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## INTRODUCTION

Off-balance sheet activities include items such as loan commitments, letters of credit, and revolving underwriting facilities. Institutions are required to report off-balance sheet items in conformance with Call Report Instructions. The use of off-balance sheet activities may improve earnings ratios because earnings generated from the activities are included in the income numerator, while the balance of total assets included in the denominator remains unchanged.

Examiners should review the risks and controls associated with off-balance sheet activities during examinations. Reviews should consider the adequacy of items such as:

- Policies, practices, and internal controls;
- Conformance with applicable laws and internal bank guidelines;
- Credit quality and collectability of off-balance-sheet credit items; and
- Board oversight and audit activities.

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## OFF-BALANCE SHEET LENDING ACTIVITIES

When reviewing off-balance sheet lending activities, examiners should apply the same general examination techniques they use when evaluating a direct loan portfolio. For example, examiners should consider the adequacy of internal controls and board-approved policies at banks with a material level of off-balance sheet lending activities. Comprehensive policies generally address issues such as underwriting standards, documentation and file maintenance requirements, collection and review procedures, officer lending limits and customer borrowing limits, board and loan committee approval requirements, and board reporting requirements. Generally, overall limits on contingent liabilities and specific sub-limits on various types of off-balance sheet lending activities, either as a dollar amount or as a relative percentage (such as a percent of total assets or capital), are also often addressed.

When evaluating individual credit lines, examiners should review all of a customer's borrowing arrangements with the bank (e.g., direct loans, letters of credit, and loan commitments). Other factors analyzed during direct loan reviews, such as collateral protection and the borrower's financial condition, repayment history, and ability/willingness to pay are also applicable when reviewing contingent liabilities such as letters of credit and loan commitments.

When analyzing off-balance sheet lending activities, examiners should evaluate the probability that lines will be funded and, if applicable, whether loss allowances adequately reflect off-balance sheet credit risks. Such allowances should not be included as part of the general allowance for loan and lease losses (ALLL). Credit exposures on financial instruments with off-balance sheet credit risk should be recorded separate from the ALLL related to a recognized financial instrument (i.e., an on-balance sheet financial asset). Allowances for off-balance sheet credit exposures are reported in Call Report Schedule RC-G - Other Liabilities.

Examiners should also consider standby letters of credit when determining legal limitations on loans to one borrower and compliance with Section 337.2(b) of the FDIC Rules and Regulations.

## Letters of Credit

A letter of credit (LOC) is a document issued by a bank on behalf of its customer authorizing a third party to draw drafts on the bank up to a stipulated amount under specific terms and conditions. A letter of credit is a conditional commitment (except when prepaid by the account party) on the bank's part to pay drafts drawn in accordance with the document's terms. There are four basic types of letters of credit: travelers, sold for cash, commercial, and standby.

**Travelers** – A travelers letter of credit is addressed by the bank to its correspondents authorizing drafts by the person named in accordance with specified terms. These letters are generally sold for cash.

**Sold for Cash** – When a letter of credit is sold for cash, the bank receives funds from the account party at the time of issuance. This letter is not reported as a contingent liability, but rather as a demand deposit.

**Commercial** – A commercial letter of credit is issued to facilitate trade or commerce. Generally, drafts are drawn upon when the underlying transaction is consummated as intended. Commercial letters of credit not sold for cash represent contingent liabilities. Refer to the International Banking section of this Manual for further details on commercial letters of credit.

**Standby** – A standby letter of credit (SBLC) is an irrevocable commitment on the part of the issuing bank to make payment to a designated beneficiary. Payments to a beneficiary are guaranteed in exchange for an ongoing, periodic fee throughout the life of the letter. An SBLC can be either financial-oriented, where the account party is to make payment to the beneficiary, or performance-oriented, where a service is to be performed by the account party. SBLCs are issued for a variety of purposes, such as to

improve the credit rating of a beneficiary, to assure performance under construction contracts, and to ensure the beneficiary satisfies financial obligations payable to major suppliers.

ASC Topic 460, Guarantees, clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. ASC Topic 460 applies to standby letters of credit, both financial and performance. Commercial letters of credit and other loan commitments, commonly thought of as funding guarantees, are not included in the scope of ASC Topic 460 because those instruments do not guarantee payment of a money obligation and do not provide for payment in the event of default by the account party.

While no particular form is required, SBLC documents generally contain certain descriptive information. The first item generally includes a separate binding agreement wherein the account party agrees to reimburse the bank for any payments made under the SBLC. The actual letter is often labeled as a standby letter of credit, specifies a stipulated amount, covers a specific period, and details relevant information that must be presented to the bank before any draws will be honored due to the account party's failure to perform. Most SBLCs are carefully worded so that the bank is not involved in making any determinations of fact or law at issue between the account party and the beneficiary.

The primary risks relative to SBLCs are credit risk (the possibility of default on the part of the account party), and funding risk (the potential inability of the bank to fund a large draw from normal sources). An SBLC is a potential extension of credit and should be evaluated in a manner similar to direct loans. The credit risk could be significant under an SBLC given its irrevocable nature, especially if the SBLC is written for an extended period. Generally, a bank can rescind a direct loan commitment to a customer if the customer's financial condition deteriorated and the loan commitment contained an adverse-change clause. However, such would not be applicable with an SBLC since it is an irrevocable agreement between the bank and the beneficiary.

An SBLC can be participated or syndicated. Unlike loans, however, the sale of SBLC participations does not diminish the total contingent liability of the issuing bank. The name of the issuing bank is on the actual letter of credit, and the bank must therefore honor all drafts whether or not the participants are willing or able to disburse their pro rata share. Syndications, on the other hand, represent legal apportionments of liability. If one bank fails to fulfill its obligation under the SBLC, the remaining banks are not liable for that bank's share.

Section 337.2(d) of the FDIC Rules and Regulations requires banks to maintain adequate controls and subsidiary records of SBLCs, comparable to records maintained on direct loans, so that a bank's total liability may be determined at all times. Banks are also required to reflect all SBLCs on published financial statements. Consistent with Section 337.2(d) credit files should reflect the current status of SBLCs, and adequate reports regarding the types and volume of SBLCs should be maintained. These reports enable management and the board to monitor credit risks and identify potential concentrations so that appropriate action can be taken, if needed, to reduce undue exposure.

Examiners should assess the need to adversely classify or designate as Special Mention an SBLC if draws under the facility are probable and credit weaknesses exist. For example, deterioration in the account party's financial condition could jeopardize performance under the letter of credit and result in a draw by the beneficiary. If a draw occurs, the offsetting loan to the account party may become a collection problem, especially if it is unsecured.

### **Loan Commitments**

A loan commitment is a written agreement, signed by the borrower and bank, detailing the terms and conditions under which the bank will fund a loan. The commitment will specify a funding limit and have an expiration date. For agreeing to make the accommodation, the bank may require a fee and/or maintenance of a stipulated compensating deposit balance from the customer. A commitment can be irrevocable (like an SBLC facility) and operate as a contractual obligation by the bank to lend when requested by the customer. Generally, commitments are conditioned on the customer maintaining a satisfactory financial position and the absence of defaults in other covenants. A bank may also enter into an agreement to purchase loan commitments from another institution, which should be reflected as off-balance sheet items, until the sale is consummated. Loan commitments related to mortgage loans that will be held for sale are discussed in the Mortgage Banking Section below.

Some types of commitments are expected to be drawn upon, such as a revolving working capital line to fund operating expenses or a term loan facility for equipment purchases or developing a property. Other commitments serve as backup facilities, such as for commercial paper, whereby draws would not be anticipated unless the customer is unable to retire or roll over the issue at maturity.

Less detailed than a formal loan commitment, is a line of credit, which expresses to the customer, usually by letter, a

willingness by the bank to lend up to a certain amount over a specified period. This type of facility is disclosed to the customer and referred to as *advised* or *confirmed* lines, in contrast to *guidance* lines, which are not made known to the customer, but are merely used by the bank as lending guidelines for internal control or operational purposes. Many lines of credit are cancelable if the customer's financial condition deteriorates, while others are simply subject to cancellation at the bank's option.

Disagreements can arise as to what constitutes a legally binding commitment on the part of the bank. For example, a credit arrangement could be referred to as a *revocable line of credit*, but at the same time, it may be a legally binding commitment to lend if consideration has been given by the customer and the terms of the agreement between the parties result in a contract. When appropriate, examiners should consider the extent of the bank's legal obligation to fund commitments designated as revocable to ensure that obligations are properly documented and legally defensible should the bank need to cancel a loan commitment.

Credit documentation often contains a *material adverse change* (MAC) clause, which is intended to allow the bank to terminate the commitment or line of credit arrangement if the customer's financial condition deteriorates. The extent to which a MAC clause is enforceable depends on whether a legally binding relationship continues if specific financial covenants are violated. Although the enforceability of MAC clauses may be subject to some uncertainty, such clauses may provide the bank with leverage in negotiations with the customer over issues such as requests for additional collateral or personal guarantees.

Whether a bank will fund a loan commitment or line of credit cannot always be easily determined; therefore, careful analysis is often necessary. A MAC clause may allow the bank to decline funding to a borrower that defaulted on a loan covenant. Some banks may decline funding requests if any covenant is broken, whereas others might be more accommodative and make advances unless a borrower appears likely to file bankruptcy. The procedures followed by the bank, in acceding to or denying funding requests involving adverse conditions commonly factor in a borrower's financial condition, credit history, and repayment prospects. These factors are also important considerations in the examiner's overall evaluation of credit risk.

Examiners should consider the type, volume, and anticipated funding of loan commitments and lines of credit when assessing a bank's funds-management program and rating the liquidity position. Examiners should review internal management reports estimating the amount of commitments that require funding over various periods.

For further information, refer to the Liquidity and Funds Management section of this Manual.

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## TRANSFERS OF FINANCIAL ASSETS

### Mortgage Banking

Commitments to originate mortgage loans that will be held for sale often include interest rate lock commitments. In general, rate lock commitments are agreements to extend credit to a borrower at a specified interest rate. The agreements, which can involve fixed or floating rate commitments, protect borrowers from rising interest rates while loan applications are being processed.

Interest rate lock commitments on mortgage loans that will be held for sale are derivatives and must be recorded at fair value on the balance sheet as either an asset or liability. The commitments are reported as over-the-counter written options on schedule RC-L, Derivatives and Off-Balance Sheet Items, along with its notional amount.

Banks often enter into an agreement with an investor to sell mortgage loans that are originated under mandatory-delivery or best-efforts contracts. Mandatory-delivery and best-efforts contracts that meet the definition of a derivative are reported on the balance sheet at fair value and on schedule RC-L as forward loan sales commitments. In lieu of entering into a best efforts or mandatory-delivery contract, a bank may use the securitization market as a facility for selling originated mortgage loans.

A bank may not offset derivatives with negative fair values (liabilities) against those with positive fair value (assets), unless the criteria for *netting* under U.S. GAAP have been satisfied. Further, a bank may not offset the fair value of forward loan sales commitments against the fair value of derivative loan commitments of mortgage loans held for sale because the commitments typically have different counterparties.

Commitments to originate mortgage loans that will be held for investment purposes and commitments to originate other types of loans require evaluation to determine whether the commitments meet the criteria of a derivative. Often, these commitments to lend will not meet the net settlement requirement under ASC Topic 815 and would not be considered derivatives. Unused portions of loan commitments not considered derivatives are reported as off-balance sheet items if the aggregate amount individually exceeds 10 percent of the bank's equity capital.

The accounting and reporting standards for derivative activities are set forth in ASC Topic 815, Derivatives and Hedging and in ASC Topic 948, Financial Services - Mortgage Banking. ASC Topic 815 requires all derivatives to be recognized on the balance sheet as either assets or liabilities at their fair value. Additional information is available in the Capital Markets Handbook, the Call Report Glossary, and the instructions for RC-L, Derivatives and Off-Balance Sheet Items.

### Financial Assets Sold Without Recourse

Financial assets sold without recourse, where the bank has surrendered control and meets the other conditions of a sale under ASC Topic 860, are accounted for as loan sales. In the case of loan participations, the transfer of a portion of an entire financial asset must meet the definition of a participating interest. If the transfer of a portion of a financial asset qualifies as a participating interest, and the other conditions for sale are met, the bank is required to allocate the previous carrying amount of the loan between the participating interest sold and the participating interest it continues to hold based on relative fair values as of the date of transfer. Further discussion of loan participations is contained in the Loans section of this Manual.

If, as a result of a change in circumstances, a selling bank regains control of a transferred financial asset that was previously accounted for as a sale, the change should generally be accounted for in the same manner as a purchase of a transferred financial asset from the purchaser in exchange for the liability assumed. If a transfer of the financial asset does not meet the conditions for sale treatment, the transferring bank and the acquiring transferee shall account for the transfer as a secured borrowing with pledge of collateral.

### Financial Assets Sold With Recourse

Financial assets transferred with recourse may or may not qualify for sales treatment under U.S. GAAP. In some circumstances, recourse provisions could mean that the transferred financial asset(s) have not been isolated beyond the reach of the transferring bank or its consolidated affiliates, i.e., the first criteria under ASC 860 for sales treatment. For example, when an insured bank transfers loan participation with recourse, the participation generally will not be considered isolated from the selling bank in the event of FDIC receivership. Section 360.6 of FDIC Rules and Regulations limits the Corporation's ability to reclaim loan participations *without recourse* as defined in the regulation, but does not limit the Corporation's ability to reclaim loan participations *with recourse*. Recourse provisions in loan participations sold prior to January 1, 2002, do not necessarily preclude sale accounting for the

transfer. Refer to Manual Section 3.2 - Loans for additional information.

If the financial asset transfer, e.g., a loan sale, qualifies as a sale under ASC Topic 860, the bank shall remove the transferred asset from the balance sheet, recognize and initially measure the fair value of the servicing asset or liability (if applicable) and any other asset obtained or liability incurred, before recognizing the gain or loss on the sale. Transfers of financial assets not meeting sales treatment are accounted for as secured borrowings.

If an asset transfer that qualifies for sale treatment under U.S. GAAP contains certain recourse provisions, the transaction would be treated as an asset sale with recourse for purposes of reporting risk-based capital information in Schedules RC-R and RC-S within the Call Report. When reviewing assets sold with recourse, examiners should consider the recourse attributes when calculating risk-based capital. For further information, refer to the Call Report Glossary under Transfers of Financial Assets, ASC Topic 860, and Part 324 of the FDIC Rules and Regulations.

### Recourse and Direct Credit Substitutes

A recourse obligation or direct credit substitute may arise when a bank transfers assets in a sale and retains an obligation to repurchase the assets or absorb losses. The repurchase or absorption of losses may be due to a default of principal or interest or any other deficiency in the performance of the underlying obligor. Recourse may also exist implicitly where a bank provides credit enhancements beyond any contractual obligation to support assets it sold.

When an examiner encounters recourse arrangements or direct credit substitutes (commonly found in securitization and mortgage banking operations), they should refer to the Call Report instructions, Part 324 of the FDIC Rules and Regulations, and ASC Topics 815 and 860.

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## OFF-BALANCE SHEET CONTINGENT LIABILITIES

### Bankers Acceptances

The following discussion refers to the roles of accepting and endorsing banks in bankers acceptances. It does not apply to banks purchasing other banks' acceptances for investment purposes, which is described in the Other Assets and Liabilities section of this Manual. Bankers acceptances may represent either a direct or a contingent liability of the bank. If the bank creates the acceptance, it constitutes a direct liability that must be paid on a

specified future date. If a bank participates in funding an acceptance created by another bank, the liability resulting from such endorsement is only contingent in nature. In analyzing the degree of risk associated with these contingent liabilities, the financial strength and repayment ability of the accepting bank should be considered. Further discussion of bankers acceptances is contained in the International Banking section of this Manual under the heading Forms of International Lending and in the Glossary of the Instructions for the Call Report.

### Revolving Underwriting Facilities

A revolving underwriting facility (RUF) (also referred to as a note issuance facility) is a commitment by a group of banks to purchase, at a fixed spread over some interest rate index, the short-term notes that the issuer/borrower is unable to sell in the Euromarkets, at or below the predetermined rate. In effect, the borrower anticipates selling the notes as funds are needed at money market rates, but if unable to do so, has the assurance that credit will be available under the RUF at a maximum spread over the stipulated index. A lead bank generally arranges the facility and receives a one-time fee, and the RUF banks receive an annual commitment or underwriting fee. When the borrower elects to draw down funds, placement agents arrange for a sale of the notes and normally receive compensation based on the amount of notes placed. The notes usually have a maturity range of 90 days to one year and the purchasers bear the risk of any default on the part of the borrower. There are also standby RUFs, which are commitments under which Euronotes are not expected to be sold in the normal course of the borrower's business.

An inability to sell notes in the Euromarkets could result from financial deterioration of the borrower, or from volatile, short-term market conditions, which precipitate a call by the borrower on the participating banks for funding under the RUF arrangement. The evaluation of RUFs by the examiner should follow the same procedures used for reviewing loan commitments. An adverse classification should be accorded if it is determined that a loan of inferior quality will be funded under a RUF.

### Standby LOC Issued By Another Depository Institution

Standby letters of credit issued by another depository institution (such as a correspondent bank), a Federal Home Loan Bank (FHLB), or another entity on behalf of a bank are potential future obligations for the bank that are reported as other off-balance sheet liabilities. Often, an FHLB will offer SBLC products to secure uninsured public deposits (i.e., deposit balances from public entities exceeding FDIC insurance limits, which may require

additional protection due to state laws). Banks may choose this option as an alternative to pledging liquid assets such as U.S. Treasury securities. However, this does not mean the bank is free of asset encumbrance. As part of the SBLC agreement, the FHLB agreements may require collateral, but from a wider variety of assets, such as loans or other types of securities.

It is important to assess the implications for pledging requirements and contingent funding availability when a bank uses SBLCs to meet public deposit collateral requirements. The Call Report can serve as an initial source to gauge an institution's involvement in this activity. Schedule RC-L, item 9.c requires banks to report SBLCs if the total amount is greater than 25 percent of total equity capital (reported in Schedule RC, item 27.a).

### ← ADVERSELY CLASSIFIED CONTINGENT LIABILITIES

Category I contingent liabilities are defined as liabilities that will give rise to a corresponding increase in bank assets if the contingencies convert into actual liabilities. Such contingencies should be evaluated for credit risk and if appropriate, listed for Special Mention or adverse classification. This examination treatment does not apply to Category II contingent liabilities where there will be no equivalent increase in assets if a contingency becomes a direct liability. Examination treatment of Category II contingencies is covered under Contingent Liabilities in the Capital section of this Manual.

The classification of Category I contingencies is dependent upon two factors: the likelihood of the liability becoming direct and the credit risk of the potential acquired asset. Examiners should refer to the Report of Examination Instructions and the Bank of Anytown contained in this Manual for Report of Examination treatment when considering to list contingent liabilities as special mention or to assign adverse classifications.

Adverse classification and Special Mention definitions for direct loans are set forth in the Loans section of this Manual. The following adverse classification and Special Mention criteria should be viewed as a supplement to those definitions when evaluating contingent liability credit risk.

**Special Mention** – The chance of the contingency becoming an actual liability is at least reasonably possible, and the potentially acquired assets are considered worthy of Special Mention. An example would be the undrawn portion of a poorly supervised accounts receivable line where the drawn portion is listed for Special Mention.

**Substandard** – The chance of the contingency becoming an actual liability is at least reasonably possible, and the potentially acquired assets are considered no better than Substandard quality. Undisbursed loan funds in a speculative real estate venture in which the disbursed portion is classified Substandard and the probability of the bank acquiring the underlying property is high, would be an example of a Substandard contingency.

**Doubtful** – The chance of the contingency becoming an actual liability is probable, and the potentially acquired assets are considered of Doubtful quality. Undisbursed loan funds on an incomplete construction project wherein cost overruns or diversion of funds will likely result in the bank sustaining significant loss from disposing the underlying property could be an example of a Doubtful contingency.

**Loss** – The chance of the contingency becoming an actual liability is probable, and the potentially acquired assets are not considered of bankable quality. A letter of credit on which the bank will probably be forced to honor draws that are considered uncollectible is an example of a Loss contingency. A Loss classification normally indicates that a balance sheet liability (specific reserve) should be established to cover the estimated loss. For further information as to when a contingency should be reflected as a direct liability on the balance sheet, refer to ASC Subtopic 450-20, Contingencies, Loss Contingencies.