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OVERVIEW

Financial institutions maintain cash on hand and at correspondent banks to comply with statutory reserve requirements and to meet customer demands. Cash accounts include U.S. and foreign coin and currency on hand and transit, clearing, and cash items. Demand and time deposits maintained at correspondent banks are often known as due from accounts, or correspondent balances. Banks maintain correspondent accounts to facilitate the transfer of funds.

Cash

Every bank must maintain a certain amount of U.S. and/or foreign coin and currency on hand. To avoid having excess nonearning assets and to minimize exposure to misappropriation and robbery, each bank should establish a policy to maintain cash balances at the minimum levels necessary to meet reserve requirements and customer demands. Federal Reserve Regulation D governs the level of required reserves. Part 326 of the FDIC Rules and Regulations requires banks to adopt appropriate security procedures to discourage robberies and to assist in apprehending persons who commit such acts.

Clearings

The term clearing is used to describe the activities involved with processing financial transactions from the time a transaction is made until it is settled. Clearing items include checks, drafts, notes, and other items that represent instructions for processing financial transactions. Financial institutions accept, collect, and process a variety of payment instruments and can participate in a variety of clearing and settlement systems.

For decades, many communities with two or more banks organized local clearinghouse associations which adopted rules governing the exchange of checks. Clearings were also processed through regional associations, correspondent banks, or the Federal Reserve. Physical items such as checks (typically submitted in batches) were often processed on proof and sorting machines that facilitated an institution's ability to verify the accuracy of individual documents, separate items by pre-identified categories, provide balance verifications for transaction types (proof), and send cash items drawn on other banks for collection (transit). Proof machines had paper handling mechanisms that fed checks, deposit slips, and other items into the system. As each item went into the system, a proof operator read and entered the courtesy amount of the check (the face value of the check). The proof machine then printed the face value on the bottom of the item in Magnetic Ink Character Recognition (MICR) ink so the transaction information could be processed electronically. Most proof machines also had a MICR reader

that allowed them to read the bank and item number from pre-encoded MICR information.

Legislative changes and advances in technology now allow banks to process clearing items, or have items processed by a servicer, on equipment that captures images of items, reads the information, including MICR data, and stores images and data in a computerized file. The file can then be transmitted electronically for settlement. Similarly, institutions are now able to use remote deposit capture systems. With remote deposit capture, instead of physically transporting checks to a banking facility, customers are able to scan checks on devices maintained in their own offices and transmit information electronically to a financial institution or its service provider.

Although institutions can process clearing items such as checks quickly and efficiently using modern technologies, in many situations, checks are no longer the most convenient payment instruments for consumers. Often consumers use checks merely for person-to-person transactions that are not conducive to electronic payments. Many consumers have shifted to using fully electronic payments through Automated Teller Machine, Point-of-Sale, and on-line bill payment systems.

No matter how transactions are initiated or processed, a bank's objective remains the same: to forward items for collection quickly so funds are available as soon as possible; to distribute checks and deposits efficiently to their destinations; to establish that deposit totals balance with the totals shown on deposit tickets; to prove subsidiary and general ledger entries and other transactions; to collect data for computing customer's service charges and available funds; and to accomplish the functions accurately, securely, and efficiently.

Cash Items

Cash items are checks or other items in process of collection payable in cash upon presentation. A separate control account of all such items is generally maintained on the bank's general ledger and supported by a subsidiary record of individual amounts and other pertinent data. Cash items and related records usually are in the custody of one employee at each banking office who is designated as the collection, or exchange, teller.

In normal daily operations, all banks have items which are charged to demand deposits but which cannot be charged to individual accounts because of insufficient funds, a lack of information, unknown accounts, etc. Such items include return items, rejects, or unposted debits and may consist of checks, loan payments, or other debit memos. In some banks, such items are separated and an entry is made

reclassifying them to a separate asset account. Other banks include the items in a subsidiary control account in the individual demand deposit ledgers. In that case, the account would have a debit balance that would be credited when the bank returns the checks to their sources.

Cash items not in process of collection should be carried in a noncash account and reported as other assets. These include items payable upon presentation that a bank has elected to accumulate until forwarding to payers on a periodic basis. Items not immediately payable in cash upon presentation, or items that were not paid when presented and require further collection efforts should also be included in an appropriate account, such as suspense, and shown under other assets. Many banks establish a three-day limit, after which all items not collected must be automatically transferred from cash items to a suspense account. Refer to the Other Assets section of this Manual for additional comments on cash items not in process of collection.

Due From Banks

As noted above, due from accounts enable the transfer of funds between banks. The accounts are used to facilitate the collection of cash items and cash letters, the transfer and settlement of security transactions, the transfer of participation-loan funds, the purchase or sale of Federal funds, and for many other purposes.

Due from accounts may also exist when a bank utilizes the services of another bank and maintains a minimum or compensating balance in full or partial payment for the services received. Such services may involve processing cash letters, packaging loan agreements, performing information technology or payroll services, collecting out-of-area items, or exchanging foreign currency.

Balances due from institutions cover all interest-bearing and noninterest-bearing balances whether in the form of demand, savings, or time balances, but excludes certificates of deposit held for trading.

Reciprocal balances arise when two depository institutions maintain deposit accounts with each other, i.e., when a reporting bank has both a due from and a due to balance with another depository institution. Reciprocal balances between the reporting bank and other depository institutions may be reported on a net basis when a right of set off exists. Net due from balances should be reported as deposit assets. Net due to balances should be reported as deposit liabilities.

DEPOSIT NOTES

Some banks have purchased deposit notes as investments. These instruments are a form of deposit liability somewhat similar to negotiable time certificates of deposit (CD). "Deposit notes" have been structured like corporate bonds by having a five-day corporate settlement period for purchases and semiannual interest payments calculated on a 30/360-day basis. Although maturities vary from nine months to 15 years, most "deposit notes mature in four to seven years. While the foregoing contract terms could be incorporated into a CD, certain banks, for marketing purposes, prefer to use the "deposit note" format.

Bank purchases of such notes should be made in accordance with established investment and asset/liability management policies. While these note issues tend to be rated, banks considering the purchase of a deposit note should nonetheless obtain the offering circular or other similar information to ensure that they understand the nature of such notes (including possible deposit insurance coverage) before investing. A bank's investment in a deposit note should generally be included on the balance sheet in the interest-bearing balances due from depository institutions asset category. However, if the offering circular or note instrument for a particular deposit note is available for review and it does not contain a statement to the effect that the liability represented by the note is a deposit liability of the issuing bank, the bank's investment in the note should be treated as a security or a loan based on the characteristics of the note.

Structured CDs

Structured CDs are similar to structured note investment securities in that they have customized features typically containing embedded options or having cash flows linked to various indices.

The uncertainty of the cash flows, caused by movements in interest rates or other indices, may expose banks that invest in the CDs to heightened market risk, liquidity risk, or other such risks traditionally experienced in the context of investment securities. As a result, investments in structured CDs warrant heightened supervisory attention to ensure that management understands, and has the ability to adequately monitor and manage these risks.

The risk profile of structured CDs can be very similar to that of structured notes. Certificates may include step-up features with call options, inverse floating or dual indices, or other such terms. These types of terms, in addition to severe early withdrawal penalties and the lack of an established secondary market, may result in cash flow behavior similar to that of structured notes. Proper controls for these investments include effective senior management supervision, board oversight, periodic reporting, and appropriate policies and

procedures. The degree and complexity of an institution's monitoring and reporting systems should be commensurate with the volume and complexity of their investment in structured certificates.

Classification of structured CDs should be consistent with the adverse classification guidelines outline in the Securities and Derivatives section of this Manual.

EXAMINATION OBJECTIVES

When reviewing activities related to cash and due from bank accounts, examiners should consider the issues discussed below.

Primary Reserves

Cash and balances due from other banks generally represent an institution's primary liquidity reserves, except to the extent they include required reserves. Excessive cash or due from balances can have an adverse impact on earnings because they generate little or no income, while insufficient balances can contribute to a weak overall liquidity position. Examiners should review the level of primary reserves as part of the Earnings and Liquidity reviews. Some assistance in making this assessment may be obtained by referring to the UBPR. If a bank's level of cash and due from bank accounts appears considerably out of line with those of the peer group (after considering reserve requirements), or if the level changed significantly from the previous examination, or over a period of time, further investigation may be warranted.

Interbank Liabilities

All insured institutions are required to establish and maintain written policies and procedures to prevent excessive exposure to any individual correspondent, in accordance with Federal Reserve Regulation F (12 CFR Part 206), Limitations on Interbank Liabilities. This rule covers all exposure to a correspondent, including credit and liquidity risks and operational risks related to intraday and interday transactions. The regulation requires banks to establish prudent standards that consider credit, liquidity, and operational risks when selecting correspondents and terminating relationships. Where exposure is considered significant, banks must periodically review their correspondents' financial condition.

Policy standards should include exposure limits when a correspondent's financial condition, or the general level of exposure to a correspondent, creates a significant risk to a bank. Exposure limits may be fixed by amount or flexible, but should be based on the financial condition of the correspondent and the type and level of identified exposure.

Regulation F provides that when exposure limits are required, banks should limit interday credit exposure to a correspondent to 25 percent of a bank's capital, unless the bank can demonstrate that its correspondent is at least adequately capitalized. When a correspondent is not at least adequately capitalized, banks should reduce their credit exposure to the 25 percent level within 120 days after the date when the current Call Report or other relevant report would be available.

Compensating Balances

Banks may be exposed to insider abuse if their officers, directors, or principal shareholders have loans at correspondent banks. For example, a correspondent bank may provide a bank insider a below-market rate loan if that officer establishes a below-market rate deposit account at the correspondent bank (in the name of their bank). In this situation the officer would be abusing their position by receiving personal gain (the below-market rate loan), and harming the bank by establishing an account at the correspondent that receives below-market returns. Therefore examiners should be alert to potential abusive relationship between executive officers, directors, and principal shareholders of a bank and that bank's correspondent banks.

Such arrangements may constitute a breach of a bank official's fiduciary obligations to the depositing bank and thus to its depositors, creditors and shareholders. In some cases, the arrangements may also involve a criminal offense.

Accordingly, if the bank maintains a correspondent account with another bank which has extended credit to any of the above persons or anyone associated with them and where there is evidence that the depositing bank may have suffered a detriment because of the loan/deposit arrangement, the situation should be thoroughly investigated. This is also the case when the bank holds a deposit from another bank and has outstanding extensions of credit to such persons in the other bank or their associates. Refer to the Bank Fraud and Insider Abuse section for further information.

Correspondent Concentration Risks

The FFIEC issued guidance (FIL-18-2010) detailing the expectation that financial institutions take actions beyond the minimum requirements established in Regulation F. The guidance clarifies that risk management practices relating to correspondent concentrations should encompass all credit and funding exposures. In addition, management should be aware of its affiliates' exposures to individual correspondents and their affiliated entities.

A financial institution's relationship with a correspondent can result in credit (asset) and funding (liability) concentrations. Asset concentrations may be present when an institution

maintains significant due from balances; or advances, or commits to advancing, significant funds to a correspondent or their related entities. Liability concentrations may exist when an institution maintains significant due to balances; or depends on a correspondent or their related entities for a disproportionate share of its total funding.

Some correspondent concentrations may involve legitimate business purposes, such as concentrations arising when an institution maintains large due from accounts to facilitate clearing activities. However, correspondent concentrations represent diversification risks that management should consider when formulating strategic plans and risk limits. Examiners should ensure management performs appropriate due diligence procedures and adequately identifies, monitors, and manages all credit and funding concentrations.

Due Diligence

Financial institutions that maintain, or contemplate entering into, credit or funding arrangements with other financial institutions should establish correspondent risk management programs. The programs should include written investment, lending, and funding policies that incorporate appropriate risk limits. In addition, the programs should ensure institutions conduct analysis of credit transactions prior to committing to, or engaging in, the transactions. The terms of all credit and funding transactions should avoid conflicts of interest and conform to sound investment, lending, and funding practices.

Identifying Credit Concentrations

Credit concentrations involve a variety of assets and activities. For example, an institution could have due from bank accounts, Federal funds sold on a principal basis, and direct or indirect loans to or investments in a correspondent bank. When calculating credit concentration levels, institutions should aggregate all exposures, including, but not limited to:

- Due from demand and time accounts,
- Federal funds sold on a principal basis,
- Over-collateralized amounts on repurchase agreements,
- Under-collateralized portions of reverse repurchase agreements,
- Net credit exposures on derivatives contracts,
- Unrealized gains on unsettled security transactions,
- Direct or indirect loans to or for the benefit of the correspondent, and
- Investments in the correspondent, such as stocks, subordinated debts, or trust preferred securities.

Identifying Funding Concentrations

The primary risk relating to funding concentrations is that an institution may need to replace the advances on short notice or on unfavorable terms. The risks may be more pronounced if funds are credit sensitive or the party advancing the funds has a weakened financial condition. Additionally, the level of risk relating to a funding concentration is likely to vary depending on the type and maturity of the funds and the structure of the recipient's overall sources of funds. For example, a concentration in overnight unsecured funding would raise different concerns than a concentration in secured long-term funding. Also, the risks of a concentration from a particular correspondent would be more significant if the level of funds constituted a high percentage of an institution's overall funding sources.

Calculating Credit and Funding Concentrations

When identifying credit and funding concentrations, institutions should calculate both gross and net exposures to individual correspondents and to groups of affiliated correspondents. Exposures are reduced to net positions to the extent the transactions are secured by the net realizable proceeds from readily marketable collateral or are covered by valid and enforceable netting agreements.

Monitoring Correspondent Relationships

Management should maintain written policies and procedures designed to prevent excessive exposure to correspondents in relation to the correspondent's financial condition. The depth and frequency of monitoring procedures may be more or less aggressive depending on the type and level of risk exposures. Institutions should implement procedures that ensure ongoing, timely reviews of correspondent relationships, include documentation requirements, and specify when risks that meet internal criteria are to be brought to the attention of the board of directors.

In monitoring correspondent relationships, institutions should specify internal parameters relative to information, ratios, or trends that will be reviewed for each correspondent on an ongoing basis such as:

- Deteriorating trends in capital, asset quality, or earnings,
- Increasing levels of other real estate owned,
- Significant use of volatile funding sources such as large CDs or brokered deposits,
- Downgrades in its credit ratings, if publicly traded, and
- Public enforcement actions.

Managing Correspondent Concentrations

Institutions should establish prudent internal concentration limits for each correspondent, as well as ranges or tolerances for each factor being monitored. Institutions should also

develop contingency plans for managing risks when internal limits, ranges, or tolerances are met, either on an individual or collective basis. However, contingency plans should not rely on temporary deposit insurance programs for mitigating concentration risks.

Contingency plans should provide for the orderly reduction of identified concentrations over reasonable timeframes. Such actions may include, but are not limited to:

- Reducing the volume of uncollateralized/uninsured funds,
- Transferring excess funds to other correspondents,
- Requiring a correspondent to serve as an agent rather than as principal for Federal funds sold,
- Modifying credit and funding limits to a correspondent, and
- Specifying timeframes to meet targeted reductions for different types of exposures.

EXAMINATION PROCEDURES

Examiners should review correspondent relationships to ascertain whether an institution's policies and procedures appropriately manage correspondent concentrations. Examiners should also review the adequacy and reasonableness of an institution's contingency plans for managing correspondent concentrations. The Examination Documentation Modules include examination procedures regarding the evaluation of the internal controls for cash, cash items, and correspondent bank accounts. Refer to the Other Assets and Liabilities and the Internal Routine and Controls sections for additional details.