a material supervisory issue is otherwise indicated, the Reserve Bank will conduct its off-site review of the organization using surveillance results and relevant financial, supervisory, and other information, including correspondence or other communications with bank management and the primary bank supervisor. Any on-site review should be targeted, as appropriate, to those areas where additional information is needed to develop the management and composite ratings.

9. The complete holding company rating would include a composite rating as well as all of the component ratings.

5000.0.4.6.3 Rating Assignments for Holding Companies with Total Consolidated Assets Between $1 Billion and $5 Billion

All companies with total consolidated assets between $1 billion and $5 billion (whether deemed complex or noncomplex) must be assigned a complete holding company rating. The complete holding company rating would include a composite rating as well as all of the component ratings. The ratings must be communicated to the holding company in writing within 60 days from the completion of the inspection; however, Reserve Banks are encouraged to adopt an internal target of 45 days for the processing and mailing of reports for companies rated 3, 4, or 5. (See SR-93-4.)

5000.0.5 BHCs EXEMPT FROM THE PROHIBITIONS OF SECTION 4 OF THE BHC ACT

BHCs exempt from the prohibitions of section 4 of the Bank Holding Company Act of 1956, as amended, as a result of any of the following exemptions will not be subject to any required periodic inspection:

1. section 4(a)(2)—permanent grandfather rights
2. section 4(c)(i)—labor, agricultural, or horticultural organization
3. section 4(c)(ii)—85 percent family-owned
4. section 4(c)(12)—irrevocable declaration to cease to be a BHC
5. section 4(d)—hardship exemption

However, the Reserve Bank should continue to monitor the financial condition of such holding companies and should conduct inspections whenever there is any indication of a potential problem in a subsidiary bank.

5000.0.6 OUT-OF-DISTRICT INSPECTIONS

In addressing the issue of Reserve Bank supervision of out-of-District facilities, the Board approved the policy that the Reserve Bank of the District where the parent holding company or lead bank is located would be responsible for the supervision, examination, inspection, and applications of all of that company's out-of-District facilities. The following administrative procedures and guidelines have been established.

The Reserve Bank responsible for the supervision of the parent holding company is also responsible for the supervision of all of its nonbank subsidiaries, regardless of location. Classification of assets of out-of-District nonbank subsidiaries should be performed at the office of the parent company by the responsible Reserve Bank when sufficient information is available or could be made available upon request. In adopting the inspection-frequency requirements for selected BHCs (see above), the Board recognized that inspection of nonbank subsidiaries and classification of nonbank assets were an essential part of the inspection process. However, an on-site inspection of out-of-District nonbank subsidiaries should not be done routinely by the responsible Reserve Bank. If the responsible Reserve Bank concludes that information necessary to classify assets is available only on-site, or if problems or other material circumstances lead to the conclusion that an on-site inspection is required, the local Reserve Bank should be asked to perform the inspection. Staff from the responsible Reserve Bank may participate when supervisory problems are serious enough to warrant the involvement of the responsible Reserve Bank.

5000.0.7 MULTI-TIER BHC INSPECTIONS

With the marked increase in interstate banking activity, a growing number of multi-tier BHC structures exist in which the top-tier and second-tier institutions (as well as other lower-level tiers) are in different Federal Reserve Districts. Consistent with the policy in SR-78-464 on the supervision of out-of-District nonbank subsidiaries, the general framework now in place will remain the primary guideline. The Reserve Bank responsible for the supervision of the top-tier BHC will also be responsible for the supervision of all of the subsidiary-tier BHCs and their nonbank operations, regardless of the District where they are located.

Given this overall policy direction, general guidelines are established for inter-District coordination for multi-tiered BHCs where the second-tier institution is located in a different District from that of the top-tier parent holding company. (See SR-89-25.)

5000.0.7.1 Population of Second-Tiers Suitable for On-Site Inspection

A second-tier holding company (and other lower tiers) that (1) has assets greater than $5 billion, (2) irrespective of size, has a financial condition deemed in need of special supervisory attention (BHC or lead bank rated 3, 4, or 5), or (3) is prone to insider or abusive practices would usually warrant an on-site inspection, the preparation of an inspection report, the assignment of a rating, and a presentation of findings to management, as well as the board of directors if the board includes any "outside directors." To the extent possible, the inspection should be coordinated with that of the top-tier parent holding company.

5000.0.7.2 Frequency Guidelines for Second-Tier BHCs over $5 Billion

It is assumed that a second-tier BHC will be subject to inspection-frequency guidelines that pertain to the top-tier on a consolidated basis. Although top-tier companies greater than $10 billion in assets may be subject to a second on-site presence annually, these guidelines are not intended to require a second annual presence for the second-tier company.

5000.0.7.3 Frequency Guidelines for Second-Tier BHCs Rated 3, 4, or 5

When a second-tier holding company requires special supervisory attention or is prone to insider or abusive practices, the responsible Reserve Bank may conclude that the second-tier holding company warrants inspection at least as frequently or more frequently than the top-tier holding company. Under such circumstances, it would be appropriate for the second-tier holding company to receive a second presence annually, despite the fact that the top-tier holding company may be inspected less frequently. Problem BHCs acquired as "debts previously contracted'' need not be inspected any more frequently than the top-tier company.

5000.0.7.4 Second-Tier Shell BHCs

To the extent that the second-tier holding company is strictly a shell without outside directors and no substantive policymaking authority, and to the extent that the records necessary to review its operations and condition are available at the location of the top-tier holding company, the inspection of the second-tier need not be done on-site, but may be done at the top-tier parent location. In either case, if an inspection is conducted, a rating should be assigned to the second-tier holding company. (See SR-89-25.)

5000.0.7.5 Staffing of Inspections of Out-of-District Second-Tier BHCs and Nonbank Subsidiaries

To the extent possible and consistent with the principles of efficiency and effectiveness, the responsible Reserve Bank should rely on the local Reserve Bank to provide the resources necessary to conduct the inspection of out-of-District second-tier BHCs and nonbank subsidiaries that are located in that District, including nonbank subsidiaries held directly by the parent. However, the responsible Reserve Bank has overall responsibility for the consolidated organization and must determine the appropriate scope of the inspection to ensure that it is consistent with the overall supervisory objectives for the consolidated organization. The following guidelines supplement SR-89-25 and SR-79-464.

Consistent with this overall responsibility, the responsible Reserve Bank should also decide, in consultation with the local Reserve Bank, how the inspection will be managed. The examiner-in-charge (EIC) may come from either the responsible Reserve Bank or the local Reserve Bank, or in some instances co-EICs may be appropriate. Selection of the EIC depends on a variety of factors, including the composition of the examination crew, the complexity of the supervisory plan, the condition of the organization, the degree of centralization within the consolidated organization, and the knowledge of local banking conditions. For those inspections involving co-EICs, the EIC from the responsible Reserve Bank will have overall responsibility for the findings and the rating resulting from the inspection. The co-EICs will, of necessity, communicate and coordinate closely, ensuring that all matters affecting the supervised banking organization are carefully considered and presented as a single Federal Reserve position. (See SR-93-48.)

5000.0.7.6 Scope of Inspection

The inspection of the second-tier ought to be conducted on a full-scope basis at least every other inspection. Interim inspections may be done on a limited-scope or targeted-scope basis. Any full-scope inspection of a second-tier BHC should include a review of the loan-administration function and an evaluation of the adequacy of the internal loan-review capability in order to determine the reliance that can be placed on the information by the regulators and the parent.

5000.0.7.7 Need for a Report

When an on-site inspection of a second-tier holding company is conducted, inspection findings should ordinarily be presented in a separate report to its management and a summary provided to the board of directors (in those cases where any outside directors are on the board). The inspection report on the top-tier holding company will incorporate the findings pertaining to any coordinated inspection of the second-tier holding company, either by reference to a separate report to be attached or by inclusion of relevant findings in a summary presented in the body of the report on the top-tier company.

5000.0.7.8 Surveillance and Reporting Requirements

The local Reserve Bank is responsible for maintaining a high level of current awareness of the financial condition and activities of large second-tier holding companies (and other lower-tier companies) in its District. To assist in this regard, quarterly consolidated financial statements on Form FR Y-9C should be requested by the *responsible* Reserve Bank from all second-tier (and lower-tier) holding companies with consolidated assets greater than $1 billion. As is the case with Form FR Y-9LP that is already being submitted by a second-tier holding company, the reporting holding company should be instructed to send the completed Form FR Y-9C directly to the Reserve Bank responsible for the top-tier BHC. The responsible Reserve Bank, in turn, should electronically transmit the data to the Board and also send a hard copy to the local Reserve Bank for its information. Any analysis of the second-tier holding company's condition should be exchanged between Reserve Banks.

5000.0.7.9 Intra-District Multi-Tiered BHCs

In those cases where a multi-tier holding company exists within a single Federal Reserve District, inspection guidelines remain essentially the same as those presented above.

5000.0.8 INTERAGENCY INSPECTION OR EXAMINATION AGREEMENTS

To ensure continuing close coordination and consistency in the examination and supervision of banking organizations, the three federal bank regulatory agencies (that is, the Federal Reserve System, OCC, and FDIC) have adopted two policies intended to enhance the interagency supervision of BHCs and their bank and nonbank subsidiaries.

5000.0.8.1 Interagency Coordination of BHC Inspections and Subsidiary Bank Examinations

The first policy was adopted in conjunction with the Federal Financial Institutions Examination Council (FFIEC) and addresses large and problem holding companies and holding companies with deteriorating financial conditions. The policy requires the agencies to coordinate the BHC inspection and the examination of the lead bank subsidiary for—

1. any BHC with consolidated assets in excess of $10 billion;
2. any BHC or BHC subsidiary lead bank rated composite 4 or 5 (the two lowest rating categories) under the Bank Holding Company Rating System or the Uniform Rating System for banks; and
3. any BHC or BHC subsidiary lead bank rated composite 3 (the middle of the rating categories) whose financial condition appears to have worsened significantly since the last inspection or examination.

It is recognized that substantial problems could develop for a holding company as a result of serious difficulties in significant subsidiary banks other than its largest bank, and the policy as adopted affords the agencies the flexibility to conduct coordinated examinations when any bank, regardless of size, has problems warranting supervisory concern. In implementing this aspect of the policy, the agencies will conduct coordinated examinations when any significant bank subsidiary is rated 4 or 5, or when the financial condition of any other subsidiary causes serious concern about that subsidiary's impact on the condition of the holding company or any other banking affiliate.

5000.0.8.2 Interagency Agreement to Conduct Concurrent Examinations of Certain BHCs and Their Lead Bank Subsidiaries

The second policy implements a program to conduct an annual concurrent examination by the Federal Reserve and the OCC or FDIC of holding companies with consolidated assets greater than $1 billion and their lead bank subsidiaries. The major provisions of this program are as follows:

1. The agencies will conduct concurrent examinations of certain BHCs and their lead bank subsidiaries, as well as any other subsidiary or subsidiaries as appropriate. Concurrent examinations are defined as the performance of certain on-site examination activities by examiners from the agencies on a simultaneous or coordinated basis so as to enhance cooperation, minimize potential duplication, and reduce burden on banking institutions. Concurrence does not necessarily require coincidence of beginning and closing dates of bank and holding company examinations. The geographical location of the lead bank shall determine the district bank and regional office responsible for coordination of examination logistics of all involved subsidiaries.
2. The banking organizations to which this program will apply will be mutually agreed upon by the director of the Division of Banking Supervision and Regulation (FRS) and the senior deputy comptroller for bank supervision (OCC) for holding companies with lead national bank subsidiaries, and by the director of the Division of Banking Supervision and Regulation (FRS) and the

director of the Division of Bank Supervision (FDIC) for holding companies with lead state-chartered nonmember bank subsidiaries. These banking organizations will be specified in a list prepared jointly by the FRS and OCC for holding companies with lead national banks, and by the FRS and FDIC for holding companies with lead state-chartered nonmember banks.

3. In general, this program will apply to holding companies whose lead bank subsidiaries are national or state-chartered nonmember banks and whose consolidated holding company assets are equal to or exceed $1 billion. However, the program may be applied to other holding companies upon the agreement of the FRS, OCC, and FDIC.
4. In general, banking organizations included in the program will be examined annually, although each agency reserves the right not to participate in an examination due to resource constraints or other supervisory imperatives.
5. The agencies will mutually agree on the division and sharing of work assignments and routines for concurrently examining the holding company and the bank, with the goal of minimizing unnecessary overlap, duplication, and burden on the banking organization. In general, the division of examination duties will be based on the locus of primary statutory examination and supervisory responsibility, but will recognize that in some areas the agencies have common supervisory interests and needs for information.
6. Findings, conclusions, recommendations, reports, and transmittal letters pertaining to examinations of the holding company or subsidiaries included in the program should be provided to or discussed with the district bank and regional office of the other agency responsible for coordination of the concurrent examinations before being forwarded to management or directors of the holding company or bank (or banks).
7. Each district bank and regional office receiving examination information from the other agency should inform the other agency on a timely basis of any major findings, conclusions, or recommendations with respect to which the receiving agency substantially disagrees.
8. Before forwarding examination results to management or directors, every effort should be made to resolve significant differences between the district bank and regional office concerning major examination findings, conclusions, and recommendations.
9. Significant differences that cannot be resolved by examiners or officials at the regional office-district level should be referred to the director of the Division of Banking Supervision and Regulation (FRS) and the senior deputy comptroller for bank supervision (OCC) for ultimate resolution, in the case of a holding company and its lead national bank. Cases that involve significant differences at the regional office-district level with regard to a holding company and its lead state-chartered nonmember bank will be referred to the director of the Division of Banking Supervision and Regulation (FRS) and the Director of the Division of Bank Supervision (FDIC) for ultimate resolution. If major differences cannot be resolved, the agencies may proceed with the transmission of examination findings and conclusions to management according to each agency's existing procedures.
10. Reasonable efforts should be made by the agencies to hold joint or combined final interviews and meetings with the management or directors of the holding company and the bank subsidiaries to discuss significant supervisory issues involving examination results. In the ordinary course, the district bank (FRS) would initiate meetings with the holding company, and the regional offices (OCC and FDIC) would initiate meetings with the national or state-chartered nonmember bank subsidiaries, respectively. If such meetings are not appropriate or feasible, each agency should inform the other agency in advance of any plans to meet with management or directors of the holding company or bank to discuss significant supervisory matters, and the other agency should be given the opportunity to attend such meetings or send a representative. If the other agency does not attend or send a representative, significant results of the meetings should be transmitted to that agency.
11. This agreement is intended to foster cooperation and is not meant by the exclusion of other arrangements to preclude other reasonable efforts or cooperative arrangements to strengthen interagency coordination and consistency.
12. Nothing in this agreement precludes or prohibits the agencies from examining any entity for which the agency has statutory

examination authority, or from taking timely supervisory action against any entity for which the agency has statutory supervisory authority.

5000.0.8.3 Interagency Policy Statement on Examination Coordination

On June 10, 1993, an interagency policy statement was developed to strengthen coordination and cooperation among the federal banking agencies responsible for examining and supervising depository institutions and their holding companies, thus minimizing the disruptions and burdens associated with the examination process. The policy expands on existing interagency agreements. (See SR-93-30.)

5000.0.8.3.1 Primary Supervisory and Coordination Responsibility

Examinations or inspections of a particular legal entity are to be conducted by the federal regulatory agency that has primary supervisory authority for that entity. In carrying out its supervisory responsibilities for a particular entity within a banking organization, each regulatory agency, to the extent possible, is to rely on examinations or inspections conducted by the primary regulator of the affiliate, thereby avoiding unnecessary duplication and unnecessary disruption of the banking organization. In certain situations, however, it may be necessary for a regulatory agency other than the entity's primary supervisory authority to participate in the examination or inspection in order to fulfill its regulatory responsibilities.

Primary supervisory authority and coordination responsibilities are organized as follows:

OCC	national banks
FDIC	state nonmember banks
OTS	thrift holding companies and savings associations
FRB	parent BHCs, nonbank subsidiaries of BHCs, the consolidated BHC, and state member banks

The primary federal regulator is responsible for scheduling, staffing, and setting the scope of supervisory activities, including coordinating formal and informal *administrative* actions, as necessary. In fulfilling these responsibilities, the primary regulatory agency is to consult closely with the other appropriate agencies when there is need for coordination.

5000.0.8.3.2 Overview of Examination Coordination and Implementation Guidelines

The agencies are to make every effort to coordinate the examinations and the inspections of banking organizations. Coordinated examinations and inspections may not be practical in all cases because of resource constraints, serious scheduling conflicts, or geographic considerations; however, particular emphasis will be placed on coordinating examinations and inspections of 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.

5000.0.8.3.3 Coordinating the Planning, Timing, and Scope of Examinations and Inspections

When multiple regulators have authority over a legal entity, representatives from the appropriate supervisory offices should, if necessary, meet quarterly to discuss supervisory strategies for specific banking organizations. They should meet at least annually to review and establish examination and inspection schedules, to plan for the next year, and to consider the need for coordination in the following areas:

1. sharing the strategy and scope of each examination or inspection
2. determining if agencies other than the primary regulator of a particular entity should participate in the examination or inspection of that entity
3. determining whether a consolidated request letter should be prepared to avoid duplicative information requests
4. sharing workpapers and resultant findings and conclusions from prior examinations and inspections
5. other areas as necessary

5000.0.8.3.4 Interagency Review of Bank, Nonbank, and Parent-Company Activities

Certain functions and procedures—such as internal audit, credit review, and the procedures for determining the allowance for loan and lease losses—transcend the boundaries that distinguish legal entities. Such functions and procedures may be located at the bank or holding company level. The primary regulator of the depository institution and the holding company both may have supervisory responsibility to assess such functions. In these cases, coordinated and concurrent examinations or inspections should be conducted to avoid duplicative reviews and unnecessary disruption.

The primary regulator of the entity being examined or inspected should take the lead in a coordinated examination or inspection, unless there is an agreement that another agency will serve as the lead agency. The responsibilities of the lead agency, in consultation with other appropriate agencies, include developing the scope of the examination or inspection and determining the staff requirements. The lead agency will also coordinate scheduling of the examination or inspection and the presentation of examination or inspection findings to the appropriate management.

5000.0.8.3.5 Joint Meetings Between Regulators and Bank or BHC Management

At the conclusion of examinations or inspections conducted under the guidelines, the agencies should coordinate and plan joint meetings with the board of directors to discuss the findings and conclusions. The agencies will coordinate responsibility as outlined in the guidelines.

5000.0.8.3.6 Significant Differences in Agencies' Findings, Conclusions, and Recommendations

Before examination or inspection results are forwarded to management or boards of directors, every effort should be made to resolve any significant differences in major findings, conclusions, and recommendations. These differences should be resolved by examiners or officials at the regional level within 10 business days of identification. If the regional offices cannot resolve the matter, it should be referred to the national level, where it will be resolved within a reasonable time frame.

5000.0.8.3.7 Inspection and Examination Reports

The primary regulator should prepare the formal report of examination or inspection covering the entity for which it is the primary federal regulator. The primary regulator will also prepare the report when it serves as the lead agency. The report should be addressed and transmitted to the directors of the entity for which the regulator is the primary federal supervisory authority. The report may also be sent to the directors of other entities that have a need for the information. The agencies may agree, if necessary and appropriate, to prepare a joint report.

5000.0.8.3.8 Coordinating Information Requests

Any request for information to be obtained from an entity for supervisory purposes should normally be made through the entity's primary regulator. The primary regulator should also share relevant supervisory information with the other appropriate regulatory agencies.

5000.0.8.3.9 Coordinating Enforcement Actions

When one or more regulatory agencies are contemplating an enforcement action, the agencies should consider initiating a joint enforcement action to address and correct deficiencies within a banking organization. *At a minimum,* each agency considering enforcement action should inform the other agencies. This provision reaffirms the existing interagency enforcement agreement.

5000.0.8.3.10 State Banking Departments

The agencies will endeavor to coordinate with state banking departments, when appropriate and feasible.

5000.0.9 POLICY FOR COMMUNICATING PROBLEMS OF SUPERVISORY CONCERN TO MANAGEMENT AND BOARDS OF DIRECTORS

5000.0.9.1 Introduction

On October 7, 1985, the Board announced a second policy to strengthen and formalize practices for communicating the findings of examinations or inspections to management and boards of directors and to set out guidelines for such meetings. The policy—

1. establishes specific criteria for determining which examination findings require follow-up meetings with boards of directors and sets out guidelines for such meetings,
2. requires that, in addition to providing a complete examination or inspection report to the bank or BHC, a written summary of findings be sent to the bank or BHC for distribution to each director, and
3. requires that senior Reserve Bank officials become more involved in presenting examination findings to boards of directors.

The policy was effective immediately, with initial implementation on January 1, 1986.

5000.0.9.2 Meetings with Directors

The decision to hold a meeting with the board of directors at the conclusion of a state member bank examination or a BHC inspection is to be determined on the basis of the organization's financial condition, its size, the type of examination or inspection conducted, and other factors which, in the judgment of the Reserve Bank, indicate the need for a meeting. To the extent possible, meetings with the boards of directors of state member banks should include representatives of the state banking department. Where appropriate, meetings with the boards of BHCs may be held jointly with the meeting of the lead bank subsidiary's board of directors and the bank's primary federal or state bank supervisor.

5000.0.9.2.1 Criteria for Conducting Meetings

5000.0.9.2.1.1 Condition

For those BHCs with consolidated assets of $1 billion or more, a meeting with the board of directors is to be held at the conclusion of any full-scope inspection in which a BHC is rated BOPEC composite 4 or 5. SR-02-01 stipulates that a meeting between Reserve Bank staff and the board of directors to communicate findings is not required for—

1. complex holding companies with consolidated assets of less than $1 billion; and
2. noncomplex holding companies with consolidated assets of less than $1 billion that have a subsidiary depository institution in less than satisfactory condition, or with a less than satisfactory management rating, or where a material supervisory issue is otherwise indicated.

However, a meeting should be conducted between Reserve Bank staff and the board of directors to communicate findings when supervisory concerns warrant such action.

Except for the above situation, meetings are required if an organization is rated composite 3 and its condition appears to be deteriorating or has shown little improvement since the previous examination or inspection in which it received a composite 3 rating.[10] A meeting should also be held with all these organizations following a limited-scope or targeted examination or inspection, if deemed appropriate and desirable by the Reserve Bank. (See SR-95-19.)

5000.0.9.2.1.2 Size

A meeting will be required at the conclusion of a full-scope examination or inspection of all multinational organizations and major regional organizations with assets in excess of $5 billion. Reserve Banks also are encouraged to conduct such meetings at the conclusion of a full-scope examination or inspection of regional institutions with assets $1 billion or more.

5000.0.9.2.1.3 Guidelines for Meetings

Meetings with boards of directors will have to be tailored to meet the needs of each specific situation. In general, meetings with the full board are preferred, but in certain cases the Reserve Bank may determine that a meeting with a committee of the board of directors, such as the executive or audit committees, will serve adequately. In all cases, however, the written summary of examination or inspection findings is to be provided to each member of an organization's board of directors.

For BHCs with consolidated assets of $1 billion or more, the Reserve Bank's presentation to the board should ordinarily be chaired by a Reserve Bank official, with the examination staff in attendance. The larger the organization or

10. Reserve Banks also are encouraged to hold a meeting at the conclusion of a full-scope inspection of an organization with assets of $1 billion or more rated composite 2 if its condition appears to be deteriorating, and with those organizations rated composite 3 even if showing some improvement.

more serious its problem, the more senior the Federal Reserve official should be.

Reserve Bank presidents are expected to become directly involved in the supervision of multinational organizations and regional institutions with over $5 billion in assets that have been rated composite 3, 4, or 5. Reserve Banks have the discretion to determine the circumstances under which the participation of Reserve Bank presidents is appropriate and necessary. It may be necessary for the Reserve Bank president to meet with the board of directors and become involved in other ways; the precise nature of involvement will depend on the situation.

A meeting with the board of directors should include a formal, structured presentation containing a clear statement that an institution is considered a ''problem'' institution[11] or is about to become a problem institution if existing conditions deteriorate. Use of slides, other visual aids, and hard-copy handouts is encouraged. Information should also be presented on financial trends and peer-group comparisons. The presentation should make clear the nature of problems uncovered, such as—

1. deficiencies in capital, asset quality, earnings, or liquidity;
2. violations of law;
3. inadequacies in policies, practices, and reporting systems necessary for the proper administration of the organization;
4. lack of well-documented lending, collection, investment, and liability-management policies;
5. failure of management in addressing previously discussed deficiencies;
6. lack of reporting systems sufficient to keep senior management and the board of directors fully informed; and
7. failure of the board of directors to participate in the active management of the organization.

For BHCs with consolidated assets of less than $500 million, the Reserve Banks, effective March 30, 1995 (SR-95-19), were provided the discretion to have senior supervision or examination staff represent the Reserve Bank in meetings with the directors of banks and BHCs. Conference calls with directors may be made in place of on-site meetings for these BHCs when considered appropriate and if an on-site meeting was held following the previous inspection.

11. As has been long-standing Federal Reserve practice, the exact composite or component ratings assigned in the examination or inspection are not to be disclosed to persons other than the directors or senior management. (See section 4070.0.9.)

5000.0.9.3 Summary of BHC Inspection Findings

The Federal Reserve Banks will provide special written reports summarizing the results of the inspection findings to BHCs in the following situations (see SR-85-28):

1. An organization is rated composite BOPEC 3, 4, or 5 (except for organizations rated BOPEC 3 or 4 when a written summary report was provided on a preceding inspection (see SR-95-12); the organization has been taking actions to comply fully with the provisions of that report; and, in the examiner's judgment, no good purpose would be served by issuing another summary report).
2. An organization is rated composite 1 or 2 but is showing signs of a significant deterioration in condition or an apparent violation of law.

Examiners in these and other cases may decide to issue summaries to board members when the summaries will prove constructive in resolving potential or actual problems.

The inspection report page ''Examiner's Comments and Other Matters Requiring Special Board Attention'' may serve as the full text of the summary report to directors and should be written with that purpose in mind. The discussion on the page (and thus in the summary report) should focus on identified problems of the organization rather than its strengths. Problems should be presented in a succinct and unmistakably clear manner. The types of actions to be taken by the directors and management to address these problems should be specifically noted. Institutions rated 4 or 5 are to be told they are ''problem'' institutions that warrant ''special supervisory attention.'' Institutions rated 3 are to be informed that their condition is not satisfactory, that they are subject to more than normal supervision, and that they may become ''problems'' if their weaknesses are not addressed adequately.

The summary report will be sent directly to the banking organization's management for their distribution to each director. The transmittal letter to the banking organization is to state that the report is a summary of identified problems and contemplated supervisory actions and to request that management distribute the report to each director. The letter is to state further that each director should read the report, sign the introductory statement attesting to having read the report, and return the report to management. Management is to keep on file copies of the statements signed by the directors, but is to destroy all but a file copy of the summaries themselves.

To provide the directors with prior notice of the deficiencies to be discussed, the directors' summary report is to be completed and distributed before any Reserve Bank meeting with the board of directors. Reserve Banks should also make every effort to distribute the complete examination or inspection report to management before meeting with directors.

5000.0.10 SUMMARY TO DIRECTORS OF INSPECTION FINDINGS

SUMMARY TO DIRECTORS OF INSPECTION FINDINGS

Prepared by the
Federal Reserve Bank

____

For the Board of Directors of

____

____

Inspection Conducted As of

____

This summary is the property of the Board of Governors of the Federal Reserve System and is furnished to members of the board of directors of the bank holding company inspected for their confidential use. The report is strictly privileged and confidential under applicable law, and the Board of Governors has forbidden its disclosure in any manner without its permission. Under no circumstances should the holding company, or any of its directors, officers, or employees disclose or make public in any manner the report or any portion thereof. In reviewing this summary, it should be kept in mind that an inspection is not the same as an audit report.

THIS SUMMARY SHOULD BE HELD IN STRICTEST CONFIDENCE

5000.0.10 SUMMARY TO DIRECTORS OF INSPECTION FINDINGS—Continued

Summary Signature Page

The attached summary of an inspection of ____________________________ completed on _______________________________, has been prepared to assist members of the board of directors of the bank holding company in fulfilling their fiduciary responsibilities. As a member of the board you are urged to review this summary and the inspection report as soon as possible.

As an elected member of the holding company's board of directors, you have a duty to ensure that the organization is operated in a safe and sound manner. You may be held liable for losses caused by your failure to supervise properly the affairs of the holding company. It is suggested that you review one or more of the publications that explain the functional and legal responsibilities of a director.

Congress has placed great emphasis on the role of holding company directors and officers by passing legislation allowing regulatory authorities to use ''cease and desist'' actions against individuals, to assess civil money penalties, and even to remove an officer or director demonstrating willful or continuing disregard for safety and soundness considerations.

This summary is the property of the Board of Governors of the Federal Reserve System and is furnished to members of the board of directors of the bank holding company inspected for their confidential use. The report is strictly privileged and confidential under applicable law, and the Board of Governors has forbidden its disclosure in any manner without its permission. Under no circumstances should the holding company, or any of its directors, officers, or employees disclose or make public in any manner the report or any portion thereof. In reviewing this summary, it should be kept in mind that an inspection is not the same as an audit report. After reviewing this summary, please sign below and return this entire document to the bank holding company.

I have received and read the attached summary of the inspection of ________________________ by the Federal Reserve Bank of _______________ conducted as of __________________________.

____
S/director

____
Date

5000.0.10 SUMMARY TO DIRECTORS OF INSPECTION FINDINGS—Continued

Summary of Inspection Findings

5000.0.11 COMPLETION STANDARD FOR INSPECTION REPORTS

Inspection reports issued by the Federal Reserve must be completed and mailed within 60 calendar days, beginning with the day following the examiner's exit meeting. This standard applies to all inspections, regardless of the complexity of the BHC. For BHCs rated 3, 4, or 5, Reserve Banks are encouraged to follow an internal target of 45 calendar days for processing and mailing reports. When reports are issued jointly with other state banking agencies, this standard may be extended at the discretion of the senior management at the Reserve Bank. (See SR-93-4.)

5000.0.12 COMBINED EXAMINATION/INSPECTION REPORT FOR BHCs WITH LEAD STATE MEMBER BANKS

Reserve Banks are permitted, under the circumstances and procedures specified in SR-94-46, to issue a combined report for a BHC and its lead state member bank subsidiary. A letter should be sent to the qualified holding companies that explains their option of receiving a combined report. The combined report may be issued when—

1. a BHC's lead bank subsidiary is a state member bank,[12] and
2. the holding company's board of directors formally approves, by board resolution, a combined report being released to its lead state member bank subsidiary.

A combined examination/inspection report format is attached to SR-94-46. At a minimum, a combined report will contain all examination report pages required by the interagency bank examination report instructions, as well as information on the parent holding company, its bank and nonbank subsidiaries, and the consolidated BHC organization. For detailed information on required and optional report pages, see section 6000 of the *Commercial Bank Examination Manual* and sections 5010.0 to 5010.43 of this manual.

Separate examination and inspection Supervisory Information System (SIS) entries are required for each combined report. The combined report's cover page is to be green, must provide BHC and Bank RSSD[13] numbers, and must clearly indicate that the report is a combined report.

12. In cases where the company has more than one state member bank, separate examination reports should be prepared for all other state member bank subsidiaries.

13. Research, Statistics, Supervision and Regulation, and Discount and Credit (RSSD)

Manual Section No.	*Report Page No.*	*Report Page Title*
FR 1225:		
5010.2		Cover
5010.3	i.	Table of Contents
5010.4	1.	Examiner's Comments and Matters Requiring Special Board Attention
5010.5	2.	Scope and Abbreviations of Inspection
5010.6	3.	Analysis of Financial Factors
5010.7	4.	Audit Program
5010.8	5.	Parent Company Comparative Balance Sheet
5010.9	6.	Parent Company Comparative Statement of Income and Expenses
5010.10	7.	Summary of Consolidated Classified and Special Mention Assets, and Other Transfer Risk Problems
5010.11	8.	Consolidated Comparative Balance Sheet
5010.12	9.	Comparative Consolidated Statement of Income and Expenses
5010.13		Consolidated Capital Structure
5010.14		Policies and Supervision
5010.15		Violations
5010.16		Other Matters
5010.17		Classified Assets and Capital Ratios of Subsidiary Banks
5010.18		Organization Chart
5010.19		History and Structure
5010.20		Investment in and Advances to Subsidiaries
5010.21		Commercial Paper
5010.22		Lines of Credit
5010.23		Commercial Paper/Lines of Credit (including questions)
5010.24		Contingent Liabilities and Schedule of Balance-Sheet Accounts Not Detailed Elsewhere (Parent)
5010.25		Statement of Changes in Stockholder's Equity
5010.26		Income from Subsidiaries (Fiscal and Interim)
5010.27		Cash Flow Statement (Parent) (including questions)[1]
5010.28		Parent Company Liquidity Position
5010.29		Parent Company and Nonbank Assets Subject to Classification
5010.30		Bank Subsidiaries
5010.31		Nonbank Subsidiaries
5010.32		Nonbank Subsidiary Financial Statements
5010.33		Fidelity and Other Indemnity Insurance
5010.34		(Reserved for future use)
5010.35		Other Supervisory Issues
5010.36		Extensions of Credit to Bank Holding Company Officials and Their Related Interests and Investments in and Loans on Stock or Obligations of Their Related Interests
5010.37		Interest Rate Sensitivity—Assets and Liabilities
5010.38		Treasury Activities/Capital Markets
5010.40	A	Principal Officers and Directors
5010.41	B	Condition of the Bank Holding Company
5010.42	C	Liquidity and Debt Information
5010.43	D	Administrative and Other Matters

1. This page is required to be included in the inspection report for bank holding companies with consolidated assets in excess of $1 billion or those companies that have substantive fixed charges or debt outstanding, as well as selected others at the option of the Reserve Bank.

Manual Section No.	*Report Page No.*	*Report Page Title*
FR 1241:		
5010.13		Capital Structure (lead bank subsidiary)
5020.1		Bank Subsidiary
5020.2		Other Supervisory Issues

This ‘‘full-scope’’ report is designed to be used as a minimum standard in reporting the results of a bank holding company inspection. The report to be provided to the bank holding company consists of a Core Section and an Appendix Section, the latter consisting of certain required financial statements. Supporting schedules are added to the Core or Appendix Sections when an area of concern or problem is addressed. Such schedules provide detailed information relevant to a particular activity area.

The Core Section contains a table of contents, a summary of the scope of the inspection, and a page that presents the examiner’s comments and discusses matters requiring special Board attention. Also, the Core Section should contain an analysis of financial factors, including an assessment of the quality of assets and a complete analysis of the BOPEC components. Specifically, the Core Section is made up of the pages described in the following subsections.

5010.1.1 CORE SECTION

The inspection report format contains the following pages in the Core Section:

Page No.	*Page Title*
	Standard Report Cover
i.	Table of Contents
1.	Examiner’s Comments and Matters Requiring Special Board Attention
2.	Scope of Inspection and Abbreviations
3.	Analysis of Financial Factors
4.	Audit Program

5010.1.2 APPENDIX SECTION

The Appendix Section will consist of a mandatory section that presents the following financial statements for the organization:

- Parent Company Comparative Balance Sheet
- Parent Company Comparative Statement of Income and Expenses
- Consolidated Comparative Balance Sheet
- Consolidated Comparative Statement of Income and Expenses

Bank holding company inspections should be conducted as of the latest fiscal quarter. All financial statements should be presented as of the most recent calendar quarter. The dollar amounts are reported in thousands.

Financial statements prepared by the bank holding company may be used to meet these requirements provided they are prepared in accordance with generally accepted accounting principles and are, in the examiner’s judgment, suitably detailed, clear, and accurate. Any adjustments to any financial statements made by the examiner should be footnoted. Any other supporting schedules or visual aids (for example, graphs or charts) can be included in the Core Section to communicate and/or support the examiner’s findings. Percentages should be rounded to the nearest tenth of 1 percent, unless finer detail is necessary.

5010.1.3 OPTIONAL PAGES TO BE INCLUDED IN THE CORE OR APPENDIX SECTIONS

Supporting Report Pages for All Inspections

The listed optional report pages are to provide support[1] to the Core or Appendix Section of the report. They will normally be sequenced as listed below. If a problem area is cited within the Core Section, the respective typed supporting report pages need to be included to support the critical comments. The optional pages listed in this section are to be included by the examiner in the report when they convey significant

1. Supporting report pages refers to information gathered in essentially the same format as when the page is being prepared by the examiner for inclusion in the report. However, certain information may not provide sufficient value to address an area of concern in the report, but should be retained in workpaper form to provide evidential matter for the inspection report. For example, the Statement of Changes in Stockholders’ Equity may be summarized in an audit report or may be included with the company’s audited annual financial statements. The examiner reviews the statement and concludes that the information is reliable and complete and that it agrees with the respective balances reported in the inspection report. A photocopy of the information could be used to provide evidence of the examiner’s review, including any related notes.

findings in the Core Section or when they support the discussion in the Core Section with an Appendix page. If appropriate standardized report pages do not exist to address a particular area of concern, the relevant analytical support can be included on the ''Other Matters'' page as part of the inspection report. Any or all supporting report pages and workpapers should be available to be forwarded immediately to Board staff, if requested.

The designated supporting report pages are—

- Policies and Supervision
- Summary of Consolidated-Classified and Special-Mention Assets, and Other Transfer Risk Problems
- Consolidated Capital Structure
- Capital Structure (lead bank subsidiary)
- Treasury Activities/Capital Markets
- Violations
- Other Matters
- Classified Assets and Capital Ratios of Subsidiary Banks[2]
- Organization Chart
- History and Structure
- Investment in and Advances to Subsidiaries
- Commercial Paper (Parent)
- Lines of Credit (Parent)
- Commercial Paper/Lines of Credit (Parent) (including questions)
- Contingent Liabilities and Schedule of Balance-Sheet Accounts Not Detailed Elsewhere (Parent)
- Statement of Changes in Stockholders' Equity
- Income from Subsidiaries (Fiscal and Interim)
- Cash Flow Statement (Parent) (including questions)[3]
- Parent Company Liquidity Position
- Parent Company and Nonbank Assets Subject to Classification
- Bank Subsidiaries
- Nonbank Subsidiaries
- Nonbank Subsidiary Financial Statements
- Fidelity and Other Indemnity Insurance
- Other Supervisory Issues
- Extensions of Credit to Bank Holding Company Officials and Their Related Interests and Investments in and Loans on Stock or Obligations of Their Related Interests
- Interest Rate Sensitivity—Assets and Liabilities

In addition to the FR 1225 report pages, a few replacement report pages are designated as FR 1241 pages. The following pages are designed and are to be used for smaller bank holding companies having less than $150 million in assets:

- Capital Structure (lead bank subsidiary)
- Bank Subsidiary
- Other Supervisory Issues

5010.1.4 CONFIDENTIAL SECTION FOR ALL INSPECTION REPORTS

The confidential section for bank holding company inspection reports is reserved for confidential comments that will be limited to staff of the Federal Reserve System. The Confidential Section of the inspection report will consist of the following pages:

Page	*Page Title*
A.	Principal Officers and Directors
B.	Condition of the Bank Holding Company
C.	Liquidity and Debt Information
D.	Administrative and Other Matters

Discussion presented in the confidential section should be kept to a minimum. As much information as possible should be incorporated in other sections of the report that are available to the bank holding company. The complete analysis of the holding company organization (that is, BOPEC components) is to appear in the front of the report on the ''Analysis of Financial Factors'' page. The information reported on these confidential pages should be printed on yellow paper.

5010.1.5 GENERAL COMMENTS FOR ALL REPORT PAGES

The specified format of the report pages should be used whenever possible, but when flexibility is necessary, additions and limited deletions can be made. Examiners are required to include in the Core Section only a relatively small number

2. Included if assets are classified and/or written up as required.

3. This page is required to be included in the inspection report for bank holding companies with consolidated assets in excess of $1 billion or those companies that have substantive fixed charges or debt outstanding, as well as select other organizations at the option of the Reserve Bank.

of report pages and, in the Appendix Section, only financial statements for the organization. These pages will normally be sequenced as listed previously. At the same time, examiners have the discretion to decide whether to include other standard pages in a report and whether to include them in the Core or the Appendix Sections. This choice should be made on the basis of whether the content of the page will highlight a significant inspection finding (in which case, the finding should be included in the Core Section) or whether the content will provide support for comments offered in the Core Section (in which case, the finding should ordinarily be placed in the Appendix Section).[4] Given the discretion being accorded examiners to tailor reports to accurately convey inspection findings, reports prepared for large and small companies alike should be prepared to achieve that objective.

Another important objective is to avoid excessive length in the report, particularly in the open section, that can result from including comments that may provide directors and management with information of marginal importance or from repeating findings and conclusions on different pages of the report.[5] In addition, reports should be understandable and readable. A further objective is for examiners to determine precisely what should be conveyed in their reports to boards of directors and management and then to present that information in clear and concise language.

All reports are to be on 8½- by 11-inch paper, bound on the left margin. Responses to questions should be provided below the last question in the section or, if necessary, on an additional page. Do not repeat the question in the response. Indicate the question number in the response.

All credit-extending nonbank subsidiaries will be subject to asset classification. The examiner should recommend that management maintain a loan-loss reserve that is adequate to offset 100 percent of assets classified loss and still have a balance sufficient to absorb normal unidentified, unanticipated, future losses from operations. The examiner and BHC management should consider the guidance provided in section 2065.2 on the determination of an adequate level for the Allowance for Loan and Lease Losses. Examiners should also review the organization's loan-loss history to determine trends and to help evaluate the adequacy of the existing reserve.

4. If a problem area is cited within the Core Section, inclusion of the listed, typed, supporting report pages will be necessary to support the critical comments.

5. While brevity is an important goal, examiners should note that, when an enforcement action is contemplated, the inspection report must fully support the proposed provisions of the enforcement document.

The official name, location, and the RSSD ID number of the bank holding company being inspected is to be provided. Also provide the dates the inspection commenced and concluded as well as the inspection date. The cover includes a notice that its content is strictly confidential.

The cover must include the official seal of the Board of Governors of the Federal Reserve System. It may also include the names and seals of the Reserve Bank and the state bank supervisory agency that participated in the inspection as part of a cooperative inspection agreement.

FR 1225–Cover
(Revised 7/94)

REPORT OF
BANK HOLDING COMPANY
INSPECTION

Name: ______________________________ Inspection Commenced: ______________________________

Location: ______________________________ Inspection Concluded: ______________________________

RSSD ID Number: ______________________________ Inspection Date: ______________________________

THIS REPORT OF INSPECTION IS STRICTLY CONFIDENTIAL

This report has been prepared by an examiner selected or approved by the Board of Governors of the Federal Reserve System. The report is the property of the Board of Governors and is furnished to directors and management for their confidential use. The report is strictly privileged and confidential under applicable law, and the Board of Governors has forbidden its disclosure in any manner without its permission, except in limited circumstances specified in the law (12 USC 1817(a) and 1831m) and in the regulations of the Board of Governors (12 CFR 261.11). Under no circumstances should the directors, officers, employees, trustees or independent auditors disclose or make public this report or any portion thereof except in accordance with applicable law and the regulations of the Board of Governors. Any unauthorized disclosure of the report may subject the person or persons disclosing or receiving such information to the penalties of Section 641 of the U.S. Criminal Code (18 USC 641). Each director or trustee, in keeping with his or her responsibilities, should become fully informed regarding the contents of this report. In making this review, it should be noted that this report is not an audit, and should not be considered as such.

FEDERAL RESERVE BANK OF

The table of contents indicates the report pages included in the report and the sequential numbering of pages within the report. All pre-numbered Core Section inspection report pages are included in each table of contents along with any other supporting report pages. Supporting report pages will be numbered sequentially in FR 1225, starting with page number ‘‘11’’.

If included, individual subsidiaries may be listed with their respective page numbers, or they may be grouped such as ‘‘Nonbank Subsidiaries’’ with a page reference such as ‘‘26–26c’’ to indicate the number of such subsidiaries. At the bottom of the page, insert the commencement date of the previous inspection followed by the date of the financial statements in parentheses.

The report page is to include a summary of the examiner's findings relating to—

- violations,
- criticisms,
- special comments,
- matters requiring special board attention, and
- recommendations.

In addition, it will also include the BOPEC financial composite rating (see SR-88-37 and section 4070.0.9). Beginning in January 1997, component ratings for the current inspection and the two prior inspections will be reported at the top of the page as illustrated below (see SR-96-26). Component ratings should only be detailed if the date of the inspection is after January 1, 1997.

BOPEC Rating System

Inspection Date:	*Current Inspection 09-03-X7*	*Prior Inspection 10-19-X6*	*Prior Inspection 8-22-X5*
Composite rating:	2	2	2
Component ratings:			
Banks	2		
Other (nonbank subsidiaries)	2		
Parent company	2		
Earnings	2		
Capital adequacy	2		
Management	S		

This listing should be followed by the uniform definition of the assigned composite rating. The uniform definitions of the component ratings assigned need not be included in reports; however, they should be made available to management and directors upon request.

When a combined examination/inspection report format is used, similar matrices for each composite and component rating assigned should be included in the report.

Numeric and alphabetic component ratings should also be included on the pages of reports that discuss findings related to the components.

The purpose of this report page is to communicate to the holding company's board of directors and its management the examiner's views on the overall condition of the company, significant problems that have been identified in the inspection, and actions the company's board of directors and management need to take to correct the company's problems and strengthen its condition. The comments should summarize only material concerns, criticisms, analyses, or violations, referring the reader to an appropriate optional report page for additional detail. The use of subcaptions to identify and separate the areas subject to comment is encouraged.

The comments are generally written on an exception basis. Avoid laudatory comments. The examiner may, however, comment on improvements initiated by management.

Items suitable for discussion within the Examiner's Comments and Matters Requiring Special Board Attention report page include, but are not limited to—

- policies and supervision of subsidiaries,
- earnings,
- cash flow or liquidity,
- level of classified assets,
- adequacy of capital,
- borrowings,
- condition of subsidiaries,
- violations of the Bank Holding Company Act and Regulation Y,
- violations of section 23A and/or section 23B of the Federal Reserve Act and other statutes,
- fees and dividends being paid to the parent by subsidiaries,
- audit function, and
- information that is to serve as an alternative to issuing a separate Summary to Directors of Inspection Findings.

Any substantive recommendations contained elsewhere in the inspection report should be presented briefly in the core page entitled "Examiner's Comments and Matters Requiring Special Board Attention." A summary comment relative to the adequacy of the BHC's oversight of its subsidiaries may be provided. Any comments that refer specifically or indirectly to details presented elsewhere in the report should be consistent with that information. Each inspection report page entitled Examiner's Comments and Matters Requiring Special Board Attention will be written to accomplish these objectives: give an overall assessment of the condition of the company, discuss significant problems, and specify needed corrective action. In cases of composite ratings of 3, 4, and 5, the text of this page will also be used for the summary report. The signature of the examiner-in-charge should appear below the comments.

The scope of the inspection describes generally the coverage parameters of the inspection. When determining the scope of the inspection, the examiner must consider the Board's policy statement on the examination and inspection of state member banks and bank holding companies (October 7, 1985, S-2493). See sections 5000.0.7 to 5000.0.9.

The scope generally includes a presentation of the following:

- the purpose for the inspection
- which subsidiaries were inspected on-site and which were done from the parent's location
- the depth of inspection coverage[1]
- an identification of the peer group(s) and the bank holding companies used for comparison with the bank holding company being inspected
- the source of information regarding the administration of policies and the supervision over subsidiaries
- comments as to the extent examiners relied on internal classification systems or classifications of other bank regulatory agencies
- the senior officers with whom the overall inspection findings were discussed
- the sources upon which the examiner based his conclusions and/or recommendations

The opening paragraph of the scope should include authority under which the inspection was conducted (section 5(c) of the Bank Holding Company Act of 1956, as amended), and may include the dates the inspection commenced and closed, and the date(s) of financial statements used as the basis for the inspection.

In brief paragraphs, the examiner should also indicate what minute books were read, which nonbank subsidiaries were examined, what size loans were reviewed in credit-extending subsidiaries, with whom corporate policies were discussed, and to what extent banking subsidiaries were reviewed.

The report page will also include explanations of abbreviations used in the report. Generally, abbreviations familiar to the BHC should be used. However, efforts should be made to incorporate at least a part of the name into the abbreviation as opposed to relying strictly on initials which tend to become confusing. Also, it is desirable that abbreviations of bank subsidiaries include the word ''bank'' to distinguish them from the parent company and/or nonbank subsidiaries with similar names.

1. This includes a statement as to the percentage of loans reviewed in each credit-extending nonbank subsidiary, without consideration to statistical sampling or any form of extrapolation. The ratio will include loans actually reviewed by Federal Reserve examiners divided by total loans in each nonbank subsidiary. When different categories of loans are housed in a nonbank subsidiary, it may be relevant to provide a breakdown by percentage of loans reviewed for each category of loans, further segregated by current and delinquent categories. See SR-90-26.

The Analysis of Financial Factors presents a complete financial analysis of the components (nonconfidential BOPEC comments) of the holding company—parent, bank subsidiaries, nonbank subsidiaries, and consolidated (as applicable)—supported and followed by parent and consolidated financial statements, consolidated asset quality, and consolidated capital ratios. See section 4000 for specific information on analyzing financial factors.

The analysis is to serve the informational needs of senior management of the holding company and the supervisory authorities by presenting both positive and negative factors affecting the condition of the major components and the consolidated company. Such analysis helps identify problems or potential problems and measures the holding company's ability to be a source of financial strength to its subsidiaries. This analysis is considered one of the most important parts of the report.

The information is available from discussions with management, financial statement data within the report, published statements such as the SEC Form 10-K, and unpublished information sometimes available through the offices of the officer in charge of finance, the treasurer, or the comptroller.

5010.6.1 PARENT COMPANY

For the parent company, present an analysis of each of the financial factors in narrative form. Tables may be used to support the narrative analysis.

The analysis of the parent should include a discussion of the following: debt structure (with indications of how debt proceeds are used), debt/equity ratios (with comparisons to previous years), sufficiency of cash flow, sources and stability of income, interest coverage, dividend-payout ratios, classifications of parent company assets, changes in dividend policy, comparisons to peer group, and a conclusion about whether the holding company is considered to be a source of financial strength to its subsidiaries.

Within the analysis of the parent, the examiner should also include comments regarding whether dividend payments to stockholders have been reasonable, considering the parent's leveraged position, debt servicing, cash flow, and capital needs. The examiner should describe how dividend policy is formulated and what the policy is. See the Board's policy on cash dividend payments in section 2020.5.1.

Dividends paid by subsidiaries, both bank and nonbank, to the parent company are the means by which a cash return is realized on the investment in subsidiaries, thus enabling the parent to pay dividends to its shareholders and to meet its debt-service requirements and other obligations. The examiner will need to conclude and discuss in the report whether dividend assessments of any subsidiary are excessive. The examiner can draw conclusions about excessive dividends based on discussions with management concerning dividend policies and information that may be contained in the report, such as—

1. peer-group averages,
2. the condition and capitalization of each subsidiary,
3. the type of subsidiary (credit-extending subsidiaries need more capitalization than service subsidiaries),
4. the bank holding company's reasons for extracting proportionately more or less from each subsidiary,
5. past policy and payments, and
6. compliance with regulatory policy and guidelines.

5010.6.2 BANK SUBSIDIARIES

A summary write-up should be prepared for each bank subsidiary comprising 10 or more percent of the bank holding company's consolidated assets and/or bank subsidiaries evidencing material financial deficiencies or other characteristics that should be brought to the attention of the bank holding company's board of directors.[1] These write-ups should summarize noteworthy examiner comments from the open section of the latest reports of examination of the subsidiary bank(s) and comment on any actions taken to correct significant weaknesses or violations. The summary should also include an analysis of the level and trend of earnings and classified assets, and the adequacy of capital (for example, Tier 1, total capital, and leverage ratios).

1. In determining the subsidiary banks that require write-ups, examiners should be mindful of the effect that the cross guarantee provisions of FIRREA can have on nontroubled bank subsidiaries.

For the other bank subsidiaries, the examiner should provide an overall summary: the number of subsidiaries by composite rating, an overall analysis of the level and trend of earnings, classified assets, capital (that is, capital adequacy), and any other financial analysis indicators.

5010.6.3 NONBANK SUBSIDIARIES

The examiner should present an analysis of the condition and an analysis of the risk assessment of nonbank subsidiaries. The analyses presented within this report page should support the nonbank component of BOPEC without causing the reader to refer to other report pages.

Because of the number of nonbank subsidiaries of a bank holding company, it may not be possible or reasonable to discuss the condition and risk assessment of each subsidiary in this section of the inspection report. The analysis presented on this page should, therefore, be based on the combined performance of the nonbanking activities. However, if the company has significant or troubled credit-extending nonbank subsidiaries, individual analyses of each of these subsidiaries should be included.

The analysis of nonbank subsidiaries should include information on the nonbank's financial condition, including the level, trend, and quality of earnings; composition of the loan portfolio; level and trend of classified, past-due, and nonperforming assets; and the adequacy of the loan-loss reserve, capital, financial management of debt-to-equity ratios, and funds management. The combined risk assessment should address the funding risk, earnings exposure, operational risks, asset quality, capital adequacy, contingent liabilities and other off-balance-sheet exposures, management information systems and controls, transactions with affiliates, growth in assets, and the quality of oversight provided by the management of the bank holding company and nonbank subsidiary (see SR-93-19). Conclude with a general statement on the condition and overall risk assessment of the nonbank subsidiaries.

5010.6.4 CONSOLIDATED

Present an analysis of the consolidated balance sheet, including levels and trends of debt, the adequacy of capital (Tier 1, total capital, and leverage ratios), growth in loans, assets and liabilities, and peer-group comparisons. Also present an analysis of the consolidated earnings trends, asset quality, and the adequacy of valuation reserves. Such analysis should include comments on performance results based on net interest margins, return on average assets, return on average equity, factors influencing earnings, and peer-group comparisons. Include a statement on the condition of the company, including its reliance on interest-sensitive funds and its ability to borrow additional short- or long-term funds or to issue new capital stock.

5010.6.5 GENERAL INSTRUCTIONS

The examiner should make certain that—

1. the figures and comments related to the parent are consistent with the various parent-company financial statements;
2. the analysis of bank subsidiaries is consistent with data included on the ‘‘Bank Subsidiaries’’ and the ‘‘Classified Assets and Capital Ratios of Subsidiary Banks’’ pages;
3. the analysis of nonbank subsidiaries is consistent with data on the ‘‘Nonbank Subsidiary,’’ ‘‘Nonbank Subsidiary Financial Statements,’’ and ‘‘Nonbank Company Assets Subject to Classification’’ report pages;
4. the consolidated analysis is consistent with information presented throughout the report, primarily with the consolidated financial statements and the unaffiliated borrowings on the ‘‘Liquidity and Debt Information’’ confidential page ‘‘C’’;
5. all names are the same as those on the ‘‘Scope and Abbreviations’’ Core page 2, the ‘‘Organization Chart’’ page, and other report pages and tables within the report; and
6. all debt figures agree with the unaffiliated borrowings of the ‘‘Liquidity and Debt Information’’ confidential page ‘‘C.’’

This page presents the adequacy of the internal audit program, the effectiveness and quality of the overall audit program, and the BHC's relationship with its external auditor. See section 2060.1 for related information.

The examiner's review of the BHC's internal audit program will establish whether the program is adequate to effectively audit the BHC's operations regularly. It will also help determine whether the audit function provides the directors with sufficient information on the corporation's conditions and operations. The review will allow the examiner to determine the external auditor's role and relationship with the internal auditor.

The information on the audit program is available from the auditor, audit committee, the audit staff, and the internal audit reports. Information on the external auditor should be available from the management letter, the internal auditor, and the audit committee minutes.

Comments on the internal audit program may include an appraisal of the effectiveness of the program at meeting the frequency guidelines for auditing subsidiaries, information on the recipients of audit reports, and the party to whom the auditor is responsible. The examiner's comments on the external auditor may include the name of the firm, the scope of the audit, the degree of interface with the internal auditors, any ''qualified opinion'' submitted by the independent auditors in certifying the most recent years' financial statements, and any pertinent comments regarding relations with the directors' audit committee. The comments should conclude with an appraisal of the quality and effectiveness of the overall audit program.

The following is a list of suggested questions for the internal auditor in developing comments for this section:

5010.7.1 INTERNAL AUDITOR

1. How is the audit staff organized? To whom do they report?
2. What are the educational backgrounds and experience of the staff?
3. What is the size of the staff and the length of time that most of the staff have been in audit? Is the staff large enough to meet the functional requirements of the job under the guidance and leadership of the auditor? Is the department used as a training ground for other departments?
4. What is the schedule for the audit of banking and nonbanking subsidiaries and for particular departments therein?
5. Are copies of audit programs and reports available for the Federal Reserve's review?
6. Are audit programs coordinated with and workpapers reviewed by outside accountants?
7. Are qualified EDP auditors on the staff?

Although more information is obtained through interviews with the auditor, as opposed to receiving responses to written questions, these questions represent a general framework on which the conversation may develop.

5010.7.2 EXTERNAL AUDITORS

1. Have independent public accountants audited the bank holding company's consolidated financial statements for the FR Y-6 annual report if the BHC's consolidated assets exceed $500 million or more?
2. Does the external auditor work with the internal auditor in establishing the scope and frequency of audits?
3. In addition to performing some of the basic functions of the internal auditor, did the external auditor review the internal auditing program to assess its scope and adequacy?
4. When the BHC does not have sufficient earnings to employ an internal audit staff, yet the complexities of the organization necessitate the need for an audit, has an external auditor been engaged for this purpose?
5. Does the external auditor have the ability to conduct surprise audits and sufficient flexibility for establishing the scope of the audits and in making recommendations on internal control changes?
6. Have the BHC's insured depository institutions furnished their independent auditors with the required call reports, memorandums of understanding, written agreements, and other designated supervisory information required by section 7(a) of the FDIC Act (see section 2060.1.1)?

The comments detailed on this report must be consistent with summarized comments on the Policies and Supervision page and the Other Supervisory Issues page (item 8). Any noteworthy deficiencies in the audit program may be included on the Examiner's Comments and Matters Requiring Special Board Attention, core page 1, at the examiner's discretion.

The comparative balance sheet presents the composition of the parent company's balance sheet as to assets, liabilities, and capital and should be representative of the functions and activities of the company. The comparative balance sheet allows the reader to compare changes in accounts on a line-by-line basis from one period to another. It aids and gives written support to the financial analysis.

The parent company balance sheets may be requested in the officer's questionnaire or may be obtained from the accounting department. Fiscal statements can also be found in the most recent SEC Form 10-K and the FR Y-6 and Y-9 LP.

The detail on the most recent balance sheet accounts should be reconciled to subsidiary ledgers or a detailed trial balance. The statements should be adjusted to reflect generally accepted accounting principles. Adjustments should be footnoted. The statements should be presented in four columns with two interims and two fiscals except for year-end inspections when only two fiscals are required. The presentation should be (from left to right) current interim period, prior interim period, current fiscal, and prior fiscal. The statement may be formatted like the FR Y-9 LP.

The parent company comparative balance sheet should have specific detail or schedules supporting balance-sheet accounts and amounts as follows.

1. Show investments in and advances to subsidiaries as separate accounts, with separate subtotals for banks and nonbanks.

2. Provide supplementary schedules on the ''Contingent Liabilities and Schedule of Balance-Sheet Accounts Not Detailed Elsewhere (Parent)'' page showing a breakdown of accounts not detailed in the report, such as marketable securities, CDs, and other investments when considered appropriate or when the account exceeds 25 percent of total footings.

2. Break out goodwill and other intangibles from ''Other Assets'' or ''Investments in Subsidiaries,'' and detail on the ''Contingent Liabilities and Schedule of Balance-Sheet Accounts Not Detailed Elsewhere (Parent)'' page.

3. Break out ''other real estate owned'' from ''Other Assets,'' and detail on the ''Contingent Liabilities and Schedule of Balance-Sheet Accounts Not Detailed Elsewhere (Parent)'' page.

4. ''Other Assets'' and ''Other Liabilities'' should be broken down and detailed on the ''Contingent Liabilities and Schedule of Balance-Sheet Accounts Not Detailed Elsewhere (Parent)'' page if any item in the account is considered significant.

5. Mandatory convertible debt instruments should be shown separate from subordinated capital notes and debentures and detailed on the unaffiliated borrowings on the ''Liquidity and Debt Information'' confidential page ''C.''

6. Stockholder's equity should contain the following categories, as applicable: common stock, perpetual preferred stock, limited life preferred stock, capital surplus, retained earnings (undivided profits), reserves for contingencies and other capital reserves. Limited life preferred stock should be shown separate from stockholders' equity. For all capital stock issues indicate in a footnote the par value and the number of shares authorized and outstanding for each period. If there is more than one type of stock, indicate the voting rights, preferential dividend rights, and conversion rights, where applicable.

The examiner should make certain that the—

1. investments in subsidiaries equals the investments detailed on the ''Investment in and Advances to Subsidiaries'' page,

2. advances to subsidiaries equals advances detailed on the ''Investment in and Advances to Subsidiaries'' page,

3. commercial paper total equals the commercial paper totals detailed on the Commercial Paper (Parent) page and the ''Liquidity and Debt Information'' confidential page ''C,''

4. total of short-term and long-term debt equals the same totals for unaffiliated borrowings on the ''Liquidity and Debt Information'' confidential page ''C,''

5. ''Other Assets'' and any other accounts detailed on the ''Contingent Liabilities and Schedule of Balance-Sheet Accounts Not Detailed Elsewhere (Parent)'' page reconciles to the corresponding items on the page (the ''Contingent Liabilities and Schedule of Balance-Sheet Accounts Not Detailed Elsewhere (Parent)'' page may show only significant items in the categories without totals), and

6. parent's equity accounts equal those on the ''Statement of Changes in Stockholder's Equity'' and on the ''Consolidated Comparative Balance Sheet'' page.

The comparative income statement presents income of the parent available to satisfy expense requirements. It also can be an indicator of the structure of services and activities provided at the parent level.

The purpose of the statement is to determine—

- the levels and types of intercompany income,
- that the sources of external income are consistent with authorized activities,
- the changes in corporate policy via changes in intercompany income, and
- that the types and levels of the parent's expenses are appropriate for the parent's activities.

All statements of income and expenses should be requested in the officer's questionnaire. Fiscal information can be found in the holding company's annual report to shareholders, FR Y-6, and/or SEC Form 10-K. Interim results are generally requested from the corporation's accounting or comptroller department.

Two interims and two fiscals should be presented unless the inspection is as of fiscal year-end, when only two fiscals are required. The report page should show all significant categories of operating income and expense. A supplementary schedule should be provided breaking down any category of other income or expense that equals or exceeds 25 percent of its respective total.

If possible, insurance commission income is to be shown net of premiums collected, and, when available, commissions should be broken down to show those directly related to credit extended within the bank holding company organization. The various income components from internal and external sources need to be detailed separately to allow cross checking with the ''Income from Subsidiaries'' pages.

Equity in undistributed earnings of subsidiaries should be listed below net operating income to derive ''net income.'' Where applicable, show separately the equity in undistributed earnings of subsidiary banks and nonbanks.

The examiner should make certain that—

- dividends, interest, management, and service fees and equity in undistributed earnings of subsidiaries equal the totals on the ''Income from Subsidiaries'' pages and
- net income equals the amounts reported on the ''Statement of Changes in Stockholders' Equity (Parent)'' and ''Comparative Statement of Income and Expense (Consolidated)'' pages. In those cases where the figures do not agree, the difference should should be footnoted and detail should be provided for the difference.

Classified assets, off-balance-sheet transactions, and other transfer-risk problems (OTRP) are summarized by organizational level, whether at the parent company, banking subsidiaries, or nonbank subsidiaries, and compared with valuation reserves established to absorb known and potential losses. For banking subsidiaries the classified items are derived from the most recent federal and state examinations for the individual bank subsidiaries.

Report the classification, reserve, noncurrent, and loan/lease-level ratios as detailed on the report page. The ratio of consolidated classified assets to tier 1 capital should be included. The "continued" page should contain comments regarding the sources of information and methods used by the examiner for determining consolidated asset quality.

For the parent company, the classification totals should be broken down into the major asset categories (e.g., "Loans," "Other Real Estate," and "Other Assets"). The lead bank subsidiary's classification should be broken out along with any other bank that has classified assets representing 20 percent or more of total consolidated classified assets. The assets of a nonbank credit-extending subsidiary should be broken out if the nonbank subsidiary had classifications greater than 5 percent of consolidated classified assets or other large problem credits or classified assets.

There may be occasions when one or more subsidiary banks may not have been subject to an asset-quality review by a bank supervisory agency within the last two years, which impedes the bank holding company examiner from making an accurate judgment on the company's asset quality. The examiner may accept the internal criticized assets of the bank holding company *only if* the internal system was tested by the examiner and deemed to be valid. Generally, such testings should be conducted as necessary in order to make an informed judgment on consolidated asset quality. Comments should be provided about whether the examiner was able to rely on information depicting asset quality or that such information was not available.

Classification totals of off-balance-sheet transactions, if any, should be broken out separately and summarized for each level of the organization (parent company, bank subsidiaries, and nonbank subsidiaries).

The source for reporting classified asset totals should be stated (FRB, OCC, FDIC, internal operations, or internal audit review) along with the respective as-of date. As an alternative, classified asset totals may be listed for individual bank and nonbank subsidiaries. The purpose of preparing this summary is to—

1. determine the amount and degree of risk and potential loss associated with on- and off-balance-sheet transactions and activities (This is accomplished by summarizing the amount of classified assets and losses and other potential losses that may result from on- and off-balance-sheet activities, including off-balance-sheet risk and transfer risk at the consolidated organizational level, as well as the general composition of such potential losses at the parent company, bank subsidiaries, or nonbank subsidiaries);
2. analyze ratio trends in consolidated asset quality for the current and previous two inspections;
3. determine the extent to which such classified assets and off-balance-sheet risk influence the overall financial condition of the consolidated organization;
4. determine the adequacy of reserves (The page alerts management about the need for increasing the valuation reserve accounts);
5. disclose problem assets and off-balance-sheet transactions requiring management's attention;
6. show in summary form all classifications and criticisms assigned by examiners in determining asset quality and the adequacy of respective reserves; and
7. aid in the identification of existing and potential problems in the banks that may have an overall effect on the bank holding company.

The information for the report page is derived from two other completed pages or workpapers, "Parent Company and Nonbank Assets Subject to Classification" and "Classified Assets and Capital Ratios of Subsidiary Banks." The information is obtained by determining the collectibility or forced-sale value of assets or potential losses that may arise from certain on- and off-balance-sheet transactions. For banks, the information is to be generated from bank examination reports that are available at the Reserve Bank. (The holding company may have copies of the open sections of the reports.)

Investments in and advances to bank and

nonbank credit-extending subsidiaries by the parent are not to be classified. The examiner may, however, classify the parent's investments in and advances to non-credit-extending nonbank subsidiaries. For additional information on classifying an investment to a non-credit-extending subsidiary, see section 4070.0.

The use of abbreviations for the subsidiaries within narrative comments, as presented on the "Scope and Abbreviations" core page 2, is permissible. The examiner may comment on and analyze lending policies, documentation, collection procedures, and past-due volume in the aggregate. Such comments should be consistent with comments contained in other report pages and workpapers.

The examiner should provide comments on the adequacy of the valuation reserves and any recommendations to management to provide for additional loan-loss provisions. The examiner should also recommend that management maintain a level of loan-loss reserves that is adequate to offset 100 percent of assets classified loss and still have a balance sufficient to absorb normal unidentified, unanticipated future losses from operations.

Weighted classified assets includes 100 percent of loss, 50 percent of doubtful, 20 percent of substandard, and, when applicable, value impaired (net of adjusted transfer-risk reserve). It is appropriate to comment on weighted classified assets on the "Analysis of Financial Factors" core page 3.

Noncurrent loans and leases refers to the end-of-period dollar amount of loans and lease-financing receivables past due 90 days or more and still accruing, plus those carried in nonaccrual status, as reported for each loan category. This report page should not be included in the core section of the report for one-bank holding companies. For those bank holding companies, the examiner will include the classifications on the "Parent Company and Nonbank Assets Subject to Classification" and the "Bank Subsidiaries" report pages when assets are classified or written up as required.

The examiner should make certain that the aggregate classifications and reserve amounts agree with those reported for the parent, the banking subsidiaries, and the nonbank subsidiaries on the "Parent Company and Nonbank Assets Subject to Classification" and the "Classified Assets and Capital Ratios of Subsidiary Banks" pages or workpapers. If classifications are discussed on the "Examiner's Comments and Matters Requiring Special Board Attention" page, the totals should be confirmed.

5010.10.1 CLASSIFICATION OF ASSETS

On May 7, 1979, the three federal banking agencies issued a joint statement announcing a "Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks." The statement includes definitions of the classification categories and specific information on classifying securities in bank examinations. The classification categories established are also applicable to classifying parent company and nonbank assets. Although the classification categories for bank and nonbank assets are the same, the classification standards generally are not applied to classifying a bank's nonbank assets due to the difference in risk characteristics of the assets. Despite the differences that may exist between bank and nonbank assets, the standards for classifying investment securities can be applied directly to securities held by the parent company. The statement revised bank examination procedures established in 1938 and revised July 15, 1949. Classification units are designated as substandard, doubtful, and loss.

5010.10.1.1 Substandard Assets

A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or 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 bank will sustain some loss if the deficiencies are not corrected.

5010.10.1.1.1 Substandard Classification—Guidelines for an Asset When a Substantial Portion Has Been Charged Off

In some cases, credit-extending subsidiaries with loans to financially troubled borrowers have charged off substantial portions of these credits. Consistent with long-standing supervisory practice, the evaluation of each extension of credit should be based on the fundamentals of the particular credit. That is, the evaluation of each credit should be based on the borrower's (or the collateral's) current and stabilized cash flow, earning and debt-service capacity, financial performance, net worth, guarantees, and future prospects and on other factors relevant to the borrower's ability to service and retire its debt.

Based on consideration of all of the above relevant financial factors, this evaluation may indicate that a credit has well-defined weaknesses that jeopardize repayment in full but that a portion of the loan may be reasonably assured of repayment. When a charge-off has been taken in a sufficient amount so that the remaining recorded balance of the loan is being serviced (based on reliable sources of cash flow) and is reasonably assured of repayment, this remaining recorded balance would generally be classified no more severely than substandard.[1] Consistent with long-standing classification guidelines, a substandard classification of the remaining recorded balance would only be appropriate when well-defined weaknesses continue to be present in the credit. For example, when the remaining recorded balance of an asset is secured by readily marketable collateral, the portion that is secured by this collateral would generally not be classified. (See SR-91-18.)

This approach would generally be appropriate when an organization maintains sufficient controls over its lending function and maintains adequate current documentation to support the credit analysis of the loan. This classification approach could not be used for loans for which the loss exposure cannot be reasonably determined, e.g., loans collateralized by properties subject to environmental hazards. This approach would also not be justified when sources of repayment are considered unreliable.

5010.10.1.2 Doubtful Assets

An asset classified doubtful has all the weaknesses inherent in one classified substandard. However, it has 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.

5010.10.1.3 Loss Assets

Assets 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 asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. Fifty percent of the total of doubtful and all of loss will be deducted in computing the net sound capital of the bank. Amounts classified loss should be promptly charged off.

1. The accrual/nonaccrual status of the loan must continue to be determined in accordance with the glossary to the current call report or bank holding company reporting instructions. Thus, while these partially charged-off loans may qualify for nonaccrual treatment, cash-basis recognition of income will be appropriate when the criteria specified in the report guidance is met.

5010.10.2 APPRAISAL OF SECURITIES IN BANK EXAMINATIONS

Investment-quality 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 grades and unrated securities of equivalent quality. Neither market appreciation nor depreciation in these securities will be taken into account in figuring net sound capital of the bank. This policy is intended to apply to recognized sound investment practices of banks and not to those situations in which the portfolio requires special treatment by a supervisory agency.

Sub-investment-quality securities are those in which the investment characteristics are distinctly or predominantly speculative. This group generally includes securities in grades below the four highest grades and unrated securities of equivalent quality, defaulted securities, and sub-investment-quality stocks.

Securities in grades below the four highest rating grades and unrated securities of equivalent value will be valued at market price (fair value) and the depreciation will be classified doubtful; remaining book value will be classified substandard. Depreciation in defaulted securities and sub-investment-quality stocks will generally be classified loss; remaining book value will be classified substandard.

An exception to the above will be made in the case of municipal general obligations that are backed by the credit and taxing power of the issuer. The entire book value of sub-investment-quality municipal general obligations, which are not in default, will be classified substandard. In the event of a default of a municipal general obligation, a period of time is usually necessary to permit the market for these defaulted securities to stabilize or for the issuer to put in place budgetary, tax, or other actions that may eliminate the default or otherwise improve the post-default value of the securities. The market for the defaulted securities will be periodically reviewed by the regulatory authorities. Upon a determination that a functioning market has been reestablished, depreciation on defaulted municipal general obligations will be classified as loss. During such interim, the book value of all defaulted municipal general obligation securities will be classified doubtful. (The above exceptions will not apply in those instances where the supervisory authorities determine that there is no likelihood that the municipality will be able ultimately to repay or satisfactorily restructure its obligations.)

5010.10.3 1979 REVISION TO THE 1938 ACCORD

Type of Security	Security Classifications		
	Substandard	Doubtful	Loss
Investment-quality	XXX	XXX	XXX
Sub-investment-quality, except	Market value (fair value)	Market depreciation	XXX
Sub-investment-quality, municipal general obligations	Book value	XXX	XXX
Defaulted securities and sub-investment-quality stocks, except	Market value (fair value)	XXX	Market depreciation
Defaulted municipal general obligations:			
Interim	XXX	Book value	XXX
Final, i.e., when market is reestablished	Market value (fair value)	XXX	Market depreciation

This Core report page is to present the consolidated balance sheet as of the financial statement date, the comparable date for the previous year, and the last two fiscal year-end statements. When the inspection is conducted at fiscal year-end, only two fiscal year-end statements need be presented. The comparative statement allows the reader to analyze any changes in asset, liability, and capital structure and to determine the condition of the consolidated organization on the specified dates.

The financial statements should be requested in the officer's questionnaire. Fiscal financial statements can also be obtained from the FR Y-6, FR Y-9, the SEC Form 10-K, and published reports to shareholders.

The balance sheets should be presented in columnar form with the current interim first, prior interim period, current fiscal and prior fiscal. They may be formatted like the FR Y-9.

In preparing the comparative balance sheet, the following should be done.

1. Gross loans should be shown and then netted of unearned discount and reserve for loan losses.

2. Federal funds sold and securities purchased under resale agreements may be shown as one amount or separately, depending on how the company prepares its statements. Similar treatment should be given to federal funds purchased and securities sold under repurchase agreements on the liability side.

3. Total deposits should be broken down or footnoted to show interest-bearing and noninterest-bearing deposits in domestic and foreign offices.

4. Mandatory convertible debt instruments should be shown separate from subordinated capital notes and debentures and detailed on the ''Liquidity and Debt Information'' Confidential Page ''C.''

5. Stockholder's equity should be detailed using the following categories, as applicable: common stock, perpetual preferred stock, capital surplus, retained earnings (undivided profits), and reserves for contingencies and other capital reserves.

The amount of total consolidated debt should agree with unaffiliated debt for the current period on the ''Liquidity and Debt Information'' Confidential page ''C.'' Any exceptions should be footnoted.

Equity capital should agree with the individual components shown on the ''Statement of Changes in Stockholders' Equity (Parent)'' page for the respective periods and with stockholders' equity on the ''Parent Company Comparative Balance Sheet'' Core page 5. Any exceptions should be footnoted.

Figures used in the analysis on the ''Analysis of Financial Factors'' Core page 3 and the ''Capital Structure (Consolidated)'' pages should agree with this statement.

This report page is to present a *consolidated* statement of income and expense as of the financial statement date, the comparable date for the previous year, and the last two fiscal year-end statements. When the inspection is conducted at fiscal year-end, only two fiscal year-end income and expense statements need be presented. The statement aids the reader in an analysis of corporate earnings performance on a consolidated basis and provides the ability to further analyze changes in income and expense accounts from one period to another.

Statements of income and expenses should be requested in the officer's questionnaire. Statements for fiscal periods can also be obtained from the FR Y-6, FR Y-9, the SEC Form 10-K and published reports to stockholders.

The statement of income and expenses should be presented in columnar form with the current interim first, prior interim period, current fiscal, and prior fiscal. They may be formatted like the FR Y-9.

Any detail available that breaks down ''interest income'' for the most recent fiscal year into components should be presented either on the statement as a footnote or on a supplemental page, the ''Comparative Statement of Income and Expenses (Consolidated)'' page, if considered appropriate by the examiner.

Provisions for loan losses should be shown as a line item and not grouped in ''other expenses.'' ''Other income'' and ''other expenses'' should be broken down to provide additional detail at the discretion of the examiner.

Net income should normally agree with net income of the parent on the ''Comparative Statement of Income and Expenses (Parent)'' page and the ''Statement of Changes in Stockholders' Equity (Parent)'' page. Footnote differences.

The risk-based capital guidelines apply on a consolidated basis to bank holding companies with consolidated assets of $150 million or more. For these BHCs, the designated FR 1225 report page will be used. For BHCs with consolidated assets of less than $150 million, the risk-based capital guidelines apply on a bank-only basis unless (a) the parent holding company is engaged in nonbank activity involving significant leverage (e.g. engaged in significant off-balance sheet activity); or (b) the parent company has a significant amount of outstanding debt that is held by the general public. For BHC with total assets of less than $150 million the Capital Structure (FR 1241) report page is used.

5010.13.1 BHCS WITH CONSOLIDATED ASSETS OF $150 MILLION OR MORE—[CORE PAGE 10—CONSOLIDATED CAPITAL STRUCTURE (FR 1225)]

The consolidated capital structure report page summarizes the various components of the BHC risk-based capital ratios. Two report pages are provided to allow for risk-based capital computations during transition and at year-end 1992 for final implementation. The pages provide the various limitations for the respective components of Tier 1 and Tier 2 capital. For both report pages, the first page summarizes ‘‘Total Qualifying Capital’’ comprised of Tier 1 and Tier 2 capital, adjusted for investments in unconsolidated financing subsidiaries and reciprocal holdings of capital.

Tier 1 capital consists of permanent core capital elements (common equity, noncumulative perpetual preferred stock, a limited amount of cumulative perpetual preferred stock, and minority interest in the equity of consolidated subsidiaries). Tier 1 capital is derived by subtracting goodwill from the sum of Tier 1 capital elements.

Tier 2 capital consists of: (a) a limited amount of the allowance for loan and lease losses; (b) auction rate perpetual preferred stock plus any cumulative perpetual preferred stock exceeding its Tier 1 limitation; (c) perpetual debt, mandatory convertible securities, and other hybrid capital instruments; (d) long-term perpetual preferred stock; and (e) limited amounts of term subordinated debt, intermediate-term preferred stock, and unsecured long-term debt issued prior to March 12, 1988.

For Tier 2 capital, the amount of mandatory convertible securities that have the proceeds of common or perpetual preferred stock dedicated to retire or redeem them should be treated as term subordinated debt subject to the established limit of 50 percent of Tier 1 capital. Mandatory convertible securities, net of the perpetual preferred or common stock dedicated to redeem or retire the issues, are included within Tier 2 on an unlimited basis. Tier 2 capital may not exceed Tier 1 capital.

Investments in unconsolidated financial subsidiaries and reciprocal holdings of capital are subtracted from the combined total of Tier 1 and Tier 2 capital to determine the amount of total qualifying capital.

Core page 10–1 provides a summary of risk weighted on- and off-balance sheet assets, adjusted (reduced) for the excess of the allowance for loan and lease losses not included in Tier 2 capital and the allocated transfer risk reserve (ATRR). In addition, it provides a comparative peer and historical summary of risk-based capital ratios, growth rates, and dividend payout ratios.

Core page 10–2 provides a summary comments section to discuss any pertinent aspects of the institution’s capital structure not evident from the schedule.

The information on the capital structure page will give support to the examiner’s evaluation of the bank holding company’s capital adequacy. The most convenient method to obtain the information is to request it in the officer’s questionnaire, or through direct contact with the accounting department.

The amounts on the risk-based capital schedules should be shown as of the same date as the ‘‘Consolidated Comparative Balance Sheet’’ of the inspection report. Refer to the Risk-based Capital Guidelines in Appendix A of Regulation Y and Manual sections 4060.3 and 4060.4 for a discussion of the Capital Adequacy Guidelines and the minimum risk-based capital and leverage ratios for BHCs.

Use the instructions and guidance found on the report page and worksheets. When completing the supplementary capital section, insert the aggregate amount of each component in the space provided. If more than one issue of a particular Tier 2 capital component is outstanding, a range of rates should be shown in the appropriate space, giving the lowest and the highest rates paid.

Comments under the Risk-based Capital schedule should include:

- Any unusual terms and conditions relating to issues of supplementary capital that the examiner feels should be mentioned;
- An indication of whether a subsidiary bank's equity represents the proceeds from the issuance of parent debt (double leverage);
- A presentation or description of risk-based capital components for statutory purposes if there is a violation for which the statutory definition is relevant.
- A situation whereby the levels of risk warrant significantly higher risk-based capital ratios than the minimums.

The amounts of Tier 1 and Tier 2 used in this analysis of consolidated risk-based capital on the ''Analysis of Financial Factors'' page should be consistent with the amounts on this page.

5010.13.2 WORKSHEETS

In addition to the report pages, BHC Risk-Based Capital Calculation Worksheets have been developed for examiner use with year-end 1992 final implementation. The worksheets are to be retained with the examiner's workpapers. If the bhc generated data was validated by the examiner and accepted to support or partially substitute for the computation of the elements, it should also be retained with the worksheets. The worksheets provide more detail as to the composition of core capital elements and supplementary capital elements. In addition, the footnotes provide more detailed explanations of the various components than are found on the actual report pages.

5010.13.3 BHCS WITH LESS THAN $150 MILLION IN CONSOLIDATED ASSETS—[PAGE—CAPITAL STRUCTURE (LEAD BANK OR OTHER BANK SUBSIDIARY (FR 1241)]

The FR 1241 report page is used primarily for the lead bank. Report pages have been developed for year-end 1992 final implementation. The report pages are nearly identical to those used for state member bank examinations (FR 1460). If there is no one lead bank, the report pages should be prepared for each comparable lead bank.

This report page provides a summary of the policies formulated by the board of directors by which active management supervises holding company operations. The objective is to determine whether there are adequate formal policies developed and supervised, either directly through the board of directors, or by a delegation of the authority, for the parent company and its subsidiaries. Another objective is to evaluate management's performance in carrying out those policies for the entire organization. These policies aid in giving insight into the operations of the holding company. The policies should ensure that all statutory and regulatory requirements are met and that proper controls (management information systems) are in place to minimize risk. Examiners should encourage BHCs to develop formal written policies on all items presented.

The report page is to provide an analysis of the adequacy of supervision exercised by the holding company over its subsidiaries, and policies concerning intercompany relationships. Also included is a discussion of deficiencies in the policy-making process, any noncompliance with existing policies, and the plans for correcting any deficiencies.

In the officer's questionnaire, the examiner may request some of the information pertaining to policies. Insight into policies may also be gained by reviewing the holding company's annual reports to stockholders and through discussions with management. If the holding company does not have any formal written policies, the organization's operating procedures should be discussed with officers responsible for the various areas.

Compliance with policies may be determined by reviewing recent internal and external audit reports, recent bank examinations, and discussions with management at the subsidiary level, and by conducting tests to determine the extent of compliance with policies. Discussions with management are necessary to obtain a thorough understanding of management and supervisory practices, policy-development techniques, the degree to which management information is utilized to monitor subsidiaries, and overall management philosophy.

The policies should be summarized as succinctly as possible in narrative form. If the holding company has no formal policies the examiner may use an introductory statement indicating that comments were derived from discussions with senior management. Absence of any formal policies may require the examiner to make a recommendation on the "Examiner's Comments" Core page 1 that the holding company strongly consider the establishment of formal written policies in order to supervise its subsidiaries more effectively.

This report page should address existing policies and the level of control and supervision exercised over subsidiaries. How effectively policies are carried out should be shown in the respective sections of the report. Where policies result in violations of law or regulation, comments should be made on the "Examiner's Comments" Core page 1 and detailed on the "Violations" page. If any policy is considered inconsistent with safe and sound banking practices, the matter should be presented on Core page 1 and detailed elsewhere in the report.

Comments on policies that are on other pages in the report should be consistent with this report page. Those comments and report pages are:

1. Dividends and fees from subsidiaries—on the "Statement of Changes in Stockholder's Equity," "Income from Subsidiaries," and the "Cash Flow Statement (Parent)" pages.
2. Dividends paid to shareholders—on the "Statement of Changes in Stockholder's Equity," and the "Cash Flow Statement (Parent)."
3. Budgeting and tax planning—on the "Other Supervisory Issues" page.
4. Internal audit—on the "Audit Program" page.
5. Insider transactions—on the "Extensions of Credit to BHC Officials" page.

5010.14.1 QUESTIONS TO BE ADDRESSED ON THE POLICIES AND SUPERVISION REPORT PAGE

5010.14.1.1 Level of Control and Supervision Exercised over Subsidiaries

1. Do subsidiaries operate autonomously? What is the degree of overlap between BHC and bank management?
2. Who sets major policies of the corporation?
3. How does the holding company monitor the operations of its subsidiaries (reports, directors, etc.)?
4. Are the subsidiaries involved in formulating the holding company's budget and tax plan-

ning? How is the holding company's budget developed and at what corporate level is income tax planning coordinated?

5. Describe the intermediate and long-term strategic planning process and whether the subsidiaries are integrated into a consolidated planning process. Does the consolidated plan include the minimum elements discussed in section 2010.4 of this manual? Is the plan effective and is it consistently applied?

6. How is the internal audit of subsidiaries performed?

- Does an audit team audit each subsidiary on a periodic basis?
- What is the frequency of the audit cycle?
- To whom does the audit department report?
- Is there an audit committee of directors?

7. Is the control and supervision of subsidiaries deficient?

5010.14.1.2 Loans and Investments of Subsidiaries (See sections 2010.2 and 2010.3.)

1. Does the parent company's policies address the minimum elements of a lending policy as listed and described in section 2010.2 of this manual?

2. Does each subsidiary have its own loan policy or does the holding company establish policy for all subsidiaries? Are lending policies considered adequate and is there general compliance?

3. Does each subsidiary handle its own investment portfolio or are investments managed at the holding company level? Are investment policies adequate and is there general compliance? Are investment-authorization procedures adequately detailed to prevent circumvention of investment-policy directives?

4. Does the holding company have a credit review team or is credit review handled by each subsidiary?

5. Does the BHC have a policy establishing limits on consolidated concentrations of credit?

5010.14.1.3 Funds Management and the Adequacy of Existing Policies (See section 2010.1.)

1. Does the parent-company management have policies in place to prevent funding practices that put at risk the welfare of the subsidiary banks or the consolidated organization?

2. Does the parent company maintain for itself and its subsidiaries policies that provide guidance and controls for funding practices?

3. To what extent do the subsidiaries follow the funding policies and how effective are they in reducing risk to the entire organization?

4. At a minimum, do the parent company's funding policies address:

a. Capitalization levels for bank subsidiaries, the nonbank subsidiaries, and the consolidated organization as to whether the policy for:

- Bank and consolidated capital are consistent with the Board's capital adequacy guidelines;
- Nonbank capital includes maintaining the capital level at industry standards;
- The holding company specifies the desired range of capital for each entity, and the measures that should be taken in the event that capital falls below that level;
- The parent company specifies the degree of double leverage that it is willing to accept;
- Each entity specifies the method for calculating dividends?

b. Asset/liability management including interest rate sensitivity matching, maturity matching, and the use of interest rate futures and forwards and other financial derivative instruments?

c. How nonbank subsidiaries fund their activities?

5010.14.1.4 Loan Participations Among Subsidiaries (See sections 2010.2 and 2020.2.)

1. Under what circumstances are loans participated?

2. Who determines the type of loans that may be participated? Does the BHC have policies in that regard? Are credit standards included in the lending policy for purchased loan participations and does the policy require complete loan documentation.

3. Does the lending policy place limits on the amount of loans purchased from any one source and does it place an aggregate limit on such loans?

4. Are low-quality loans allowed to be participated?

5010.14.1.5 Dividends and Fees From Subsidiaries

1. What is the policy for assessing dividends from subsidiaries?
2. Does the policy take into account statutory and regulatory restrictions on bank dividends as well as subsidiary asset quality, earnings, the ability to service debt and growth prospects?
3. What is the policy for determining fees charged to subsidiaries in relation to management and other services rendered?
4. Are service fee arrangements supported by contracts and are the subsidiaries actually receiving the services?
5. Are the fees charged to subsidiaries reasonable and justifiable in relation to the fair market value of the services provided? If no market exists for the services provided, are fees based on their cost plus a reasonable profit? Has the BHC directly or indirectly through other subsidiaries burdened its banking subsidiaries with excessive fees or unreimbursed charges to fund its debt service, dividend payments or support of other subsidiaries?

5010.14.1.6 Risk Evaluation and Control

1. Has the bank holding company formalized policies and procedures in identifying, evaluating, and controlling risk?
2. What has management done to limit its risk exposure in relationship to the amount of the organization's capital, or earnings?
3. Do audit procedures include a determination as to whether management's risk evaluation and control procedures are being followed as prescribed?
4. Has the bank holding company taken steps to identify and control its exposure to losses resulting from contingent liabilities and off-balance sheet activities such as standby letters of credit, interest rate swaps, foreign exchange contracts, currency swaps, options, securities lending and borrowing, insider transactions, and commitments to lend?

5010.14.1.7 Management Information Systems

1. How effective and timely are the parent company's policies and procedures with respect to its management information systems as to:
    - Audit
    - Budget
    - Reporting
    - Insurance
2. Does the board of directors receive sufficient information about key areas of its operations?

5010.14.1.8 Internal Loan Review

1. Is an internal loan review program in existence for bank and/or nonbank subsidiaries? If no program exists, does the size and complexity of the organization warrant implementation of a formal process?
2. Will the internal loan review procedures adequately identify deteriorations in credits, loans that do not comply with written loan policies and loans with technical exceptions in a timely manner?
3. Is the loan review function independent of the loan approval function, with written findings reported to a board committee or senior management committee not directly involved in lending?
4. Are the quality and size of the internal loan review staff sufficient in relation to the organization's size and complexity?
5. Are the scope and frequency of the loan review procedures adequate?

5010.14.2 DISCUSSION AND APPRAISAL OF OTHER PARENT COMPANY POLICIES

Another parent company policy that should be discussed and appraised, in addition to those listed on the ''Policies and Supervision'' page is the Consolidated Planning Process whereby the subsidiaries are integrated into a consolidated plan. See Manual section 2010.4.

This report page is used to present information on all violations discussed in the inspection report. The objective of the report page is to bring violations to the attention of the board of directors for corrective action and to alert the supervisory agencies to the need for supervisory attention.

The information reported should center on violations by the holding company uncovered during the course of the inspection and those that are discovered through a review of reports filed with supervisory authorities. Information on violations by the subsidiary bank(s) in its dealings with the holding company or affiliates may be obtained from the most recent bank examination reports or uncovered during the holding company inspection.

This page should include all BHC and nonbank subsidiary violations of the Act, Regulation Y, Section 23A and 23B violations of the Federal Reserve Act, and other applicable statutes and regulations. A complete write-up is necessary if the violation is not detailed on another page (including the date of the violation or transaction, a description of the transaction or act, the reason for the violation, the amount of the transaction, and the amount of any potential or actual loss). When the information is presented elsewhere, a brief summary and a reference to that page is sufficient.

Violations of the holding company should be presented first, followed by the nonbank subsidiaries and then bank subsidiaries. Bank violations not involving the holding company or nonbank subsidiaries should not be detailed here.

If violations of sections 23A and 23B of the Federal Reserve Act (transactions with holding company affiliates) are disclosed in a subsidiary bank's examination report or during the inspection of the holding company, comments should be limited to a brief summary on the ''Violations'' page with a reference to the intercompany transaction(s) on the ''Other Supervisory Issues'' page. This latter page will contain additional detail on the violation. (Note: only bank subsidiaries can be cited for the violations of sections 23A and 23B of the Federal Reserve Act although the violation may have resulted from holding company actions). The examiner may also criticize management on the ''Examiner's Comments'' Core page 1 of the inspection report for causing the bank to be in violation of sections 23A and 23B provisions.

Apparent violations should be presented on the ''Other Matters'' page, and may be presented on the ''Examiner's Comments'' page if considered appropriate by the examiner. Violations will be reviewed on a case by case basis for possible follow-up administrative action(s).

Violations must be presented in brief on the ''Examiner's Comments'' page referring the reader elsewhere for detail. The examiner should ensure that information contained on these related pages is consistent.

This page presents nonconfidential information or issues which would not be suitable for presentation on any other page in the report. BHC plans may be discussed here in order to anticipate any regulatory or supervisory considerations. *Apparent* violations are also presented here and may be referred to on ''Examiner's Comments'' page or on other report pages at the examiner's discretion. BHC plans for future activities may be presented.

The information might be derived from minutes of the corporation and/or subsidiaries, discussions with management, and examiner observations during the inspection.

Other information that may be summarized can include:

1. Corporate plans (debt or equity issues, acquisitions, sale of assets). Be certain management has no objection to the reference to these plans. Otherwise, present such information on page C;
2. Any unfunded pension liabilities;
3. Overall condition of corporate records; and
4. Any other comments deemed appropriate by the examiner and not noted elsewhere in the report.

Any reference that involves dollar amounts, ratios, or other information contained in schedules or comments elsewhere in the report should be cross-checked.

Procedures for Inspection Report Preparation (Page—Classified Assets and Capital Ratios of Subsidiary Banks) Section 5010.17

This report page provides a summary of asset classifications and capital ratios as of the most recent federal and state examinations for the individual bank subsidiaries. The objective of the page is to aid in the identification of existing or potential problems in the banks which may have an overall effect on the holding company.

The information is to be derived from bank examination reports which are available at the Reserve Bank. (The holding company may have copies of the open sections of the reports.)

The banks are to be listed in the same order as they appear on the Organization Chart or Investments in and Advances to Subsidiaries report pages. Total assets or total average assets should be shown as presented in the examination report. Do not adjust total assets by adding back valuation reserves.

For bank holding companies, tier 1 capital includes common equity and qualifying cumulative and noncumulative perpetual preferred stock, less goodwill and other designated intangible assets. Common stockholders equity includes common stock; related surplus; and retained earnings, including capital reserves and adjustments for the cumulative effect of foreign-currency translation, net of any treasury stock, less net unrealized holding losses on available-for-sale equity securities with readily determinable fair values.

Qualifying cumulative perpetual preferred stock is limited within tier 1 to 25 percent of the common stockholders equity and minority interest. Total capital includes tier 1 plus tier 2 capital.

Weighted classified assets includes 100 percent of loss, 50 percent of doubtful, and 20 percent of substandard and value-impaired (when applicable), net of allocated transfer risk reserves (ATRR).[1] It is appropriate to comment on weighted classified assets on the Analysis of Financial Factors page.

When determining supervisory asset-quality ratings (the [A]sset rating in ‘‘CAMELS’’) for the BHC’s subsidiary banks, an asset-quality ratio is used based on a comparison of weighted classified assets to tier 1 capital (as defined for leverage purposes) plus the allowance for loan and lease losses. Examiners should use this ratio and the accompanying benchmarks in conjunction with all the other factors normally evaluated when assessing asset quality for each institution.

The allowance for loan and lease losses is defined as the bank’s total ALLL. The ALLL is *not* subject to the 1.25 percent limitation on supplementary capital elements for this calculation (that is, all of the ALLL is included in the denominator of the ratio).

The ratio of these assets to tier 1 capital plus the allowance for loan and lease losses is then compared to the existing asset-quality benchmark table to determine the asset-quality rating.

Asset-Quality Table

Asset-Rating Ranges	*Asset-Quality Ratio*
1	under 5%
2	5% to 15%
3	15% to 30%
4	30% to 50%
5	over 50%

Examiners should use the asset-quality table and other pertinent factors, including loan policies, credit administration, portfolio concentrations, and past-due levels, to determine the final asset-quality rating. While individual bank ratios may change slightly, depending on the amount of cumulative preferred stock, mandatory convertible debt, and other supplementary elements, the change in the ratio itself should not result in a change in the bank’s asset-quality rating.

This page should not be prepared for one-bank holding companies. The examiner may show this data on the Bank Subsidiaries page. However, the examiner may use this page to reflect successive examination data for several years to indicate trends. The examination dates should be cross-checked to those shown on the Bank Subsidiaries page.

1. See SR-92-2 regarding the treatment of value-impaired classifications for asset-quality purposes.

Procedures for Inspection Report Preparation (Page—Organization Chart) Section 5010.18

This report page presents an organization chart, giving a schematic description of the structure of the organization, the intercompany relationships and the degree of control of subsidiaries.

An organization chart provided by the holding company for various regulatory filings may be used, with revisions made for new or divested subsidiaries. The information required below may simply be added to the existing chart.

The organization chart may be pictorial (box format) or linear (listing format). The parent should be presented at the head of the page. Banks should be presented individually in the same area. Nonbanks should be presented individually in the same area (if possible).

Each subsidiary should be shown by its official name; however, there is no need to indicate the address unless necessary to distinguish identity. Subsidiaries of banks and second tier nonbank subsidiaries may be omitted or shown at the examiner's discretion. Abbreviated charts should be so footnoted.

Abbreviations used throughout the report should be presented on the ''Structure and Abbreviations'' Report page and also on the bottom of this page or following the chart. Generally, abbreviations familiar to the BHC should be used. However, efforts should be made to incorporate at least a part of the name into the abbreviation as opposed to relying strictly on initials which tend to become confusing. Also, it is desirable that abbreviations of bank subsidiaries include the word ''Bank'' to distinguish them from the parent company and/or nonbank subsidiaries with similar names.

Indicate the percentage of ownership to the nearest tenth of one percent and include directors' qualifying shares. Where all, or nearly all of the subsidiaries are wholly-owned, detail the exceptions and provide a footnote to the effect that unless shown, ownership is 100 percent.

The names and/or abbreviations shown on the organization chart are to be consistently used throughout the report (for example, the ''Income from Subsidiaries,'' ''Investment in and Advances to Subsidiaries,'' and the ''Nonbank Subsidiary'' and the ''Bank Subsidiary'' pages).

Where applicable, the order established on this page should be used in all tables of the report.

The report page provides an abbreviated history of the organization including name changes, acquisitions, mergers, reorganizations and divestitures. The objective is:

1. To present the chronological development of the bank holding company.
2. To list nonbank activities engaged in by the parent company and its subsidiaries.
3. To provide a measure of size relative to competing institutions.

The information that is included in this report page may be obtained from documents filed with the Federal Reserve System. For lines 1 through 3, refer to reports filed with the FRB such as the registration statement and FR Y–6. In response to item 3, one bank holding companies formed before December 31, 1970, first became subject to the Act on December 31, 1970, with the passage of the 1970 Amendments to the Act. A multibank company formed between 1956 and December 31, 1970, became subject to the Act on the date of controlling its second subsidiary bank. All BHCs formed after December 31, 1970, became subject to the Act on the date of controlling their first bank subsidiary. For response to item 4, history is available in applications to FRB and in public documents such as annual reports to stockholders and SEC Form 10-K. For additional information contact the corporate secretary.

Comments responding to item 4 are to be in narrative and/or list form and should include:

1. The present number of banking subsidiaries, the percent of State deposits on an aggregate basis and size ranking in the State. For a money-center holding company, also provide its ranking on a national basis.
2. The date and outline of any acquisitions, mergers, reorganizations, or name changes.
3. A list and brief description of activities in which the nonbanking subsidiaries are engaged.
4. A discussion of any permanent or limited grandfather rights, and any plans for divestment of shares or termination of nonbank activities.

The activities shown on this page should be consistent with those shown on the nonbank subsidiary pages.

5010.20.1 INVESTMENT IN AND ADVANCES TO SUBSIDIARIES

This schedule details the parent's financial relationships with its subsidiaries. It will be used to support comments or analyses in other sections of the report, or to clarify answers to the questions on the continued page, ''Investment In etc.—continued.''

The objectives of the report page are:

1. To determine the percent of the parent's assets comprised of investments in and advances to each subsidiary.
2. To help determine the dependency of subsidiaries on advances from parent.

The parent's investments in and advances to each subsidiary are usually detailed in ledgers maintained by the accounting department. Each subsidiary is listed individually beginning with banks, providing subtotals for banks and nonbanking subsidiaries.

The investment in each subsidiary is to include any related unamortized goodwill. Provide a ''total'' in the ''investment'' column. From this total subtract the aggregate unamortized goodwill in all subsidiaries and detail the ''goodwill'' on the ''Contingent Liabilities'' page.

Totals for investments and advances should agree with the ''Comparative Balance Sheet'' page. The Parent's investment should be equal to its proportionate interest in each subsidiary's equity as presented in financial statements on the ''Nonbank Subsidiary Financial Statement and Condition'' and the ''Bank Subsidiaries'' pages plus any unamortized goodwill. Parent's advances should also equal ''loans from parent'' as detailed on the ''Nonbank Subsidiary Financial Statement and Condition'' and the ''Bank Subsidiaries'' pages.

5010.20.2 INVESTMENT IN AND ADVANCES TO SUBSIDIARIES (continued)

For this continuation page, the answers to questions 1 through 6 provide information on the funding of subsidiaries.

The objectives of each question are as follows:

Question 1—To determine the amount of goodwill in the investment in each subsidiary.

Question 2—To determine if the parent ''forgave'' the indebtedness of any of its subsidiaries which might indicate an inability to service its debt properly or other financial difficulties in the subsidiary.

Question 3—To determine the extent of the parent's borrowings invested as equity since the last inspection. The subsidiary's enlarged capital base might provide additional debt capacity.

Question 4—To determine if the advances are on a preferential rate basis, to help in analyzing the subsidiary's earnings proficiency.

Question 5—To determine if there is any difficulty in the subsidiary regarding its ability to service its debt properly.

Question 6—To determine if the parent lends its credit and debt capacity to its subsidiary and to aid in the analysis of the parent's contingent liabilities.

The answers to all questions should be verified against company records and discussed with the comptroller, the treasurer or the finance officer. Details on some questions can come from company's latest SEC Form 10-K or the annual report to stockholders. All questions should be answered; if not applicable, so state. It is not necessary to repeat the question when answering.

Any guarantees should also be included as contingent liabilities.

Commercial paper is a source of funds for the parent and its subsidiaries. This schedule presents the maturity and placement of commercial paper in use in the parent's operations and/or for back-up to the commercial paper. The page is required if the parent issues commercial paper.

The objectives of this report page are:

1. To summarize the extent of the parent's use of commercial paper and its ability to continue the use of this funding tool.
2. To help determine the overall liquidity position of the parent company.
3. To determine the volatility of commercial paper issued, including average turnover rate.
4. To determine whether any subsidiary bank is providing compensating balances for the benefit of the parent or nonbank affiliate.

The information required in the schedule should be requested in the officer's questionnaire or can be obtained from the accounting or treasurer's departments and verified with the general ledger. If at all possible, the data should be as of the financial statement date. (An alternate date is acceptable for the Maturity Schedule but should be specified.) The schedule should also be prepared for each nonbanking subsidiary which issues its own commercial paper.

The total commercial paper should equal amounts on ''Parent Company Comparative Balance Sheet'' (Core Page 5) and the confidential ''Liquidity and Debt Information'' page C, unless an alternate date is used.

Lines of credit are a source of funds for the parent and its subsidiaries. This schedule presents the lines of credit available for the parent's operations and/or for back-up to commercial paper.

The purpose of the report page is to be able to determine the degree of use of the lines of credit and the availability of these lines to back-up commercial paper borrowings. It is also intended to help determine the overall liquidity position of the parent company.

The information required in the schedule should be requested in the officer's questionnaire or can be obtained from the accounting or treasurer's departments and verified with the general ledger. If at all possible, the data should be as of the financial statement date.

The exact names and locations of line banks should be shown in the ''Lines of Credit'' section and totals calculated for the dollar amount columns. If a BHC has an extensive number of line banks, the detail for each line of credit may be eliminated at the discretion of the examiner with aggregate amounts and ranges included in the appropriate columns. In this instance, the total number of line banks involved and a general comment as to geographic distribution should be included.

If any subsidiary bank maintains compensating balances on behalf of the parent, the examiner should place an asterisk in the column and determine that the bank is compensated so that it does not incur a loss of income. Any resulting loss of income should be commented upon. See Manual sections 2020.4 and 2080.1.

The total lines of credit in use should equal amounts reported on ''Parent Company Comparative Balance Sheet'' (Core page 5) and the confidential ''Liquidity and Debt Information'' page C.

The answers to questions 1 through 13 should provide information about the quality of the commercial paper and the procedures for its issuance. They should also discuss funding involving the issuance of commercial paper backed by lines of credit. Examiners should refer to sections 2080.05 and 2080.1 before completing this report page.

The purpose of the report page is—

1. to determine the quality of commercial paper and to appraise the company's ability to raise additional funds in the marketplace;
2. to determine how the proceeds from commercial paper sales will be used;
3. to decide whether the use of commercial paper is in keeping with statutory requirements and regulatory requirements such as those of the Securities and Exchange Commission (SEC);
4. to determine whether the use of commercial paper satisfies liquidity needs (see section 2080.1);
5. to determine if policies in the commercial-paper funding system are safe and sound;
6. to determine if backup sources of funds are available and adequate to meet the liquidity needs of the parent; and
7. to address the examiner's concerns about commercial paper policies, controls, and marketing methods.

The information needed to complete this report page is usually available from the holding company's investment or funds-management department. It may also be obtained through discussions held with management responsible for the holding company's funding program. The information may also be available from rating agencies and in contractual agreements with lending banks.

Question 1 asks for any changes in the commercial paper rating that may show a changing financial condition. See appendix A of this section, which lists rating indicators used by commercial paper rating companies. Determine the cause for any change in the rating.

Bank holding companies with lower credit ratings may issue commercial paper by obtaining credit enhancements. Such credit support may be obtained from letters of credit (LOC paper) or a surety bond issued by an insurance company having a high credit rating (called credit-supported commercial paper). Bank holding company commercial paper with a lower credit rating can also be backed by other high-quality assets serving as collateral (called asset-backed commercial paper), thus allowing the bank holding company to enter the market as an issuer. (See section 2128.03 for inspection guidance about such commercial paper enhancements.)

Question 1 further instructs the examiner to report the range of current rates paid on all commercial paper. By presenting the range of current rates paid on different maturities of commercial paper, the examiner can compare rates paid with those of the bank holding company's peers. This will aid in determining the "marketplace's" impression of the company's condition, as reflected by the rates the company must pay to attract funds.

The yields on commercial paper track those of other money market instruments. Like U.S. Treasury bills, a commercial paper instrument is a discount instrument. Because of exposure to credit risk, the yields on commercial paper are usually higher than those of U.S. Treasury bills. As in the case of Treasury bills, interest on commercial paper is computed on a 360-day year. Treasury bills, in contrast to commercial paper, are exempt from state and local taxes and are more liquid than commercial paper.

When responding to question 2, if any subsidiary sells commercial paper for its own use or for the parent, indicate why the bank holding company chooses to structure its funding in this way. For example, a commercial finance nonbank subsidiary of a bank holding company was authorized by the Board to underwrite (purchase) and deal in (resell or place with institutional investors) commercial paper as agent for the issuers (see section 3600.21.1). A section 20 subsidiary also can underwrite and deal in, or act as riskless principal in the placement of, commercial paper, if authorized by the Board by order.

A parent company could issue commercial paper directly or through a broker. The examiner therefore needs to be aware of the difference between direct paper and dealer paper. Direct paper is sold by the issuing firm directly to investors without using a securities dealer or an intermediary. Direct-paper issuers generally require continuous funds and therefore find it more cost-effective to establish their own sales force to sell their commercial paper directly to investors. In the case of *dealer-placed commer-*

cial paper, the issuer uses the services of a securities firm to sell its commercial paper.

If the subsidiary's name is similar to the parent's, note whether an investor can tell, by its name or through other means, that the issue is associated with the parent.

With regard to question 3, the commercial paper specimen should clearly state that it *is not* an FDIC-insured obligation of any bank subsidiary. (See section 2080.1.)

The minimum round lot in commercial paper transactions is usually $100,000, although some issuers sell commercial paper in denominations as low as $25,000. With regard to question 4, bank holding companies generally should not sell commercial paper in denominations of less than $25,000. This is to ensure that the commercial paper instrument is suitable for investment by sophisticated investors as opposed to the general public. Commercial paper investors are typically institutional investors.

Rollover of commercial paper proceeds on maturity is common. The SEC has stated that obligations that are payable on demand or have provisions for automatic rollover do not satisfy the nine-month (270 days) maturity standard. SEC staff, however, has issued no-action letters for commercial paper master-note agreements.[1] These agreements allow eligible investors to make daily purchases and withdrawals (subject to a $25,000 minimum) as long as the maturity of the note and each investor's interest therein do not exceed nine months. Such master-note agreements may allow prepayment by the issuer any time, or upon demand of the investor.

Commercial paper and commercial paper master-note agreements can result in a potential source of funding mismatch from the use of what is commonly called "deposit sweeps." This practice is based upon an agreement with a subsidiary bank's deposit customers (typically corporate accounts). Such agreements allow these customers to reinvest amounts in their deposit accounts above a designated level in overnight obligations of the parent bank holding company.

In view of the extremely short-term maturity of these sweep arrangements, banking organizations should be advised to exercise great care when investing the proceeds. Appropriate uses of the proceeds of such deposit-sweep arrangements are limited to short-term bank obligations, short-term U.S. government securities, or other highly liquid, readily marketable, investment-grade assets that can be disposed of with minimal loss of principal. (See also sections 2080.05 and 2080.1 when reviewing commercial paper activities.)

Concerning question 5, investing in the bank holding company's commercial paper by a subsidiary bank's trust department is generally regarded as self-dealing and a violation of trust regulations, absent express written authority and the consent of all of the trust's beneficiaries. Bank holding company examiners finding such trust department holdings should discuss the matter in detail with Reserve Bank trust examiners or the Board's Trust Activities Section, Division of Banking Supervision and Regulation.

In response to question 6, the examiner should indicate the use of the proceeds and whether such use is considered long-term or short-term. (See also sections 2080.05 and 2080.1.)

Question 7, on concentration of holdings, is intended to aid in determining if any party can exert influence on the bank holding company due to its commercial paper holdings. If any individual, organization, or industry holds more than 10 percent of the commercial paper, indicate if the holder(s) exerts any influence on the bank holding company's management.

In response to question 8, if there is any indication of difficulty in refinancing commercial paper at maturity, discuss this in significant detail. Indicate the reasons for the difficulty, the problems it poses for management, and management's plans to rectify those problems. This is a particularly sensitive issue because of the financial exposure that could be created by an inability to refinance.

1. A master note is a negotiated agreement or contract (negotiated as to size, maturity, and price) between a borrower and investor that permits the investor to place cash, up to a stated amount, with the borrower over a designated period of time. Such unsecured credit agreements (no note is actually issued, only an agreement is signed at the beginning of the arrangement) are limited to borrowers with the highest credit ratings and large investment institutions.

Master notes have characteristics similar to those of a revolving-credit arrangement. The outstanding amount allowed may vary daily but is limited by a stated cap imposed by the issuer. Investors in such agreements control the amount invested in the note on the basis of the amount of surplus cash that is on hand. Either party can terminate the agreement with only 24 hours' notice. In reality, it is a longer-term funding vehicle because the parties generally are interested in maintaining a long-term relationship.

Unlike commercial paper, master notes are indirectly accessible to a wider array of investors. Investment firms group investments from small investors with investments made by a few large institutional investors and place the funds in master notes. The master note, unlike commercial paper, avoids the task of writing daily individual tickets for each customer. Disadvantages of the master note are the potential for daily variation in the amount invested and the potential for sudden redemption.

Question 9 is intended to aid in determining the degree to which the bank holding company can rely on its line banks. Lines that have not been confirmed in writing or for which no contractual obligation exists are less certain to be available than those that are confirmed and contractual.

As question 10 implies, lines of credit are often specifically established solely to back up commercial paper borrowings. Such lines impart a measure of security to the bank holding company. Evaluate the adequacy of the total amount of these lines in relation to the volume of outstanding commercial paper.

In asking about systematic rotation, question 11 is intended to help the examiner determine if the bank holding company routinely uses the proceeds from a line of credit to pay off another, and whether the bank holding company has ever been in an aggregate nonborrowing position during a given year. If the bank holding company routinely and continuously relies on its ability to repay its lines with other line borrowings, discuss the potential effects on the bank holding company's ability to service its debt properly.

Question 12 asks for information on reciprocal lines that reveals the relationship between the lender and the bank holding company. A line's reciprocity may have a bearing on the degree to which the borrower may rely on the lender.

Question 13 is intended to help the examiner evaluate the relationship between the parent and its nonbank subsidiary. In those cases in which a subsidiary is authorized to borrow directly on the parent's lines, the examiner should evaluate the parent's internal controls and management information systems for supervising the subsidiary's borrowings.

5010.23.1 APPENDIX A—COMMERCIAL PAPER RATINGS

Rating Notations by Commercial Paper Rating Companies*
(Highest- to Lowest-Quality Rating)

Rating Company†			
Standard and Poor's	Moody's	Duff and Phelps	Fitch
Investment grade:			
A-1/A1+	Prime-1 (P-1)	Duff-1 (D 1–/1/1+)	F-1/F-1+
A-2	Prime-2 (P-2)	Duff-2 (D-2)	F-2
A-3	Prime-3 (P-3)	Duff-3 (D-3)	F-3
Non–investment grade:			
B	NP (Not prime)	Duff-4 (D-4)	F-S
C (Doubtful)			
In default:			
D		Duff-5 (D-5)	D

* The definition of ratings varies by rating agency.

† This list of rating companies is for the examiner's information only. The list is not an endorsement of these companies by the Federal Reserve.

Listed on this page are any material assets and liabilities (actual and contingent) not detailed on the parent company's balance sheet or other schedules in the report. Contingencies include guarantees, lease or loan commitments, letters of credit, interest rate swaps, futures and forwards transactions and pending litigation.

The purpose of this report page is:

1. To determine the extent of the parent's potential obligations and the related strain on its financial capacity resulting from contingencies.

2. To determine the quality of "Other Assets." These assets are subject to evaluation and classification, if appropriate. "Other Assets" is sometimes found to include assets acquired in violation of section 4 of the Act (particularly section 4(c)(2)).

3. To detail "Other Liabilities" which may indicate external funding relationships otherwise not presented.

The information should be derived directly from the BHC's financial statements and the board of directors' and executive committee's minutes. Management should be asked to verify and explain any contingent liabilities. A review of all "Other Assets" and "Other Liabilities" in the general ledger and subsidiary ledgers should be conducted and analyzed for appropriate types and amounts of accounts. Suspense accounts should be aged, particularly if shown as a net amount.

If there are no contingent liabilities state "None reported." Normally only items appearing on the balance sheet as of inspection date will be listed. If prior periods' items are listed, columns with dates corresponding to those on the balance sheet should be used.

Refer to Manual section 5010.8 for guidelines on presentation of details of "Other Assets" or "Other Liabilities."

The parent's guarantees on the "Investment In and Advances To Subsidiaries" page should be included as contingent liabilities. "Other Assets" and "Other Liabilities" totals should reconcile to the line items on the "Parent Company Comparative Balance Sheet" page.

The reconciliation of capital accounts provides a summary of transactions which have caused changes in each of the equity accounts for the periods indicated. There should be no charges against paid-in capital that are properly chargeable to income.

The report page is used to record and analyze changes in stockholders' equity and to determine the effects on the financial condition of the holding company.

The information should be requested in the officer's questionnaire. Sources for prior periods include the FR Y–6, FR Y–9 LP, the annual and quarterly reports to stockholders, previous reports of inspection and the SEC Form 10-K. Current period changes can be obtained from the corporation's accounting or comptroller's department.

The presentation should begin with the last two fiscal years and include the most recent year-to-date interim. The column heading ''Capital Stock'' can include common and preferred stock. However, it is necessary to distinguish the type and amount which can be accomplished by using (C) and (P), for common and preferred, beside the amounts. An appropriate legend can be inserted in the column heading.

Net income reported should agree with that reported on the ''Comparative Statement of Income and Expenses (Parent)'' and the ''Comparative Statement of Income and Expenses (Consolidated)'' pages. If net income reported on this page does not agree with the income on a consolidated basis (i.e. differences caused by minority interests), include a footnote to explain the reason for the differences.

Balances at year-end and interim period should agree with accounts on the ''Parent Company Comparative Balance Sheet'' and the ''Comparative Statement of Income and Expense (Consolidated)'' pages. Footnote and explain any differences.

These ''Interim'' and ''Fiscal'' pages can be used when the parent receives income from more than one subsidiary, or where it is needed to support comments or analyses in other sections of the report. Both the ''Interim'' and ''Fiscal'' pages should be included in the report when this situation is applicable. From the data on these two pages, the examiner is able to analyze the contribution to overall earnings made by each of the subsidiaries. The schedule also reflects the extent of the parent's upstreaming income from its subsidiaries.

The purpose of these report pages is:

1. To determine the relative share of the individual subsidiary's contribution to the holding company operation;
2. To analyze the dividend payout ratio and to compare payouts between subsidiaries;
3. To determine the proportion of each subsidiary's income paid to the parent as fees; and
4. To determine the degree of interest coverage on advances to subsidiaries.

For the interim and fiscal periods, some items can be obtained from the parent's income statement and from the BHC's workpapers showing eliminations on the consolidating income statement. Additional information can be obtained from the holding company's accounting department or comptroller.

The banks should be presented first, then nonbanks. Subtotals should be provided.

The dividend payout ratio is calculated by dividing total dividends by net income after taxes and securities transactions. Show an average payout ratio for banks and nonbanks, respectively, and an overall payout ratio. Do not show negative percentages.

5. Fees as a percentage of the subsidiary's operating income is calculated using total operating income before expenses. No subtotals for banks and nonbanks are required.

Equity in undistributed earnings, dividends, interest and total fees should equal that reported for each period on the ''Comparative Statement of Income and Expenses (Parent)'' page. For wholly-owned subsidiaries, the sum of the ''Equity in Undistributed Earnings'' and ''Dividends'' columns should equal its net income for the related period.

The analysis is performed and the statement is completed for BHCs with consolidated assets in excess of $1 billion, or when substantial fixed charges exist or debt is outstanding, when required by the Reserve Bank. This statement indicates the results of the parent's management of its cash position and identifies major sources of working capital and areas of disbursement. The statement also presents the cash earnings of the parent company. The cited ratios measure the parent company's ability to meet its fixed obligations and the ability of the residual earnings to cover common stock dividends. When combined with an analysis of the parent company's cash income sources from subsidiaries, it serves as a partial basis for determining the parent company's debt servicing capacity, and thus an assessment of its leverage. In addition, projected cash flow information aids in the analysis of the BHC's ability to properly service its debt.

Only items affecting cash should be shown. The ''Next Fiscal Year'' column completion is optional at the examiner's discretion if the inspection occurs early in the current year (i.e. the inspection is in January 19X6 and thus would require the data through the end of 19x7).

The objective of the report page is:

1. To determine the ability of the parent to manage its cash position and operate within debt service and funding requirements;
2. To measure the parent's ability to meet its fixed obligations and its dependency on borrowed funds to meet its cash needs;
3. To determine if the parent company's dividends to stockholders are covered by residual cash earnings;
4. To analyze any cash flow transactions which may adversely affect the financial stability of the parent;
5. To discuss parent company deficit cash flows provided by its own operations.
6. To discuss any parent company borrowings needed to sustain dividend payments to shareholders;
7. To discuss the scope for increasing cash flow to the parent company; and
8. To discuss steps management has taken, or plans to take, to restore adequate cash earnings coverage for fixed charges and dividend payments, and whether such plans should be commensurate with the maintenance of adequate loan loss reserves and Tier 1 capital levels in the bank and major nonbank subsidiaries.

The information may be requested in the officer's questionnaire and a copy of the ''Cash Flow Statement (Parent)'' page may be included with the questionnaire.

To complete the page refer to the holding company's cash receipts and disbursements journal and its general ledger and income statement(s). Also refer to any cash flow and income projections prepared by the organization.

The statement should be verified and reconciled, to the extent possible, to the BHC's published statements. Any additional items not provided for in the preprinted statement can be separately listed in an appropriate space.

Any dividends considered unreasonable should be discussed in the comments section. Dividends paid with funds derived from new borrowings should be discussed in detail.

Any significant cash flow transactions should be discussed. Refer to section 4010 for examples of such transactions.

If shortfalls exist, discuss on the ''Cash Flow Statement (Parent)'' page. For example, if the parent has a deficit cash flow provided by its own operations (as is often the case), discuss how the parent offsets (or plans to offset) the deficit. If the question is not applicable, state ''NA.''

If the BHC must incur additional debt in order to sustain its dividend payments to shareholders, discuss this in detail on the ''Cash Flow Statement (Parent)'' page.

To the extent that the accrual method of accounting is used, income and expense items should agree with the figures on the ''Comparative Statement of Income and Expenses (Parent),'' and between balance sheet periods, the ''Statement of Changes in Stockholder's Equity (Parent)'' pages and the ''Income from Subsidiaries'' for the fiscal year are as follows:

1. Dividends, and management and service fees from subsidiaries should agree with those on the ''Comparative Statement of Income and Expenses (Parent)'' and the ''Income from Subsidiaries'' pages;
2. Interest income should agree with the amounts reported on the ''Comparative Statement of Income and Expenses (Parent)'' and the ''Income from Subsidiaries'' pages;
3. Interest expense should agree with the amounts reported on the ''Comparative Statement of Income and Expenses (Parent)'' page;
4. Salaries and employee benefits should be the same as those reported on the ''Comparative

Statement of Income and Expenses (Parent)'' page; and

5. Dividend payments made by the parent should agree with those reported on the ''Statement of Changes in Stockholder's Equity (Parent)'' page.

Other increases and decreases in cash which should agree with changes in balance sheet items on the ''Parent Company Comparative Balance Sheet'' page are:

1. Increases in borrowed funds;
2. Decreases or increases in advances to subsidiaries; and
3. Debt retirement or reductions.

The Parent Company Liquidity Position page is prepared for bank holding companies with consolidated assets in excess of $1 billion and those with substantial debt outstanding, as well as select others at the option of the Reserve Bank. The report schedule provides a structured analysis of all assets and liabilities within predetermined remaining maturity categories. The schedule is designed to place emphasis on remaining maturing assets and liabilities of less than one year.

When the schedule is initially completed, the examiner is provided with an indication of whether the parent company has an adequate cushion of short-term liquid assets within the 0 to 30 days and the 0 to 90 days categories to cover short-term liabilities, or whether a pattern of short-term funding gaps exist. Following adjustments, if any, to maturing assets or liabilities, the resulting schedule sets forth a framework for observing funding mismatches, thus serving as tool for assessing the parent company's overall liquidity position.

A net positive gap is expected in the 0 to 30 days category to show the parent's ability to ride out a temporary market disarray. Similarly, a cumulative positive position is expected in the 0 to 90 days categories, despite any deficiency within the first 0 to 30 days category. A failure to satisfy those conditions requires the examiner to address the deficiency within the ''Examiner's Comments'' page. Results of the analysis are to be discussed in the parent company section on the ''Analysis of Financial Factors'' page in the inspection report.

The report schedule is prepared:

1. To determine whether the bank holding company is avoiding funding strategies that could undermine public confidence in the liquidity or stability of their banks; and

2. To evaluate the holding company's ability to meet its maturing obligations, covert its assets with minimal loss, obtain cash from other sources, or roll over or issue new debt obligations;

3. To determine whether the level of the parent's liquid assets is sufficient to cover its short-term obligations;

4. To analyze the contractual maturity structure of its assets and liabilities and to estimate the underlying liquidity of the parent company's liabilities and assets, giving particular attention to interest bearing deposits in and advances to subsidiaries (Note: Parent company advances to subsidiaries should be considered a reliable source of liquidity only to the extent that they fund assets of high quality that can be readily converted to cash);

5. To identify funding surpluses or deficits for specific maturity intervals;

6. To provide an analytical framework for observing funding mismatches in assessing the parent company's overall liquidity position;

7. To provide an analytical tool and a basis for discussion of parent company liquidity with management; and

8. To provide a basis for developing or evaluating existing parent company contingency plans, including any reliable unused back-up lines of credit. (Note: In the event that maturing liquid assets are not sufficient to satisfy short-term obligations, primarily in the 0 to 90 days categories, and the parent company has no contingency plan to cover mismatches (shortfalls) in the under 1 year categories, the parent company must be requested to develop such contingency plans that must include standby facilities that will be reliable during times of financial stress. For those BHCs with less than satisfactory parent or consolidated supervisory ratings (3 or worse), or any BHC subject to serious liquidity or funding pressures, those BHC's must include in their contingency plan specific plans to reduce or eliminate entirely their outstanding short-term obligations.)

The information for the schedule should be obtained from the parent company's balance sheet for the contractual maturing amounts of assets and liabilities, and slot the amounts into the five maturity categories depicted.

While analyzing the contractual maturities of the assets and liabilities, the examiner must consider the underlying liquidity of the parent's intercompany advances and deposits and the extent to which they fund high quality assets that can be readily converted into cash.

The examiner should refer to the Manual's funding sections 2080.0 to 2080.6 and sections 4010.0 to 4010.2 that address parent company cash flow and liquidity.

The report page data should be entered as of the inspection report financial statement date. The examiner may, at his or her option, incorporate the schedule into the inspection report to substantiate or clarify particular judgements. Assets should be recorded net of any allowance (contra asset) accounts.

The examiner should assess the contractual maturity structure of the parent company's balance sheet by preparing the schedule according to the parent's maturing assets and liabilities. The scheduled can be adjusted to better appraise the parent company's liquidity position by analyzing interest bearing deposits with bank subsidiaries and advances to subsidiaries. The ''Other Assets'' may be sub-categorized within the additional space provided. The completed schedule may be used as a basis of discussing parent company liquidity with management. The examiner should comment on the findings on the ''Analysis of Financial Factors'' page in the inspection report (whether or not the schedule is included in the report).

The total of each asset account should equal the respective assets as listed on the ''Parent Company Comparative Balance Sheet'' for the inspection report financial statement date, net of any separately listed allowance or contra asset account balances or any adjustments for market valuations. The total of each liability account should equal the respective liabilities as listed on the ''Parent Company Comparative Balance Sheet'' as of the inspection report financial statement date.

This report page is included in all reports when assets are classified and written up. For inspections of bank holding companies with less than $150 million in total assets, it is to be included in the Core section of the report. The information reported represents analyses and conclusions for the classification of the parent's assets and identifies all of the nonbank subsidiary's classified assets. Refer to the instructions for the ''Summary of Consolidated Classified and Special Mention Assets, and Other Transfer Risk Problems,'' Core page 7, for a discussion of classification standards.

The purpose of the report page is to—

- determine the risk involved in the parent's activities,
- determine the adequacy of reserves,
- disclose problem assets requiring management's attention, and
- aid in the analysis of the condition of the nonbank subsidiary(ies).

The information is obtained by an evaluation of the parent's assets and the assets of nonbank subsidiaries. For nonbank company assets, the information is obtained through examining the loan and lease portfolios, and reviewing credit files, loan reviews, past-due lists, credit analyses, and watch lists prepared by the holding company.

Any asset classified doubtful or loss requires a write-up unless the amount is insignificant to the company's operations. *Where asset reviews are undertaken, the examiner should note at which entities the asset reviews were performed, and their level of coverage.* Any classified asset that is challenged by management also requires a write-up.

Loan write-ups may extend across the entire page. At a minimum, show the total amount of extension of credit booked by the parent, name of debtor, name of guarantors, collateral, amount of classification in appropriate category, date originated, maturity, purpose, and where deemed necessary, a short write-up giving the reason for the classification. Also identify any participation with a subsidiary, including the subsidiary's name and amount held by the subsidiary.

Nonbank loans classified substandard may be listed alphabetically with no write-up required, unless the holding company management disagrees with the classification. For other nonbank assets classified substandard, some minimum comment is necessary. For example, the examiner may make one general comment concerning the deficiencies of several credits or other assets listed.

Any nonbank subsidiary loan classified doubtful or loss, where the amount classified exceeds the lesser of $100,000 or 5 percent of the subsidiary's total assets, should include a brief write-up stating the reason(s) for classification. However, at the discretion of the examiner, any doubtful or loss classification may be the subject of a write-up.

In the case of nonbank subsidiaries such as consumer finance companies where there are relatively small amounts and a large volume of accounts involved, the use of ''bulk classification'' by degree of delinquency may be more desirable than listing each loan individually. The examiner may provide write-ups on any classified nonbank subsidiary asset deemed appropriate.

The classification totals should agree with ''Examiner's Comments,'' and/or ''Analysis of Financial Factors'' pages. Any major asset problems may be discussed on the ''Examiner's Comments'' or ''Analysis of Financial Factors'' pages and should be cross checked.

This FR 1225 report page presents consolidated financial statement data (a condensed balance sheet and income data) for the lead bank and any other subsidiary bank or banks (that is, subsidiary banks that have consolidated assets of $150 million or more) or for those bank subsidiaries that exhibit conditions warranting special supervisory attention (that is, rated composite 3, 4, or 5 under the Uniform Interagency Bank Rating System). The summary of the examiner's comments and other important data extracted from the latest report of examination are incorporated into the analysis of the bank component of the BOPEC rating on the ''Analysis of Financial Factors'' page. The summary is incorporated when a bank subsidiary comprises 10 or more percent of consolidated assets and/or when a bank subsidiary evidences material financial deficiencies or other characteristics that should be brought to the attention of the bank holding company's board of directors including noted bank violations.[1] As banking assets make up the majority of the assets of the holding company, the condition of the larger banks and special supervisory attention banks may have a significant impact on the condition of the consolidated organization.

The financial statements should be requested in the officer's questionnaire. Balance-sheet and income data can be obtained from the reports of condition, income, and dividends of the subsidiary banks.

Provide a condensed balance sheet as of the inspection date and a statement of income. The income data should be presented in a comparative columnar format and should include total operating revenue, total operating expenses, net operating income, applicable income taxes, net securities gains or losses, and net income. The balance-sheet and income data, while condensed, should provide detail to permit analysis of earnings and capital. Where any past or potential problems exist, the examiner may include more detailed statements to support comments presented.

All pages should bear the same ''Bank Subsidiaries'' page number, except that the number should be suffixed with a −1, −2, −3, etc., to reflect the subsequent ''Bank Subsidiaries'' pages.

The FR 1241 ''Bank Subsidiary'' report page is used for the lead bank subsidiary when its assets are less than $150 million.

The following items should be checked to make certain that—

1. advances from the parent company agree with the ''Investment in and Advances to Subsidiaries'' page;
2. the holding company's proportionate share of the capital accounts reconciles with the investment shown on the ''Investment in and Advances to Subsidiaries'' page;
3. external (unaffiliated) debt shown agrees with that on the ''Unaffiliated Borrowings'' page;
4. net income reconciles with the sum of equity in undistributed earnings and dividends on the ''Income from Subsidiaries'' pages, in proportion to the holding company's percentage of ownership; and
5. any relevant comments made on the ''Bank Subsidiaries'' pages agree with Core page 1, ''Examiner's Comments and Matters Requiring Special Board Attention.''

1. In determining the subsidiary banks that require write-ups, examiners should be mindful of the effect that the cross-guarantee provisions of FIRREA can have on nontroubled bank subsidiaries.

For each direct nonbank subsidiary (and its significant subsidiaries not consolidated in its statements), a summary is to be provided of its history, activities, classifications, and risk exposure. Nonbank subsidiary pages consist of ''Nonbank Subsidiary,'' ''Nonbank Subsidiary Financial Statements,'' and ''Nonbank Assets Subject to Classification.'' Each subsidiary should be presented as a ''unit.'' Successive subsidiaries should be sequentially presented (for example, 18a, 18b, etc.). The information provided on the report page should aid in the determination of permissibility of activities and locations, and the evaluation of the subsidiary's asset quality.

1. Provide the proper name of the organization, location, date of approval, date of acquisition or establishment, date activity commenced, statutory authority, and approved branch office locations should be obtained from Reserve Bank records, presented, and verified with the holding company's records. Note the date of approval for each activity and office, if applicable.

2. For going concerns acquired by the bank holding company, state the date acquired. For de novo subsidiaries, state the date established .

3. For de novo subsidiaries, state the date activity commenced. Indicate if the BHC has received approval for any de novo activity that has not yet been commenced. Identify any approved activity for which authority has expired.

4. Number 6 refers to the exemptive provision (statutory authority) of the Bank Holding Company Act relied upon to continue to engage in the activity. If section 4(c)(8) of the act is indicated, also provide the corresponding reference to section 225.25(b) of Regulation Y to indicate the specific activities.

5. Provide the city and state location for each branch; however, if the subsidiary has a great number of branches (for example, a consumer finance subsidiary), the examiner may present only the number of offices located in each state or foreign location.

6. For the history and description section, summarize the activities in which the company is engaged and discuss how it has expanded its operations (de novo or by acquisition). Discuss any violations that may have been uncovered.

7. Prepare a written risk assessment of each active nonbank subsidiary, addressing the financial and managerial concerns outlined below.[1] This assessment is to identify subsidiaries with a risk profile that warrants an on-site presence. In formulating this assessment, the examiner should consider all available sources of information including, but not limited to—

- findings, scope, and recency of previous inspections;
- ongoing monitoring efforts of surveillance and financial-analysis units;
- information received through first-day letters or other pre-inspection communications;
- regulatory reports and published financial information; and
- reports of internal and external auditors.

The risk assessment should address each nonbank subsidiary's funding risk, earnings exposure, operational risks, asset quality, capital adequacy, contingent liabilities and other off-balance-sheet exposures, management information systems and controls, transactions with affiliates, growth in assets, and the quality of oversight provided by the management of the bank holding company and nonbank subsidiary. Examiners are expected to document their assessment of the overall risk posed by each nonbank subsidiary on this report page or equivalent inspection workpaper. See SR-93-19.

The examiner should make certain that the classifications and valuation reserves summarized for the nonbank subsidiaries agree with totals on either the ''Summary of Consolidated Classified and Special Mention Assets, and Other Transfer Risk Problems'' page or the ''Parent Company and Nonbank Assets Subject to Classification'' page.

1. The assessment of nonbank activities in large, complex organizations may be focused on an intermediate-tier company with oversight responsibility for multiple nonbank subsidiaries.

This page presents a condensed statement of condition for credit extending and special supervisory attention nonbank subsidiaries (and others at the examiner's discretion) as of the inspection date, and income data for the latest fiscal year and the year-to-date. The purpose of the report page is to aid in the analysis of the condition of each nonbank subsidiary and in the analysis of its effect on the consolidated company. The page is completed for all credit extending subsidiaries and may be completed for any other subsidiary deemed appropriate.

Financial statements should be requested in the officer's questionnaire. In the case of larger subsidiaries other financial information may be obtained from the F.R. Y–6, the SEC Form 10-K, published reports to stockholders and reports filed with professional associations. Details relevant to the financial statements can be found by reviewing various accounting records.

The balance sheet should be structured to provide sufficient detail for meaningful analysis, including specifics on valuation reserves and stockholders' equity. Income data should also be provided for the latest fiscal year plus the year to date (i.e., total revenue, net operating income, net income, rates of return). Provide a condensed income statement for the year to date if considered necessary.

The examiner should ascertain that:

1. Advances from the parent agree with the ''Investment in and Advances to Subsidiaries'' page;
2. The holding company's proportionate share of the capital accounts reconcile to the investment shown on the ''Investment in and Advances to Subsidiaries'' page;
3. External debt reported agrees with the information reported on the ''Liquidity and Debt'' Confidential page ''C''; and that
4. Net income reconciles with equity in undistributed earnings and dividends paid on the ''Income from Subsidiaries'' pages, in proportion to the holding company's percentage of ownership.

This page presents the fidelity and other indemnity insurance coverage of the holding company and its subsidiaries. Refer to section 2060.5 for related information. The report page is used to provide a summary as to whether:

1. The parent and nonbank subsidiaries have been insured against the potential for significant losses by maintaining proper and sufficient insurance;
2. A comprehensive review of the insurance program is conducted periodically by management and at least annually by the board of directors and entered into the minutes;
3. A determination can be made as to which entity(ies) is responsible for paying the premiums and if the manner in which such payments are allocated is equitable among the affiliates that receive the coverage benefits; and
4. Procedures are in place to assure that claims are filed promptly.

The information on insurance coverage is usually available from an ‘‘insurance officer’’ and from a review of insurance policies during the inspection. The examiner should conduct a review of insurance coverage with the ‘‘insurance officer.’’ In summarizing results, the examiner should indicate if any nonbank subsidiary is covered under a separate policy or if it is not covered. Also, it should be stated whether the policy is maintained by the bank and whether the BHC and nonbanks are covered by the bank’s policy. The method used to allocate the cost of insurance to the subsidiaries should also be provided.

The comments detailed on the report page should be consistent with summarized comments on the ‘‘Policies and Supervision’’ page and the ‘‘Other Supervisory Issues’’ page, item 7, if included in the report. Any noteworthy deficiencies in the insurance program may be included on the ‘‘Examiner’s Comments’’ page at the examiner’s discretion.

Procedures for Inspection Report Preparation (Reserved for Future Use)

Section 5010.34

This report page consists of topics dealing with litigation and commitments, the supervisory reports, intercompany transactions and other topics of supervisory concern.

The report page includes questions that are worded to evoke a ''yes'' response, or if there are no problems in a particular area, a ''no'' response. If there are any deviations therefrom, responses are required. Positive responses as to either the adequacy of the insurance or audit programs should only be accompanied by a reference to the appropriate inspection report page that addresses the topic. For additional guidance on answering the questions on this inspection report page refer to the ''Other Supervisory Issues'' FR 1241 report page instructions.

5010.35.1 INTERCOMPANY TRANSACTIONS (QUESTIONS 1)

This question inquires as to the existence of significant intercompany transactions or diversions of bank income subject to adverse comments. This question guides the examiner when documenting the review of compliance with Board policy, statutes and regulations regarding various kinds of intercompany transactions.

For information on diversion of bank income, review management and service fees charged the bank and any compensating balances maintained by the bank on behalf of affiliates indicated on the ''Comparative Statement of Income and Expenses (Parent)'' and the ''Commercial Paper (Parent)'' pages, respectively. Comments on section 23A considerations may be found by a review of bank examination reports. The examiner may refer to Manual 2020.6 (management and service fees) for instructions on examining for diversions of bank income. For information on examining for 23A and 23B violations, see Manual section 2020.1 (transactions between affiliates) and the other Manual intercompany transactions sections 2020.2–2020.7.

Violations of section 23A and 23B of the Federal Reserve Act and section 106(b) of the 1970 Amendments to the Bank Holding Company Act may be summarized on the ''Examiner's Comments'' page and listed on the ''Violations'' page with the reader referred to this page for detail. If the examiner includes comments concerning other intercompany transactions on Core page 1, ''Examiner's Comments,'' the information should be cross-checked.

5010.35.2 COMPENSATING BALANCES (QUESTION 2)

If a subsidiary bank is not adequately compensated for maintaining compensating balances at another institution for debt advances to the holding company, provide:

1. The average collected and book balance or the range of the balance;
2. Any arrangement whereby the loan or line of credit agreement between the creditor bank and parent contains a requirement to maintain a correspondent account; and
3. Comments as to whether the subsidiary bank is reimbursed for maintaining the compensating balance.

Refer to Manual section 2020.4 (compensating balances).

5010.35.3 INTERCORPORATE INCOME TAX PRACTICES (QUESTION 3)

Information on intercorporate tax practices may be obtained from the accounting or comptroller's department. Manual section 2070.0 (taxes) may be referred to for information on examining intercorporate tax transactions which includes the Board's intercorporate tax policy statement of September 20, 1978.

In addition to the above references, examiners should be aware that whenever there is a consolidated income tax return filed, it is important that a formal tax agreement exists between the parent and each subsidiary (approved by each board of directors). Examiners should encourage management to prepare such an agreement if not already in place.

Board policy states that taxes paid by a subsidiary bank to its parent should not be in excess of what the bank would pay if it filed on a separate entity basis. However, certain adjustments, in particular the allocation of tax benefits in a consolidated return, may result in higher payments than would have been made had the bank been unaffiliated (i.e., the surtax exemption must be allocated between organizations filing a consolidated return whereas an entity filing alone could use the entire exemption). The Board normally would regard such adjustments (that result in amounts in excess of filing alone) as acceptable. The Board does not wish to prescribe the tax accounting methods to be used by BHCs. However, the Board does require that those methods employed give bank subsidiaries equitable treatment.

The examiner should comment whenever any of the following has occurred:

1. A subsidiary has been required to make tax payments to its parent that significantly preceded the date the consolidated tax payments are paid to IRS. (In general, ''significantly'' means not in excess of five business days.)
2. A subsidiary bank is due a tax refund due to a fiscal net loss on a taxable basis (or due to other tax credits) and the parent has not refunded to the bank taxes paid by the bank to the parent in previous tax periods.
3. The subsidiary bank has passed up deferred income tax liabilities to the parent along with an equivalent amount of cash or earning asset. Such transactions must be reversed by a reinstatement of the deferred tax on the books of the bank, along with the transfer by the parent of an equivalent amount of cash or appropriate earning asset.

5010.35.4 TIE-IN ARRANGEMENTS (QUESTION 4)

As for tie-in arrangements, see Manual section 3500.0 (tie-in considerations). This Manual section provides information on examining for impermissible tie-in arrangements. Information on tie-in arrangements is available from BHC and nonbank subsidiary management and may also be found by reviewing standard lending agreements and manuals.

5010.35.5 INSIDER TRANSACTIONS (QUESTION 5)

Consider:

1. The policy in regard to extensions of credit by a bank holding company or its nonbank subsidiaries to the BHC officials (executive officers, directors or ''more than 10 percent'' shareholders) or the BHC officials' interests in the organization;
2. Prohibitions on bank extensions of credit contained in the Financial Institutions Regulatory and Interest Rate Control Act of 1978; and
3. Whether the bank holding company has a conflict of interest statement or business ethics policy that has been distributed to employees.

If there are insider transactions subject to comment, list the parent and nonbank subsidiary extensions of credit to BHC officials. Also, comment on the compensation to the officials. See Manual sections 2050.0, 2110.0, and 5010.36.

5010.35.6 LITIGATION (QUESTION 6)

A ''yes'' response to this question would require a summary of any litigation involving the parent bank holding company and the bank and nonbank subsidiaries, which could have a significant effect on the holding company. The purpose of this question is to aid the examiner in the analysis of the financial condition of the holding company by determining if any pending litigation poses a threat to the financial condition of the BHC.

Any information on law suits should be requested in the officer's questionnaire. Information on litigation which may have a significant impact on the company is often included in the published annual report to stockholders or in the SEC Form 10-K.

Comments on litigation should be presented in narrative form summarizing the details of the lawsuit, including, if possible, the opinion of the holding company's counsel as to the possible outcome of the suit. Generally, include only suits representing more than 10 percent of the holding company's stockholders' equity capital. Discussion of immaterial litigation should be avoided.

Any litigation which may have a significant effect on the bank holding company may be summarized on the Examiner's Comments, Core page 1, at the discretion of the examiner. Also, any litigation which, in the opinion of management or counsel, is expected to result in a significant liability should be noted on the ''Contingent Liabilities (Parent)'' page.

5010.35.7 INSURANCE PROGRAM (QUESTION 7)

See Manual sections 2060.5 and 5010.33.

5010.35.8 AUDIT PROGRAM (QUESTION 8)

A negative response to this question will result from application of the inspection instructions found in Manual sections 2060.1 and 5010.34. Comments responding to this question should be confined to briefly summarizing any audit program deficiencies and should reference any detailed information provided on other report pages.

5010.35.9 CREDIT QUALITY REVIEW PROGRAM (QUESTION 9)

This question refers to the examiner's review of the BHC's internal loan review program. A negative response would result from the examiner's use of the inspection instructions and procedures found in Manual section 2060.6.

5010.35.10 SUPERVISORY REPORTS (QUESTION 10)

A "yes" response with regard to this topic would result in providing information on the timeliness and accuracy of the bank holding company's submittal of required reports, such as the FR Y–6, Y–8 and the Y–9's to the Reserve Banks. If the bank holding company is consistently late in filing its reports or if there are repeated discrepancies that need correction, it could be indicative of operational deficiencies or a lack of managerial direction within the bank holding company.

Information on the timeliness and accuracy of reports must be obtained from the Reserve Bank unit handling the reports and by verifying selected items to corporate records. If reports are routinely filed late or inaccurately, the reason and the measures the bank holding company may be taking to eliminate the problem should be stated on this inspection report page.

5010.35.11 OUTSTANDING COMMITMENTS TO THE BOARD OF GOVERNORS (QUESTION 12)

This question reminds the examiner to appraise the bank holding company's compliance in fulfilling commitments made to the Board or the Reserve Bank. Thus, if there are any commitments outstanding which the holding company has made to the Board or the Reserve Bank, appropriate comments should be provided on the page.

Each Federal Reserve Bank is required to report to the Board's Division of Banking Supervision and Regulation on a semi-annual basis the status of unfulfilled commitments. The examiner should review this Reserve Bank report before beginning the inspection.

Commitments should be summarized presenting the nature of the commitment, the date the commitment was made, and, if applicable, the time frame in which it must be fulfilled. If the time frame has expired, or if an extension is deemed necessary to fulfill the commitment, details must be presented. The examiner may choose to make a reference to the unfulfilled commitment on the "Examiner's Comments" Core page 1, if considered appropriate.

The Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA), as amended by FDICIA, accompanied by the Board's complimentary Regulation O, governs *bank* extensions of credit to insiders. With the passage of FDICIA and the complementary revision of Regulation O, there is the possibility that there will be an increase in the volume of parent company and nonbank subsidiary extensions of credit to BHC officials and their related interests. The report page presents information on parent company and nonbank extensions of credit to insiders, as well as parent company and nonbank subsidiary investments in and loans on stock or obligations of BHC officials' related interests. Examiners must reference Manual section 2050.0 to complete this page.

This report page is intended to identify extensions of credit to BHC officials so that those credits may be reviewed for propriety and compliance with the policies of the BHC and Manual section 2050.0. Although *Regulation O applies only to bank extensions of credit*, for BHC inspection purposes, definitions contained in Regulation O shall be used by System examiners in order to provide a uniform, comparable approach to reviewing extensions of credit to BHC officials.

The information requested on the report page should be requested in the officer's questionnaire. Other sources may include the annual report to shareholders, the FR Y–6 and filings with the Securities and Exchange Commission.

BHC examiners should review Manual section 2050.0 and Regulation O, and should be familiar with the definitions contained in the regulation. Examiners are asked to identify such credits for in-depth review and analysis. Although Regulation O applies specifically to extensions of credit by banks, and not the parent or nonbank subsidiaries, examiners may criticize a BHC's or nonbank subsidiary's direct extensions of credit to BHC officials or their related interests as an unsound practice or may criticize a specific loan for credit reasons. *Such extensions of credit are not to be cited as violations of Regulation O.*

During a BHC inspection, BHC officials should be made aware that information necessary for the completion of this page is being collected to evaluate practices, policies, or particular credits, but that FIRA and Regulation O apply exclusively to bank extensions of credit.

Section 215.4 of Regulation O entitled ''General Prohibitions'' sets forth various restrictions on bank extensions of credit to BHC officials. In general, if the BHC examiner reviewing BHC and nonbank subsidiary direct extensions of credit to BHC officials and their related interests concludes, after consultation with counsel for the Reserve Bank, that the extension of credit would not have been in compliance with section 215.4 had it been a bank extension of credit, the examiner may conclude that it is appropriate to criticize the practice or the loan. If it is concluded that the BHC or nonbank subsidiary extended the loan in order to circumvent the restrictions on bank extensions of credit, comments to that effect should be incorporated onto the ''Other Supervisory Issues'' page or a ''Continued'' page. Such comments may be also summarized on page 1, ''Examiner's Comments'', at the discretion of the examiner based on the degree of materiality, severity and impact.

Specifically, section 215.4 of Regulation O (in part) requires bank extensions of credit to BHC officials not to be on preferential terms, not to have more than the normal risk of repayment, and over certain dollar amounts to be approved by the bank's directors. In addition, it requires bank extensions of credit to executive officers, principal shareholders, and their related interests not to exceed the bank's legal lending limit to any such individual and his/her related interests.

In reviewing BHC and nonbank extensions of credit to ''related interests,'' note that a related interest is defined in section 215.2(k) of Regulation O as ''a company that is controlled by a person . . .'' The definition of ''company'' for purposes of Regulation O specifically excludes any ''insured bank.'' However, for purposes of completing these report pages, and evaluating the propriety of BHC and nonbank extensions of credit to (and investments in) ''related interests'' of BHC officials, ''related interests'' shall include ''banks.'' Therefore, a BHC or nonbank direct extension of credit to (or investment in) a BHC official's ''related interest'' that is itself a bank (other than a subsidiary bank of the subject BHC), should be reported.

For purposes of this page, ''direct'' extensions of credit represent obligations of the BHC official or related interest, alone or as co-maker while an ''indirect'' extension of credit includes a BHC official's or a related interest's endorsement or guarantee of an extension of credit to a third party, and obligation's to the BHC official's immediate family (spouse, all minor children, and all children, including adults, residing in the individual's home). BHC and nonbank extensions of credit to a BHC official who serves in two or more capacities, i.e., director and executive officer, should only be presented once.

In completing the ''Schedule,'' the examiner may select the cut-off amount used to determine which items are listed individually based on materiality. However, any extension of credit (or group of credits) to an individual BHC official and his/her related interests that would have exceeded the subsidiary bank's lending limit had it been made by the bank, should be listed individually. (In multibank holding companies, use the banks' aggregate lending limit.)

In listing ''Terms'' within the ''Schedule,'' include at a minimum interest rate and date of maturity. ''Comments'' are intended to include a brief description of any collateral, endorsements, the purpose of the loan, the nature of the borrower's relationship to the lender if not self-evident, and status of repayment if delinquent or classified.

Identify the source and cost of funds used by the BHC to extend the loan. Any adverse affect to the BHCs net income should be commented on.

Extensions of credit should be consistent with policies summarized on the ''Policies and Supervision'' page. Otherwise, additional comments might be warranted.

The purpose of this report page is to present a brief analysis of the interest sensitivity of assets and liabilities on the inspection date and to further support the analysis in the form of ratios similar to a current ratio and a net working capital to total assets ratio. Positive or negative gaps within maturity buckets are gathered in the form of cumulative gap totals. The analysis can be prepared for each level of the organization.

Such an analysis is designed to determine whether maturing interest sensitive assets match maturing interest sensitive liabilities on a 1 to 1 basis within specified maturity ranges and on a cumulative basis over time.

The information for the report page can be gathered from financial management maturity analyses and interest sensitivity reports prepared by the bank holding company's management. A limited amount of maturity information on interest sensitive assets and liabilities may be obtained from Bank Call Reports, Bank Holding Company Y reports, Bank Performance Reports, and BHC Performance Reports, and can be used if the inspection ''as of'' date is the same as the date of these reports.

From information collected, list interest sensitive asset totals and liability totals within the maturity buckets provided for the consolidated entity. The maturity ranges may be adjusted to or expanded to coincide with interest rate sensitivity reports generated by the bank holding company management.

Next, subtract the liability totals from the asset totals to get the ''Gap'' totals. For each maturity range beyond 91 days, add the next repricing interval ''Gap'' total to the previous ''Cumulative Gap'' totals to obtain the repricing interval's cumulative gap.

To determine the ratio of interest sensitive assets to interest-sensitive liabilities, use the cumulative gap for the denominator. Extend the percent out to at least two decimal places.

Provide narrative analysis for any maturity period or cumulative negative or positive gap positions, stating what measures will be taken by management to address any adverse gap positions.

This report page presents generalized questions for the examiner to answer on treasury activities and capital markets. This page must be included in inspection reports prepared for bank holding companies that have significant exposure in the capital markets. Specific guidance can be found in section 2125.0, in the Federal Reserve System's *Trading Activities Manual*, and in SR-93-69, December 20, 1993. Procedures for inspecting and preparing the written analysis should be based on this supervisory guidance. In banking organizations with national or state nonmember lead banks and where capital markets activities are conducted exclusively at the subsidiary bank, examiners should coordinate the collection of the information included on this page with the lead bank supervisory agency.

The purpose of this report page is to identify directors and principal officers and determine the level of participation and responsibility in the affairs of the holding company, and to identify outside relationships in order to determine conflicts of interest. The page contains the names of the principal officers of the company and their position with other subsidiaries. This page also presents the names of directors, the number of years they have served in that capacity, their year of birth (to possibly assess management's plans for succession), regularity of their attendance at directors' meetings, and principal outside employment. Note if any director is also a director of a Federal Reserve Bank or branch.

The directors and principal officers' fees, compensation and other benefits information is also to be obtained and retained in the workpapers. If desired by the Reserve Bank, such salary, bonus, benefits, and other remuneration information may be included on this page. Criticism of directors' fees should be carefully considered.

The directors' ownership information (i.e. address of each director and the number of shares owned) is also to be obtained and may also be reported or retained in the workpapers. If the holding company has an advisory board or honorary directors, the data on these persons may be included on the report page at the examiner's discretion.

All information on principal officers and directors such as year of birth, responsibility and compensation, etc. should be requested in the officer's questionnaire. Attendance data should be available from the board of directors' minutes. Such information may also be contained in reports to shareholders, FR Y–6, proxy statements and SEC filings.

The directors and principal officers should be listed alphabetically with their city and State of residence indented immediately below their names. If appropriate for mailing purposes, show each director's mailing address.

The principal officers and directors are to be listed in order of rank, and alphabetically where officers have identical titles. For directors and principal officers, membership on principal committees of the board should be coded and placed immediately after the name on the same line (i.e., E = Executive, A = Audit). If a director has been elected since the last inspection, the date of election should be shown immediately after his name. For example:

John Smith elected 4-1-x1

The officer and director positions held with subsidiaries should be kept as brief as possible, utilizing abbreviations established on the ''Structure and Abbreviations'' Core Page 3. List only major positions if routinely assigned to staff of all subsidiaries.

A brief summary of benefits provided to officers and employees (i.e., pension plans, life and health insurance) may be presented at the bottom. Such information can assist in determining whether the principal officers appear to be adequately or overly compensated.

Special financial arrangements for specific officers may also be noted. Such arrangements would include salary contracts, unusual bonuses, fees or expense allowances, stock options, deferred compensation, and exclusive use of real estate, automobiles and airplanes.

When indicating occupation or principal business affiliation of directors, use concise, descriptive designations instead of general notations such as ''merchant'' or ''industrialist.'' If the director is an officer or principal in a firm, show also the nature of the business in parentheses (e.g., law firm, CPA, pharmaceutical manufacturer, etc.).

The examiner should verify that the directorship is in compliance with Regulation L or R and that the number of directors is consistent with the corporations' bylaws. The examiner should also indicate the regular schedule of directors' meetings at the bottom of the report page to provide the Reserve Bank with information needed to plan attendance at board meetings.

Examiners should be careful to use the same names and titles of officers when referring to the individuals elsewhere in the report.

In general, this report page presents pertinent information that is deemed confidential by the Reserve Bank and available to regulatory authorities. The report page is used to discuss and assess, confidentially, the going-concern operating results and the prospects for resolving any problems or areas of concern. The report page should be also used to discuss compliance problems relating to statutory, regulatory, or administrative provisions cited within the core or other open sections of the report. The potential for any improvement or weakening in economic conditions should also be discussed to the extent they have a bearing on earnings potential.

The specific information to be provided on the report page is—

1. information on the organization's near-future financial prospects, giving particular consideration to debt servicing and the likelihood of improving any current problems;

2. an assessment of holding company management as to the experience and qualifications of principal personnel when relative to the assessment, and a listing of subsidiary bank ratings, effective examination dates, and type and scope of examinations;

3. the examiner's concise assessment of management's oversight of the BHC's policies and supervision of subsidiaries with respect to the level of control and supervision exercised over subsidiaries (see sections 2010.0 to 2010.4) should be discussed (An evaluation of the bank holding company's recognition and control of exposure to risk should also be provided (see section 2160.0), as well as an evaluation of management information systems (MIS) based on the guidance found in sections 2060.0 through 2060.6.);

4. a discussion of the reasons for the component ratings and overall BOPEC rating assigned;

5. an analysis of chain banking organizational structure (The examiner must determine whether the BHC is a member of a *chain banking organization*. A chain banking organization may be defined generally as a collection of independent banking organizations that are controlled by the same individual, family, or a group of individuals closely associated in their business dealings.);

6. a listing of individuals or groups that control more than 5 percent of the BHC's outstanding stock (Discuss any significant changes in ownership. A review of ownership is to include a determination as to whether an individual or group of shareholders exercise significant influence over the BHC. It should also include a discussion of fiduciary holdings of the parent company's stock and convertible debt of the BHC's subsidiaries.);

7. a presentation of confidential information relating to the components of the BHC rating system, avoiding repetition by cross referencing report pages in the open section; and

8. examiners' comments on any other supervisory concerns or aspects of the BHC's condition warranting confidential treatment. Comments on any violation and/or a BHC's unsafe and unsound practice should be included with any recommendations for Federal Reserve administrative action. Any plans of the holding company which are considered to be of a confidential nature should also be discussed.

Financial-analysis comments on the bank holding company organization (that is, BOPEC components, not the ratings) that are not of a confidential nature are to be discussed on the Analysis of Financial Factors core page 4.

The date and type of examination and assigned rating can be obtained directly from the latest examination report of each subsidiary bank. The other information is to be derived from discussions with senior management.

The information pertaining to ratings (CAMELS) and ratios of the banks is to be presented in columnar form with the banks listed as they appear on the organization chart. Also include any comment on the bank(s) deemed to warrant confidential treatment.

The examiner is expected to review and use the examination ratings of the other federal agencies where appropriate; however, if substantive differences of opinion exist as to the bank's composite rating, adjustments to the rating may be made and footnoted accordingly.

The examiner should make certain that the bank names or abbreviations are consistent with the organization chart and other tables in the inspection report. Any ratios or comments used in the rating analysis should be checked to corresponding areas in the open section.

Procedures for Inspection Report Preparation (Confidential Page C—Liquidity and Debt Information) Section 5010.42

This page provides a ''snapshot'' picture of the parent company's short-term gap position as it relates to the amount of commercial paper compared to net short-term GAP within repricing maturity categories and also the cumulative GAP position within the maturity buckets. The page provides summary information of aggregate data from the ''Commercial Paper (Parent),'' ''Parent Company Liquidity Position'' and the ''Unaffiliated Borrowings'' pages or workpapers.

The lower portion of the schedule provides details on unaffiliated borrowings such as the amount and types of external indebtedness of the parent and its subsidiaries. Information regarding various debt covenants such as cross default clauses, collateral information and negative covenants can be included.

The purpose of the page is to aid in evaluating the company's ability to service its debt and to operate within the constraints of debt restrictive covenants. It also aids in evaluating the appropriateness of the uses of the proceeds of the organization's borrowings.

Information for the source report pages or workpapers required for an analysis of parent company liquidity, commercial paper and other short-term debt, and long-term unaffiliated borrowings should be requested in the officer's questionnaire or can be obtained from the BHC's accounting department. Totals should be brought forth from the ''Commercial Paper (Parent)'' and the ''Parent Company Liquidity Position'' pages or workpapers, or reconciled to the general ledger. Footnotes to financial statements in published reports contain much of this information.

For the commercial paper information, derive the totals from the total column on the ''Commercial Paper (Parent)'' report page, combining the totals for over 91 days maturity. Commercial paper maturity totals should be presented as a line item showing the aggregate outstanding balance netted by any amount held by subsidiaries.

For the ''Long-term Debt'' portion of the report page, present unaffiliated long-term borrowings in tabular form for (a) the parent, (b) each nonbank subsidiary, and (c) the bank subsidiaries (combined).

For the parent company and each nonbank subsidiary, show the borrower, lender, description of the debt, original amount, origination date, interest rate, maturity date, present outstanding balance, any significant repayment provisions, collateral, use of proceeds, major restrictive covenants and any requirements for compensating balances. In addition, mandatory convertible debt instruments of the parent should be identified and the conversion provisions detailed. In the case of large bank holding companies that have an extensive number of debt issues, detail for each issue may be eliminated at the discretion of the examiner so long as aggregates for similar issues are shown along with ranges for rates and maturities and summary information regarding the other terms of the debt.

For the ''Net GAP'' and ''Net Cumulative GAP'' use the respective total amounts (''Net Position'' and ''Cumulative Excess Deficiency)'' on the ''Parent Company Liquidity Position'' report page. Bank mortgage indebtedness may be aggregated at the discretion of the examiner, showing amounts only without other detail. Capitalized lease obligations may be included in that total. For all other bank borrowings, including debentures issued to unaffiliated sources, provide complete detail.

Debt amounts on this page should agree with those shown for the ''Parent Company Comparative Balance Sheet'' for Core Page 5, the ''Bank Subsidiaries'', the ''Nonbank Subsidiary Financial Statements'' pages or workpapers, and the ''Consolidated Comparative Balance Sheet'' Core page 8 (when adjusted to net intercompany borrowings).

Procedures for Inspection Report Preparation (Confidential Page D—Administrative and Other Matters) Section 5010.43

This report page summarizes the examiner participants and their total workdays devoted to the inspection and provides clarification on checklist items where appropriate. Other comments should be directed to planning arrangements affecting the scope of the inspection. When nonbank subsidiaries are inspected, describe the extent of the review of the records. The examiner should cite any special problems encountered which would aid future inspections. Recommendations, suggestions, and information needed to conduct the next inspection should also be included for the next Examiner-in-Charge.

Information regarding planning is limited to the on-site planning of the work to be performed. Comments should be of a professional nature and should be strictly devoted to providing information that can be used in planning and performing an inspection (location and access to specific BHC records, inspection control problems, availability of facilities for staff, key officer and director contacts, information pertaining to the Internal Audit Committee members, internal and external auditors, and etc.)

Information pertaining to the access to, and the storage of, workpapers and any personal information such as lodging, travel arrangements and geographical directions should be confined to the workpapers. Comments not directly related to the on-site conducting of the inspection should be avoided.

The purpose of the confidential report page is to present pertinent information to be used only by regulatory authorities. The page is reserved to summarize internal information derived from Reserve Bank inspection staff that would not be addressed in other confidential report pages. The information reported on this page may also be derived from discussions with senior bank management, workpapers, accounting records, board of directors' minutes, and etc.

Bank names or abbreviations should be consistent with the organization chart and other tables in the inspection report.

This report page presents financial statement data (a condensed balance sheet and income data) for one-bank holdings companies and other bank holding companies that may have assets of less than $150 million. Place the name of the bank at the top on the line provided. For multi-bank companies, the page may be completed for the lead bank or comparable lead banks and each bank requiring special supervisory attention. The balance sheet and income data should be obtained from the last two calendar year ends and the most recent report of condition, while the examination data should be obtained from the last three examination reports. Refer to 5010.30.

This inspection report page incorporates onto one page a comprehensive list of questions covering many areas of supervisory concern. The questions can be answered with a "yes" or "no," or a not applicable response ("N/A"). Detail is required on an exception basis. Provided below are some guidelines to consider for several of the listed questions. Many of the questions are self-explanatory. Some questions (e.g. questions addressing audit and insurance activities) duplicate topics covered by other work papers. The purpose of the duplication and format of the report page is to provide a cross-check within the inspection report to make certain that all relevant areas have been included in the report. If relevant comments have been provided on other report pages in the "open" section, the comments need not be duplicated on this report page. Only a reference to the other report page is needed.

5020.2.1 LEVEL OF CONTROL AND SUPERVISION EXERCISED OVER SUBSIDIARIES (QUESTION 1)

Consider:

1. Whether the subsidiaries operate autonomously;
2. The degree of overlap between BHC and bank management;
3. Who sets major policies of the corporation;
4. How the holding company monitors the operation of its subsidiaries;
5. The role of supervision by the parent over the subsidiary banks in formulating the holding company's budget, tax planning, investment policies, internal controls and audits;
6. The extent of control resulting from directors having dual roles and responsibilities at the parent and subsidiary levels; and
7. Whether problems resulting from unqualified directors carry over from the parent to the subsidiaries.

5020.2.2 DIVIDENDS FROM SUBSIDIARIES (QUESTION 2)

Consider:

1. The policy for paying dividends in relation to the earnings and capital needs of the subsidiary. For banks the examiner should rely on the most recent examination report of the federal supervisor; however an independent conclusion must be made.
2. The reasonableness of the parent company's policy for assessing dividends from the subsidiary banks and whether it is being complied with.

5020.2.3 REPRESENTATIONS MADE IN APPLICATIONS TO THE BOARD (QUESTION 3)

Consider:

1. Whether the holding company has complied with all representations and agreements made with the Board. If no such agreements or representations have been made, state not applicable (N/A). The examiner should review transmittal letters for commitments associated with approved applications since the last full scope inspection. The supervisory file maintained by management at each bank holding company should also be reviewed for such agreements or representations.
2. Whether correspondence has been initiated with the appropriate Reserve Bank that provides an appropriate explanation as to why those representations and agreements have not been adhered to.
3. Whether the holding company is complying with any Reserve Bank reply to the holding company's notification.

5020.2.4 COMPENSATING BALANCES (QUESTION 4)

1. If a subsidiary bank is not adequately compensated for maintaining compensating balances at another institution for debt advances to the holding company, provide:
   a. The average collected and book balance or the range of the balance;
   b. Any arrangement whereby the loan or line of credit agreement between the creditor bank and parent contains a requirement to maintain a correspondent account; and
   c. Comments as to whether the subsidiary bank is reimbursed for maintaining the compensating balance.
2. Refer to Manual section 2020.4.

5020.2.5 MANAGEMENT AND OTHER SERVICES PERFORMED FOR SUBSIDIARIES (QUESTION 5)

If applicable, describe the holding company's policy on assessing management and services fees for work performed for the subsidiary bank. Provide comments as to whether the policies and fees are reasonable, and if not, why not. When answering this question, refer to Manual section 2020.6.

The examiner's comments should cover the following: (a) terms of the management or other service agreement or contract, if any, including the basis for charging fees, and the dates of adoption and expiration; (b) whether the boards of directors of each company have approved the agreement or contract; (c) description of the service, personnel providing the service, and whether the personnel are on the subsidiary bank's payroll; (d) conclusion on whether the services are actually being performed as stated and reasonableness of fees charged.

For multi-bank holding companies, the examiner should expand his comments to cover the role of supervision by the parent over the subsidiary banks, their lending and investment policies, budgeting and tax planning, and internal controls and audits.

5020.2.6 INTERCOMPANY TRANSACTIONS (QUESTION 6)

Review parent and nonbank subsidiary borrowings, including overdrafts from the subsidiary bank(s), for the past year and comment on significant transactions. If any extension of credit to affiliates by a bank or other transaction is deemed to violate section 23A or 23B of the Federal Reserve Act, so state. See Manual section 2020.1.

Describe any arrangement whereby the parent or nonbank subsidiary has purchased/sold significant participations or any other assets from/to a subsidiary bank. Also, discuss material transactions not discussed elsewhere in the report.

5020.2.7 INSIDER TRANSACTIONS (QUESTION 7)

Consider:

1. The policy in regard to extensions of credit by a bank holding company or its nonbank subsidiaries to the BHC officials (executive officers, directors or ''more than 10 percent'' shareholders) or the BHC officials' interests in the organization;
2. Prohibitions on bank extensions of credit contained in the Financial Institutions Regulatory and Interest Rate Control Act of 1978; and
3. Whether the bank holding company has a conflict of interest statement or business ethics policy that has been distributed to employees.

If there are insider transactions subject to comment, list the parent and nonbank subsidiary extensions of credit to BHC officials. Also, comment on the compensation to the officials. See Manual sections 2050.0, 2110.0, and 5010.36.

5020.2.8 TAX ALLOCATION (QUESTION 8)

See Manual sections 2070.0.

5020.2.9 USE OF SUBSIDIARY BANK PERSONNEL, OR ASSETS TO SELL CREDIT RELATED LIFE INSURANCE TO THE BANK'S CUSTOMERS (QUESTION 9)

This question refers to the Board's May 1981 policy statement on the disposition of income from the sale of credit life, health and accident, and mortgage life insurance (credit life insurance) related to loans made by state member banks. A reasonable amount of compensation must be paid to the state member bank in recognition of the role played by its personnel, premises, and goodwill in credit life insurance sales. As a general rule ''reasonable compensation'' means an amount equivalent to at least 20 percent of the affiliate's net income attributable to the financial institution's credit life insurance sales.

At the time of the Board's adoption, the policy was recommended for adoption by the other federal bank regulatory agencies thru the Federal Financial Institutions Examination Council. Therefore, the question is applicable to all banking subsidiaries, not just state member banks. If reasonable compensation is not being received by any or all subsidiary banks. Comment on this subject only when the parent or nonbank subsidiary receives income from the sale of insurance directly related to extensions of credit by a bank subsidiary. Describe any arrangement between the subsidiary bank(s) and the parent or nonbank affiliate concerning the sale of insurance directly related to extensions of credit. Note whether and/or when such arrangement was formally approved by the subsidiary bank's board of directors. Describe the manner of disposition of such insurance income. In situations where the subsidiary bank provides personnel and/or facilities for the sale of credit related insurance but receives no income, the bank, as a minimum, must be reimbursed for out-of-pocket costs.

5020.2.10 TIE-IN ARRANGEMENTS (QUESTION 10)

See Manual section 3500.0.

5020.2.11 LITIGATION (QUESTION 11)

If the holding company or its subsidiary(ies) is a defendant in any litigation, the results of which could have a significant adverse effect on the overall organization, provide details of the lawsuit, including, if possible, the opinion of the holding company's counsel as to the possible outcome of the suit. As a general guideline, include only suits representing more than 10 percent of the holding company's stockholder's equity capital.

5020.2.12 INSURANCE PROGRAM (QUESTION 12)

See Manual section 2060.5.

5020.2.13 AUDIT PROGRAM (QUESTION 13)

See Manual section 2060.1.

5020.2.14 INTERNAL LOAN REVIEW (QUESTION 14)

See Manual section 2060.6.

5020.2.15 ACCURACY AND TIMELINESS OF REPORTS (QUESTION 15)

If reports filed with the Federal Reserve (e.g. the FR Y–6 Annual Report) are not filed accurately and/or on time, provide comments as to the holding company's plans for correcting the problem. Any changes in accounting to conform with generally accepted accounting principles, as required by FR Y–6, should be discussed here.

5020.2.16 OUTSTANDING COMMITMENTS TO THE BOARD OF GOVERNORS (QUESTION 17)

If the holding company has outstanding commitments to the Board, summarize the commitments by describing the nature of the commitment, the date the commitment was made, and if applicable, the time frame in which it must be fulfilled. If the time frame has expired, or if an extension is deemed necessary to fulfill the commitment, details must be presented. The examiner may choose to make a reference to the unfulfilled commitment on the ''Examiner's Comments'' page 1, if considered appropriate.

5020.2.17 OTHER MATTERS HAVING A DETRIMENTAL IMPACT (QUESTION 18)

Discuss here any other matter having a detrimental impact upon the subsidiary bank(s) not discussed elsewhere in this report, and deemed pertinent by the examiner. Examples of some subject areas to be considered might be:

1. Public debt issues and commercial paper liabilities of the parent or nonbank subsidiary.

Comment on the following items where appropriate:

(1) Describe the debt instrument, including amount, interest rate, maturity, purchasers, and use of proceeds; (2) agency ratings; (3) determine whether any subsidiary (particularly a bank) sells the debt issue for its own use or on behalf of the parent and make critical comments whenever the issue does not clearly state that the issue is not an insured obligation of a bank subsidiary; (4) discuss any difficulties experienced in refinancing the debt; and (5) if a line of credit is used to back up a short term issue, indicate the lending bank, credit line, amount in use, expiration date, and required fee or compensating balance maintained by a subsidiary bank, if any, and whether the bank is being remunerated by the parent or nonbank affiliate. (See Manual section 5010.23.)

2. Adequacy of recordkeeping of the holding company, including nonbank subsidiaries. If

included, recommendations concerning the adoption of minimum recordkeeping standards should be presented and justified.

3. Contingent liabilities or violations not addressed elsewhere in the report (such as treasury stock purchased in violation of Regulation Y).

4. Payment of cash dividends in excess of net earnings available for common shareholders over the past year and the rate of earnings retention is not consistent with the organization's capital needs, asset quality, and overall financial condition.

5. Adverse relationships not elsewhere mentioned, such as inappropriate allocation of income and expenses of a nonbank activity performed by subsidiary bank employees.

Manual Section 5030.0 Page No.	*Report Page No.*	*Report Page Title*
FR 1225:		
3	i.	Table of Contents
4	1.	Examiner's Comments and Matters Requiring Special Board Attention
5	2.	Scope of Inspection and Abbreviations
6	3.	Analysis of Financial Factors
7	4.	Audit Program
8	5.	Parent Company Comparative Balance Sheet
9	6.	Parent Company Comparative Statement of Income and Expenses
10	7.	Summary of Consolidated Classified and Special-Mention Assets, and Other Transfer Risk Problems
11	8.	Consolidated Comparative Balance Sheet
12	9.	Comparative Consolidated Statement of Income and Expenses
13–14	10.	Consolidated Capital Structure
15		Policies and Supervision
16		Violations
17		Other Matters
18		Classified Assets and Capital Ratios of Subsidiary Banks
19		Organization Chart
20		History and Structure
21–22		Investment in and Advances to Subsidiaries
23		Commercial Paper
24		Lines of Credit
25		Commercial Paper/Lines of Credit (including questions)
26		Contingent Liabilities and Schedule of Balance-Sheet Accounts Not Detailed Elsewhere (Parent)
27		Statement of Changes in Stockholders' Equity
28–29		Income from Subsidiaries (Fiscal and Interim)
30–32		Cash Flow Statement (Parent) (including questions)[1]
33–34		Parent Company Liquidity Position
35		Parent Company and Nonbank Assets Subject to Classification
36		Bank Subsidiaries
37		Nonbank Subsidiary
38		Nonbank Subsidiary Financial Statements
39		Fidelity and Other Indemnity Insurance
40		(Reserved for Future Use)
41		Other Supervisory Issues
42–43		Extensions of Credit to Bank Holding Company Officials and Their Related Interests and Investments in and Loans on Stock or Obligations of Their Related Interests
44		Interest Rate Sensitivity—Assets and Liabilities
44.1		Treasury Activities/Capital Markets
45	A	Principal Officers and Directors
46	B	Condition of the Bank Holding Company
47	C	Liquidity and Debt Information
48	D	Administrative and Other Matters

1. This page is required to be included in the inspection report for bank holding companies with consolidated assets in excess of $1 billion or those companies that have substantive fixed charges or debt outstanding, as well as selected others at the option of the Reserve Bank.

Manual Section 5030.0 Page No.	*Report Page No.*	*Report Page Title*
FR 1241:		
49–50		Capital Structure (lead bank subsidiary)
51–52		Bank Subsidiary
53		Other Supervisory Issues

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REPORT OF BANK HOLDING COMPANY INSPECTION
FR 1225

Corporate title	Street	City
County	State	Zip Code

Mailing Address: ______________________

____

______________________ ______________________
Federal Reserve Bank Examiner in Charge

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Consolidated Comparative Statement of Income and Expenses	9
Consolidated Capital Structure	10

Date of Previous Inspection (Financial Statements as of) ______________________

Page 1

EXAMINER'S COMMENTS AND MATTERS
REQUIRING SPECIAL BOARD ATTENTION

Page 2

SCOPE OF INSPECTION AND ABBREVIATIONS

Page 3

ANALYSIS OF FINANCIAL FACTORS
(In thousands)

Page 4

AUDIT PROGRAM

Comment on the adequacy and the effectiveness of the holding company's audit program, including scope and frequency of audits of subsidiaries, and the relationship with the holding company's accounting firm. Identify to whom the auditor is responsible and who receives the audit reports. Describe the nature of any ''qualified opinion'' submitted by the independent auditors in certifying the most recent year's financial statements and any pertinent comments regarding relations with the directors' audit committee. If the holding company does not have its own audit staff, describe the role of the internal audit staffs of the subsidiaries, and the role of the independent accounting firm of the holding company, and state if such arrangements are adequate.

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PARENT COMPANY COMPARATIVE BALANCE SHEET
(In thousands)

	As of December 31, 19x3	19x2	19x1
ASSETS			
Cash and due from banks	$	$	$
Securities			
Loans and leases, net			
Investments in and rec. due from subsidiaries			
Premises and equipment			
Intangible assets			
Other assets			
Total Assets			
LIABILITIES			
Short-term borrowings			
Long-term borrowings			
Mandatory convertible securities			
Subordinated notes and debentures			
Other liabilities			
Balances due to subsidiaries			
Limited-life preferred stock			
Total Liabilities			
STOCKHOLDERS’ EQUITY			
Perpetual preferred stock			
Common stock			
Capital surplus			
Retained earnings			
Less: Treasury stock			
Total Stockholders’ Equity			
Total Liabilities and Stockholders’ Equity	$	$	$

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PARENT COMPANY COMPARATIVE STATEMENT
OF INCOME AND EXPENSES
(In thousands)

	For the Month Ended	For the Year Ended December 31,	
	19x3	19x2	19x1
INCOME			
Income from subs:			
Dividends	$	$	$
Interest			
Mgmt. and service fees			
Other income			
Securities gains (losses)			
Other income			
Total			
EXPENSES			
Personnel expense			
Interest			
Provisions			
Other expenses			
Total			
INCOME BEFORE TAXES AND EQUITY IN UNDISTRIBUTED EARNINGS			
Income taxes (Credits)			
Extraordinary items			
INCOME BEFORE EQUITY IN UNDISTRIBUTED EARNINGS			
Equity in undistributed earnings			
NET INCOME	$	$	$

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SUMMARY OF CONSOLIDATED CLASSIFIED AND SPECIAL MENTION ASSETS, AND OTHER TRANSFER RISK PROBLEMS
(In thousands)

Organization	Special Mention	Other Transfer Risk Problems	Substandard	Value Impaired	Doubtful	Loss	Total	Valuation Reserves
Parent:								
Bank Subsidiaries:								
Nonbank Subsidiaries:								
Total								
Total Classifications:								

Trends in Consolidated Asset Quality

Information dates as of:	19x1	19x2	19x3
Weighted classifications[1] / Tier 1 + Allowance for loan losses[2]			
Total classifications / Tier 1 + Allowance for loan losses[2]			
Allowance for loan and lease losses / Total loans and leases			

Information dates as of:	19x1	19x2	19x3
30+ PD & NA/Total loans & leases			
90+ PD & NA/Total loans & leases			
Allowance for loan and lease losses/ 90+ PD & NA			

1. Weighted classifications equal the aggregate of 20 percent of assets classified substandard and value impaired (net of allocated transfer risk reserve), 50 percent of doubtful, and 100 percent of loss.
2. For this ratio, tier 1 capital is to be calculated using risk-based capital guidelines effective December 31, 1992. Also, the allowance for loan and lease losses is included without limit.

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CONSOLIDATED COMPARATIVE BALANCE SHEET
(In thousands)

	, 19x3	As of December 31, 19x2	19x1
ASSETS			
Cash and due from banks	$	$	$
Securities			
Federal funds sold and Reverse REPOs			
Loans and leases—net ICNE			
Less: Reserves			
Trading account assets			
Premises and fixed assets			
Other real estate owned			
Affiliated investments			
Acceptances—customer's liab.			
Intangible assets			
Other assets			
Total Assets			
LIABILITIES			
Deposits			
Federal funds purchased and REPOs			
Commercial paper			
Other short-term borrowings			
Other long-term borrowings			
Mortgage indebtedness and lease obligations			
Mandatory convert. sec.			
Subord. notes and deb.			
Liability on acceptances			
Minority interest			
Other liabilities			
Limited-life prfd. stock			
Total Liabilities			
STOCKHOLDERS' EQUITY			
Perpetual prfd. stock			
Common stock			
Capital surplus			
Retained earnings			
Less: Treasury stock			
Total Stockholders' Equity			
Total Liabilities and Stockholders' Equity	$	$	$

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CONSOLIDATED COMPARATIVE STATEMENT
OF INCOME AND EXPENSES
(In thousands)

	For the Months Ended , 19x3	For the Year Ended December 31, 19x2	For the Year Ended December 31, 19x1
INTEREST INCOME			
Loan interest and fees	$	$	$
Lease financing rec.			
Interest bearing bank balance			
Securities			
Trading account income			
Fed. funds sold & Rev. REPOs			
Other interest income			
Total Interest Income			
INTEREST EXPENSE			
Deposits			
Fed. funds purch. & REPOs			
Borrowed funds			
Other interest expense			
Total Interest Expense			
NET INTEREST INCOME			
Provisions			
Net Interest Income After Provisions			
OTHER OPERATING INCOME			
Fiduciary activities			
Service charges and fees			
Trading account income			
Other income			
Security gains (losses)			
Total Other Income			
OTHER OPERATING EXPENSE			
Personnel			
Premises and fixed assets			
Other expenses			
Total Other Expense			
INCOME BEFORE TAX AND OTHER ADJUSTMENTS			
Income taxes (Credits)			
Minority interest			
Extraordinary items			
NET INCOME	$	$	$

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CONSOLIDATED CAPITAL STRUCTURE
(In thousands)

	As of December 31, x
TIER 1 CAPITAL:	
Common Stockholders' Equity:	
Common stock (par $_____: shares issued _____)	$
Common stock surplus	
Undivided profits and capital reserves (net)	
Less:Treasury stock	(______________)
Total Common Stockholders' Equity	
Cumulative foreign currency translation adjustments	
Minority interest in equity accounts of consolidated subsidiaries	______________
Subtotal of Core Capital Elements	
Perpetual preferred stock eligible for Tier 1	______________
Tier 1 Capital Elements	______________
Less: Goodwill	(______________)
Tier 1 Capital	______________
TIER 2 CAPITAL:	
Subordinated debt, intermediate-term preferred stock, and unsecured long-term debt	
Perpetual preferred stock and surplus eligible for Tier 2 only (par $_____: shares outstanding _____: rate_____%)	
Perpetual preferred stock exceeding Tier 1 limit	
Perpetual debt	
Mandatory convertible securities (net)	
Long-term limited-life preferred stock	
Allowance for loan and lease losses	______________
Supplementary Capital Elements	
Less: Supplementary capital elements eligible for Tier 1	(______________)
Tier 2 Capital Elements	
Less: Amount Tier 2 Capital exceeds Tier 1 Capital	(______________)
Tier 2 Capital	______________

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CONSOLIDATED CAPITAL STRUCTURE
(In thousands)

TOTAL QUALIFYING CAPITAL:	As of December 31, x
Tier 1 Capital	$
Tier 2 Capital	
Less: Investments in unconsolidated financial subsidiaries	( )
Reciprocal holdings of capital	( )
Total Qualifying Capital	$
RISK-WEIGHTED ASSETS:	
Risk-weighted balance sheet assets[1]	$
Risk-weighted off-balance sheet assets	
Add: Goodwill	
Gross Risk-Weighted Assets	
Less: Excess allowance for loan and lease losses (not included in capital)	( )
Allocated transfer risk reserve	( )
Risk-Weighted Assets	$

CAPITAL RATIOS AND TRENDS:

	Peer Data December 31, 19x1	As of December 31, 19x1	December 31, 19x0	December 31, 19x9
Tier 1 capital ratio:[2] Year-end 1992 rules	%	%	%	N/A %
Total capital ratio: Year-end 1992 rules	%	%	%	N/A
Tier 1 leverage ratio[3]	%	%	%	N/A
Tangible leverage ratio[4]	%	%	%	N/A

1. Risk-weighted balance sheet assets excludes all goodwill, net unrealized loss in marketable equity securities, investments in unconsolidated banking or financial subsidiaries, and reciprocal holdings of capital.
2. The Tier 1 capital ratio is calculated by deducting ½ of all investments in unconsolidated banking or financial subsidiaries from Tier 1 capital and dividing the remaining amount by risk-weighted assets. If there is insufficient Tier 2 capital from which the other half of the investments in unconsolidated banking or financial subsidiaries would be deducted, then also deduct the deficient amount from Tier 1 capital.
3. The Tier 1 leverage ratio is calculated by dividing Tier 1 capital (as defined by the final capital guidelines, effective December 31, 1992) by average total assets (for the most recent quarter) less all goodwill.
4. The tangible leverage ratio is calculated by deducting all intangibles from Tier 1 capital and dividing by average total assets (for the most recent quarter) less all intangibles.

Page

POLICIES AND SUPERVISION

Discuss and appraise the parent company's policies with respect to:

The level of control and supervision exercised over subsidiaries.

Dividends and fees from subsidiaries.

Loans and investments of subsidiaries.

Risk evaluation and control.

Funds management and the adequacy of existing policies.

Management information systems.

Loan participations by and between subsidiaries.

Internal loan review.

Page

VIOLATIONS

Page

OTHER MATTERS

Page

CLASSIFIED ASSETS AND CAPITAL RATIOS OF SUBSIDIARY BANKS
(In thousands)

Bank and Date of Examination	Total Assets	Sub-standard	Doubtful	Loss	Valua-tion Reserves	1992 Tier 1 Capital	1992 Total Capital	Weighted Classi-fied Assets[1] To 1992 Tier 1 Capital Plus Valua-tion Reserve	1992 Tier 1 Capital To Average Total Assets

1. Includes 100 percent of loss, 50 percent of doubtful, and 20 percent of substandard and value impaired.

Page

ORGANIZATION CHART

Page

HISTORY AND STRUCTURE

1. Date and State of incorporation:
2. Date acquired control of first subsidiary bank:
3. Date became subject to the Bank Holding Company Act of 1965, as amended:
4. Comment on the bank holding company's structure:

Page

INVESTMENT IN AND ADVANCES TO SUBSIDIARIES
As of________________
(In thousands)

Subsidiary	Investment	Advance	Total	% of Parent's Total Assets	% of Parent's Stock-holders' Equity

Page

INVESTMENT IN AND ADVANCES TO SUBSIDIARIES

1. If the parent's investment in a subsidiary differs from its proportionate interest in the stockholders' equity of the subsidiary, provided detail.
2. Provide details if any advance to a subsidiary has been reclassified as equity by the parent company since the last inspection.
3. Provide details if the proceeds of any parent company borrowings have been injected into its subsidiaries as Tier 1 and/or Tier 2 capital since the last inspection.
4. How does the parent determine the interest rate charged to the subsidiaries?
5. Does the parent company require timely payment of interest charged to subsidiaries?
6. Does the parent guarantee any liablities of the subsidiaries?

Comments:

Page

COMMERCIAL PAPER
(In thousands)

As of________________

Maturity Schedule

Maturity	Direct Placements	Dealer Placements	Total
0–30 days			
31–90 days			
91–180 days			
Over 180 days			
Total			

Page

LINES OF CREDIT
(In thousands)

As of________________

Lending Bank	Credit Line	Expiration Date	In Use	Available	Compensating Balance*

*Compensating balance maintained by subsidiary bank on behalf of parent.

Page

PARENT COMPANY COMMERCIAL PAPER AND LINES OF CREDIT

1. Indicate the commercial paper rating, the rating agency, any recent changes in the rating, and the range of current rates paid on all paper.
2. Does any subsidiary sell commercial paper either for its own use or on behalf of the parent? If so, discuss.
3. Does the commercial paper clearly state that it is not an insured obligation of any banking subsidiary?
4. What is the minimum denomination of commercial paper sold?
5. Indicate the amount of parent's commercial paper being held in the trust department(s) of the subsidiary bank(s).
6. Discuss the holding company's policy with regard to the use of the proceeds from the sale of commercial paper.
7. Is there any concentration of holdings in excess of 10 percent of the bank holding company's commercial paper by any individual, organization or industry? If so, discuss.
8. Has the parent experienced any difficulty in refinancing its commercial paper at maturity? If so, discuss.
9. Indicate which of the lines of credit are contractual obligations of the lender.
10. Indicate which lines are specifically used as back-up lines for commercial paper borrowings.
11. Indicate if the lines of credit are used on a systematic rotation basis.
12. Indicate which lines of credit are reciprocal between the lender and either the subject bank holding company or its subsidiary banks.
13. Indicate if any subsidiary is authorized to borrow directly on the parent company's lines of credit.

Comments:

Page

PARENT COMPANY CONTINGENT LIABILITIES AND SCHEDULE
OF BALANCE SHEET AND INCOME & EXPENSE
ACCOUNTS NOT DETAILED ELSEWHERE
(In thousands)

Page

PARENT COMPANY STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
(In thousands)

	Preferred Stock	Common Stock	Capital Surplus	Retained Earnings	Treasury Stock	Total
Balance as of 12-31-x3						

Page

INCOME FROM SUBSIDIARIES - INTERIM
For the ____ months ended ____
(In thousands)

Subsidiary	Equity in Undis-tributed Earnings	Dividends	Dividend Payout Ratio	Interest	Manage-ment Fees	Service Fees	Fees as a Percent of Subsidiary's Net Income

Page

INCOME FROM SUBSIDIARIES - FISCAL
For the ____ months ended ____
(In thousands)

Subsidiary	Equity in Undis-tributed Earnings	Dividends	Dividend Payout Ratio	Interest	Manage-ment Fees	Service Fees	Fees as a Percent of Subsidiary's Net Income

Page

PARENT COMPANY CASH FLOW STATEMENT
(in thousands)

		Prior Fiscal Year	Current Fiscal Year	Next Fiscal Year
INCOME				
Dividends from subsidiaries		$	$	$
Interest from subsidiaries				
Management and service fees				
Other operating cash income				
Total Cash Income				
EXPENSES				
Interest	(2)			
Lease and rental	(3)			
Salary and employee benefits				
Other operating cash expenses				
Total Cash Expenses				
BEFORE TAX CASH INCOME				
Income tax payments from:				
Bank				
Nonbank/Other				
Income tax payments				
AFTER TAX CASH INCOME	(1)			
EXTERNAL SOURCES				
Issuance of stock				
Net increase in borrowed funds				
Advances to subsidiaries repaid:				
Bank				
Nonbank				
Sale of assets				
Total External Sources		$	$	$

Page

PARENT COMPANY CASH FLOW STATEMENT
(in thousands)

	Prior Fiscal Year	Current Fiscal Year	Next Fiscal Year
EXTERNAL USES			
Net decrease in borrowed funds	$	$	$
Dividend payments: Preferred (5)			
Common (6)			
Equity investment in subsidiaries:			
Bank			
Nonbank			
Advances to subsidiaries:			
Bank			
Nonbank			
Purchase of assets			
Total External Uses			
NET CHANGE IN CASH POSITION			
CASH BALANCE BEGINNING			
ENDING CASH BALANCE	$	$	$
Memorandum:			
Contractual long-term debt retired (4)	$	$	$

Page

PARENT COMPANY CASH FLOW STATEMENT
(in thousands)

	Prior Fiscal Year	Current Fiscal Year	Next Fiscal Year
FIXED CHARGE COVERAGE RATIO:			
$\dfrac{(1)+(2)+(3)}{(2)+(3)+(4)+(5)}$			
COMMON STOCK CASH DIVIDEND COVERAGE RATIO:			
$\dfrac{(1)-[(4)+(5)]}{(6)}$			

1. Are the parent company's fixed charges covered by its cash earnings? What is the amount of excess or deficiency?
2. Are the parent company's dividend payments to stockholders covered by its residual cash earnings? What is the amount of excess or deficiency?
3. Giving full consideration to the requirements for loan loss reserves and capital structure of the bank and the major nonbank subsidiaries:
   (a) Is the present level of dividends paid by the bank and the major nonbank subsidiaries to the parent company sustainable?
   (b) What is the scope for increasing the cash flow to the parent company?
4. If cash flow is insufficient to cover fixed charges and cash dividend payments, discuss the steps management has taken, or plans to take, to restore adequate cash earnings coverage. Include comments on whether such plans would be commensurate with the maintenance of adequate loan loss reserves and capital levels in the bank and the major nonbank subsidiaries.
5. If cash flow is insufficient to cover cash dividend payments, should the parent company revise its dividend policy to conform to the Board's guidelines on the payment of cash dividends?
6. Discuss significant cash flow transactions as deemed appropriate by the examiner.

Page

PARENT COMPANY LIQUIDITY POSITION
(In thousands)

As of________________

	0–30 Days*	31–90 Days	91 Days– 1 Year	1–2 Years	2 Years Plus	Total
ASSETS						
Cash & Non-interest Bearing Balances Due from Banks						
Interest Bearing Deposits:						
With Subsidiary Banks						
With Other Banks						
Securities Purchased Under Agreements To Resell						
Advances/Loans to:						
Subsidiaries**						
Non-affiliated Entities						
Marketable Investment Securities (Market Value)						
Trading Account						
Interest Receivable						
Dividends Receivable						
Investments in Subsidiaries						
Other Assets						
Totals						

Page

PARENT COMPANY LIQUIDITY POSITION
(In thousands)

	0–30 days*	31–90 days	91 days–1 Year	1–2 Years	2 Years Plus	Total
LIABILITIES						
Commercial Paper						
Master Notes						
Due to Banks						
Securities Sold Under Agreements to Repurchase						
Interest Payable						
Dividends Payable						
Other Short-term Liabilities or Debt						
Other Liabilities						
All Long-term Debt						
Totals						
Net Position						
Cumulative Excess (Deficiency)			***			

*For certain organizations, this grouping may be broken down into two categories 0–7 days and 8–30 days.
**Do not include mandatory convertible or equity commitment notes.
***Cumulative deficiency in this category must be covered appropriately through a contingency plan, including unused back-up lines of credit.

Page

PARENT COMPANY AND NONBANK SUBSIDIARY ASSETS
SUBJECT TO CLASSIFICATION

	Classification		
Description of Assets*	Substandard (Amount)	Doubtful (Amount)	Loss (Amount)

*Including maker (and endorser where applicable), security and comments.

Page

BANK SUBSIDIARIES
(in thousands)

Page

NONBANK SUBSIDIARY

1. Name:
2. Location:
3. Date of FRS approval:
4. Date acquired or established:
5. Date activity commenced (*de novo* only):
6. Statutory authority:
7. Branch office locations:
8. History and description:
9. Risk assessment:

Page

NONBANK SUBSIDIARY FINANCIAL STATEMENTS
(in thousands)

Page

FIDELITY AND OTHER INDEMNITY INSURANCE

	Name of Surety	Primary Amount	Excess Amount	Expiration Date

1. Bankers blanket and fidelity bonds:

   a. Blanket bonds

   b. Excess fidelity bonds

2. Are all officers and employees covered by bankers blanket or fidelity bonds?_____

3. Date of last recorded directors' approval of bankers blanket and fidelity bonds:_____

4. Indicate if any of the above coverage applies to any subsidiary of the holding company.

5. Indicate if any subsidiary of the holding company maintains the above coverage and extends the coverage to the holding company.

Examiner's Comments:

Page

OTHER SUPERVISORY ISSUES
(FR 1225)

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1. Are there any intercompany transactions subject to comment? ____ . If so, discuss.
2. Does the subsidiary bank(s) maintain compensating balances at another institution for debt advanced to the holding company? ____ . If the bank is not adequately compensated, discuss.
3. Do the holding company's intercorporate income tax accounting policies and practices conform with the Board of Governor's September 1978 policy statement? ____ . If not, discuss.
4. Is the holding company in compliance with the tie-in prohibitions contained in Section 106(b) of the BHC Act Amendments of 1970? ____ . If not, discuss.
5. Are there any insider transactions subject to comment? ____ . If so, discuss.
6. Is the holding company or its subsidiary(ies) a defendant in any litigation the results of which could have a significantly adverse effect on the overall organization? ____ . If so, discuss.
7. Is the insurance program for the holding company considered adequate? ____ . If not, discuss.
8. Is the holding company's audit program considered adequate? ____ . If not, discuss
9. Is the holding company's quality review program considered effective? ____ . If not, discuss.
10. Are reports filed with the Federal Reserve System prepared accurately and submitted on a timely basis? ____ . If not, discuss.
11. Has the holding company complied with all representations made in application(s) to the Board of Governors? ____ . If not, discuss.
12. Does the holding company have any outstanding commitments to the Board of Governors? ____ . If so, discuss.

Page

EXTENSIONS OF CREDIT TO BANK HOLDING COMPANY OFFICIALS AND THEIR RELATED INTERESTS AND INVESTMENTS IN AND LOANS ON STOCK OR OBLIGATIONS OF THEIR RELATED INTERESTS
(In thousands)

Recapitulation

	Direct	Indirect
1. Extensions of credit by the parent or its nonbank subsidiaries to:		
a. principal shareholders'[1] of the parent company or its subsidiaries (excluding the subsidiary bank's nonbank subsidiaries)		
b. directors of the parent company or its subsidiaries (excluding the subsidiary bank's nonbank subsidiaries)		
c. executive officers[2] of the parent company of its subsidiaries (excluding the subsidiary bank's nonbank subsidiaries)		
d. related interests[3] of a bank holding company official[4]		
2. Investment of the parent company and its nonbank subsidiaries in stocks, bonds or other obligations of a related interest[3] of a bank holding company official[4]		
3. Loans by the parent company or its nonbank subsidiaries to any borrower secured by stocks, bonds of other obligations of a related interest[3] of a bank holding company official.[4]		
Totals		

1. ''Principal shareholder'' as defined in Section 215.2(j) of Regulation O.
2. ''Executive officer'' as defined in Section 215.2(d) of Regulation O.
3. ''Related interests'' as defined in Section 215.2(k) of Regulation O. Note the terms ''company'' and ''control'' are defined in Section 215.2(a) and (b) respectively, of Regulation O. However, for purposes of this item, ''related interests'' shall also include ''insured banks.''
4. ''Bank holding company official'' is defined as any director, executive officer, or principal shareholder of the parent company or any of its subsidiaries, excluding the subsidiary bank's nonbank subsidiaries.

Page

EXTENSIONS OF CREDIT TO BANK HOLDING COMPANY OFFICIALS AND THEIR RELATED INTERESTS AND INVESTMENTS IN AND LOANS ON STOCK OR OBLIGATIONS OF THEIR RELATED INTERESTS
(In thousands)

Schedule

Listed individually below within each group as defined on the previous page are only those loans and investments of $______ or more and all loans and investments classified; all other loans and investments are combined within each group and are not listed individually. Duplications within and between groups are deducted from the total of the appropriate group.

Name of Borrower or Investment and Comments	Direct	Indirect	Terms

Page

INTEREST RATE SENSITIVITY
ASSETS AND LIABILITIES
(In Thousands)

	Repricing Interval				
	1–90 Days	91–180 Days	181–365 Days	1–2 Years	2–5 Years
Interest-Sensitive Assets:					
Totals					
Cumulative totals					
Interest-Sensitive Liabilities:					
Totals					
Cumulative totals					
Gap					
Cumulative Gap					
Interest-sensitive Assets/ Interest-sensitive Liabilities (cumulative)			%	%	%
Cumulative gap/ Total assets			%	%	%

Comments:

Page

TREASURY ACTIVITIES/CAPITAL MARKETS
(FR 1225)

1. Provide an overview of the organization's capital markets activities. The overview should distinguish between various types of functional activity, such as market making, trading, or end user, and include a relevant measure of volume for the activity as well as earnings performance.

2. Does the organization maintain written policies and procedures that clearly outline the process for controlling risks inherent in the organization's functional activities? Describe where policies and procedures are deficient.

3. Does the organization have a written overall strategy covering all capital markets activities? ____ Explain.

4. Has this strategy been effectively communicated to the Board of Directors? ____ Explain.

5. Does the organization have risk-management processes in place to manage and control all significant risk exposures (e.g., market, credit, operations, liquidity, and legal-risk exposures)? ____ Can the organization manage and control risks on a consolidated basis? ____ Explain.

6. Specifically, describe how the organization measures and manages the market-risk exposures related to these activities. Is this process adequate given the complexity and size of the activities as well as the capital position of the institution? ____ Explain.

7. Also describe how the organization measures and manages both the current and potential credit-risk exposures related to these activities. Is this process adequate given the complexity and size of the activities as well as the capital position of the institution? ____ Explain.

8. Does the organization have management information systems to provide accurate and timely information to senior management and the board of directors?

9. Are internal control processes sufficient to ensure safe and sound operations? ____ Explain.

10. Does the organization have an audit plan for capital markets activities? ____ Is it Adequate? ____ Explain.

Page A

Confidential Section
PRINCIPAL OFFICERS AND DIRECTORS

Regular schedule of director's meetings: _____.

Fee paid each director: _____.

*Meetings missed of _____ held during the last _____ months.

Name Address (City, Sate) Year of Birth	Shares Owned	Years on BHC Board	Meetings Missed*	Salary (1 and 2 only)	Bonus (1 and 2 only)	Title/Position at: 1. Holding Company (Committees) 2. Subsidiary and/or Affiliate 3. Prinicpal Occupation or Business Affiliation
				$	$	1. 2. 3.
				$	$	1. 2. 3.
				$	$	1. 2. 3.
				$	$	1. 2. 3.
				$	$	1. 2. 3.

Page B

Confidential Section
CONDITION OF BANK HOLDING COMPANY

1. Future prospects of holding company.
2. Assess Management and the Board of Directors. In addition, appraise the policies with respect to the level of control and supervision exercised over subsidiaries, including risk evaluation and control and management information systems.
3. Subsidiary bank(s), date of most recent examination and rating.
4. Is the holding company a member of a chain banking organization? _____ Summarize significant problems at any affiliated holding company, subsidiary bank or in the chain organization.
5. List individuals or groups that own or control 5 percent or more of the outstanding voting shares of the bank holding company's stock. Discuss significant changes in ownership.
6. Other supervisory concerns.
7. BOPEC Rating.
8. Recommendations for supervisory action.

Comments:

Page C

Confidential Section
LIQUIDITY AND DEBT INFORMATION
(In thousands)

Parent Only Short-term GAP Position

	0–30 days	31–90 days	91 days–1 year
Liquid Assets			
Commercial Paper			
Net			
Net cumulative			

Long-term Debt

List all unaffiliated long-term debt in the following format indicating the amount that qualifies as Tier 2 capital.

Borrower	Type of Issue	Original Amount	On Date	Rate	Due Date	Present Out-standing	Lender
		$		%		$	
		$		%		$	
		$		%		$	
		$		%		$	
		$		%		$	
		$		%			

Page D

Confidential Section
ADMINISTRATIVE AND OTHER MATTERS

Name of Examiners	Total Work Days: Field	Total Work Days: Office

Final meeting held with:

Contact persons for records of bank holding company:

Suggestions for the next inspection:

Comments on Other Matters:

______________________________ Page
Bank Subsidiary Name

BANK SUBSIDIARY CAPITAL STRUCTURE
(In thousands)

	As of December 31, 19xx
TIER 1 CAPITAL:	
Common Stockholders' Equity:	
Common stock (par $_____: shares issued _____)	$
Common stock surplus	
Undivided profits and capital reserves (net)	__________
Total Common Stockholders' Equity	
Cumulative foreign currency translation adjustments	
Noncumulative perpetual preferred stock and related surplus (par $_____: shares outstanding _____: rate_____%)	
Minority interest in equity accounts of consolidated subsidiaries	
Tier 1 Capital Elements	__________
Less: Goodwill	(__________)
Tier 1 Capital	__________
TIER 2 CAPITAL:	
Subordinated debt and intermediate-term preferred stock	
Mandatory convertible securities (net)	
Cumulative perpetual preferred stock and related surplus (par $_____: shares outstanding _____: rate_____%)	
Long-term limited-life preferred stock	
Allowable allowance for loan and lease losses	__________
Supplementary Capital Elements	
Less: Supplementary capital elements eligible for Tier 1	(__________)
Tier 2 Capital Elements	
Less: Amount Tier 2 Capital exceeds Tier 1 Capital	(__________)
Tier 2 Capital	__________
TOTAL QUALIFYING CAPITAL:	
Tier 1 Capital	$
Tier 2 Capital	
Less: Investments in unconsolidated financial subsidiaries	( )
Reciprocal holdings of capital	(__________)
Total Qualifying Capital	$__________

Page

BANK SUBSIDIARY CAPITAL STRUCTURE
(In thousands)

	As of December 31, x
RISK-WEIGHTED ASSETS:	
Risk-weighted balance sheet assets[1]	$
Risk-weighted off-balance sheet assets	
Gross Risk-Weighted Assets	
Less: Excess allowance for loan and lease losses (not included in capital)	( )
Allocated transfer risk reserve	( )
Risk-Weighted Assets	$ [2]

CAPITAL RATIOS AND TRENDS:

	Peer Data December 31, 19x1	Quarter Ended December 31, 19x1	Year Ended December 31, 19x0	Year Ended December 31, 19x9
Tier 1 capital ratio:[3]				
Year-end 1992 rules	%	%	%	%
Total capital ratio:				
Year-end 1992 rules	%	%	%	%
Tier 1 leverage ratio[4]	%	%	%	%
Tangible leverage ratio[5]	%	%	%	%

1. Risk-weighted balance sheet assets excludes all goodwill, net unrealized loss in marketable equity securities, investments in unconsolidated banking or financial subsidiaries, and reciprocal holdings of capital.
2. If the bank's risk-based capital ratios exceed the December 31, 1992 minimum requirements and detailed risk-weighted asset information is not readily available, then write 'NA' here and on Tier 1 capital ratio and total capital ratio lines below.
3. The Tier 1 capital ratio is calculated by deducting ½ of all investments in unconsolidated banking or financial subsidiaries from Tier 1 capital and dividing the remaining amount by risk-weighted assets. If there is insufficient Tier 2 capital from which the other half of the investments in unconsolidated banking or financial subsidiaries would be deducted, then also deduct the deficient amount from Tier 1 capital.
4. The Tier 1 leverage ratio is calculated by dividing Tier 1 capital (as defined by the final capital guidelines, effective December 31, 1992) by average total assets (for the most recent quarter) less *all* goodwill.
5. The tangible leverage ratio is calculated by deducting all intangibles from Tier 1 capital and dividing by average total assets (for the most recent quarter) less all intangibles.

Page

BANK SUBSIDIARY
(In thousands)
(FR 1241)

Balance Sheet Data

	, 19x3	As of December 31, 19x2	19x1
Cash and due from banks	$	$	$
Investments			
Federal funds sold			
Loans (net of ICNE)			
Valuation reserve	( )	( )	( )
Other assets			
Total Assets			
Total deposits			
Borrowings			
Other liabilities			
Subordinated debt			
Total liabilities			
Stockholders' Equity			
Total Liabilities and Stockholders' Equity	$	$	$
Asset growth rate	%	%	%

Income Data

	Months Ended (Month), 19x3	For the Year Ended December 31, 19x2	19x1
Net Income	$	$	$
Cash dividends	$	$	$
Net income to average assets	%	%	%
Cash dividends to net income	%	%	%

Page

BANK SUBSIDIARY
(In thousands)
(FR 1241)

Examination Data

	As of		
	(Month), 19xx	(Month), 19xx	(Month), 19xx
Classified assets:			
Substandard			
Doubtful			
Loss			
Weighted classified assets[1] to Tier 1 and Allowance for loan losses[2]	%	%	%

1. Twenty percent of substandard and value impaired (when applicable), plus 50 percent of doubtful, plus 100 percent of loss classification.
2. For this ratio, Tier 1 capital is to be calculated using risk-based capital guidelines effective December 31, 1992. Also the allowance for loan and leases losses is included without limit.

Page

OTHER SUPERVISORY ISSUES
(FR 1241)

1. Comment on the extent of control the holding company exercises over the policies of the subsidiary bank. ____ .
2. Is the holding company's policy on assessing dividends from the subsidiary bank(s) reasonable and is it being complied with? ____ .
3. Has the holding company complied with all representations made in application(s) to the Board of Governors? ____ .
4. Does the subsidiary bank(s) maintain compensating balances at another institution for debt advanced to the holding company? ____ .
5. If applicable, describe the holding company's policy on assessing management and service fees for work performed for the subsidiary bank. Are policies and fees reasonable? ____ .
6. Are there any intercompany transactions subject to comment? ____ .
7. Are there any insider transactions subject to comment? ____ .
8. Do the holding company's intercorporate income tax accounting policies and practices conform with the Board of Governors' September, 1978 policy statement? ____ .
9. If the holding company uses a subsidiary bank's personnel, or assets to sell credit related life insurance to the bank's customers, does the holding company give the bank reasonable compensation for its services in compliance with the Board of Governors' policy statement of May, 1981? ____ .
10. Is the holding company in compliance with the tie-in prohibitions contained in Section 106(b) of the BHC Act Amendments of 1970? ____ .
11. Is the holding company or its subsidiary(ies) a defendant in any litigation the results of which could have a significantly adverse effect on the overall organization? ____ .
12. Is the insurance program for the holding company organization considered adequate? ____ .
13. Is the holding company's audit program considered adequate? ____ .
14. Is the holding company's credit quality review program considered effective? ____ .
15. Are reports filed with the Federal Reserve System prepared accurately and submitted on a timely basis? ____ .
16. Did the inspection uncover any violation of law, regulation or Federal Reserve policy statement not cited above? ____ .
17. Does the holding company have any outstanding commitments to the Board of Governors? ____ .
18. Is there any other matter having a detrimental impact on the subsidiary bank(s) not discussed elsewhere in this report?____ .

5040.0.1 OBJECTIVES

The limited-scope inspection will review all areas of activity covered by a full-scope inspection report but less intensively.

5040.0.2 IMPLEMENTATION GUIDELINES

The ultimate responsibility for determining the appropriateness of the limited scope, and the actual elements of the scope of the inspection beyond the guidelines, rests with the Reserve Bank.

Certain report pages are required to be included in the limited-scope inspection. Other pages are required when certain events trigger their applicability, "exception (E)" pages. Pages not required may be included at the Reserve Bank's option. These are labeled as "optional" pages.

5040.0.2.1 Required Report Pages

As in the full-scope inspection report,[1] the limited-scope inspection report is divided into three parts: a core section, a section consisting of report pages that provide support to the core section, and a confidential section.

Core section. The core section of the report serves as the main vehicle for communicating the results of the inspection to management. The core pages contain the scope of the inspection, comments on administration of policies and supervision over subsidiaries, and an analysis of the BOPEC components, any or all of which could be used to support supervisory action, when necessary.

Support section. The supporting report pages contain narrative and financial and other data to support the analyses in the core section. The *required* pages provide the primary statistical support when addressing important supervisory problems or issues, and as appropriate, the BOPEC rating, or supervisory action, when needed.

Confidential section. The pages in this section are also required since they address matters of supervisory importance and other matters not deemed appropriate in the open section.

For a limited-scope inspection, the following report pages are *required:*

Manual Section No.	*Page Location*	*Page Title*
5010.2		Cover (FR 1427)
5010.3	Page i	Table of Contents
5010.4	Core Page 1	Examiner's Comments
5010.5	Core Page 2	Scope of Inspection
5010.41	Confidential Page B	Condition of the BHC

The Directors' Summary Report will be required as in the full-scope inspection. Appropriate information provided by other reporting vehicles, inspection/examination activities or other financial institution regulatory agencies should be considered. Refer to footnote #3 for further guidance as to the need for a Directors' Summary Report.

1. The basis for the limited-scope inspection report will be the "large" report, FR 1225.

5040.0.2.2 Exception Limited-Scope Report Pages

The following ‘‘exception (E)’’ pages should be included in the report as indicated below:

Manual Section No.	*Page Location*	*Page Title*
5010.6	Core Page 3	Structure and Abbreviations
5010.7	Core Page 4	Analysis of Financial Factors
5010.10	Core Page 7	Summary of Consolidated Classified and Special Mention Assets, and Other Transfer Risk Problems
5010.11	Core Page 8	Consolidated Comparative Balance Sheet
5010.12	Core Page 9	Comparative Statement of Income and Expenses (Consolidated)
5010.13	Core Page 11*	Capital Structure (Consolidated)[2]
5010.14	Page	Policies and Supervision
5010.15	Page	Violations
5010.16	Page	Other Matters
5010.17	Page*	Classified Assets and Capital Ratios of Subsidiary Banks
5010.19	Page*	History and Structure
5010.27	Page	Cash Flow Statement (Parent)
5010.28	Page	Parent Company Liquidity Position
5010.29	Page*	Parent Company and Nonbank Assets Subject to Classification
5010.31	Page*	Nonbank Subsidiary
5020.2	Page	Other Supervisory Issues
5010.40	Confidential Page A*	Principal Officers and Directors
5010.43	Confidential Page D	Administrative Matters

Pages with an (*) are optional if the limited-scope inspection is preceded by a full-scope inspection within the same annual period.

2. The corresponding FR 1241 page may be used if the basis is to be a lead bank subsidiary rather than on a consolidated position.

5040.0.2.2.1 Reasoning for Including ‘‘E’’ Pages

The ‘‘E’’ pages are included when the activities are present, or have been disclosed through the inspection process, or when significant findings or issues must be reported and communicated to management or to the appropriate supervising agency(ies). The limited-scope inspection report may include, at the discretion of the appropriate Reserve Bank, copies of the Bank Holding Company Financial Statements (FR Y-9) and Reports of Condition of Subsidiary Banks in place of pages containing required or optional financial statements. The FR Y-9 statements or the Reports of Condition should only be included when the financial statements accurately represent the condition of the bank holding company as determined during the inspection.

5040.0.2.3 Optional Limited-Scope Report Pages

In the limited-scope inspection, several pages have been labeled as optional because of the nonexistence of an activity or the absence of a problem in that area. Any inspection report page may be included in the report at the option of the Reserve Bank or the examiner-in-charge. Note that the ‘‘Commercial Paper’’ and related pages (5010.21 through 5010.23) are optional since the existence of this activity would be a ‘‘complex’’ organization, requiring a full-scope examination within the same annual period.

The *optional* pages are:

Manual Section No.	*Page Location*	*Page Title*
5010.8	Core Page 5	Parent Company Comparative Balance Sheet
5010.9	Core Page 6	Comparative Statement of Income and Expenses (Parent)
5010.18	Page	Organization Chart
5010.20	Page	Investment in and Advances to Subsidiaries
5010.21	Page	Commercial Paper (Parent)
5010.22	Page	Lines of Credit (Parent)
5010.23	Page	Commercial Paper and Lines of Credit (Parent)
5010.24	Page	Contingent Liabilities and Schedule of Balance Sheet Accounts Not Detailed Elsewhere (Parent)
5010.25	Page	Statement of Changes in Stockholders’ Equity
5010.26	Page	Income from Subsidiaries (Fiscal and Interim)
5010.30	Page	Bank Subsidiaries
5010.32	Page	Nonbank Subsidiary Financial Statements and Condition
5010.33	Page	Fidelity and Other Indemnity Insurance
5010.34	Page	Audit Program
5010.37	Page	Interest Rate Sensitivity—Assets and Liabilities
5010.42	Confidential Page C	Liquidity and Debt Information

5040.0.3 LIMITED-SCOPE INSPECTION PROCEDURES

Procedure:	Complete FR 1417 and indicate that the scope was limited (‘‘L’’).
Nature of Inspection:	Disclose on the ‘‘Scope of Inspection’’ page that the scope is limited including any additional procedures utilized for a certain area or activity during the inspection that might be comparable to a full-scope inspection.
Directors’ Summary:	Required under the same conditions as in the full scope.[3]
Rating:	Assign BOPEC rating as appropriate. Indicate under what circumstances the rating was assigned and what components were changed, including the reasons why they were changed.
Inspection Cover:	Cover will designate ‘‘limited’’ scope (FR 1427) and will be a designated color other than the full-scope reports.

3. Should generally be prepared in accordance with the requirement for the preparation of written reports to directors summarizing the examination finding following a full-scope examination. Reserve Banks that have previously identified the problems and provided a report to the directors are not required to prepare the summary for the limited-scope inspection.

5040.0.4 LIMITED-SCOPE INSPECTION REPORT COVER (FR 1427)

FR 1427–Cover
(Revised 7/94)

REPORT OF BANK HOLDING COMPANY INSPECTION

(Limited Scope)

Name: ____________________

Location: ____________________

RSSD ID Number: ____________________

Inspection Commenced: ____________________

Inspection Concluded: ____________________

Inspection Date: ____________________

THIS REPORT OF INSPECTION IS STRICTLY CONFIDENTIAL

This report has been prepared by an examiner selected or approved by the Board of Governors of the Federal Reserve System. The report is the property of the Board of Governors and is furnished to directors and management for their confidential use. The report is strictly privileged and confidential under applicable law, and the Board of Governors has forbidden its disclosure in any manner without its permission, except in limited circumstances specified in the law (12 USC 1817(a) and 1831m) and in the regulations of the Board of Governors (12 CFR 261.11). Under no circumstances should the directors, officers, employees, trustees or independent auditors disclose or make public this report or any portion thereof except in accordance with applicable law and the regulations of the Board of Governors. Any unauthorized disclosure of the report may subject the person or persons disclosing or receiving such information to the penalties of Section 641 of the U.S. Criminal Code (18 USC 641). Each director or trustee, in keeping with his or her responsibilities, should become fully informed regarding the contents of this report. In making this review, it should be noted that this report is not an audit, and should not be considered as such.

FEDERAL RESERVE BANK OF

5050.0.1 OBJECTIVES OF A TARGETED INSPECTION

A targeted inspection is designed to focus intensively on one or more specific areas, activities, or problems relating to a bank holding company. Such inspections may be conducted for various reasons, including serving as a complement to an annual full-scope inspection.[1] Targeted inspections are conducted as directed by the System or at the discretion of the individual Reserve Banks. As a minimum, the inspection procedures used are comparable to a full-scope inspection.

1. FR 1225 will serve as the basis for a targeted inspection.

Report Pages Included:	Cover (FR 1428)
	Table of Contents for included pages and a key for abbreviations used in the report
	Examiner's Comments
	Scope of Inspection
	Other report pages supporting the scope, and the nature of the targeted inspection, as deemed appropriate by the Reserve Bank and the examiner-in-charge.
	Confidential pages consisting of confidential page B, "Condition of the Bank Holding Company," and confidential page D, "Administrative Matters."
Nature of Inspection:	Disclose on the "Scope of Inspection" that the scope is targeted and describe the procedures utilized for the targeted areas or activities.
Directors' Summary:	Required as prescribed in the full scope.[2]
Rating:	A new BOPEC *composite rating* of 1 through 5 would only be assigned if the bank holding company inspection results provide sufficient information to either reaffirm or modify the most recently assigned BOPEC composite rating. At least one component area must be rated between 1 and 5 in order to assign a new composite rating; otherwise a composite rating of 0 should be assigned.

2. Should generally be prepared in accordance with the requirement for the preparation of written reports to directors summarizing the examination finding following a full-scope examination. Reserve Banks that have previously identified the problems and provided a summary report to the directors are not required to prepare the summary for the targeted examination.

5050.0.2 TARGETED INSPECTION REPORT COVER (FR 1428)

FR 1428–Cover
(Revised 7/94)

REPORT OF BANK HOLDING COMPANY INSPECTION (Targeted Scope)

Name: ______________________

Location: ______________________

RSSD ID Number: ______________________

Inspection Commenced: ______________________

Inspection Concluded: ______________________

Inspection Date: ______________________

THIS REPORT OF INSPECTION IS STRICTLY CONFIDENTIAL

This report has been prepared by an examiner selected or approved by the Board of Governors of the Federal Reserve System. The report is the property of the Board of Governors and is furnished to directors and management for their confidential use. The report is strictly privileged and confidential under applicable law, and the Board of Governors has forbidden its disclosure in any manner without its permission, except in limited circumstances specified in the law (12 USC 1817(a) and 1831m) and in the regulations of the Board of Governors (12 CFR 261.11). Under no circumstances should the directors, officers, employees, trustees or independent auditors disclose or make public this report or any portion thereof except in accordance with applicable law and the regulations of the Board of Governors. Any unauthorized disclosure of the report may subject the person or persons disclosing or receiving such information to the penalties of Section 641 of the U.S. Criminal Code (18 USC 641). Each director or trustee, in keeping with his or her responsibilities, should become fully informed regarding the contents of this report. In making this review, it should be noted that this report is not an audit, and should not be considered as such.

FEDERAL RESERVE BANK OF

A management information system (MIS) can be described as an automatic data processing system designed to aid in the performance of management functions. The MIS system is used in the decision-making process, which facilitates the collection and presentation of information to plan, organize, and control activities within the confines of the organizational culture. MIS encompasses the policies, procedures, and internal controls pertaining to management reporting which provide the information needed by the board to monitor and ensure control of operations and activities. MIS supports all levels of the organization in the execution of their duties—from the board of directors down to the lowest level of management within the company. A successful MIS will support the strategic direction of the company and promote the process by which decisions are made.

The objective of a targeted MIS inspection is to determine if the corporation has in place a management information system which is capable of providing its board of directors and senior management committees with sufficient, reliable, and timely data from which informed decisions can be made to monitor and manage risks. As a result, the targeted inspection uses a ‘‘top-down’’ approach, which focuses on the information used by the board and senior management committees and on the overall MIS architecture. For further inspection guidance, see the MIS sections 2060.0 to 2060.5 and SR-95-45 and its exhibits. The MIS supporting other levels of management should be reviewed during subsequent bank holding company inspections.

A targeted MIS inspection should be performed in companies in which there has been a notable alteration in the risk profile or aggressive expansion, or in which significant changes in information systems have occurred. This will ensure that executive management and the board have taken into consideration MIS and its ability to keep up with the changes in the organization. It should be noted that there is no one management reporting system. Depending on the structure of the organization, the activities that it engages in, the risk profile that results, and the technological environment that it operates under, MIS will be different in each bank holding company.

A key element of a successful MIS is the creation of the necessary technological support system. Since MIS is the primary tool for executive management and the board to monitor risk and measure performance, it is vital that the generated reports are accurate, provide sufficient information, and address all areas of the organization. Thus, data integrity is a key factor in analyzing the MIS process; inaccurate data can lead to faulty conclusions by management and the board. In addition, information flows to the top level of the organization should be comprehensive enough to allow for informed decisions. An overload of trivial information can cause confusion and slow the decision-making process.

The MIS inspection process focuses on three broad areas:

1. Relevance and Use of MIS
   - overall risk assessment of the corporation
   - identification of risk responsibilities and reporting lines within the organization
   - evaluation of the quality and relevancy of MIS reports
2. Internal Controls over MIS Integrity
   - identification of information flows and internal control points
   - evaluation of internal controls over information flows
   - evaluation of the report-development process and contingency plans
3. MIS Architecture and Planning
   - analysis of corporate strategic and technology plans, and the effect of their interrelationship on MIS
   - identification of the system architecture, including planned enhancements, and its effect on MIS
   - evaluation of the capability of system architecture to assimilate acquired organizations and the subsequent effect on MIS

The targeted MIS inspection evaluates the information flows to senior management and the computer or manual systems which support them. Bank holding company inspections place emphasis on reports generated by MIS rather than on the process by which they are created.

Management information systems are made up of various subsystems and will generally be unique to the organization. MIS will be influenced by the structure of the organization, its activities, its risk profile, and its technological capabilities. The targeted MIS inspection guidelines and procedures focus on the three broad areas outlined above and provide examiners with guidance on how to evaluate a bank holding company's MIS process.

5052.0.1 RELEVANCY AND USE OF MIS

Management information requirements will be determined by the size and complexity of an organization's operations. As an organization grows in size and its operations become more complex, management must recognize that information needs change. In addition, strategic goals may dictate a change in the focus of the company, requiring revisions in data collection and presentation. Guidelines and requirements for reports that flow to executive management and the board should be established, recognizing, however, that different levels of the organization have different informational needs.

The effectiveness of MIS has to be analyzed in terms of its ability to assist executive management and the board in identifying, monitoring, and controlling risks throughout the organization. Reports should be analyzed for quality, timeliness, and consistency. They should provide coverage of the major areas in the institution and communicate information clearly and concisely. An organization might have a comprehensive MIS, but if pertinent information is not flowing to executive management and the board of directors, the system is not effective.

Information must be presented in a summarized form, which is easy to read and understand. Procedures must be in place to allow for rapid collection and assimilation of data allowing for timely presentation to executive management and the board. The presentation of data should be consistent from one period to another to avoid any undue confusion. Changes in format need to be agreed on by all users of the report before implementation. Data should cover all areas of risk within the organization and provide comparisons to enable executive management and the board to measure performance.

An assessment of the executive management committee and board members should be performed. A review of reporting lines should also be performed. (See section 2060.4.)

5052.0.2 INTERNAL CONTROLS OVER MIS INTEGRITY

The review of data integrity of reports to the board of directors and executive management committee is essential to ensure that information flows are accurate and that reports are consistently prepared. For each report reviewed, the flow of information through MIS must be identified, including computer platforms, applications software, and interrelationships with other computer systems. Controls such as data entry and modification, data security, disaster recovery, back-up, and program changes should be assessed. Any points in the system where manual intervention occurs should be identified, and information on the flexibility of the system should be obtained.

The procedures used to assess the data integrity controls will vary depending on the nature of the computer platform and application software and on the amount of manual intervention required to produce the report. However, in all cases, the assessment of MIS data integrity controls should begin with a review of the results of prior inspections and the result of internal and external audit reports. Previously identified deficiencies that have not been corrected can affect the integrity of current data.

Reports produced by a mainframe application system should have controls within the mainframe environment and in the application system used to produce the report. These controls are reviewed during EDP examinations and periodic EDP audits. These examination and audit reports should be used as leverage during the MIS inspection, and the current status of deficiencies noted should be ascertained through discussions with internal auditors and management.

Reports may also be produced by personal computers using spreadsheet and other office-product software in a distributed processing environment. Reviews of distributed processing systems require interviews with the persons responsible for preparing the reports. Any instances of manual intervention in such an environment must be identified and evaluated. The most recent EDP examination report should also be reviewed for any deficiencies noted in the bank holding company's microcomputer policies and procedures. A review of internal audit reports for the applicable business area and discussions with audit personnel will reveal whether this PC/spreadsheet application has been audited recently.

5052.0.3 MIS ARCHITECTURE AND PLANNING

The business plan and the computer system's architecture plan should be designed to complement each other and must support the strategic plan. The business plan identifies the goals, target markets, and areas of risk of the organization. The architecture plan describes the corporate technological plans for implementing the systems that will achieve the strategic and business goals, and it should include MIS.

Information is a valuable corporate asset. In a competitive banking environment, the ability to effectively manage this asset is crucial to a bank holding company's ability to remain competitive, introduce new products and services, and achieve desired goals. Therefore, the computer system's architecture plan should be developed in conjunction with its business plan. The architecture plan should ensure that mainframe processing and MIS are appropriately integrated and in place for the banking organization to achieve its strategic goals.

The dynamic and competitive banking and technology environments make effective planning critical. Reconcilement of the business and computer system's architecture plans is necessary to determine the effectiveness of the banking organization's planning process. With the proliferation of mergers and acquisitions in the financial industry, this process becomes more complicated. It is essential that management have a clear vision of its strategic and business goals and the technology required to achieve them if it is to effectively manage the divergent technologies that may be inherited through mergers and acquisitions. Bank holding companies in this situation should decide which acquired systems will survive. Documentation should support management's decision, and formal conversion plans should be documented. Telecommunications, compatibility of systems, data integrity, capacity, contingency planning, and data security are especially critical in this situation and should be evaluated in the planning and conversion process.

Ultimately, the business and the computer system's architecture plans should support the strategic plan. If these plans do not complement one another, the ability of management to achieve its goals may be difficult.

5052.0.4 INSPECTION OBJECTIVES

1. To review the organizational structure to determine the various levels of decision-making and reporting lines, risk assessment, and controls, including board and executive management committees.
2. To assess the adequacy of the management reports generated for their timeliness, quality, accuracy, and coverage of crucial areas.
3. To evaluate reports in terms of their ability to measure the company's progress in meeting its financial and business goals, including the capability to produce forecasts using various scenarios.
4. To evaluate management procedures for reacting to elevated risk, weaknesses, or deficiencies disclosed by the MIS, and the system's ability to adapt to change caused by regulatory and accounting issues or by other market conditions.
5. To determine if the policies, practices, procedures, and internal controls regarding management information systems and management reporting are adequate.
6. To evaluate the controls in place to ensure the integrity of the information within MIS, including data security, disaster recovery, and the system's development life cycle.
7. To determine if the functions of automated systems, reconcilement procedures, and reporting processes are completely understood by staff and that these functions are fully documented.
8. To ensure that an architecture plan exists that includes MIS and that it supports the business and strategic plans.
9. To determine if a management process exists for MIS planning, including organizational responsibility, development, and implementation.
10. To determine if a strategy exists for an effective consolidation of systems in the event of a merger or acquisition.
11. To recommend enhancements and/or corrective action when policies, practices, procedures, internal controls, or MIS are deficient.

5052.0.5 INSPECTION PROCEDURES

5052.0.5.1 General

1. Present the first-day request letter to executive management well in advance of the targeted inspection commencement date, allowing sufficient time for data collection (e.g., at least two weeks before). (See SR-95-45, exhibit A, for a sample first-day letter.) The examiner-in-charge should review the responses well in advance of the start of the inspection.
2. Solicit the cooperation of key senior officials

in organizing and conducting a meeting to discuss with them the identification, control, and reporting of identified risks within the various key operating areas of the bank holding company. Request that key senior management officials make or arrange for presentations during this meeting that will identify the major departments, functions, and activities within the organization and how MIS is used to identify and manage risk. (See SR-95-45, exhibit B.)
3. Draft the inspection report for participating examiners to review before the close of the on-site phase of the inspection, ensuring the inclusion of all relevant findings.

5052.0.5.2 Relevancy and Use of MIS

1. Review the organizational structure to determine reporting lines and the various levels of decision making, risk assessment, and controls. Determine if there are any corporate policies specific to risk management or internal reporting requirements.
2. Review the board and executive management committee structure, including its membership, mission, and authority and the experience levels of the members.
3. Read board and committee minutes and obtain sample copies of the board and committee packets.
4. Obtain a listing of internal reports that are submitted to corporate executive management and the board of directors. Ask that copies of each of these *top-level* reports be attached to the listing.
   a. Review each listed report for timeliness, clarity, completeness, relevancy, and measurability.
   b. Analyze the management reports for information sufficient to measure the company's progress in meeting its financial and business goals, including the ability to produce various forecasting scenarios.
5. Identify management procedures for reacting to elevated risk, weaknesses, or deficiencies disclosed by MIS. Evaluate the system's ability to handle regulatory and accounting issues and to adapt to change.
6. Discuss the examiners' perceptions of MIS reports with executive management as to their timeliness, clarity, completeness, relevancy, and measurability.

5052.0.5.3 MIS Integrity and Internal Controls

1. Review and analyze any policies, procedures, and practices governing the corporation's MIS, including descriptions of existing controls to ensure data integrity throughout the system, disaster-recovery plans, and standardized procedures for the development and use of systems and applications.
2. Review the architecture of MIS. Determine whether there is a single MIS system or a number of related systems. Ascertain if MIS is produced by the mainframe, distributed processors, personal computers, or a combination of these systems. Identify the databases in use for MIS reporting.
3. For each board and executive management report identified, review and verify the flow of data through MIS to the reports, include all computer platforms and application software used. Identify risk points and the controls in place to ensure data integrity. (See SR-95-45, exhibit C for a suggested format.)
4. For each report, verify the controls over data input and the report-distribution process. Determine that sufficient controls are in place to reasonably ensure the accuracy and confidentiality of the data.
5. Review all internal and external audit, regulatory examination, and outside consultant reports concerning MIS since the previous inspection. Note any deficiencies and/or recommendations, and determine whether management has taken appropriate corrective action. Perform follow-up action on any unresolved issues.
6. Through discussions with management and other personnel, determine if any significant changes to MIS are planned. If so, obtain and document the details and analyze their potential effect on MIS integrity.

5052.0.5.4 MIS Architecture and Planning

1. Review the corporate strategic, business, and computer architecture plans, if applicable, to determine if the architecture plan supports the strategic and business goals. The business plan should reflect goals in support of the strategic plan, and any differences between these plans should be reconciled. If a reconcilement has not been performed, request that management complete one during the inspection. Otherwise, complete the reconcilement.

2. Request (or create) a conceptual overview model to identify the flow of information through the organization. (See SR-95-45, exhibit D.)
3. Evaluate management's conversion planning process by selecting a recently converted or consolidated MIS application for review. This application will be emphasized when completing other sections of the work program.
4. After determining the extent of merger and acquisition activity at the institution, review conversion plans and the methodology for consolidating systems and ascertain their effectiveness.
5. Review a copy of development plans for any significant MIS-related projects. Determine if they address cited MIS weaknesses, meet strategic and business goals of the organization, and are in compliance with established policies.
6. Discuss with executive management any inconsistencies among the business, system architecture, and strategic plans.

Examiners' access to automated databases that include supervisory data on state member banks (SMBs) and bank holding companies (BHCs) has been significantly enhanced. In addition, the increased availability of copiers, fax machines, and personal computers has made it possible for SMBs and BHCs to more easily transfer data to Reserve Banks. As a result, the volume of information on SMBs and BHCs available to examiners in Reserve Bank offices has been greatly augmented, and many inspection activities that have traditionally been conducted in the field can now be completed in Reserve Bank offices.

The option to complete certain inspection activities in Reserve Bank offices has various advantages. For example, examiners' ability to access automation resources, reference materials, and senior staff is much better in the office than on-site. In addition, in completing more activities off-site, Reserve Banks can reduce the burdens of on-site evaluations of SMBs and BHCs. Further, greater reliance on off-site work can allow Reserve Banks to reduce travel-related expenses.

5060.0.1 CONDUCTING INSPECTION ACTIVITIES IN RESERVE BANK OFFICES

Examiners should conduct in Reserve Bank offices all inspection activities that can be efficiently and effectively completed off-site. Activities that may be completed off-site include planning the inspection, reviewing historical information, completing preliminary financial analyses, and preparing certain report pages using data maintained at Reserve Bank offices. For additional information, see SR-95-13 (SUP).

When using this approach, examiners should contact BHCs by letter and ask them to forward to Reserve Bank offices financial and other information to be used in the off-site portion of the inspection. Most information that has traditionally been requested in first day letters and made available to examiners at the start of an inspection should be requested, with the exception of documents such as minute books or bulky printouts that would be inappropriate or impractical to have sent. While it is anticipated that this approach will be preferred to approaches that require a longer on-site examiner presence, BHCs are not required to be inspected under this approach and should be given the option to be inspected using traditional on-site approaches. Given the burdens imposed on BHCs to prepare and mail materials to Reserve Bank offices, Reserve Banks should also offer to pay the shipping costs and give adequate lead time in requesting materials.

In the cases of certain shell BHCs, Reserve Banks are authorized to complete all inspection activities off-site on an every-other-inspection basis. As noted above, however, these BHCs should be given the option to be inspected using the traditional on-site approach. Noncomplex shell bank holding companies (NCSBHCs)[1] with less than $500 million in assets that on their last inspection were rated BOPEC 3 or better may be inspected off-site, subject to the following restrictions.

- If information becomes available to the Reserve Bank in the period between inspections suggesting that the condition of an organization is deteriorating significantly, an on-site inspection should be scheduled or commenced immediately if warranted.
- Deteriorating 3-rated BHCs are excluded and must be inspected on-site.
- When a BHC's lead bank subsidiary is an SMB, the inspection of the BHC should be carried out in the field concurrently with the examination of its lead bank.
- NCSBHCs in the same metropolitan statistical area as the Reserve Bank or its bank supervision staff should be inspected on-site unless there is good reason to do otherwise. Newly formed NCSBHCs or those that have recently undergone a change in control should also be inspected on-site.
- If a BHC is unable to forward the information necessary to conduct an off-site inspection, or if the company is assigned a BOPEC rating of 4 or 5 or is determined to be a deteriorating 3-rated organization as a result of an off-site inspection, an on-site inspection should be scheduled or commenced immediately if warranted.
- Information requested from the NCSBHC should include all information typically requested in a first day letter, as well as copies from the company's general and subsidiary ledgers that document all significant account-

1. Noncomplex shell bank holding companies are those without credit-extending nonbank subsidiaries or debt held by the general public whose condition is predicated almost entirely on the condition of subsidiary banks.

ing entries made since the last on-site inspection, copies of cancelled checks written since the last on-site inspection, copies of the BHC's notes payable and receivable, copies of all agreements between the BHC and its bank subsidiaries, and any other information considered necessary to complete an off-site inspection of the institution.
- Findings on the BHC's condition and compliance with laws and regulations should be conveyed to management by telephone or, if the situation requires, in person at company or Reserve Bank offices. The examiner-in-charge should then complete an inspection report for transmission to the company.

5060.0.2 OFF- AND ON-SITE BHC INSPECTION PROCEDURES—APPENDIX 1

This appendix includes inspection procedures that can be completed in the Reserve Bank's offices and those procedures that should be conducted on-site. A sample first day letter information request form is included.

5060.0.2.1 Activities That Can Be Completed in the Office

Work to be performed in the office in preparation for a bank holding company inspection should include the—

- determination of the scope of inspection,
- completion of financial schedules and certain other pages, and
- review of historical financial and supervisory data leading to preparation of draft financial analyses (for example, parent, subsidiary banks, consolidated entity).

In addition, if centralized management functions (for example, investments, asset/liability management, internal audit, or loan review) are performed by the bank holding company, a preliminary understanding of these functions can be obtained in the office by reviewing policies, reports, and other relevant materials. Further, if the bank holding company has nonbank subsidiaries, the preliminary risk assessment mandated by SR-93-19 (see sections 5010.7.3 and 5010.31) can be performed in the office, based on information submitted by the institution.

5060.0.2.2 BHC Inspection Activities That Should Be Conducted On-Site

The following inspection activities are recommended and should continue to be performed at the bank holding company:

- review of credit and investment files at holding company and nonbank subsidiaries for quality, documentation, and compliance with policy, laws, and regulations;
- in-depth discussions with management;
- verification of selected financial information;
- review of selected tax workpapers, including the review of intercompany tax allocations;
- observation of operations and internal controls;
- collection of follow-up documentation to complete the financial analysis;
- review of documents such as minute books for the holding company and nonbank subsidiaries and bulky printouts that would be inappropriate or impractical to have sent to the Reserve Bank's office;
- exit meetings with management.

5060.0.2.3 Sample Information Request for a Bank Holding Company

Information To Be Mailed to the Federal Reserve Bank

1. Exhibits A through N (See attachment #2, SR-95-13). Also, please assemble applicable workpapers that correspond to reported information for verification on-site.
2. The corporation's current legal-entity and management organization charts, detailing line and staff authority from the chairman of the board through the various division heads.
3. Copies of any strategic planning documents.
4. A copy of the most recent information package provided to the directors in connection with regular board meetings.
5. A copy of any other management reports that summarize the performance of the subsidiary banks.
6. Schedules of internal audits and internal loan reviews for the prior and current year. In addition, please furnish a copy of the most recent management letter provided to the corporation by its external auditing firm and management's formal response.
7. List of consolidated past-due, restructured, and nonaccrual loans and overdrafts; watch-list

report; and any results of internal loan-grading systems.

8. Loan-loss reserve adequacy evaluation (consolidated and lead bank). Include the most recent calculation for assessing the adequacy of the loan-loss reserve based on the organizations's internal methodology.

9. Risk-based capital analysis (consolidated and lead bank) for the most recent quarter-end and two prior year-ends, including workpapers. Break out guaranteed loans and loans secured by certificates of deposit. Also include the total amount and proportionate guarantee of each loan guaranteed by such entities as the FmHA, SBA, and VA.

10. Current and upcoming year's budgets (consolidated and lead bank).

11. A copy of any capital, dividend, or cash-flow plans or projections.

12. Most recent internal consolidated interest-rate-sensitivity analysis and liquidity analysis.

13. Parent-company consolidating entries and consolidated comparative financial statements as of the most recent quarter-end.

14. Parent-company-only comparative financial statements as of the most recent quarter-end.

15. The parent company's trial balance as of the most recent quarter-end.

16. Details of any items included in parent-company ''other'' assets, liabilities, income, or expense, which cannot be readily identified from the most recent quarter-end trial balance.

17. A summary of insurance coverage for the parent company and its subsidiaries. Please include a copy of the cover pages of each policy, along with the amount of coverage and expiration date. In addition, also indicate the most recent board approval of such coverage.

18. A detailed schedule of all consolidated borrowings as of the most recent quarter-end. Include the average interest rate paid on each type of borrowing.

19. For the parent company only, please provide the following information on all outstanding obligations: (a) amount outstanding, (b) lender (if publicly held, only note holders of greater than 10 percent), (c) origination and maturity dates, (d) interest rate and payable dates, (e) principal repayment schedule, and (f) reason for incurring debt.

20. A schedule of the fiduciary holdings of the parent company's stock and convertible debt by the parent's subsidiaries. Indicate the degree of investment authority the respective trust departments have over these shares.

21. Copies of all intercompany management and service agreements along with (1) the names of the staff members responsible for the administration of these activities and (2) documentation showing the basis of the assessments.

22. Litigation letter from the holding company's attorneys relating to the status of all lawsuits in which the holding company or its subsidiaries is named defendant. If none, please submit a letter from an officer of the holding company indicating such.

23. A complete copy of all written policies that have been amended or adopted since the previous FRB inspection.

24. A copy of the bank's most recent Report of Condition and Income (call report), including the corresponding internal balance sheet and income statement (daily statement) for the lead bank.

25. Daily statement for the lead bank as of the inspection date.

26. Copies of any ''key man'' or ''split-dollar'' life insurance policies held at the holding company or the subsidiaries.

27. Copy of compensation agreements with subsidiary bank personnel who sell credit-related life insurance for the holding company, along with any tie-in policies, if applicable.

28. Copy of any other compensation arrangement either at the holding company or between the holding company and the subsidiary banks.

29. Most recent market-rate survey for local deposits at the lead bank.

30. For all nonbank subsidiaries, please provide (a) financial statements for the most recent quarter-end; (b) strategic plans; (c) directors' monthly reports; (d) internal audit reports; and (e) a trial balance of all credits, delinquency reports, nonperforming reports, and watch-listed loans for credit-extending subsidiaries.

Information To Be Provided at the Holding Company

31. Access to all written policies pertaining to specific operational areas (for example, due diligence/acquisitions, lending, funds management, tax allocation, and dividends).

32. Access to internal audit and internal loan review reports and workpapers.

33. Minutes of meetings of the board of directors, shareholders, and any committees. Please include a list of committees and their members, and fees paid to directors.

34. Holding company articles of incorporation and by-laws.

35. Stock register.

36. Access to federal tax returns filed since the most recent FRB inspection, along with workpapers. In addition, provide schedules of intercompany tax allocations for the corresponding periods, including projected allocations.

37. Access to parent company accounting records such as ledgers, journals, and check registers.

38. Access to monthly account-analysis statements for any parent company transaction accounts held at a subsidiary bank.

39. For all nonbank subsidiaries, please provide (a) directors' minutes; (b) annual budgets and cash flow projections; (c) checking account statements and check registers and/or cash receipts and disbursements registers; (d) a listing of directors and officers; and (e) access to credit policies and credit files for all nonbank credit-extending subsidiaries.

40. Access to due-diligence reports and workpapers and assimilation plans.

41. Any available information on local economic conditions.

5060.0.3 PROCEDURES FOR IMPLEMENTING OFF-SITE INSPECTIONS FOR CERTAIN SHELL BHCS—APPENDIX 2

This appendix includes procedures for implementing the program authorizing off-site inspections for certain shell BHCs. Listed below are general procedures that can be followed in implementing the program for off-site inspections of certain noncomplex shell bank holding companies (NCSBHCS). Sample documents are included that can be used in implementing the program, including examples of correspondence with eligible bank holding companies and a sample first day letter information request form.

5060.0.3.1 General Procedures for Off-Site Inspections

In implementing the program, Reserve banks should conform to the following procedures:

1. Senior management of bank holding companies should be notified before or early in the calendar year if their company qualifies for a full off-site inspection. They should also be informed that they may opt out of the off-site process and that, even if they choose to participate, the Reserve Bank may conduct the inspection on-site if conditions change or if, at some point during the year, examiners will be traveling to the company's vicinity to carry out other activities.

2. When the Reserve Bank is ready to conduct the off-site inspection, the holding company should be contacted by telephone, as well as by letter. An information request form should be attached to the letter.

3. After assigned examiners have reviewed information forwarded by the company, additional information may be requested by telephone or other means if deemed necessary. Once all necessary information has been received, the designated examiners should commence the off-site inspection.

4. Findings of the inspection should be conveyed to company management by telephone or, if the situation requires, at company or Reserve Bank offices.

5. The examiner-in-charge should then complete an inspection report for transmission to the company.

SAMPLE LETTER

Date:

BHC Official
BHC Name
Address

Dear BHC Official:

This year, the Federal Reserve Bank of New York will conduct off-site inspections of certain bank holding companies. Your company will be inspected during 19X0 and presently qualifies for an off-site review by our office.

As part of our off-site program, you will receive an information request form which must be completed and returned to the Reserve Bank. The Reserve Bank will reimburse you for postage expenses. The form requires responses to several questions, as well as submission of copies of certain holding company financial documents. Our examiners will review the information, complete their analysis, and discuss their findings with management, either by telephone conference or, if necessary, at the offices of your bank holding company. Following the off-site review, holding company management will receive a written report which will include the following:

- a description of the scope of the inspection;
- the examiner's presentation of the financial condition and performance of the parent company and the subsidiary bank;
- an evaluation of the company's compliance with laws and regulations; and
- the examiner's comments, conclusions, and recommendations.

We have found that the off-site inspection program has proved attractive to many banking organizations. However, participation is not mandatory. Therefore, if you do not wish to participate, please sign and mail the enclosed form by DATE. We do want to make it clear, however, that while we plan to conduct an off-site review of your company if you accept this proposal, we still may conduct an on-site inspection if conditions change or if examiners are otherwise in your vicinity.

Should you have any questions concerning the off-site inspection program, please contact OFFICE STAFF MEMBER at (800) ___-____, extension ____.

Sincerely,

Officer
Title

Enclosure

SAMPLE RESPONSE FORM

OFF-SITE INSPECTION PROGRAM
FEDERAL RESERVE BANK OF NEW YORK
RESPONSE FORM

We do not wish to participate in the off-site inspection program in 19X0.

Name of Company: ______________________

City: ______________________

State: ______________________

Signed: ______________________

Title: ______________________

SAMPLE LETTER

Date:

BHC Official
BHC Name
Address

Dear BHC Official:

Pursuant to our telephone conversation of (Date), an off-site inspection of (BHC Name), will be conducted by our office. Please respond to each item of the information request form attached and complete the enclosed schedules. Please be aware that all items submitted for review will be retained by our office and not returned to the company. Therefore, it is advisable to submit copies of records rather than originals. Upon receipt of the items requested, we will reimburse your bank holding company for the postage expense.

In order for us to use the off-site program, you must submit a complete response to this information request no later than (Date). If we are unable to satisfactorily resolve any issues arising from your response to this request, or if the information contained in your response is substantially incomplete, we will schedule the company for an on-site inspection.

Upon review of the information submitted, we will contact you to schedule a meeting with our examiners. If you have any questions concerning the inspection process or the preparation of your responses, please contact (Office Staff Member) at (800) ___-____, extension ____.

Sincerely,

Name
Examiner

Enclosures

SAMPLE INFORMATION REQUEST FORM

BHC
OFF-SITE INSPECTION CONDUCTED AS OF
DATE __/__/__

INFORMATION REQUEST FORM

Please submit or provide responses to the following (if non-applicable, answer N/A):

1. Statements for the most recent quarter and the two latest fiscal years:

   A. Parent Company -- Balance Sheet

   B. Parent Company -- Income Statement

   C. Parent Company -- Statement of Changes in Stockholders' Equity

   D. Bank -- Reports of Condition and Income (most recent quarter only)

   E. Reconciliation of the parent company's "Investment in Bank" account to the subsidiary bank's "Stockholders' Equity" as reported in the Reports of Condition

2. The bank's daily statement and income and expense statement dated __/__/X0.

3. Projected cash flow worksheet for the year 19X1 (see attached form).

4. Excerpts from the company's general ledger and subsidiary ledgers containing all significant accounting entries since __/__/__.

5. Detail of any "other assets" or "other liabilities" accounts for the company, as well as "other income" or "other expense" items, presented in financial statements requested above IF the amounts exceed $500.

6. Details on any liabilities, contingent or otherwise, not appearing in the financial statements.

7. A copy of the company's bank statements and its check register and/or cancelled checks issued since __/__/__.

8. A copy of any notes payable and/or receivable of the bank holding company (including a copy of any related loan agreements) if they have been put in place or amended since the last inspection.*

*The last inspection of __(BHC Name)__ was conducted on __(Date)__.

SAMPLE INFORMATION REQUEST FORM—Continued

- 2 -

9. A copy of any agreements originating since the last inspection between the company and the bank, between stockholders, or between the bank holding company and the stockholders.

10. A list of changes of specific services performed by the holding company for the bank or for any other company since the last inspection. Also indicate the method for computing fees, provide copies of any relevant agreements, and provide documentation supporting any management/service fee assessments.

11. For any changes to the parent company's investments in stocks of companies OTHER THAN subsidiaries, a list of the (1) date of acquisition/sale, (2) number of shares acquired/sold, (3) resulting percentage ownership, and (4) nature of business engaged in by the subject company.

12. A copy of any internally prepared reports of problem loans and nonperforming assets for the banking organization.

13. A list of any stock issuances or redemptions by the company since the last inspection, including the issue/redemption date and price. Also, list all stockholders and their percentage interest in the holding company as of __/__/__.

14. A statement of the date and amount of any capital injections into the bank since the last inspection.

15. A copy of the minutes of all shareholders'/directors' meetings for the company held since the last inspection.

16. For each director of the holding company, provide his or her (1) date of birth, (2) date first elected to the board, (3) position in the bank holding company, (4) position in the bank, (5) principal occupation if different than bank or bank holding company officer, (6) ownership percentage in other financial institutions, and (7) positions in other financial institutions.

17. A statement of any material litigation affecting the company or the bank.

18. A list of all tax transactions since __/__/__. These transactions would include those between the bank and the holding company as well as any transactions with the tax authorities. (See attached example.)

19. A copy of the last two years' federal and state income tax returns, including any amendments.

20. A copy of your accountant's workpapers showing the calculation of the holding company tax benefit or liability for the last two years.

SAMPLE INFORMATION REQUEST FORM—Continued

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21. If the parent company filed for a tax loss carryback in the last two years, provide documents filed with the IRS and related prior-year tax returns.

22. A copy of the tax sharing agreement between the bank holding company and its bank subsidiary if amended or redated since the last inspection.

23. The date of the last IRS audit of the bank holding company's tax returns, an identification of the tax periods covered in the audit, and an indication of whether any assessments or refunds remain unsettled.

24. A copy of the bank's current year budget and operating projections, if available.

25. If the subsidiary bank maintains a correspondent balance at any creditor bank of the holding company, copies of (1) the monthly analysis of the account provided by the correspondent for the last 12 months, (2) any agreement whereby the loan to the holding company is contingent on the subsidiary bank maintaining such a balance, and (3) an explanation if the balances maintained by the subsidiary bank exceed the level required for services received.

26. If any Employee Stock Ownership Plan (ESOP) owns stock in the holding company, provide copies of (1) the ESOP plan and trustee agreement; (2) the ESOP's current balance sheet; (3) the independent appraisal used to determine the value of the holding company stock purchased by the ESOP; (4) any note payable, security agreement, loan agreement, and guarantees. Also provide (1) the date the plan was accepted by the IRS; (2) a description of the ESOP's current investments, including the date they were purchased and their cost; (3) the names of the individuals who have the power to vote the ESOP's stock; (4) a list of individuals having the power to make investments for the ESOP; and (5) a list of the beneficiaries of the ESOP.

27. Copies of the articles of incorporation and by-laws for the bank holding company, if amended since the last inspection.

28. If the holding company is selling insurance, list the (1) licensed agents employed by the company; (2) compensation received by each agent; (3) method for determining compensation; (4) a description of how customers of the bank are informed that they are not obligated to purchase insurance from the holding company in order to obtain credit; and (5) a breakdown of insurance accounts receivable, past due more than 90 days.

SAMPLE INFORMATION REQUEST FORM—Continued

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29. If the subsidiary bank is providing the holding company with either personnel or facilities for the sale of insurance or any noninsured investment products, a statement indicating whether the subsidiary bank is reimbursed for its expenses. If the bank is reimbursed, a description of the method used to determine such amounts. Indicate when this reimbursement method was approved by the respective boards of directors.

30. If the holding company is involved in the sale of any non-insured investment products such as annuities or mutual funds, describe the program including any arrangements that involve the use of third-party brokers. If the holding company receives any share of the related commissions or lease income or if employees of the holding company or a nonbank subsidiary of the holding company are involved in the program, please describe.

31. Copies of the dividend policies of the holding company and the subsidiary bank. If no written policy exists, provide a description of the methods used to determine the amount of dividends paid by the bank holding company or any of its subsidiaries.

32. The dates and amounts of dividends paid by the subsidiary bank since the last quarter-end.

33. A description of any changes made to the holding company’s audit and/or credit review programs.

34. Details of any directors and officers liability insurance maintained by the organization or indemnification provisions adopted by the bank or bank holding company.

35. For banker’s blanket bond and excess fidelity bond coverage, please provide (1) name of surety; (2) form number; (3) primary and excess amount of coverage; (4) expiration date; (5) name of insured; (6) an indication of whether all officers and employees of the holding company, bank, and any nonbank subsidiaries are covered; (7) the date the insurance coverage was last approved by the bank holding company’s board of directors and the bank’s board of directors; and (8) a description of how insurance premiums are allocated among the entities of the organization.

36. Details of any significant transactions since __/__/__ not already described in responses to the above questions.

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